BANKRUPTCY LAW

PRINCIPLES, POLICIES, AND PRACTICE
FIFTH EDITION

2023 Supplement

CHARLES J. TABB
Mildred Van Voorhis Jones Chair in Law Emeritus
University of Illinois College of Law

Distinguished Visiting Lecturer
Stetson University College of Law

Of Counsel
Foley & Lardner LLP

RALPH BRUBAKER
James H.M. Sprayregen Professor of Law
University of Illinois College of Law

CAROLINA ACADEMIC PRESS

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Copyright © 2023
Carolina Academic Press, LLC
All Rights Reserved

Carolina Academic Press
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
E-mail: cap@cap-press.com
www.cap-press.com

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 1
INTRODUCTION TO DEBT COLLECTION AND BANKRUPTCY

(On page 75, in the second paragraph, replace "$2,725,625" with "$3,024,725."

Then, at the end of that sentence, and before the sentence that begins "Subchapter V is modeled on chapters 12 and 13 …," insert the following:

"The debt ceiling for subchapter V was temporarily raised to $7.5 million in response to Covid, in March of 2020, but that increase sunset in March 2022. In June 2022, President Biden signed legislation that increased the debt ceiling for Subchapter V to $7.5 million. That 2022 act also replaced the chapter 13 debt ceiling of $465,275 for unsecured debts and $1,395,875 for secured debts with a single ceiling of $2,750,000. These amendments increasing the debt ceilings are scheduled to sunset in two years from the date of enactment (thus on June 22, 2024)."

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 2
INVOKING BANKRUPTCY RELIEF

B. Commencement of a Voluntary Case

3. Mechanics of Filing

(Replace the first paragraph on the top of page 86 with the following):

The required fees, which are specified in 28 U.S.C. § 1930(a) and in the bankruptcy court Miscellaneous Fee Schedule (most recently updated effective December 1, 2020), differ by chapter. Trustee fees and administrative fees are also imposed. As of 2023, the total of all fees for filing are: chapter 7—$338; chapter 9—$1,738; chapter 11 (not a railroad)—$1,738; chapter 11 (railroad)—$1,571; chapter 12—$278; chapter 13—$313; chapter 15—$1,738.

C. Conversion and Dismissal

2. Judicial Limitations on Bankruptcy Relief

(Insert the following on page 105, after Question 18 and before Part D)

Note on Litigation Tactic Filings

SGL Carbon is a seminal and important decision on "litigation tactic" bankruptcy filings. There have been some very prominent litigation tactic bankruptcies in the news more recently: the National Rifle Association (NRA) bankruptcy filing and the Johnson & Johnson (J&J) talc-liability bankruptcy case.

***In re Nat'l Rifle Ass'n of Am.*, 628 B.R. 262 (Bankr. N.D. Tex. 2021)**

The NRA is a 150-year-old membership organization (with 5 million members) whose purpose is to advance the interests of gun owners. The NRA was chartered in 1871 by a special act of the New York State Legislature as a charitable not-for-profit corporation. The NRA experienced some governance and internal control issues that prompted an investigation by the New York attorney general (NYAG), which (according to the NYAG) revealed misconduct by the NRA's controversial executive vice president, Wayne LaPierre, and the NYAG initiated a state-court lawsuit seeking dissolution of the NRA. In response, the NRA filed chapter 11 with the announced intention of using the chapter 11 plan of reorganization process to change its state of incorporation to Texas and move its headquarters to Texas. The NYAG moved to dismiss the case as a bad-faith filing, and the bankruptcy court granted that motion.

The bankruptcy court found that the principal purpose of the bankruptcy filing was to evade the dissolution remedy the NYAG was seeking in the pending state-court suit and held that this was not a proper bankruptcy purpose. Although the availability of that remedy threatened the NRA's viability as a going concern, and preserving viable business entities is one of the core purposes of chapter 11, the court distinguished the NYAG suit from nonbankruptcy *monetary* remedies that threaten the viability of an operating business because the NYAG suit was a

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

nonmonetary regulatory action. With respect to threats to operational viability from monetary financial obligations and consequent financial distress, the NRA had no financial distress at all and, indeed, was flush with cash and exhibited no increased risk of nonpayment of any financial obligations.

Why should bankruptcy relief be restricted to only those entities whose viability is threatened by financial distress, as opposed to nonmonetary regulatory obligations? We will return to that question in Part C of Chapter 4.

***In re LTL Mgmt., LLC*, 64 F.4th 84 (3d Cir. 2023)**

This case is the most prominent of the recent so-called "Texas Two-Step" mass-tort bankruptcies, which proceed essentially as follows:

Step 1. Mass-tort Defendant uses a state divisional merger statute (Texas's has been the eponymous statute of choice) to divide itself into two new companies, GoodCo and BadCo. BadCo takes on all of Defendant's mass-tort liability, but also receives the benefit of a funding agreement whereby GoodCo agrees to pay all of the mass-tort obligations allocated to BadCo. GoodCo receives substantially all of Defendant's operating business and other assets and liabilities *except* the mass-tort liability, which is replaced by GoodCo's obligations under the funding agreement with BadCo.

Step 2. BadCo files Chapter 11, but GoodCo continues Defendants' business operations without filing bankruptcy. Thus, the mass-tort liability is resolved through the Chapter 11 process without having to put the business in bankruptcy.

Several Texas Two-Step bankruptcies have been filed in recent years, all of which are still *sub judice*, except for the case filed in 2021 by the BadCo named LTL Management, formed in order to resolve the talc liability of J&J. The Third Circuit ordered the bankruptcy court to dismiss that bankruptcy case as a bad-faith filing, because J&J was capable of fully paying all of LTL's tort liability in the ordinary course of its business and had agreed to do so under the funding agreement. As the Third Circuit put it, "LTL has a funding backstop, not unlike an ATM disguised as a contract, that it can draw on to pay liabilities without any disruption to its business or threat to its viability."

Why would an eminently solvent mass-tort Defendant like J&J do a Texas Two-Step bankruptcy filing? What does Defendant hope to gain? Note the concluding substantive paragraph of the *SGL Carbon* decision. Are Texas Two-Step bankruptcies by eminently solvent mass-tort defendants the apotheosis of that which the Third Circuit warned against in that passage? We will return to these questions in Part G of Chapter 13.

D. Consumer Bankruptcy Choice: Chapter 7 or 13?

(Replace Part D.2.a.-b.iv., at pp. 109-126, with the following):

2. Limits on the Right to Choose: Dismissal for "Abuse" and the Means Test

a. Introduction and Overview

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The most common complaint levied against consumer debtors by creditors is that many consumer debtors file under chapter 7 and seek an immediate discharge of their debts, even though they allegedly could repay a significant portion of their debts out of future income under chapter 13. These debtors supposedly have significant income in excess of necessary expenses. A chapter 13 filing, though, is entirely voluntary for debtors and cannot be compelled by creditors. § 303(a). What should be done with these supposed "can-pay" debtors who do not elect to proceed under chapter 13? Courts have been reluctant to find that the debtor's prospect of future repayment ability constitutes "cause" to dismiss a chapter 7 case under § 707(a).

In 1984, Congress added § 707(b) to the Code in response to the complaints of the consumer credit industry. Under the 1984 version of § 707(b), the bankruptcy court could dismiss the chapter 7 case of an individual debtor whose debts were primarily consumer debts, if the court found that the filing was a "*substantial abuse*" of chapter 7. Once a debtor's chapter 7 case was dismissed, that debtor could either forego bankruptcy relief entirely or proceed voluntarily to file under chapter 13. Congress also added a provision in chapter 13 requiring a debtor to commit all of his "projected disposable income" to plan payments. § 1325(b). In theory, then, a debtor with meaningful repayment capacity could not proceed at all under chapter 7, and if she did choose to file under chapter 13, their creditors would receive all of the debtor's disposable income.

The consumer credit industry, however, soon grew dissatisfied with the operation of the "substantial abuse" test as a method for screening out supposed "can-pay" debtors from chapter 7. Congress had declined to define "substantial abuse," leaving it unclear just how much, and in what manner, that standard applied to debtors with the "means" to effect a meaningful repayment. In the credit industry's view, the test became almost a dead letter in many parts of the country, and gave too much discretion to bankruptcy judges, who applied the substantial abuse standard unevenly. The upshot, according to the credit industry lobby, was that significant numbers of "can-pay" debtors still were permitted to file under chapter 7.

The solution the industry proposed was to fashion a mechanical "*means test*" that would withdraw most of the discretion from the bankruptcy judges and presumptively deny access to chapter 7 relief for those individual consumer debtors who have sufficient excess income to repay at least $100 a month on their debts over five years under a chapter 13 plan.

The credit industry intensely lobbied Congress to enact this mechanical means test in place of the vague "substantial abuse" standard almost from the time the ink was dry on the 1984 law. These efforts finally bore fruit with the enactment on April 20, 2005 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The basic approach of the new law is as follows.

Under BAPCPA, the old substantial abuse test of § 707(b) is eliminated and a new "abuse" test substituted in its stead. § 707(b)(1). A detailed means test in § 707(b)(2)(A) spells out what level of excess income constitutes *presumptive* abuse. If presumptive abuse is found, then

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

dismissal of the chapter 7 filing is mandated unless the debtor can prove “special circumstances” justifying the continuation of the chapter 7 case. § 707(b)(2)(B).

If a presumption of abuse does not arise or is rebutted, the court still may dismiss the case as an abuse, considering whether the debtor filed the petition in bad faith, and looking at the “totality of the circumstances.” § 707(b)(3).

The following outlines the analytical steps taken in considering dismissal for “abuse” under § 707(b)(1) and applying the means test presumption of abuse under § 707(b)(2):

First: Dismissal for “abuse” under § 707(b)(1) is possible only for (1) an *individual* debtor (2) whose debts are primarily *consumer* debts.

Second: Only debtors whose combined family income is higher than the *state median income* for their family size are potentially subject to a presumption of abuse under the means test. § 707(b)(7). Stated otherwise, a debtor whose family income falls below the state median enjoys a safe harbor from the means test. Note, though, that such a below-median debtor is still potentially subject to dismissal for abuse based on bad faith or the totality of the circumstances, under § 707(b)(3). The U.S. Trustee’s office maintains a website that lists income medians, by family size, and which is updated approximately every six months. See:

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/median_income_table.htm

So, for example, in Illinois, the single earner income median applicable to cases filed on or after May 15, 2023 is $67,102. The median income for a family of four in Illinois is $122,289.

However, all debtors, even those below the state median, have to calculate the means test in their schedule of current income and expenditures. § 707(b)(2)(C). All individual chapter 7 debtors must file Form B122A-2, which contains the means test calculation. Note that the Official Bankruptcy Forms were revised and renumbered effective December 1, 2015. For example, old Form B22A2 became Form B122A-2. See:

https://www.uscourts.gov/sites/default/files/form_b_122a-2.pdf

Third: A “presumption of abuse” arises if the debtor has sufficient projected excess income under the following formula, § 707(b)(2)(A)(i):

a. Compute the debtor’s “current monthly income.” § 101(10A)

b. Subtract the following expenses:

(i) *living expenses*, calculated by reference to Internal Revenue Service collection guidelines for delinquent taxpayers, § 707(b)(2)(A)(ii)(I);

(ii) projected payments for 60 months on actual *secured debts*, § 707(b)(2)(A)(iii);

(iii) projected payments for 60 months on actual *priority debts*, § 707(b)(2)(A)(iv); and

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

(iv) a miscellany of special interest expenses, charitable contributions, and administrative charges, § 707(b)(2)(A)(ii)(II)–(V), § 707(b)(1).

c. Multiply by the resulting net total by 60 (for 60 months: the means test projects out five years)

d. The debtor fails the means test if that total is not less than the *lesser* of:

(i) $9,075 *or* 25% of the debtor's nonpriority unsecured claims, whichever is *greater*, § 707(b)(2)(A)(i)(I)

or

(ii) $15,150, § 707(b)(2)(A)(i)(II).

Thus, the range of repayment capacity that may demonstrate presumptive abuse ranges from a low of $9,075 to a high of $15,150 (depending on the amount of nonpriority unsecured claims). That means that any individual debtor with primarily consumer debts whose family income is above the state median and who has at least $151.25 per month in repayment capacity according to the means test could potentially face a presumption of abuse, and a debtor with excess income of $252.50 or more per month always would face the presumption.

Fourth: The debtor may rebut the presumption of abuse if she demonstrates "*special circumstances*" that require adjustment of the excess income calculation, by reducing the income component or increasing the expense side, sufficient to pass the means test after the adjustments are made. The debtor must show that she has "no reasonable alternative" but to make the adjustment and must document the special circumstances. § 707(b)(2)(B). Of course, even after rebuttal, the debtor still could be vulnerable to dismissal for bad faith or the totality of the circumstances under § 707(b)(3).

The amendments to § 707(b) include detailed standing and procedural rules, concerning who may bring what types of motions to dismiss and in what manner. § 707(b)(6), (7).

Finally, BAPCPA added rules allowing the possibility of sanctions against a debtor's counsel for filing a petition under chapter 7 that is later dismissed for "abuse." § 707(b)(4). Conversely, debtors may recover costs in certain circumstances where an unsuccessful dismissal motion is brought. § 707(b)(5).

PROBLEM 2.5

Debtor and his spouse both work. Combined, their "current monthly income" is $7,100 per month. The Illinois state median income for 2-person families is $84,892 per year (as of May 15, 2023). Debtor is self-employed as a painting contractor, and his spouse has a steady wage-earning job. Under the means test, their deductible monthly expenses are as follows: $4,400 (net of secured debt payments) under the IRS standards; secured debts of $2,000; priority debts of $300; and

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

various other deductible expenses of $100, for a total of $6,800. Their combined nonpriority unsecured debts are $80,000. They want to file chapter 7, and come to see you for advice.

a. If they file chapter 7, and nothing changes, would a presumption of abuse arise?

b. After you explain means testing to them, Debtor asks if he should stop taking painting jobs for a few months before they file. What would you tell him?

c. What if Debtor asks you if they should trade in their old Chevrolet, which is paid off, and buy a new BMW, with 60 monthly payments of $780 each?

b. The Means Test: Is There a Presumption of Abuse?

i. To Whom Does the Means Test Apply?

The means test does not apply to all debtors. First, the means test only applies to an *individual* debtor. Thus, corporate and partnership debtors are not subject to the means test.

Second, the means test applies only to a debtor who has primarily *consumer debts*. § 707(b)(1). "Consumer debt" is defined as a debt "incurred by an individual primarily for a personal, family, or household purpose." § 101(8). This definition is a familiar one in commercial law. It means that an individual debtor is not subject to the means test if she has primarily business debts.

Even if an individual debtor has primarily consumer debts, she still may not be subjected to the means test if she is protected by one of § 707(b)'s safe harbors. The most important safe harbor is for debtors with low income. Specifically, if the debtor and the debtor's spouse combined have income below the state median income for a family of their size, they will not be susceptible to the means test. § 707(b)(7). Another safe harbor is provided for disabled veterans whose indebtedness occurred primarily while the individual was on active duty or performing a homeland defense activity. § 707(b)(2)(D).

The key question usually will be determining whether a debtor's income falls below the state median. The first step is to determine the debtor's income. This calculation is made by multiplying the debtor's "*current monthly income*," defined in § 101(10A), by 12, giving a figure for the debtor's yearly income. Note that this test looks backwards, at the income the debtor received in the 6 months prior to bankruptcy. All income, taxable or not, is included, except for Social Security benefits. Second, the debtor's current monthly income must be augmented by adding the income received by her spouse, even if the case is not jointly filed. § 707(b)(7)(A). The only exception is if the debtor and the debtor's spouse are separated, in which case the debtor must submit a sworn statement reflecting as much. § 707(b)(7)(B).

After the debtor's income (as augmented by spousal income) is calculated, the next step is to determine whether the debtor's estimated yearly income falls below the applicable state median. What are these medians? "Median family income" is defined in the Code as "the median family

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

income calculated and reported by the Bureau of the Census" in the most recent year, or adjusted for inflation (reflected by the percentage change in the Consumer Price Index) in years the Census Bureau does not calculate state median incomes. § 101(39A). As noted in the preceding section, the U.S. Trustee's office maintains a website that lists applicable income medians for family sizes. The table is updated every six months or so. See (as of May 15, 2023):

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/median_income_table.htm

If the debtor is in a household of more than 4 individuals, the highest median family income of the applicable state for a family of 4 or fewer individuals is used, plus an additional $825 per month (or $9,900 per year) for each individual in excess of four. § 707(b)(7)(A).

PROBLEM 2.6

A debtor with a family of four currently resides in New Jersey and has "current monthly income" of $11,000 (for an annualized income of $132,000). The debtor is considering moving to New York to reduce her commute time to work. She wants to file bankruptcy under chapter 7. Would you advise this move? For cases filed on or after May 15, 2023, the median income for a family of four in New York was $126,167 and in New Jersey was $155,510.

ii. Income

The first step in applying the means test in any chapter 7 case for an individual debtor with primarily consumer debts is to calculate that debtors' "*current monthly income*" (CMI). The income calculation is used for two purposes: first, to determine whether the debtor's income level is above or below the state median, see § 707(b)(7), and second, to determine the debtor's repayment capacity for determining whether a presumption of abuse arises, see § 707(b)(2)(A)(i). In a chapter 13 case, CMI is used to compute the "projected disposable income" that a debtor must contribute to plan payments. § 1325(b)(1)(B), (2).

This need to compute income arises even if the debtor may be sheltered from the means test presumption of abuse because his income falls below the applicable state income median, because (i) the only way to determine if the debtor's income is below the applicable state median is to calculate that income, and (ii) all individual debtors have to file a means test calculation (Form B22A2) with their schedule of current income and expenditures, see § 707(b)(2)(C).

What is "*current monthly income*"? The first part of the definition, § 101(10A)(A), defines it as the average monthly income the debtor receives from all sources, *whether or not it is taxable income*, derived during the six-month period ending on the last day of the calendar month *prior* to bankruptcy. So, for example, if the debtor files chapter 7 on July 15, her income from the six months of June, May, April, March, February, and January would be counted. Significantly, note

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

that only *historical* income is relevant in calculating *current* monthly income. In a joint case, the spouse's income for the same time period is always included.

The second component of the definition brings in any amount paid by any entity other than the debtor (or in a joint case the debtor and debtor's spouse) on a regular basis for household expenses of the debtor and his dependents. § 101(10A)(B). So, for example, if your mother-in-law is living with you (insert bad joke here) and gives you $200 a month to help defray living expenses, that $200 counts as CMI.

The only exclusions are for Social Security benefits and payments received by victims of war crimes, crimes against humanity, or terrorism. *Id*.

Using a purely historical approach to project future repayment capacity is fraught with problems. The past is not necessarily prologue; future income may go up, and it may go down. If the congressional game is to identify which debtors could make payments on unsecured debts over the next five years in a chapter 13 case, it would make sense to use as the income figure the best possible income forecast, and past income is anything but. The debtor could be laid off prior to bankruptcy, but his past income would still count as "current monthly income." Any adjustments would have to be made in *rebutting* the presumption of abuse. Conversely, the definition of current monthly income does not account for the prospect of future increased earnings, however likely. Thus, for example, a bright young law student who has accepted a job with a big city law firm for $100,000 would not have to count that coming salary under the means test, leaving only the possibility of a dismissal on the ground of "bad faith" or the "totality of the circumstances."

A purely historical approach also creates a perverse incentive for a debtor contemplating bankruptcy to keep his income artificially low. Thus, for example, a debtor who had previously worked overtime might be well advised to stop overtime work for the six months prior to bankruptcy to lower his income.

Many of the reported cases under BAPCPA have staunchly enforced a perceived congressional mandate that income from *all* sources (other than the specific statutory exclusions), whether or not it is "taxable income," must be included in CMI. But it still must qualify as "income." An open question, on which courts have been divided, is whether the "income" component of "CMI" in the bankruptcy context should be interpreted in a similar manner as "gross income" under the Internal Revenue Code.

For example, in *Blausey v. U.S. Trustee*, 552 F.3d 1124 (9th Cir. 2009), the Ninth Circuit held that the debtor's private disability insurance benefits, for which the debtor herself had paid the premiums, counted as "income" for the CMI calculation — even though such benefits are *not* counted as "gross income" under the Internal Revenue Code. The court emphasized the statute's provision that it did not matter whether the income was "taxable income" under the IRC, apparently not appreciating the difference between "gross" and "taxable" income. Furthermore, the court relied on the statement in the legislative history that debtors should "repay creditors the maximum they can afford," H.R. Rep. 109-31(I) at 1, reasoning that the debtor could use those

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

disability benefits to repay her creditors. Under *Blausey*, though, one wonders what remains as the definitional principle of "income." Do you agree with the court that said that CMI includes "every dime a debtor gets during the relevant period except for those specifically excluded"? See *In re DeThample*, 390 B.R. 716, 721 (Bankr. D. Kan. 2008).

PROBLEM 2.7

Decide whether and how much of the following would be included in a calculation of current monthly income as specified in § 101(10A). In all cases, the Debtor files bankruptcy on January 1.

a. Assume *Blausey* is correctly decided. In the six months prior to bankruptcy (i.e., July through December), the Debtor was paid $2,000 by her employer to reimburse her for expenses she incurred on business trips on behalf of the Company. Do the expense reimbursements count as CMI?

b. A month prior to bankruptcy, on December 1, the Debtor sold her BMW (which she had purchased five years ago for $45,000) for $20,000. Are all or any part of those sale proceeds CMI?

c. A tax refund of $4,000 received two weeks before she filed bankruptcy (on December 15). See *In re Curcio*, 387 B.R. 278 (Bankr. N.D. Fla. 2008).

d. Debtor's salary of $5,000 per month from the previous year as an employee of Company, Inc. Would it matter if Debtor had been laid off on December 31?

e. A one-time bonus of $2,000, paid on December 31.

f. Debtor will be starting a new job on January 15 in which he will earn $30,000 a month.

g. Debtor's spouse earned $30,000 in the previous six months. Debtor files a non-joint case. Do you need more information?

h. Social security benefits of $1,800 received by the Debtor from July through December of the prior year.

i. Non-taxable municipal bond income of $3,000, paid on December 31.

j. Debtor's elderly mother lives with the debtor. Debtor's mother is financially independent and has a sizeable estate which generates income of $8,000 per month. However, mother is chronically ill and has trouble getting around, which is why she lives with debtor. What portion, if any, of the debtor's mother's income should be included? Do you need more information?

iii. Expenses

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

After a debtor's "current monthly income" is calculated, the next step in the means test is to determine what deductions should be allowed. The easiest way to work through the maze of allowable expense deductions is to consult Official Form B122A-2 (http://www.uscourts.gov/forms/means-test-forms/chapter-7-means-test-calculation).

The deductions are subtracted from current monthly income to arrive at the net monthly income that is used as the foundation for the means test presumption of abuse calculation. Obviously, a debtor cannot contribute *all* of her monthly income to repaying debt; everyone needs something to live on for basic monthly expenses. The primary categories of allowed deductions are:

(1) *Living Expenses*. See § 707(b)(2)(A)(ii), Form B122A-2, lines 6–32;

(2) *Secured Debts*. See § 707(b)(2)(A)(iii), Form B122A-2, lines 33–34;

(3) *Priority Claims*. See § 707(b)(2)(A)(iv), Form B122A-2, line 35; and

(4) *Chapter 13 Administrative Expenses*. See § 707(b)(2)(A)(ii)(III), Form B122A-2, line 36.

Living expenses are further subdivided into:

(a) IRS Collection Standards. § 707(b)(2)(A)(ii)(I). See Form B122A-2, lines 6–24. The three categories of IRS Standards are:

• National Standards (primarily food, clothing, and out-of-pocket health care) (lines 6–7 on Form B122A-2);

• Local Standards (housing, transportation) (lines 8–15 on Form B122A-2); and

• "Other Necessary Expenses" (lines 16–24 on Form B122A-2).

(b) *Additional Living Expense Deductions*. § 707(b)(2)(A)(ii)(I), (II), (IV), (V). See Form B122A-2, lines 25–32. Included are such expenses as continuing charitable contributions, educational expenses for minor children (up to $2,275 per year), costs of providing for the care of elderly or disabled household members, home energy costs in excess of the standards, costs to protect against family violence, and food and clothing expenses in excess of the standard.

(a) *Living Expenses*

For purposes of the means test, Congress decided that the debtor's allowed living expenses should be those specified in the Collection Financial Standards of the Internal Revenue Service. See: https://www.justice.gov/ust/means-testing/20220515

The IRS uses these Standards in setting up payment arrangements with delinquent taxpayers. In the Internal Revenue Manual, § 5.15.1.7, the IRS defines these allowable expenses as those "necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income" and as "the *minimum* a taxpayer and family needs to live." (Emphasis added). See

https://www.irs.gov/irm/part5/irm_05-015-001#idm140164172127936

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The underlying premise of the means test, then, is that consumer bankruptcy debtors deserve to be treated like income tax evaders and should live on the minimum necessary expenses for five years as they repay their consumer debts. A corollary concept is that private creditors are entitled to many of the same rights and benefits the government has in collecting taxes.

What are these Standards the IRS uses? The allowed living expenses fall into three categories:

- National Standards;
- Local Standards; and
- Other Necessary Expenses.

The U.S. Trustee's office of the Department of Justice now maintains a web site for use in applying the bankruptcy means test, and updates the allowed amounts on a periodic basis. See

https://www.justice.gov/ust/means-testing/20230515

(applicable to cases filed on or after May 15, 2023, and updated periodically, usually every six months). In addition, the Official Bankruptcy Form (B122A-2) that chapter 7 individual debtors must fill out has a detailed section (lines 6–32) that covers the living expense deductions.

One important question in applying the means test is whether debtors are limited to their *actual* expenses, or whether they may deduct higher amounts as "specified" in the Standards. For he "National Standards" and the "Local Standards," it is possible that debtors might be able to use the monthly expense amounts specified by the IRS, *even if* higher than their actual expenses — but only if such an expense is "applicable" to the particular debtor. The precise extent to which above-actual expenses might be allowed is unclear after the Supreme Court's decision in *Ransom v. FIA Card Services*, 562 U.S. 61 (2011), which is included in Part d. below. In *Ransom*, a chapter 13 case in which the chapter 7 means test standards were relevant to determine the debtor's required plan payment, the Court held that a debtor who owned a car but had *no* car payment could not deduct the transportation ownership expense. The Court reasoned that for that debtor, the transportation ownership expense was not "applicable" at all and thus could not be claimed. The Court declined to resolve the issue of what expense a debtor could claim when he did have *some* expense for car ownership, but which expense was lower than the "specified" IRS standard. See 562 U.S. at 75 n.8.

Indisputably, though, debtors *are* limited to their actual monthly expenses for categories under "Other Necessary Expenses." § 707(b)(2)(A)(ii). The Code states: "The debtor's monthly expenses shall be the debtor's applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses." § 707(b)(2)(A)(ii)(I).

National Standards

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The National Standards establish allowances for food, clothing, and other items. For cases filed on or after May 15, 2023 (and to be updated periodically), see: https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/national_expense_standards.htm

The amount of these allowances increases with family size. There is also a separate national allowance for out-of-pocket healthcare expenses. That allowance is larger for a person who is 65 or older ($154 per month) than for those younger than 65 ($79 per month). See:

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/national_oop_healthcare.htm

For families larger than 4 people, a total per-person additional allotment is provided ($356, plus age-appropriate healthcare allowance of either $79 or $154). Under the means test, debtors can add an extra 5% to the National Standards food and clothing allowances, if such an increase is demonstrated to be "reasonable and necessary" — whatever that means!

The following table provides the National Standards for a family of 4, all under age 65 (for cases filed on or after May 15, 2023), including health care:

Collection Financial Standards for Food, Clothing and Other Items, Plus Health Care

Expense	**Four Persons**
Food	$1,123
Housekeeping supplies	$90
Apparel & services	$252
Personal care products & services	$97
Miscellaneous	$431
Out-of-pocket health care	$316
Total	**$2,309**

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Local Standards

The next set of IRS standards is the Local Standards. These establish allowances for:

(1) transportation (provided on a regional basis), and

(2) housing and utilities (provided on a county-by-county basis).

This data is also found on the U.S. Trustee website, and can be accessed via drop-down links. For example, the transportation allowance for the Midwest region is found at:

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/IRS_Trans_Exp_Stds_MW.htm

For housing and utilities, an Illinois debtor would look at:

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/housing_charts/irs_housing_charts_IL.htm

The allowance for housing and utilities has two parts:

(1) non-mortgage expenses, and

(2) mortgage or rent expenses.

These two allowances are further differentiated based on (1) the county in which the debtor lives, and (2) family size. Allowances are updated every few months.

In choosing the appropriate region to use for a debtor, the area in which the debtor resides as of the date of the order of relief (i.e., the date the debtor files her bankruptcy petition) is used. To illustrate the importance of where the debtor lives (and the potential for gaming the system via careful pre-bankruptcy planning), consider the following example. The numbers used assume the case was filed on or after May 15, 2023 (and before the next periodic allowance adjustment). A debtor who lives in Cook County, Illinois has a housing allowance for a family of four of $3,026 ($903 for non-mortgage or rent expenses, and $2,123 for mortgage or rent costs); for neighboring DuPage County, the allowance is $3,273 ($824 and $2,449, respectively) — $247 per month higher. So, by moving across the county line, a debtor could insulate an additional $14,820 of income over the 60-month means test calculation period. Such a substantial sum could well make the difference between failing and passing the means test.

The transportation allowance has three components:

(1) *ownership* costs;

(2) *operating* costs; and

(3) *public transportation* costs.

Different caps are set depending on the number of cars the debtor has, up to a maximum of two cars.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Operating costs are provided on a regional basis for one or two cars. For example, in the Midwest region, Chicago Metropolitan Statistical Area, the operating allowances are $265 for one car, and $530 for two cars. A debtor who owns a car also may try to claim all or part of the public transportation cost allowance as well, but not as a matter of right; instead, she must prove the actual necessity of using public transportation.

The public transportation cost allowance is established as a national standard of $218 per month (as of May 15, 2023). A debtor who owns no cars may claim that allowance as a matter of right, and without proving any actual expenditures. As just noted, if the debtor does own a car, she could only claim public transportation on proof of actual necessity.

The *ownership* cost is based on a national standard of $629 per car, up to the two-car maximum. Obviously, if a debtor does not own a car, she cannot claim an ownership expense deduction. Also, as noted above, the Supreme Court held in *Ransom v. FIA Card Services*, 562 U.S. 61 (2011), that a debtor who owned a car free and clear (that is, had no ownership expense for the car he owned) could not claim the national standard for car ownership. The Court reasoned that the ownership expense was not "applicable" to that debtor, and thus did not qualify as an "applicable monthly expense amount[] specified" under the National and Local Standards. § 707(b)(2)(A)(ii)(I). The Court did not decide whether the debtor could claim the entire ownership deduction (now $629) if the debtor *did* still have an ownership expense, but for less than the listed Standard amount. See 562 U.S. at 75 n.8. The Official Form assumes that such a debtor *can* claim the entire $588 specified ownership amount. See line 13, Official Form B122A-2, at https://www.uscourts.gov/sites/default/files/form_b_122a-2.pdf.

Under the means test, as explained in the next subsection of this book, debtors are entitled to take a deduction for scheduled secured debts in addition to that for the IRS standards. § 707(b)(2)(A)(iii). An important issue is how the secured debt deduction and the ownership cost allowance under the IRS standards interact, if at all. Significantly, § 707(b)(2)(A)(ii), which deals with the allowances pursuant to the Standards, states, "*Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments of debt*." The most plausible interpretation of this provision is to require the debtor to subtract from IRS living expenses all payments on secured debts that otherwise would fall within the IRS categories. The theory is that a debtor should not be able to double count: that is, she cannot deduct *both* secured debt payments on a car *and* the full IRS transportation ownership allowance, or the home mortgage payment *and* the full housing allowance. Therefore, under this interpretation, a debtor would need to subtract "any payments of debt" from the ownership component of the transportation allowance and from the mortgage portion of the housing allowance. This is the approach taken in Form B122A-2 (see lines 9, 13).

Of course, recall that a debtor *might be* entitled to the full transportation allowance "specified" in the IRS Standards — even if higher than her actual expenses. The Supreme Court in *Ransom* left this possibility open, without deciding the question. See 562 U.S. at 75 n.8. Thus, if the debtor's secured debt payment is *less* than the ownership portion of the Standard, then under

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

the Standard, the debtor would get the net balance left after subtracting the secured debt payment. The full secured debt payment then would be subtracted under the secured debt provision. For example, assume debtor owns one car, and thus gets a $629 ownership allowance, and debtor has a $429 monthly secured debt payment on the car. Under the prevailing interpretation of the provision, the debtor then would get: (1) a transportation ownership allowance of $200 ($629 "specified" less secured debt payment of $388), and (2) a secured debt deduction of $429 — for a total of, surprise, $629. Under this view, the debtor would *not* get both the full transportation ownership deduction of $629 *plus* the $429 secured debt deduction.

It should be noted that there is a competing view, which argues that secured debt payments do *not* have to be deducted from the amount "specified" in the standard. See, e.g., Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 191, 197–99 (2005). The argument rests on a proffered strict reading of the statutory text (with a dash of policy thrown in). Essentially the pitch is twofold: first, the deduction for secured debt payments is in a separate subsection of § 707(b)(2)(A), and second, the amounts deducted under the Standards are "amounts specified" and are not "payments for debts" and thus do not fall within the prohibition against including any payments for debts. Under this view, the debt payment prohibition would *only* apply to the "Other Necessary Expenses" Standard, which does not "specify" an amount, but looks to the actual expenses of the debtor. If this view is upheld in the courts (ultimately we do not think it will be, and so far virtually all courts have agreed with us), then in the example in the preceding paragraph, the debtor would get to deduct *both* the full transportation allowance of $629 *and* the secured debt payment of $429, for a total of $1,058.

Other Necessary Expenses

The final category of IRS expenses allowed for use in the means test specified as "Other Necessary Expenses." Recall that only *actual* expenses of the debtor in these categories are allowed. No allowance is specified by the IRS. What sorts of expenses fall under "Other Necessary Expenses"? The IRS defines these as "*the allowable payments you make to support you and your family's health and welfare and/or the production of income.*" Examples from the Internal Revenue Manual, § 5.15.1.11, see https://www.irs.gov/irm/part5/irm_05-015-001#idm140164172127936, and from Form B122A-2 (lines 16–24) include, among other things, income and social security taxes (that's a big one, obviously!), involuntary deductions for employment (e.g., mandatory retirement contributions), term life insurance, court-ordered payments (e.g., child support or alimony), child care, health care, education (if required for one to keep her job), education for a disabled child, and telecommunication services. In all categories, the basic requirement is that such expense must be necessary for providing for the health and welfare of the taxpayer and family or aid in the production of income. Note that § 707(b)(2)(A)(ii) specifically provides that "reasonably necessary health insurance, disability insurance, and health savings account expenses" may be deducted. For the "Other Necessary Expenses" category, there is no question that secured debt payments may not be double-counted: there is no "amount

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

specified" under the IRS Standard that otherwise could be allowed without reference to the debtor's actual expenses.

The bankruptcy judge will have to exercise discretion in determining how much to allow to the debtor as "Other Necessary Expenses." This is of course necessary, but it flies in the face of one of the primary goals of the means test, which was to take discretion out of the hands of the judge and instead institute a mechanical test.

(b) *Secured Debts*

A debtor is allowed to subtract the average monthly payments on account of secured debts due over the five years a chapter 13 plan would be carried out. First, the debtor must compute the total payments scheduled as contractually due to secured creditors in the 60 months following the date of the petition, and then add payments necessary to retain her primary residence, motor vehicle, and any other necessary property. The second category is usually payments to cure arrearages. That total is divided by 60 to give the average monthly payments for secured debts. § 707(b)(2)(A)(iii).

The deduction for secured debts in calculating the means test is understandable, since the Bankruptcy Code allows secured creditors to insist on full payment out of their collateral in chapter 13. Here again, given the premise of the means test to sort out of chapter 7 those debtors who could succeed under chapter 13, the test must take the realities of chapter 13 into account. The problem that arises is one of perverse incentives. The debtor may be *rewarded* for having large amounts of secured debt by getting a break on the means test.

Imagine a case of two debtors. In all regards but one they are identical: their current monthly income is the same; they are allowed the same monthly expense deductions; their priority claim deductions are the same; they even have the same amount of unsecured debt. However, the first debtor has more secured debt than the second. In this hypothetical, assume that the first debtor passes the means test because of her higher level of secured debt, but the second debtor, with less secured debt, does not. Thus, the debtor with *less* debt is the one found to be a presumed abuser!

In applying the means test, the bankruptcy judge is not asked to examine the circumstances under which the debtor incurred secured debt, or to question the amount of that secured debt. Such inquiries would only arise in a general good faith or "totality of the circumstances" assessment under § 707(b)(3). The reported cases do indicate that a high level of secured debt is a factor often taken into account by a bankruptcy judge in dismissing a chapter 7 case as an abuse under the totality or bad faith test of § 707(b)(3).

A debtor might try several strategies to help her pass the means test. First, she could take on additional secured debt in the months before bankruptcy. Second, the debtor could choose to pay down her *un*-secured debts, at the expense of her *secured* debts, leaving her with more secured debt when the means test is computed. Finally, the debtor could choose to let payments on her

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

primary residence or motor vehicle lapse, since she could subtract any arrearages in the calculation of her secured debt.

(c) *Priority Claims*

A debtor is allowed to subtract expenses for payment of all priority claims (including priority child support and alimony claims). The amount is determined by summing the total payments on priority debt owed and dividing by 60. § 707(b)(2)(A)(iv). The logic and problems associated with the priority claim deduction are similar to those for secured debt. Recall that priority claims are the first paid among unsecured claims after the satisfaction of secured claims. These claims cover payments of domestic support obligations, administrative expenses, and pre-petition taxes, among other things. A chapter 13 plan can be confirmed only if it provides for the full payment of priority claims. § 1322(a)(2). For the means test to be a fair assessment of the debtor's ability to pay unsecured creditors in chapter 13, debtors have to be allowed to deduct such payments.

The problem again is one of perverse incentives. A debtor who is considering filing chapter 7 and whose net income is close to the margin for triggering the presumption of an abuse might choose *not* to pay priority claims, paying her unsecured debt instead. Such actions would reduce the amount of unsecured debt that applied in the means test while increasing the allowable deduction for priority debts. A disturbing consequence, then, is that a debtor with significant alimony or child support debt — the very sorts of debts Congress cares most should be paid — might put off paying those very debts in order to pass the means test!

(d) *Chapter 13 Administrative Expenses*

A debtor who is eligible for chapter 13 (*viz.*, an individual debtor with regular income and debt below the debt ceilings) also can deduct the actual administrative expenses of administering a chapter 13 case in the district where the debtor resides. The U.S. Trustee's office publishes on its website schedules of permissible chapter 13 expenses. See:

https://www.justice.gov/ust/eo/bapcpa/20230515/bci_data/ch13_exp_mult.htm

The debtor is capped at deducting 10 percent of the projected plan payments, § 707(b)(2)(A)(ii)(III), but a smaller percentage may be scheduled, depending on the judicial district. For example, in Illinois, debtors in the Central District may claim 8.7%; and debtors in the Northern District are allowed 7.5%, whereas in the Southern District 7.2% is permitted. This deduction makes sense, as a test motivated by a desire to move "can-pay" debtors into chapter 13 must take into account the realities of a chapter 13 case.

Note on Charitable Contributions

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

When the court is determining whether to dismiss a case because of either the presumption of abuse in § 707(b)(2) or general abuse under § 707(b)(3), "the court *may not take into consideration* whether the debtor has made, or continues to make" charitable monetary contributions to a qualified religious or charitable organization. § 707(b)(1). Exactly how the debtor's charitable contributions are figured into the means test is unclear; as such expenses are not explicitly included as any sort of deduction in the means test calculations. Form B122A-2 simply includes a line (line 31) for the deduction in the "Additional Living Expense Deductions." Note that the statutory exclusion does not specify any limit on the amount of charitable contributions a debtor may make for means test and dismissal purposes.

As an example, assume that for purposes of the means test, the applicable trigger payment amount was $15,150 (under § 707(b)(2)(A)(i)), and the debtor had net monthly income of $275, not including charitable contributions. Without more, this debtor would fail the means test (multiplying 60 months times $275, she has $16,500 in repayment capacity, which is more than the "abuse" trigger amount of $15,150). Assume now that this debtor contributes $100 a month to her church. The court, when examining the case of such debtor, apparently would not be allowed to dismiss the case for presumption of abuse. Why? The court can only view the debtor's net monthly income as $175 a month, not $275, because of the debtor's charitable contribution. Multiplying this new net monthly income figure of $175 by 60 gives $10,500, less than the applicable $15,150 trigger, meaning that the debtor now passes the means test.

PROBLEM 2.8

Debtor's monthly paycheck includes deductions for the following items. She wants to know if the expense is deductible under the means test.

a. Income tax withholding

b. Term life insurance

c. Mandatory contribution of 8% of salary to state retirement plan

d Voluntary contribution to 401(k) retirement plan

e. Charitable contribution to United Way

PROBLEM 2.9

When Debtor files chapter 7, she owns a Ferrari automobile. How much can she deduct under the means test with regard to her ownership of the Ferrari in the following cases? Assume that the applicable Standard for vehicle ownership expense is $629 a month (as of cases filed on or after May 15, 2023).

a. She has 60 remaining payments of $900 per month

b. She has 60 remaining payments of $300 per month

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

c. She owns the car free and clear

PROBLEM 2.10

Debtor and his spouse live alone. First, two of their grown children, who have lost their jobs, move back into the house. Then Debtor's 80-year old mother moves in. At the end of his rope, Debtor files chapter 7. How much can Debtor deduct as living expenses under the National Standards?

PROBLEM 2.11

Debtor owes alimony and child support payments of $3,000 per month to his ex-wife. For a year prior to filing chapter 7, Debtor does not make any of the required alimony and child support payments, and thus owes her $36,000 when he files. May Debtor take any deductions on the means test for the unpaid alimony and support debt? If so, how much?

iv. Calculating the Presumption

Once a debtor's current monthly income and allowable monthly deductions have been calculated, the means test is almost complete. The final step is to determine whether, based on those figures, a presumption of abuse exists. This calculation is done in three steps:

Step One:

Reduce a debtor's current monthly income by all allowable monthly deductions as outlined in § 707(b)(2)(A)(ii)–(iv), calculating a net monthly income.

Step Two:

Multiply that "net monthly income" by 60 (representing the 60 months — five years — that the debtor theoretically would devote excess funds to paying unsecured creditors in chapter 13) to come up with the debtor's total projected repayment capacity.

Step Three:

Compare that figure with the statutory "trigger" amount, which is the *lesser* of—

(a) 25% of the debtor's nonpriority unsecured claims *or* $9,075, whichever is *greater*

or

(b) $15,150.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

If the amount computed in Step Two (debtor's actual projected repayment capacity) is greater than or equal to the figure in Step Three (the trigger amount), then abuse is presumed. § 707(b)(2)(A)(I). It's that simple (just kidding).

A convenient way to think about the means test is to split debtors into three tiers based on the amount of unsecured debt they have.

• Tier One is for debtors with less than $36,300 of unsecured debt. For these debtors, abuse is presumed if their Step Two total of net monthly income over 60 months is at least **$9,075**.

• Tier Two is for debtors with unsecured debts between $36,300 and $60,600. Abuse is presumed if the debtor's Step Two total ("net monthly income" over 60 months) is more than **25%** of the debtor's unsecured debts; the repayment range is between $9,075 and $15,150.

• Tier Three includes debtors with more than $60,600 of unsecured debt. For these debtors, abuse is presumed if the debtor's Step Two total of net monthly income over five years is at least **$15,150**, without regard to how much unsecured debt such debtor actually has.

Another way to conceptualize the means test is in terms of "trigger points." Since $9,075 is the minimum amount that can trigger a presumption of abuse, and because $9,075 divided by 60 months (the projected presumption period) is $151.25, if a debtor has net monthly income (current monthly income minus deductions) of *less than $151.25 a month*, the means test presumption of abuse *never* arises. On the other hand, since any repayment capacity over 60 months of $15,150 or more always triggers the presumption, and given that $15,150 divided by 60 is $252.50, the presumption of abuse *always* arises if a debtors net monthly income is *at least $252.50*. These trigger points are summarized in the following table:

Monthly Disposable Income	**Presumption of Abuse**
Less than $151.25	Never Arises
$151.25–252.49	(1) Arises if nonpriority unsecured debt ≤ $36,300;
	(2) If nonpriority unsecured debt > $36,300, arises if repayment capacity ≥ 25% of unsecured debt
$252.50 or more	Always Arises

Note how small a margin a debtor has under the means test. A difference of $102 of income over expenses a month can be the difference between abuse *never* being presumed (e.g., disposable income of $151) and abuse *always* being presumed (e.g., disposable income of $253)!

PROBLEM 2.12

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Calculate whether a presumption of abuse arises in the following scenario:

Debtor has $28,000 in nonpriority unsecured debt; current monthly income of $5,200; and allowed deductions of $5,000 a month.

E. Commencement of an Involuntary Case

4. Petitioning Creditors

a. Claim Requirements

(On page 163, in the 4th bullet point under "Claim Requirements," replace "$16,750" with "$18,600" and then replace "April 1, 2022: with "April 1, 2025")

(On page 164, on 6th line, replace "$16,750" with "$18,600")

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 3
PROPERTY OF THE ESTATE

C. Exclusions from the Estate

(On page 193, in the carryover paragraph, replace "$1,362,800" with "$1,512,350" and replace "$2,725,600" with "$3,024,700")

(On page 193, under question 6, replace "$6,825" each time it appears with "$7,575")

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 5

UNSECURED CLAIMS

D. Priority Claims

1. General Principles

(On page 274-275, change the following dollar amounts:

- *In paragraph that begins "Fourth", replace "$13,650" with "$15,150"*
- *In paragraph that begins "Sixth", replace "$6,725" with "$7,475"*
- *In paragraph that begins "Seventh", replace "$3,025" with "$3,350")*

3. Other Priorities

(On page 297, change the following dollar amounts:

- *In paragraph titled "Grain producers and fishermen", replace "$6,725" with "$7,475"*
- *In paragraph titled "Consumer layaway deposits", replace "$3,025" with "$3,350")*

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 9

AVOIDING POWERS

E. Preferences

1. Overview of § 547

(On page 543, in line of last bullet point following "Second", replace "$6,825" with "$7,575")

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 10

DISCHARGE

E. Exceptions to Discharge

2. Fraud and Related Provisions

(On page 633, in second paragraph, replace "$725" with "$800", and replace "$1,000" with "$1,100.")

(On page 658, following the questions for the Bullock case, and before "3. Willful and Malicious Injury," insert the following):

Note on *Bartenwerfer* and Denial of Dischargeability for the Fraud of a Partner

In 2023, the Supreme Court had to decide whether under 11 U.S.C. § 523(a)(2) a debtor could be denied discharge of a debt based on fraud, when the debtor herself had not committed any fraud, but nevertheless was liable under state law because of the fraud of her partner. Kate Bartenwerfer, the debtor, had partnered with David Bartenwerfer to remodel and sell a house. With David taking charge of the project, the couple sold it to Kieran Buckley, and in doing so David made fraudulent misrepresentations to Buckley and knowingly and fraudulently concealed defects. Kate was "largely uninvolved" and did not know anything about the misrepresentations or concealment. Buckley sued both Kate and David in California state court and got a judgment for over $200,000 against both, based on the fraud. Both Kate and David filed chapter 7, and Buckley filed an adversary complaint seeking an exception to discharge for fraud under § 523(a)(2). While David's accountability under the fraud exception was not seriously questioned, the lower courts split over whether Kate also should be denied discharge of the debt obtained by David's fraud, even though she herself had no knowledge of the fraud.

In *Bartenwerfer v. Buckley*, 143 S.Ct. 665 (2023), the Supreme Court unanimously held that under § 523(a)(2)(A), Kate was precluded from discharging the debt obtained by her partner's fraud, even though she personally had not acted fraudulently. The problem for Kate was that the statute uses the passive voice, and focuses only on *the debt*, with no mention of a fraudulent actor. The debt indisputably was for money obtained by fraud, and under state law Kate, as David's partner, was liable for the debt. Under § 523(a)(2)(A), there is no additional requirement that the debtor herself have engaged in the fraud. The Court had held the same way under a prior bankruptcy act back in 1885 in *Strang v. Bradner*, 114 U.S. 555, and in *Bartenwerfer* noted that subsequent congressional codifications of the bankruptcy law supported the continued viability of the *Strang* holding. Nothing in the general fresh start policy was sufficient to overcome the clear text of the statute, especially given the *Strang* history. Note that the companion fraud provision in § 523(a)(2)(B), for false financial statements, *does* specifically require proof "that *the debtor* caused to be made or published with intent to deceive" the false statement.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 11

EXEMPTIONS

D. Lien Avoidance

(On page 699, in the second paragraph, replace "$6,825" with "$7,575" and replace "2019" with "2022" and "2022" with "2025")

D. Exemption Planning and Homestead Limitations

(On page 701, in the third paragraph, replace "$170,350" with "$189,050" and "2019" with "2022")

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 12
REORGANIZATION

G. Subchapter V Small Business Reorganizations

(On page 844 and again on page 849, in the paragraph that begins "Number Eight", replace "$2,765,625" with "$7,500,000")

(On page 847, insert the following at the end of the first paragraph)

Moreover, in the case of *In re Cleary Packaging, LLC*, 36 F.4th 509 (4th Cir. 2022), the court held that *all* of the discharge exceptions listed in § 523(a) are fully applicable to even a corporate debtor whose plan is confirmed under the cram-down provisions of subchapter V, by virtue of § 1192(2). Most other courts, however, disagree with that interpretation.

(On page 850, under "(2)", replace "$2,765,625" with "$7,500,000")

(On page 850, in the fifth paragraph, amend the last sentence to read "The $7.5 million debt limit sunset on March 26, 2022, but then was revived for two years on June 22, 2022."

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

CHAPTER 13

JURISDICTION AND PROCEDURE

(On page 970, insert the following after the Questions)

G. Synthesis: Resolving Mass-Tort Litigation in Bankruptcy

Ralph Brubaker
Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy

42 BANKR. L. LETTER NO. 8 (Aug. 2022)

Introduction

I always tell my students that corporate restructuring work is perhaps the most complex and sophisticated legal practice to which they could aspire and that there are no bounds to the creative brilliance and ingenuity of corporate reorganization professionals. The new Exhibit A for my case: the "Texas Two-Step" mass-tort bankruptcy, which proceeds essentially as follows:

Step 1. Mass-tort Defendant uses a state divisional merger statute (Texas's has been the eponymous statute of choice) to divide itself into two new companies, GoodCo and BadCo. BadCo takes on all of Defendant's mass-tort liability, but also receives the benefit of a funding agreement whereby GoodCo agrees to pay all of the mass-tort obligations allocated to BadCo. GoodCo receives substantially all of Defendant's operating business and other assets and liabilities *except* the mass-tort liability, which is replaced by GoodCo's obligations under the funding agreement with BadCo.

Step 2. BadCo files Chapter 11, but GoodCo continues Defendants' business operations without filing bankruptcy. Thus, the mass-tort liability is resolved through the Chapter 11 process without having to put the business in bankruptcy.

There are currently [several] Texas Two-Step bankruptcies that have been filed in recent years, . . . but the one that has attracted the most attention and critical scrutiny is the LTL Management case filed in order to resolve the talc liability of Johnson & Johnson (J&J). The official tort claimant's committee filed a motion to dismiss the LTL case as a bad-faith filing, but the bankruptcy court denied that motion . . . . In a thorough and thoughtful opinion, the court studiously defended the legitimacy of the Texas Two-Step bankruptcy, at least on the facts of the LTL case, but with some reasoning that also speaks to even larger systemic issues of how best (and in what forum) to resolve mass-tort obligations generally. *In re* LTL Mgmt., LLC, 637 B.R. 396 (Bankr. D.N.J. 2022). That decision (currently on appeal in the Third Circuit) thus provides an opportune occasion to take stock of this innovative new bankruptcy strategy at the intersection of complex litigation and corporate reorganizations. [Authors' Note: The bankruptcy court decision was reversed by the Third Circuit, in the opinion excepted immediately after this excerpt.]

* * * *

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The most . . . visible Texas Two-Step bankruptcy of the BadCo denominated LTL Management, LLC concerns J&J's talc liability. That case, though, involves an additional wrinkle not present in [other Texas Two-Step] cases, attributable to preexisting asset and liability partitioning in J&J's corporate family structure and perhaps also to J&J's ultimate designs for limiting its talc liability.

Incorporated in 1887, J&J first began selling baby powder in 1894, and over the ensuing century developed a full line of baby care products. In 1972, J&J established an internal operating division for its baby products business, and in 1979 transferred all assets of that business to a wholly-owned subsidiary, which ultimately came to be known as Johnson & Johnson Consumer, Inc. (JJCI). As early as 1997, plaintiffs began suing J&J and JJCI, alleging that exposure to talc in Johnson's-brand baby powder caused cancer. The number of suits multiplied after a liability judgment in 2013, growing to over 38,000 cases currently pending. In 2018, a Missouri jury awarded 22 ovarian-cancer plaintiffs $25 million of compensatory damages each ($550 million total, reduced to $500 million on appeal) and $4.14 billion of punitive damages (reduced to $1.62 billion on appeal). *See Ingham v. Johnson & Johnson*, 608 S.W.3d 663 (Mo. Ct. App. 2020). [Then] in May 2020, J&J announced that it would discontinue the sale of talc-based baby powder in the United States and Canada[, and in August 2022 announced that it would stop selling talc baby powder globally in 2023].

In October 2021, J&J effectuated the divisional merger that produced the BadCo now known as LTL Management, but LTL succeeded to *only* JJCI's asbestos liability, *not* that of J&J, whose corporate identity, assets, and liabilities were not divided. Only JJCI was divided into a new GoodCo (ultimately with the same JJCI name) and BadCo (LTL Management). Nonetheless, J&J also executed the funding agreement as a party, jointly and severally liable to LTL along with JJCI, for all of the JJCI asbestos liability assigned to LTL in the divisional merger. The LTL funding agreement, however, caps J&J's cumulative and aggregate liability thereunder at the fair saleable value of JJCI (free and clear of JJCI's obligations under the funding agreement) as of the date of a given funding request thereunder[. The minimum floor for that funding obligation, though, was set at the value of New JJCI on the date of the divisional merger], and that value is estimated to be roughly $61.5 billion.

Two days later, LTL filed Chapter 11 . . . and the . . . bankruptcy court . . . ultimately . . . denied the motion to dismiss the case as a bad-faith filing.

* * * *

Subjective Bad Faith

* * * *

The dictionary definition of "good faith" is "a state of mind indicating honesty and lawfulness of purpose." *Good Faith*, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, UNABRIDGED 978 (2002). The "bad faith" appellation in this context does not refer so much to dishonesty or deceit as to one's purposes in filing Chapter 11. But the "good faith" and "bad faith" characterizations, respectively, are used to directly designate lawfulness and unlawfulness of purpose in filing Chapter 11. That, however, is simply the name attached to a legal conclusion. Just what is it, though, that determines one's lawfulness and unlawfulness of purpose/s for filing Chapter 11?

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The bad-faith-filing doctrine seeks to identify and bar from Chapter 11 relief those "petitioners whose aims are antithetical to the basic purposes of bankruptcy." *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 119 (3d Cir. 2004). "Bad faith" Chapter 11 filings are those "that seek to achieve objectives outside the legitimate scope of the bankruptcy laws." *In re 15375 Memorial Corp. v. BEPCO, L.P.*, 589 F.3d 605, 618 n.8 (3d Cir. 2009) (quoting *In re SGL Carbon Corp.*, 200 F.3d 154, 165 (3d Cir. 1999)). Just what are those legitimate bankruptcy purposes, though, and what purposes are illegitimate?

1. Bankruptcy Is Only Appropriate As a Response to Financial Distress

. . . [T]he Third Circuit has . . . repeatedly "focused on two inquiries that are particularly relevant to the question of good faith:" (1) "whether the petition serves a valid bankruptcy purpose" and (2) whether "the primary, if not sole, purpose of the filing was a litigation tactic." *Integrated Telecom*, 384 F.3d at 119-20; *BEPCO*, 589 F.3d at 618, 625 (quoting *SGL Carbon*, 200 F.3d at 165). Moreover, the thread that seems to run through and unite both of those inquiries is financial distress.

"The Bankruptcy provisions are intended to benefit those in genuine financial distress," and thus, "good faith necessarily requires some degree of financial distress on the part of the debtor." *Integrated Telecom*, 384 F.3d at 120-21. The absence of any financial distress, therefore, is what often points to the conclusion that a debtor "fil[ed] a Chapter 11 petition merely to obtain tactical litigation advantages . . . not within 'the legitimate scope of the bankruptcy laws.' " *Id.* at 120 (quoting *SGL Carbon*, 200 F.3d at 165).

Moreover, financial distress is also the mediating force between proper and improper filings for the purpose of taking advantage of "rule changes" in bankruptcy. "Just as a desire to take advantage of the protections of the Code cannot establish *bad* faith as a matter of law, that desire cannot establish *good* faith as a matter of law[, g]iven the truism that every bankruptcy petition seeks some advantage offered in the Code." *Integrated Telecom*, 384 F.3d at 127-28. But any given Code provision "and the legislative policy underlying that provision assume the existence of a valid bankruptcy, which, in turn, assumes a debtor in financial distress. The question of good faith [from financial distress] is therefore antecedent to the operation of" all provisions of the Bankruptcy Code. *Id.* at 128.

The legitimacy of Texas Two-Step bankruptcies under such a good-faith framework is highly dubious.

2. Whose Financial Distress?

As the *LTL* bankruptcy court acknowledged, a valid bankruptcy "purpose assumes an entity in distress," *LTL*, 637 B.R. at 419, and the Third Circuit has indicated that "serious" distress "at the time of filing" is required. *SGL Carbon*, 200 F.3d at 164. For such debtors facing serious financial distress, a Chapter 11 "petition serves a valid bankruptcy purpose, *e.g.*, by preserving a going concern or maximizing the value of the debtor's estate." *Integrated Telecom*, 384 F.3d at 120.

Of course, the BadCo resulting from a Texas Two-Step has no business operations other than administering the mass-tort litigation to which it has succeeded. And in the [*BEPCO*] case . .

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

., the Third Circuit recognized that debtors with no "business other than the handling of litigation" obviously "have no going concerns to preserve." 589 F.3d at 619.

The bankruptcy court in *LTL Management*, though, nonetheless concluded that the BadCo bankruptcy filing in that case was appropriate in order to preserve and maximize the going-concern value *not* of the BadCo debtor, LTL Managment, but rather that of *nondebtors* JJCI and J&J who had not filed bankruptcy. And those nondebtor entities' going-concern value is not preserved and maximized by *filing* Chapter 11; it is preserved by *not filing* Chapter 11, thus "avoiding all of the direct and indirect costs that a bankruptcy filing would entail." Ralph Brubaker, *The Texas Two-Step and Mandatory Non-Opt-Out Settlement Powers*, HARVARD LAW SCHOOL BANKRUPTCY ROUNDTABLE (July 12, 2022) [hereinafter Brubaker, *Texas Two-Step*], https://bankruptcyroundtable.law.harvard.edu/2022/07/12/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-the-texas-two-step-and-mandatory-non-opt-out-settlement-powers/. The *LTL* bankruptcy court elaborated, as follows:

> Filings by these companies [JJCI and J&J] would create behemoth bankruptcies, extraordinary administrative costs and burdens, significant delays and unmanageable dockets. One need only look at the conflict list in this case—revealing pages and pages of domestic and global affiliated entities and related parties—to confirm that such filings would pose massive disruptions to operations, supply chains, vendor and employee relationships, ongoing scientific research, and banking and retail relationships—just to name a few impacted areas. The administrative and professional fees and costs associated with such filings would likely dwarf the hundreds of millions of dollars paid in mega cases previously filed—and for what end? Even if Old JJCI had itself filed for bankruptcy, the talc actions would still be subject to the automatic stay, the assets available to pay those claims would be no greater, and the sole issue in the case would still be the resolution of the talc liabilities.
>
> Let me be clear, this is not a case of too big to fail . . . rather, this is a case of too much value to be wasted, which value could be better used to achieve some semblance of justice for existing and future talc victims. The Court is not addressing the needs of a failing company engaged in a forced liquidation. Instead, the J&J corporate enterprise is a profitable global supplier of health, consumer products and pharmaceuticals that employs over 130,000 individuals globally, whose families are dependent upon continued successful operations. Why is it necessary to place at risk the livelihoods of employees, suppliers, distributors, vendors, landlords, retailers—just to name a few innocent third parties—due to the dramatically increased costs and risks associated with all chapter 11 filings, when there is no palpable benefits to those suffering and their families? Clearly, the added hundreds of millions of dollars that would be spent on professional fees alone would be better directed to a settlement trust for the benefit of the cancer victims. . . . [B]ankruptcy filings by J&J[or] JJCI would pose potential negative consequences, without offering a positive change in direction or pathway to success in this case.

LTL, 637 B.R. at 425.

Correspondingly, then, the *LTL* bankruptcy court concluded that the financial distress from the talc litigation that was relevant to the good-faith inquiry was *not* that of the BadCo debtor, LTL

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Management, but rather was that of the *nondebtor* operating companies, JJCI and J&J, that had *not* filed Chapter 11. And based upon the evidence presented, the court ultimately concluded "that the continued viability of all J&J companies is imperiled" because "J&J and . . . JJCI were in fact facing a torrent of significant talc-related liabilities for years to come." *LTL*, 637 B.R. at 419, 421.

That is the strongest and most sympathetic case that can be made for the potential legitimacy of Texas Two-Step bankruptcies. ***If*** mass-tort Defendant *is* experiencing a level of financial distress that would justify a bankruptcy filing by Defendant in order to resolve its mass-tort liability in bankruptcy (more on that very big "*if*" below), then a Texas Two-Step bankruptcy,

> by isolating and separating Defendant's mass-tort liability (in a new BadCo) from its business operations (in a new GoodCo) and subjecting only the former to the bankruptcy process, the value of Defendant's business (which must ultimately pay the mass-tort obligations, under a funding agreement between GoodCo and BadCo) is enhanced by avoiding all of the direct and indirect costs that a bankruptcy filing would entail. At the same time, though, Defendant can nonetheless take advantage of bankruptcy's beneficial claims resolution process, which consolidates all of the mass-tort claims, both present and future claims, in one forum—the Bankruptcy Court.

Brubaker, *Texas Two-Step*.

Whatever merit there is to permitting such a partial, limited restructuring as a theoretical and policy matter, nonetheless, it is *not* the bankruptcy system that Congress enacted. The statutory system in place is one that requires *all* of a debtor's assets and business operations be placed under the direct jurisdiction, supervision, and control of a federal bankruptcy court. *See* 28 U.S.C. § 1344(e)(1). That system ensures, for example, that *all* non-ordinary-course transactions must receive advance court approval, with scrutiny from all creditors, to ensure that the full value of the operating business is available, first and foremost, to pay creditors' claims. *See* 11 U.S.C. §§ 363-365. Moreover, that system is designed to give *all* creditors having the same relative priority rank an assurance of equal treatment. A Texas Two-Step bankruptcy, however, by only subjecting tort claimants to the bankruptcy process, essentially subordinates their claims to prior payment in full (from GoodCo) of all other creditors. And most significantly (and as discussed further below), Texas Two-Step bankruptcies sanction disregard of tort claimants' right to absolute priority over equity interests. The Texas Two-Step bankruptcy, therefore, is yet another permutation of parties and courts creating ad hoc, à la carte bankruptcies that allow those in control of the process to seriously compromise fundamental rights and protections of the "odd ones out."

Filing Chapter 11 Solely to Access Bankruptcy's Claims-Resolution Process: Herein of the Bad-Faith "Litigation Tactic" Bankruptcy

Like the makeshift distribution-and-discharge system created via nonconsensual nondebtor release practice . . ., the Texas Two-Step bankruptcy selectively extends certain beneficial aspects of bankruptcy relief to an entity that has not filed bankruptcy. In particular, via the Texas Two-Step, mass-tort Defendant gains access to bankruptcy's centralized forum,

> which consolidates all of the mass-tort claims, both present and future claims, in one forum—the Bankruptcy Court.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

> That mandatory, universal consolidation of all mass-tort claims, which is entirely unique to the bankruptcy process, is tremendously powerful and is a huge boon to facilitating aggregate settlement of Defendant's mass-tort exposure.

Brubaker, *Texas Two-Step*.

Accessing bankruptcy's claims resolution system indisputably is the *only* objective of a Texas Two-Step bankruptcy. As the debtor acknowledged in the *LTL* case, the entire purpose of J&J's Texas Two-Step was "to enable Debtor to fully resolve talc-related claims through a chapter 11 reorganization, without subjecting the entire enterprise to a bankruptcy proceeding." *LTL*, 637 B.R. at 404.

> From the outset, J&J and Debtor have been candid and transparent about employing Debtor's chapter 11 filing as a vehicle to address the company's growing talc-related liability exposure and costs in defending the tens of thousands of pending ovarian cancer claims and hundreds of mesothelioma cases, as well as future claims.

Id. at 407.

The LTL bankruptcy court enthusiastically, and at length, endorsed that objective as a perfectly legitimate, good-faith use of the bankruptcy system. The Third Circuit's [*BEPCO*] decision . . ., however, indicates that access to bankruptcy's centralized forum to resolve pending litigation, standing alone, is *not* a legitimate use of the bankruptcy system, particularly when that procedural maneuver is orchestrated for the benefit of nondebtor affiliates.

* * * *

. . . [T]he "litigation tactic" conclusion seems undeniable when, obviously and admittedly, the *only* purpose and function of a Texas Two-Step bankruptcy is to access the bankruptcy forum for resolution of the mass-tort litigation. Keeping the operating company, GoodCo, out of bankruptcy absolutely ensures that the bankruptcy case is *only* about resolving the tort litigation in bankruptcy court rather than elsewhere and *nothing* else.

How Much Financial Distress?

The *LTL* bankruptcy court's opinion is careful to link the legitimacy of the J&J Texas Two-Step to financial distress of J&J and JJCI. Were those entities actually experiencing a level of financial distress such that a J&J/JJCI Chapter 11 filing (without any divisional merger) would have been in good faith? It's hard to know for sure, of course, since that is a counterfactual hypothetical inquiry. But the Third Circuit has indicated that debtors are "allowed . . . to seek the protections of bankruptcy when faced with pending litigation that posed a *serious* threat to the companies' long term viability," as long as the "debtors experienced *serious* financial and/or managerial difficulties *at the time of filing*." *SGL Carbon*, 200 F.3d at 164 (emphasis added).

Was the talc litigation causing both J&J and JJCI *serious* difficulties at the time of the LTL bankruptcy filing? The *LTL* bankruptcy court did not characterize it in those terms. Instead, the court quoted nonprecedential authority that minimizes the requisite level of financial distress, by emphasizing that "the Bankruptcy Code does not 'require any **particular** degree of financial distress as a condition precedent to a petition seeking relief.' " *LTL*, 637 B.R. at 420 (quoting *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 61 (Bankr. S.D.N.Y. 2009) (quoting *United States v.*

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Huebner, 48 F.3d 376, 379 (9th Cir. 1994) (bolded emphasis in *LTL* opinion))). Indeed, one could easily read the court's opinion as saying that the magnitude of mass-tort litigation itself is all that matters—that sufficiently massive tort litigation *always* causes a defendant " '*some*' degree of financial distress," no matter the defendant or the defendant's resources. *LTL*, 637 B.R. at 420 (emphasis added) (quoting *Integrated Telecom*, 384 F.3d at 121).

That is the very real danger presented by even opening the door to the Texas Two-Step bankruptcy, by indulging the kind of theoretical policy argument outlined above. There will be an inevitable, relentless pressure and temptation to water down the financial-distress requirement to such an extent that Texas Two-Step bankruptcies will be largely, if not entirely, decoupled from the problem that bankruptcy is designed to address: "when the debt overhang from massive disputed obligations presents a . . . threat to entity viability and full payment of all claimants." Brubaker, *Texas Two-Step*. . . .

If we remove (or dilute into virtual nonexistence) any financial-distress requisite by saying that *any* mass-tort defendant can, if it wants, simply choose to have its mass-tort obligations resolved in Chapter 11, then the legitimacy of the Texas Two-Step is nothing more than a relative assessment of which forum is "better" at resolving mass torts—the bankruptcy system or the nonbankruptcy tort system? Indeed, that is precisely how the *LTL* bankruptcy court framed the ultimate inquiry for its decision:

> In evaluating the legitimacy of Debtor's bankruptcy filing, this Court must also examine a far more significant issue: which judicial system—the state/federal court trial system, or a trust vehicle established under a chapter 11 reorganization plan structured and approved by the United States Bankruptcy Court—serves best the interests of this bankruptcy estate, comprised primarily of present and future tort claimants with serious financial and physical injuries.

LTL, 637 B.R. at 406.

And after a lengthy commentary on the relative merits of the bankruptcy and nonbankruptcy systems for resolution of mass torts, the *LTL* bankruptcy court concluded that the bankruptcy system is superior. Thus, the court opined that "there is nothing to fear in the migration of tort litigation out of the tort system and into the bankruptcy system" and "maybe the gates indeed should be opened." *Id.* at 414, 428. Most significantly, the court concluded as follows: "The Court is unpersuaded that the tort claimants have been placed in a worse position due to" the J&J Texas Two-Step; "the interests of present and future talc litigation creditors have not been prejudiced." *Id.* at 423, 422.

I do not share the court's confidence in that conclusion. Many structural features of the bankruptcy system for aggregate resolution of mass-tort liability can (and likely do) produce systematic *under*compensation of mass-tort claimants relative to a nonbankruptcy baseline, particularly for future claimants. That is why it is so pernicious to positively invite and encourage solvent defendants to resolve their mass-tort obligations in bankruptcy, which *any* mass-tort defendant can (and will) do, if Texas Two-Step bankruptcies are prima facie legitimate . . . .

The *LTL* bankruptcy court attempted to minimize the prospects of a veritable flood of mass-tort litigation into the bankruptcy courts, but the court's prognostications are unconvincing. Indeed, the . . . Chapter 11 filing by 3M subsidiary Aearo Technologies LLC [shortly thereafter], solely for the admitted purpose of shifting hundreds of thousands of earplug liability suits against

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Aearo and 3M, out of the largest federal multi-district litigation (MDL) proceeding ever and into bankruptcy court, provides an arresting, almost-instantaneous illustration of the floodgates problem that the *LTL* bankruptcy court pooh-poohed. The stated reasons for that Chapter 11 filing explicitly relied upon the authority of the *LTL* decision, and conspicuously absent was any mention of financial distress for either 3M or Aearo, presumably because there is none. [Authors' Note: The *Aero* bankruptcy court subsequently dismissed that case as a bad-faith "litigation tactic" filing. *In re Aearo Techs. LLC*, Case No. 22-02890, 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023).]

Bankruptcy Systematically Disadvantages Mass-Tort Claimants

Not only is a Texas Two-Step bankruptcy a bald-faced "litigation tactic" Chapter 11 filing, the shift from the nonbankruptcy tort system into the bankruptcy system for resolving mass torts systematically prejudices mass-tort claimants, particularly future claimants.

1. Depriving Claimants of Due Process "Opt Out" Rights

The most important and fundamental "rule change" that is driving defendants' desire to resolve their mass-tort obligations in bankruptcy, rather than outside bankruptcy, concerns individual claimants' most basic ownership rights in their individual claims. The Supreme Court's due process jurisprudence recognizes that a tort cause of action is property belonging to the claimant. *See Tulsa Prof'l Collection Servs., Inc. v. Pope*, 485 U.S. 478, 485 (1988) ("a cause of action is a species of property . . . deserving due process protections"). One of the most fundamental incidents of a claimant's ownership of that cause of action is control—the right to assert (or not assert) that claim in court and the right to settle (or not settle) that claim with (i.e., sell it to) the defendant. Infringing claimants' property right to unfettered autonomy and control over their claims requires a compelling justification. *See Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 846 (1999) ("the burden of justification rests on the exception").

Class Action and MDL proceedings. Class actions provide a means by which a fiduciary representative can assert and (with court approval) compromise and settle the claims of others, as long as the requisites for certification of a class are met. *See* FED. R. CIV. P. 23. For multiple reasons, though, mass torts typically are *not* appropriate for class certification, which is the upshot of the Supreme Court's decisions in *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997), and *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338 (2011). Most significantly, though, even if certification of a class of damages claims were appropriate, each individual claimant would retain an absolute right to "opt out" of the class-action proceedings and pursue their claims on their own, consistent with their ownership rights. *See* FED. R. CIV. P. 23(b)(3) & (c)(2)(B)(v).

The only circumstance in which damages claimants could possibly be deprived of this ownership right—and thus have a mandatory settlement of their damages claims imposed upon them, whether or not they consent to that settlement—is if the defendant's resources constitute a limited fund that is insufficient to fully satisfy the defendant's mass-tort obligations. "As the Supreme Court made clear in its *Ortiz v. Fibreboard* decision, though, if a mass-tort defendant's resources do not constitute a limited fund . . . , individual claimants retain an absolute constitutional right to opt out of any aggregate resolution process, as part of their due process property rights in their individual claims." Brubaker, *Texas Two-Step*. *See Ortiz*, 527 U.S. at 846-48. What's more, the Supreme Court has suggested that for the kinds of damages claims typically at issue in mass torts, even if the defendant's resources *do* constitute a limited fund, the "absence of . . . opt out

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

violates due process." *Wal-Mart*, 564 U.S. at 362-63. Otherwise " 'limited fund' classes would emerge as the functional equivalent to bankruptcy." *Ortiz*, 527 U.S. at 843 (quoting Henry Paul Monaghan, *Antisuit Injunctions and Preclusion Against Absent Nonresident Class Members*, 98 COLUM. L. REV. 1148, 1164 (1998)).

A so-called quasi-class action proceeding pursuant to the federal MDL statute is simply a consolidation in one federal district court "for coordinated or consolidated pretrial proceedings" "[w]hen civil actions involving one or more common questions of fact are pending in different districts." 28 U.S.C. § 1407(a). Nothing in that statute, however, purports to infringe in the least individual claimants' ownership rights in their individual claims. Thus, if an MDL consolidation ultimately results in a proposed aggregate settlement of mass-tort claims (the facilitation of which is typically the overriding objective of an MDL consolidation), each individual claimant can choose whether to participate in that settlement or not.

Bankruptcy. The critical background setting against which the Texas Two-Step bankruptcy strategy is executed, therefore, is that there is *no* nonbankruptcy aggregation process by which a *solvent* mass-tort defendant can impose a judicially-approved, mandatory, no-opt-outs settlement on nonconsenting tort claimants. Such a process would unconstitutionally infringe individual claimants' due process rights. Bankruptcy, however, is a game-changer in that regard.

Bankruptcy is designed to address the same kind of common-pool problem, or so-called "tragedy of the commons," as is a nonbankruptcy limited-fund class action, "and the binding distribution scheme effectuated by a confirmed plan of reorganization is functionally identical to the mandatory non-opt-out settlement at issue in *Ortiz*." Brubaker, *Texas Two-Step*.

> [A] class action settlement is extremely analogous to the binding distribution scheme effectuated by a confirmed plan of reorganization in Chapter 11, complete with a preliminary injunction analogous to bankruptcy's automatic stay, an antisuit injunction upon final approval of the settlement analogous to bankruptcy's discharge injunction, and in the case of the limited-fund class action at issue in *Ortiz*, no ability whatsoever for individual claimants to opt-out of the settlement, which is of course precisely the function of the bankruptcy discharge effectuated by confirmation of a plan of reorganization. . . .
>
> Indeed, the [Supreme] Court's descriptions of the material effects of class-action settlements are entirely accurate descriptions of the relevant effects of a Chapter 11 plan of reorganization. "The terms of the settlement reflect essential allocation decisions designed to confine compensation and to limit [a debtor's] liability," by "settling the validity of the claims as a whole or in groups, followed by separate proof of the amount of each valid claim and proportionate distribution of the fund."

Ralph Brubaker, *Back to the Future Claim: Due Process in and Beyond the Mass Tort Reorganization (Part II)*, 35 BANKR. L. LETTER No. 1, at 1, 11 (Jan. 2015) (footnotes omitted) (quoting *Ortiz*, 527 U.S. at 835 n.15 and *Amchem*, 521 U.S. at 627). "Both systems enable a mass-tort defendant to impose a judicially-approved hard cap on their aggregate mass tort liability, without any opt-outs by nonconsenting claimants." Brubaker, *Texas Two-Step*.

In the nonbankruptcy context, the *Ortiz* decision prohibited such a mandatory no-opt-outs settlement in the absence of a sufficient showing that that the defendant's resources actually are a

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

"limited fund" insufficient to fully satisfy its mass-tort obligations. *See Ortiz*, 527 U.S. at 848-53. Thus, the Court prohibited limited-fund (no opt-outs) treatment of claimants in the absence of a limited fund. The financial-distress requisite for a good-faith Chapter 11 filing, likewise, prohibits limited-fund (no-opt-outs) treatment of claimants in the absence of a limited fund, as indicated by a sufficient "threat to entity viability and full payment of all claimants, [which are the common-pool limited-fund] problems that bankruptcy is designed to address." Brubaker, *Texas Two-Step*.

Mass-tort claimants have no constitutional due-process right to "opt out" of the mandatory settlement of a defendant-debtor's aggregate liability effectuated by confirmation of a Chapter 11 plan of reorganization. *See Taylor v. Sturgell*, 553 U.S. 880, 895 (2008) (quoting *Martin v. Wilks*, 490 U.S. 755, 762 n.2 (1989) ("where a special remedial scheme exists expressly foreclosing successive litigation by nonlitigants, as for example in bankruptcy or probate, legal proceedings may terminate preexisting rights if the scheme is otherwise consistent with due process")). Indeed, the Constitution itself explicitly authorizes such a mandatory no-opt-outs settlement process in the Bankruptcy Clause. Nonetheless, the good-faith filing requisite for invoking the bankruptcy process must be particularly sensitive to bankruptcy's elimination of that important constitutional protection for claimants' ownership of their individual claims. Otherwise, bankruptcy becomes too easy an end-run around mass-tort claimants' constitutional due-process rights, *e.g.*, by solvent mass-tort defendants using a Texas Two-Step bankruptcy to impose a mandatory no-opt-outs settlement (that is otherwise impermissible and unconstitutional) on nonconsenting claimants. Indeed, some scholars believe that financial distress is a constitutional requirement for Congress's exercise of its Bankruptcy Power . . . .

* * * *

In addition to the profound impact on claimants' constitutional due-process rights, bankruptcy's "mandatory non-opt-out settlement power works a dramatic change in a mass-tort defendant's ultimate aggregate liability and the complex bargaining dynamics by which that ultimate liability is determined." Brubaker, *Texas Two-Step*. Some academics hypothesize that eliminating opt-outs may, in certain circumstances, induce a mass-tort defendant to pay a "peace premium" to claimants. Others, however (myself included), are extremely skeptical that such an animal actually exists in the wild and suspect that "any value created by [eliminating opt-outs] is captured entirely by [defendants] and the lead plaintiffs' lawyers who negotiate the [mandatory no-opt-outs] deal." Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 YALE L.J.F. 960, 993 (2022). Regardless, though, there are even more structural features of the bankruptcy process that "pose[] a substantial risk of systematically undercompensating mass-tort claimants relative to a nonbankruptcy baseline, particularly for future claimants." Brubaker, *Texas Two-Step*.

2. Abridging Claimants' Absolute Priority Rights

The biggest advantage that bankruptcy presents for mass-tort defendants, both solvent *and* insolvent, is the ability of equity interests to capture value at the expense of tort victims.

Class Action and MDL Proceedings. The baseline nonbankruptcy priority norm is that creditors are entitled to payment in full ahead of equity, which by its very nature is an interest residual to that of creditors. And there are many structural legal protections in corporate and commercial law designed to protect creditors' basic right to priority over equity interests.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Because an MDL consolidation does not abridge individual claimants' ultimate control over their individual claims, it also does not interfere with their right of priority over equity interests, and the same is true for an opt-out class action. A mandatory no-opt-outs class action, however, has great potential to violate claimants' right to priority over equity interests, as the Supreme Court recognized in *Ortiz*.

The Supreme Court in *Ortiz* held that for a mandatory no-opt-outs limited-fund class-action settlement to be appropriate, the proponents "must show that the fund is limited . . . *and* has been allocated to the claimants" by the settlement, in order to justify taking away individual claimants' ability to opt out of the process and pursue their individual claims on their own. *Ortiz*, 527 U.S. at 821. Thus, the Court struck down the mandatory no-opt-outs settlement of defendant Fibreboard's aggregate mass-tort liability in that case, not only because the proponents of the settlement "failed to demonstrate that the fund was limited," but in addition, the settlement contained "allocations of assets at odds with the concept of limited fund treatment." *Id.* at 848.

> Fibreboard listed its supposed entire net worth as a component of the total (and allegedly inadequate) assets available for claimants, but subsequently retained all but $500,000 of that equity for itself. On the face of it, the arrangement seems irreconcilable with the justification of necessity in denying any opportunity for withdrawal of class members whose jury trial rights will be compromised, whose damages will be capped, and whose payments will be delayed.

Id. at 859-60 (footnote omitted).

That requirement that "the whole of the inadequate fund [i]s to be devoted to the overwhelming claims" is simply a reflection of the basic nonbankruptcy priority of creditors over equity interests and ensures that limited-fund (no opt-outs) treatment does "not give a defendant a better deal than *seriatim* litigation would have produced." *Id.* at 839.

Bankruptcy. The *Ortiz* Court derived its announced limitations on limited-fund class actions, including its implicit priority rule, from a variety of traditional limited-fund procedures, including the equitable creditors' bill, pursuant to which a court of "equity would order a master to call for all creditors to prove their debts, to take account of the entire estate, and to apply the estate in payment of the debts." *Id.* at 837 n.17 (citing 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE §§ 547-548 (I. Redfield 8th rev. ed. 1861)). Of course, the equitable creditors' bill was also the procedural vehicle used to effectuate the common-law version of corporate reorganizations, which inspired the subsequent codification of corporate reorganization procedures, culminating in our present-day Chapter 11 process. And in the common-law iteration of corporate reorganizations, the Supreme Court had an extensive jurisprudence regulating the absolute priority rights of creditors over equity interests.

Chapter 11 codifies significant departures from the common-law absolute priority rule. Regulation of the relative priority rights of creditors and equity interests under a Chapter 11 plan of reorganization revolves around a series of rules whose operation depends upon a scheme of classification of creditors and class voting on a proposed plan of reorganization, which in a mass-tort bankruptcy will effectuate the mandatory no-opt-outs settlement of the debtor's aggregate mass-tort liability. Most significantly, those rules permit equity holders to retain an interest in the reorganized debtor entity, even without payment in full of all creditor claims, as long as all creditor classes vote to accept the proposed plan. *See* 11 U.S.C. § 1129(a)(8). If a creditor class does *not*

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

vote to accept the plan, equity holders cannot receive or retain *anything* (i.e., its ownership interest must be completely wiped out) unless the plan provides for payment in full of each creditor in that rejecting class. *See id.* § 1129(b)(2)(B).

Those are the protections for a rejecting class under Chapter 11's liberalization of the common-law absolute priority rule. The strict common-law absolute priority rule protected each and every *individual* creditor's right to priority over equity. The Chapter 11 priority rules, by contrast, protect only rejecting *classes* of creditors. *See Bank of Am. Nat'l Tr. & Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 444-49 (1999).

Several aspects of that distribution priority scheme make it extremely advantageous to equity holders for a defendant's mass-tort obligations to be resolved in bankruptcy rather than the nonbankruptcy tort system (with its implicit rule of absolute priority), especially for a solvent defendant.

How Equity Captures Value at the Expense of Mass-Tort Claimants in Bankruptcy

1. "Full Payment" Plans That Don't Pay in Full

Note, that under the Chapter 11 priority rules, equity holders can *retain* their ownership interests, even if a class of creditors has rejected the plan, as long as "the plan provides that each holder of a claim of such [rejecting] class will receive or retain . . . property of a value . . . equal to the allowed amount of such claim." 11 U.S.C. § 1129(b)(2)(B)(i). That is the Code's provision for a so-called "cram down" of a rejecting class of creditors, by *either* eliminating all junior interests, such as equity, *or* by full payment of the rejecting class.

A so-called "full payment" plan, however, does not necessarily mean that each individual tort claimant will actually receive the full amount of their claim once it is eventually liquidated (by either settlement or trial). When that is the case, and when equity holders also retain ownership interests (or receive anything else) under the plan, tort claimants' loss (via less than full payment or even an increased risk thereof) is equity holders' gain—a result that could not prevail under the implicit absolute-priority rule prevailing outside bankruptcy. There are two common means by which so-called "full payment" plans can actually deny tort claimants full payment while simultaneously providing for equity holders to retain their ownership interests.

Disallowing punitive damages claims. Courts in many mass-tort bankruptcies categorically disallow any and all punitive damages claims. If all claims for punitive damages are categorically disallowed, then they do not even factor into the Bankruptcy Code's cram-down calculus, at all. Thus, equity holders can retain their interests even if mass-tort claimants have voted to *reject* a proposed plan settlement *and* the debtor has engaged in conduct that would subject it to punitive damages assessments appropriately borne by equity.

That result "undermines the purposes of punitive awards by permitting a wrongdoing debtor (or a corporate debtor's shareholders) to receive" and retain value to which they simply are not entitled under applicable nonbankruptcy law, "and for no demonstrable, countervailing bankruptcy policy objective (other than taking from the [tort] creditors to give to the shareholders)." Ralph Brubaker, *Punitive Damages in Chapter 11: Of Categorical Disallowance, Equitable Subordination, and Subordination by Classification*, 25 BANKR. L. LETTER No.7, at 1, 2, 4 (July 2005). And solvent mass-tort defendants' use of bankruptcy's unique mandatory

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

settlement process to evade any liability for punitive damages is a common (although underappreciated) stratagem.

Estimating "full payment" of all mass-tort claimants. When a plan of reorganization is proposed and confirmed in a mass-tort bankruptcy case, the debtor's aggregate liability to all mass-tort claimants is not yet fully determined and liquidated. Thus, the plan of reorganization will set up a "fund" (typically organized as a separate trust entity) to pay tort claimants as their individual claims are liquidated (through settlement or litigation) in the claims allowance process.

Nonetheless, the debtor's aggregate liability to the mass-tort claimants must be *estimated* for purposes of determining the proposed plan's compliance with the Code's confirmation rules, such as the rule permitting cram-down of a rejecting class of mass-tort claimants because "the plan provides that each holder of a claim of such [rejecting] class receive . . . property of a value . . . equal to the allowed amount of such claim." 11 U.S.C. § 1129(b)(2)(B)(i). In a mass-tort bankruptcy, compliance with such a full-payment requirement would necessarily have to rely upon a judicially determined (by a preponderance of the evidence) *estimate* of the aggregate amount necessary to fully pay all mass-tort claimants the amounts at which all of their claims are ultimately allowed.

With such a judicial estimate of aggregate liability in hand, then, a debtor can confirm a "full payment" plan by simply setting aside a "fund" *in that amount* for payment of the mass-tort claimants, *and no more*. That is the means by which a fully solvent mass-tort defendant can place a hard cap on its aggregate mass-tort liability in bankruptcy. And it is noteworthy that *all* of the funding agreements in the Texas Two-Step bankruptcies likewise *cap* GoodCo's funding obligation at the amount necessary to pay BadCo's mass-tort obligations as determined "pursuant to a plan of reorganization for [BadCo] confirmed by final, nonappealable order of the Bankruptcy Court." *LTL Funding Agreement* at 6.

The prejudice to mass-tort claimants from such a cap is obvious, given that the estimated amount may ultimately prove incorrect. Moreover, errors in setting such a cap will shortchange *only* tort claimants because it is easy enough to provide (and, of course, plans do provide) that any ultimate *surplus* in the payment trust reverts to the debtor at the end of the day. The nature of a cap, though, is that if the capped amount ultimately proves to be *insufficient*, those whose recovery is capped are simply out of luck (S.O.L. is the trade term). "Thus, when courts rely on promises or projections of full payment in approving" mandatory no-opt-outs settlements of aggregate mass-tort liability through confirmed reorganization plans, "the appeal to minimal creditor prejudice tends to ring hollow." Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 987-88 n.102.

2. The Dark Side of Claimant Voting

Equity can also capture value from tort claimants in bankruptcy by exploiting Chapter 11's class voting system, particularly given the inherent conflicts between present tort claimants and future claimants.

The two most distinctive attributes of bankruptcy's aggregative process for resolving mass-tort obligations, especially as contrasted with the nonbankruptcy tort system, are (1) its provision for a mandatory no-opt-outs settlement of aggregate liability (via the bankruptcy discharge), and

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

(2) the corollary power of voting majorities to bind dissenting minority claimants (who are barred from opting out). Many hail claimant voting as an improvement over the nonbankruptcy tort system, which has no mechanism for direct, comprehensive polling of tort creditors' approval/disapproval of a proposed aggregate settlement. While claimant democracy might seem like a laudable objective, there is a (largely overlooked and unrecognized) dark side to claimant voting in bankruptcy because of its role in the operation of the Bankruptcy Code's plan confirmation and cram-down rules.

Again, there are two means by which equity can receive or retain value under a plan of reorganization: (1) provide for payment in full of any creditor class that has rejected the proposed plan (discussed above), *see* 11 U.S.C. § 1129(b)(2)(B)(i), or (2) obtain the requisite-majority approval of the proposed plan (i.e., the settlement/fixing of the debtor's aggregate mass-tort liability) by all impaired creditor classes, *see id.* § 1129(a)(8) & (b)(1). The claimant voting process is yet another means for equity to take value away from tort claimants in bankruptcy (especially for solvent, but also for insolvent debtors).

The Bankruptcy Code takes away individual claimants' absolute (constitutional due-process) right under applicable nonbankruptcy law to opt out of any proposed settlement of a defendant's aggregate mass-tort liability. In the place of that opt-out right, the Bankruptcy Code establishes an elaborate series of structural protections for dissenters. The ultimate legitimacy and fairness of any resulting settlement, therefore, is very much a function of the extent to which the integrity of those (seemingly technical, but critically important) structural protections are maintained.

The Code's voting rules were not designed with the expectation that they would be used to settle debtors' aggregate mass-tort liability (and, as discussed above, the implicit assumption underlying these, as well as all other Code provisions, is a debtor experiencing financial distress). Mass-tort bankruptcies, therefore, present extensive opportunities to manipulate, dilute, and even eliminate the Code's important structural protections for dissenters.

Elimination of Dollar-Weighting of Votes. Under the Bankruptcy Code's voting rules, an impaired class votes to approve a proposed plan if a majority in number, holding at least 2/3 in dollar amount, of the voting claimants in that class vote to accept the plan. *See id.* § 1126(c). It is common practice in mass-tort bankruptcies that all unliquidated tort claims are placed in the same class and the dollar amount of every filed claim will be estimated, solely for purposes of voting under Bankruptcy Rule 3018(a), at $1 each. Note, then, that this practice effectively eliminates the Code's dollar-weighting of claimant votes and, thereby, converts the dual-dimension (both number of creditors and dollar value of claims) voting-approval requirement into a one-dimensional two-thirds-in-number approval. In asbestos bankruptcies, to the extent that the plan contemplates entry of a § 524(g) injunction, the requisite majority is increased even further to 75% of the voting claimants, but § 524(g) likewise contains no dollar-weighting of claimant votes. *See* 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb).

Elimination of the Code's dollar-weighting of claimant votes dilutes the voting power of large-dollar claims, which is particularly significant in the context of mass-tort bankruptcies, as it is generally recognized that high-value claims have a greater propensity to "opt out" of proposed aggregate settlements. Thus, even if a plan does *not* propose to pay all mass-tort claimants in full, equity can nonetheless retain value if the plan is sufficiently generous to lower-value (or even *no-value!*) claimholders to entice the requisite majority (2/3 or 75%) to approve the plan. Equity can

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

receive value, then, even in the face of the dissent of high-value claims (the realistic aggregate dollar-value of which may well dwarf that of the approving claimants) that will *not* be paid in full.

Capping (and Thus Reducing) Aggregate Liability by Majority Vote. That Chapter 11 voting system also presents yet another opportunity for a solvent debtor to confirm a so-called "full payment" plan that will *not* actually pay all tort claimants in full, by voting approval thereof, rather than the estimated "full payment" cram-down discussed above. The fact that a confirmed Chapter 11 plan can place a hard cap on a debtor's aggregate mass-tort liability, combined with the Code's voting scheme, allows the requisite majority of the tort claimants (2/3 or 75%) to essentially decide what that hard cap will be. As Adam Levitin has trenchantly observed, that voting process will systematically cap a debtor's aggregate mass-tort liability at an amount that is less than the aggregate settlement value that would prevail in the nonbankruptcy tort system (which cannot bind individual nonconsenting claimants to an aggregate settlement amount). *See Amicus Curiae* Br. of Adam J. Levitin at 30-33, *In re Purdue Pharma L.P.*, No 22-110 (2d Cir. Mar. 21, 2022).

Once again, then, equity holders of a solvent debtor can use the bankruptcy process to cap a debtor's aggregate mass-tort liability, even if that cap is insufficient to actually pay all tort claimants in full, and without even having to resort to the Code's cram-down provisions, as long as the plan is generous enough to a sufficient percentage of the mass-tort claimants (2/3 or 75%) to obtain a class approval. To be sure, if a solvent debtor proposes such a "full payment" plan, the court would have to find (by a preponderance of the evidence) that the proposed cap is sufficient to pay all tort claimants in full, under the plan-feasibility requirement of § 1129(a)(11). That plan-feasibility determination, though, will necessarily have to rely upon an *estimate* of the debtor's aggregate mass-tort liability, which (as discussed above) will systematically err on the side of *understating* the debtor's liability. Moreover, it is widely believed that courts are much less rigorous in scrutinizing plan feasibility in the case of a so-called consensual plan (approved by the requisite majority vote of all impaired classes). That may well be appropriate in other Chapter 11 cases, but it will magnify the systematic undercompensation of mass-tort claimants in bankruptcy.

Disenfranchising Future Claimants. All of these phenomena, that (both individually and in combination) can lead to systematic undercompensation of dissenting tort claimants in bankruptcy, are especially pronounced in cases involving as-yet-uninjured future claimants, who can be completely disenfranchised *and* simultaneously deprived of all of the Code's cram-down protections.

"The ability to bind dissenters through a class vote makes appropriate classification the touchstone of protecting the rights of dissenters." Brubaker, 1997 U. ILL. L. REV. at 986. As *Bankruptcy Law Letter*'s very own Bruce Markell has aptly noted: "Behind the assumption that voting is meaningful lies the notion that some common interest exists among members of a class. Otherwise, it makes little sense to say that anything less than a unanimous vote could bind dissenters." Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1, 12-13 (1995). Thus, Bankruptcy Code § 1122(a) provides that "a plan may place a claim . . . in a particular class only if such claim . . . is substantially similar to the other claims . . . of such class."

The Bankruptcy Code's classification and voting system is an awkward fit, at best, with classes comprised entirely of large numbers of disputed and unliquidated litigation claims, but nonbankruptcy class actions provide a helpful analogy. As previously noted, a binding resolution of a defendant's aggregate liability via class action is functionally identical "to the binding

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

distribution scheme effectuated by a confirmed plan of reorganization in Chapter 11." Brubaker, 35 BANKR. L. LETTER No. 1, at 11. Moreover, class actions implicate similar classification issues, in order to ensure that the court-appointed class representatives "will fairly and adequately protect the interests of the class" because, inter alia, the representatives' claims "are typical of the claims . . . of the class" as a whole. FED. R. CIV. P. 23(a)(3)-(4). Otherwise, it makes little sense to allow a class representative to litigate, negotiate, and/or compromise class members' claims at all.

Class-action procedures, therefore, contain a requirement virtually identical to that of Bankruptcy Code § 1122(a) that a class cannot include claims that are substantially dissimilar to those of other class members. The focus is "on whether a proposed class has sufficient unity" of interest. *Amchem*, 521 U.S. at 621.

In its important *Amchem* and *Ortiz* decisions, the Supreme Court elucidated appropriate classification in the context of class-action settlements functionally identical to a confirmed plan of reorganization in that "[t]he terms of the settlement reflect essential allocation decisions designed to confine compensation and to limit [a debtor's] liability," *id.* at 627, by "settling the validity of the claims as a whole or in groups, followed by separate proof of the amount of each valid claim and proportionate distribution of the fund." *Ortiz*, 527 U.S. at 835 n.15. And in each of those decisions, the Supreme Court held that the interests of present claimants are so fundamentally divergent from those of future claimants that "it is obvious" that a settlement that purports to bind both "holders of present and future claims (some of the latter involving no [present] physical injury and [even] attributable to claimants not yet born) requires division into" separate classes in order "to eliminate conflicting interests." *Id.* at 856.

> In significant respects, the interests of [present claimants and future claimants] within [a] single class are not aligned. Most saliently, for the currently injured, the critical goal is generous immediate payments. That goal tugs against the interest of [future claimants] in ensuring an ample, inflation-protected fund for the future.

Amchem, 521 U.S. at 626.

Assuring present and especially future claimants "adequate structural protection," *Ortiz*, 527 U.S. at 864, via separate classification is equally important in bankruptcy. Indeed, the Third Circuit itself has flagged the critical importance of a Chapter 11 "Plan's treatment of current asbestos claimants relative to future asbestos claimants," relying on the "structural inadequacy" identified in *Ortiz* and grounded in the "Court's requirement of fair treatment for all claimants—a principle at the core of equity—[which] also applies in the context of [a mass-tort bankruptcy] case." *In re Combustions Eng'g, Inc.*, 391 F.3d 190, 242 & n.57, 245 (3d Cir. 2005).

The original sin of mass-tort bankruptcies is the inclusion of both present and future claimants in the same class for purposes not only of plan treatment, but also satisfaction of the plan-confirmation requirements of Code § 1129—a practice that still prevails. That practice is deleterious because generally "the only . . . claimants capable of voting [are] present . . . claimants." Ralph Brubaker, *Unwrapping Prepackaged Asbestos Bankruptcies (Part II): The Antithesis of Creditor Equality*, 25 BANKR. L. LETTER No. 2, at 1, 6 (Feb. 2005). Plans that bind both present and future mass-tort claimants,

> then, predictably and systematically favor the interests of the largest number of present claimants . . . . Moreover, the primary concern of debtor companies struggling to cope with an onslaught of [mass-tort] litigation is not assuring an

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

> equitable distribution amongst [the mass-tort] claimants, but rather is obtaining the requisite . . . voting approval of present . . . claimants.

Id.

The bias this creates against the interests of future claimants is confirmed by our now-extensive experience with asbestos bankruptcies. Moreover, separate representation of and advocacy for the interests of future claimants is an insufficient corrective.

> The ability of a future claims representative (FCR) to adequately represent the interests of future claimants, in general, can be hamstrung by various structural features embedded in the nature of the FCR's representative role and the Chapter 11 process. Thus, there are reasons to believe that future claimants may be systematically shortchanged in bankruptcy.

Id. at 5.

Importantly, that systematic shortchanging of future claimants can inure not only to the benefit of present claimants, but also to equity holders, who can exploit bankruptcy's structural bias against future claimants to capture value from future claimants. Moreover, that is true in cases involving both solvent and insolvent debtors. Whether or not a plan proposes "full payment" of all mass-tort claimants, the Bankruptcy Code's priority and cram-down rules permit equity to receive or retain value as long as all creditor classes vote to approve the plan, including the class of mass-tort claimants, whose vote will be controlled by present claimants (because they are the only claimants capable of voting).

There is a readily available means of curbing equity holders' ability to profit at the expense of future claimants that is already embedded in the structure of the Code's confirmation rules, properly applied. To the extent that a plan will bind future claimants, Code § 1122(a) properly requires separate classification of present and future claimants, in at least two separate classes. Moreover, to the extent that future claimants simply cannot vote, a class of future claimants cannot properly be considered to have "accepted the plan" within the meaning of § 1129(a)(8), which means that plan can only be confirmed if the future-claims class can be crammed down under § 1129(b). If the plan does not propose to pay all mass-tort claimants in full, then the plan can only be confirmed if equity interests receive or retain *nothing* under the plan (i.e., their interests must be wiped out). *See* 11 U.S.C. § 1129(b)(2)(B). This would effectively prevent equity from capturing value at the expense of future claimants in the case of an insolvent debtor. But that would require a dramatic change in the prevailing practice in mass-tort bankruptcies.

Even that change, though, would not prevent equity from taking value away from future claimants in the case of a solvent debtor. That is because the future-claims class can alternatively be crammed down if the plan provides for "payment in full" of all allowed mass-tort claims. *See id.* § 1129(b)(2)(B)(i). As discussed above, though, such "payment in full" plans (that cap the debtor's aggregate mass-tort liability) will systematically err on the side of *under*compensating mass-tort claimants and particularly future claimants, given bankruptcy's various structural biases against the futures.

That is the ultimate irony in the *LTL* [bankruptcy court] decision, which repeatedly touted bankruptcy's supposedly superior ability to deal with future claims as compared to the nonbankruptcy tort system. In the case of both solvent and insolvent mass-tort defendants, though,

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

bankruptcy systematically prejudices the interests of future claimants relative to their rights (some of which are constitutional) in the nonbankruptcy tort system, and for the systematic benefit of equity interests. Contrary to the assertion of the *LTL* bankruptcy court, then, there is much to fear from the ongoing "migration of mass tort litigation out of the tort system and into the bankruptcy system." Brubaker, 131 YALE L.J.F. at 992. "Bankruptcy poses a substantial risk of systematically undercompensating mass-tort claimants relative to a nonbankruptcy baseline, particularly for future claimants." Brubaker, *Texas Two-Step*. Moreover, opening the door to Texas Two-Step bankruptcies at all will inevitably cause more and more mass-tort defendants to try to ratchet down as much as possible (or completely eliminate . . .) any requisite level of financial distress, which *LTL* itself nicely illustrates, in order to justify resolving their mass-tort obligations in the hospitable refuge of the bankruptcy court.

Conclusion

In its seminal and important *SGL Carbon* decision regarding the fundamental illegitimacy of "litigation tactic" bankruptcies, the Third Circuit sounded the alarm on transforming bankruptcy into nothing more than an alternative forum for the resolution of mass torts[.] . . . The Texas Two-Step bankruptcy is the apotheosis of that which the Third Circuit warned against.

In re LTL Management, LLC

64 F.4th 84 (3d Cir. 2023)

OPINION OF THE COURT

AMBRO, CIRCUIT JUDGE

Johnson & Johnson Consumer Inc. ("Old Consumer"), a wholly owned subsidiary of Johnson & Johnson ("J&J"), sold healthcare products with iconic names branded on consumers' consciousness—Band-Aid, Tylenol, Aveeno, and Listerine, to list but a few. It also produced Johnson's Baby Powder, equally recognizable for well over a century as a skincare product. Its base was talc, a mineral mined and milled into a fine powder. Concerns that the talc contained traces of asbestos spawned in recent years a torrent of lawsuits against Old Consumer and J&J alleging Johnson's Baby Powder has caused ovarian cancer and mesothelioma. Some of those suits succeeded in verdicts, some failed (outright or on appeal), and others settled. But more followed into the tens of thousands.

With mounting payouts and litigation costs, Old Consumer, through a series of intercompany transactions primarily under Texas state law, split into two new entities: LTL Management LLC ("LTL"), holding principally Old Consumer's liabilities relating to talc litigation and a funding support agreement from LTL's corporate parents; and Johnson & Johnson Consumer Inc. ("New Consumer"), holding virtually all the productive business assets previously held by Old Consumer. J&J's stated goal was to isolate the talc liabilities in a new subsidiary so that entity could file for Chapter 11 without subjecting Old Consumer's entire operating enterprise to bankruptcy proceedings.

Two days later, LTL filed a petition for Chapter 11 relief . . . .

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Talc claimants . . . moved to dismiss LTL's bankruptcy case as not filed in good faith. The Bankruptcy Court, in two thorough opinions, denied those motions and extended the automatic stay of actions against LTL to hundreds of nondebtors that included J&J and New Consumer. [These a]ppeals followed . . . .

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. LTL was not. Thus we dismiss its petition.

* * * *

II. ANALYSIS

* * * *

C. Financial Distress as a Requirement of Good Faith

Our precedents show a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith. . . .

* * * *

The theme is clear: absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose. "Courts, therefore, have consistently dismissed . . . petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11. . . . [I]f a petitioner has no need to rehabilitate or reorganize, its petition cannot serve the rehabilitative purpose for which Chapter 11 was designed." *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 122 (3d Cir. 2004) (quoting *In re SGL Carbon Corp.*, 200 F.3d 154, 166 (3d Cir. 1999)).

But what degree of financial distress justifies a debtor's filing? To say, for example, that a debtor must be in financial distress is not to say it must necessarily be insolvent. We recognize as much, as the Code conspicuously does not contain any particular insolvency requirement.

* * * *

. . . [W]e cannot today predict all forms of financial difficulties that may in some cases justify a debtor's presence in Chapter 11. Financial health can be threatened in [many] ways; for instance, uncertain and unliquidated future liabilities could pose an obstacle to a debtor efficiently obtaining financing and investment. As we acknowledged in *SGL Carbon*, certain financial problems or litigation may require significant attention, resulting in "serious . . . managerial difficulties." 200 F.3d at 164. Mass tort cases may present these issues and others as well, like the exodus of customers and suppliers wary of a firm's credit-risk. So many spokes can lead to financial distress in the right circumstances that we cannot divine them all. . . .

Financial distress must not only be apparent, but it must be immediate enough to justify a filing. . . . [W]e recognize the Code contemplates "the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation." *SGL Carbon*, 200 F.3d at 163. A "financially troubled" debtor facing mass tort liability, for example, may require bankruptcy to "enable a continuation of [its] business and to maintain access to the capital markets" even before it is insolvent. *Id.* at 169.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Still, encouragement of early filing "does not open the door to premature filing." *Id.* at 163. . . . Risks associated with premature filing may be particularly relevant in the context of a mass tort bankruptcy. Inevitably those cases will involve a bankruptcy court estimating claims on a great scale—introducing the possibility of undervaluing future claims (and underfunding assets left to satisfy them) and the difficulty of fairly compensating claimants with wide-ranging degrees of exposure and injury. On the other hand, a longer history of litigation outside of bankruptcy may provide a court with better guideposts when tackling these issues.

To take a step back, testing the nature and immediacy of a debtor's financial troubles, and examining its good faith more generally, are necessary because bankruptcy significantly disrupts creditors' existing claims against the debtor: "Chapter 11 vests petitioners with considerable powers—the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, etc.—that can impose significant hardship on particular creditors. When *financially troubled* petitioners seek a chance to remain in business, the exercise of those powers is justified." *Integrated Telecom*, 384 F.3d at 120 (emphasis added). Accordingly, we have said the availability of certain debtor-favored Code provisions "assume[s] the existence of a valid bankruptcy, which, in turn, assumes a debtor in financial distress." *Id.* at 128. Put another way, "Congress designed Chapter 11 to give those businesses teetering on the verge of a fatal financial plummet an opportunity to reorganize on solid ground and try again, not to give profitable enterprises an opportunity to evade contractual or other liability." *In re Cedar Shore Resort, Inc.*, 235 F.3d 375, 381 (8th Cir. 2000).

* * * *

[Previous mass-tort] cases show that mass tort liability can push a debtor to the brink. But to measure the debtor's distance to it, courts must always weigh not just the scope of liabilities the debtor faces, but also the capacity it has to meet them. We now go there, but only after detouring to a problem particular to our case: For good-faith purposes, should we judge the financial condition of LTL by looking to Old Consumer—the operating business with valuable assets, but damaging tort liability, that the restructuring and filing here aimed to protect? Or should we look to LTL, the entity that actually filed for bankruptcy? Or finally, like the Bankruptcy Court, should we consider "the financial risks and burdens facing both Old [Consumer] and [LTL]"?

D. Only LTL's Financial Condition is Determinative.

Weighing the totality of facts and circumstances might seem on the surface to require that we evaluate the state of affairs of both Old Consumer and LTL when judging the latter's financial distress. That said, we must not underappreciate the financial reality of LTL while unduly elevating the comparative relevance of its pre-bankruptcy predecessor that no longer exists. Even were we unable to distinguish the financial burdens facing the two entities, we can distinguish their vastly different sets of available assets to address those burdens. On this we part from the Bankruptcy Court.

Thus for us, the financial state of LTL—a . . . limited liability company formed under state law and existing separate from both its predecessor company (Old Consumer) and its newly incorporated counterpart company (New Consumer)—should be tested independent of any other entity. That means we focus on its assets, liabilities, and, critically, the funding backstop it has in place to pay those liabilities.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Doing so reflects the principle that state-law property interests should generally be given the same effect inside and outside bankruptcy: "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner v. United States*, 440 U.S. 48, 55 (1979). No one doubts that the state-law divisional merger passed talc liabilities to LTL. Why in bankruptcy would we recognize the effectiveness of this state-law transaction, but at the same time ignore others that augment LTL's assets, such as its birth gift of the Funding Agreement? To say the financial condition of Old Consumer prior to the restructuring—which was not bolstered by such a contractual payment right—determines the availability of Chapter 11 to LTL would impose on the latter a look-back focused on the nonavailability of a funding backstop to what is now a nonentity.

Instead, we must evaluate the full set of state-law transactions involving LTL to understand the makeup of its financial rights and obligations that, in turn, dictate its financial condition. Even were we to agree [with the bankruptcy court] that the full suite of reorganizational steps was a "single integrated transaction," this conclusion does not give us license to look past its effect: the creation of a new entity with a unique set of assets and liabilities, and the elimination of another. Only the former is in bankruptcy and subject to its good-faith requirement. *See* Ralph Brubaker, *Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy*, 42 BANKR. L. LETTER No. 8 (Aug. 2022) (observing that the Bankruptcy Code is designed to address the financial distress of the entity in bankruptcy).

We cannot say a "federal interest requires a different result." *See Butner*, 440 U.S. at 55. That is because the Bankruptcy Code is an amalgam of creditor-debtor tradeoffs balanced by a Congress that assumed courts applying it would respect the separateness of legal entities (and their respective assets and liabilities). "[T]he general expectation of state law and of the Bankruptcy Code . . . is that courts respect entity separateness absent compelling circumstances calling equity . . . into play." *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005). Put differently, as separateness is foundational to corporate law, which in turn is a predicate to bankruptcy law, it is not easily ignored. It is especially hard to ignore when J&J's pre-bankruptcy restructuring—ring-fencing talc liabilities in LTL and forming the basis for this filing—depended on courts honoring this principle. . . . It strains logic then to say the condition of a defunct entity should determine the availability of Chapter 11 to the only entity subject to it. . . .

Thus, while we agree with the Bankruptcy Court that both entities are part of our discussion of financial distress, the financial condition of Old Consumer is relevant only to the extent it informs our view of the financial condition of LTL itself.

E. LTL Was Not in Financial Distress.

With our focus properly set, we now evaluate the financial condition of LTL. It is here we most disagree with the Bankruptcy Court, as it erred by overemphasizing the relevance of Old Consumer's financial condition. And while we do not second-guess its findings on the scope and costs of talc exposure up to the filing date, we do not accept its projections of future liability derived from those facts.

After these course corrections, we cannot agree LTL was in financial distress when it filed its Chapter 11 petition. The value and quality of its assets, which include a roughly $61.5 billion payment right against J&J and New Consumer, make this holding untenable.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The Funding Agreement merits special mention. . . . [U]nder it LTL had the right, outside of bankruptcy, to cause J&J and New Consumer, jointly and severally, to pay it cash up to the value of New Consumer as of the petition date (estimated at $61.5 billion) to satisfy any talc-related costs and normal course expenses. Plus this value would increase as the value of New Consumer's business and assets increased. The Agreement provided LTL a right to cash that was very valuable, likely to grow, and minimally conditional. And this right was reliable, as J&J and New Consumer were highly creditworthy counterparties (an understatement) with the capacity to satisfy it.

. . . Most important, . . . the payment right gave LTL direct access to J&J's exceptionally strong balance sheet. At the time of LTL's filing, J&J had well over $400 billion in equity value with a AAA credit rating and $31 billion just in cash and marketable securities. It distributed over $13 billion to shareholders in each of 2020 and 2021. It is hard to imagine a scenario where J&J and New Consumer would be unable to satisfy their joint obligations under the Funding Agreement. And, of course, J&J's primary, contractual obligation to fund talc costs was one never owed to Old Consumer . . . .

Yet the Bankruptcy Court hardly considered the value of LTL's payment right to its financial condition. . . . [I]n discussing LTL's financial condition, the Court was "at a loss to understand, why—merely because [LTL] contractually has the right to exhaust its funding options [under the Funding Agreement]"—it was "not to be regarded as being in 'financial distress.' " It speculated that a draw on the payment right could force J&J to deplete its available cash or pursue a forced liquidation of New Consumer and have a "horrific impact" on those companies. . . .

Ultimately, . . . the Bankruptcy Court did not consider the full value of LTL's backstop when judging its financial condition. And at the same time it acutely focused on how talc litigation affected *Old Consumer*. Directing its sight to Old Consumer and away from the Funding Agreement's benefit to LTL essentially made the financial means of Old Consumer, and not LTL, the lodestar of the Court's financial-distress analysis. This misdirection was legal error.

We also find a variable missing in the Bankruptcy Court's projections of future liability for LTL extrapolated from the history of Old Consumer's talc litigation: the latter's successes. . . . [B]efore bankruptcy Old Consumer had settled about 6,800 talc-related claims for under $1 billion and obtained dismissals of about 1,300 ovarian cancer and over 250 mesothelioma claims without payment. And a minority of the completed trials resulted in verdicts against it (with some of those verdicts reversed on appeal). Yet the Court invoked calculations that just the legal fees to defend all existing ovarian cancer claims (each through trial) would cost up to $190 billion. It surmised "one could argue" the exposure from the existing mesothelioma claims alone exceeded $15 billion. These conjectures ballooned its conclusion that, "[e]ven without a calculator or abacus, one can multiply multi-million dollar or multi-billion dollar verdicts by tens of thousands of existing claims, let alone future claims," to see that "the continued viability of all J&J companies is imperiled."

What these projections ignore is the possibility of meaningful settlement, as well as successful defense and dismissal, of claims by assuming most, if not all, would go to and succeed at trial. In doing so, these projections contradict the record. . . .

Finally, we cannot help noting that the casualness of the calculations supporting the Court's projections engenders doubt as to whether they were factual findings at all, but instead back-of-

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

the-envelope forecasts of hypothetical worst-case scenarios. Still, to the extent they were findings of fact, we cannot say these were inferences permissibly drawn and entitled to deference. Hence, they were clearly erroneous. And as we locate no other inferences or support in the record to bear the Court's assertion that the "talc liabilities" "far exceed [LTL's] capacity to satisfy [them]," we cannot accept this conclusion either.

In this context, it becomes clear that, on its filing, LTL did not have any likely need in the present or the near-term, or even in the long-term, to exhaust its funding rights to pay talc liabilities. In the over five years of litigation to date, the aggregate costs had reached $4.5 billion (less than 7.5% of the $61.5 billion value on the petition date), with about half of these costs attributable to one ovarian cancer verdict, *Ingham*, to date an outlier victory for plaintiffs. While the number of talc claims had surged in recent years, still J&J, as of October 2021, valued the probable and reasonably estimable contingent loss for its products liability litigation, including for talc, under GAAP, at $2.4 billion for the next two years. Further, though settlement offers are only that, we do not disregard LTL's suggestion that $4 billion to $5 billion was at one time considered by plaintiffs' lawyers to be in the ballpark to resolve virtually all multidistrict ovarian cancer claims . . . . And as noted, we view all this against a pre-bankruptcy backdrop where Old Consumer had success settling claims or obtaining dismissal orders, and where, at trial, ovarian cancer plaintiffs never won verdicts that withstood appeal outside of *Ingham* and mesothelioma plaintiffs had odds of prevailing that were less than stellar.

From these facts—presented by J&J and LTL themselves—we can infer only that LTL, at the time of its filing, was highly solvent with access to cash to meet comfortably its liabilities as they came due for the foreseeable future. It looks correct to have implied, in a prior court filing [by LTL itself], that there was not "*any imminent or even likely need of [it] to invoke the Funding Agreement to its maximum amount or anything close to it*." (emphasis added). Indeed, the Funding Agreement itself recited that LTL, after the divisional merger and assumption of that Agreement, held "assets having a value at least equal to its liabilities and had financial capacity sufficient to satisfy its obligations as they become due in the ordinary course of business, *including any [t]alc [r]elated [l]iabilities*." Funding Agreement at 1, ¶ E (emphasis added). This all comports with the theme LTL proclaimed in this case from day one: it can pay current and future talc claimants in full.

We take J&J and LTL at their word and agree. LTL has a funding backstop, not unlike an ATM disguised as a contract, that it can draw on to pay liabilities without any disruption to its business or threat to its financial viability. It may be that a draw under the Funding Agreement results in payments by New Consumer that in theory might someday threaten its ability to sustain its operational costs. But those risks do not affect LTL, for J&J remains its ultimate safeguard. . . .

At base level, LTL, whose employees are all J&J employees, is essentially a shell company "formed," almost exclusively, "to manage and defend thousands of talc-related claims" while insulating at least the assets now in New Consumer. And LTL was well-funded to do this. As of the time of its filing, we cannot say there was any sign on the horizon it would be anything but successful in the enterprise. It is even more difficult to say it faced any "serious financial and/or managerial difficulties" calling for the need to reorganize during its short life outside of bankruptcy. *SGL Carbon*, 200 F.3d at 164.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

But what if, contrary to J&J's statements, *Ingham* is not an anomaly but a harbinger of things to come? What if time shows, with the progression of litigation outside of bankruptcy, that cash available under the Funding Agreement cannot adequately address talc liability? Perhaps at that time LTL could show it belonged in bankruptcy. But it could not do so in October 2021. While LTL inherited massive liabilities, its call on assets to fund them exceeded any reasonable projections available on the record before us. The "attenuated possibility" that talc litigation may require it to file for bankruptcy in the future does not establish its good faith as of its petition date. *Id.* at 164. At best the filing was premature.[18]

In sum, while it is unwise today to attempt a tidy definition of financial distress justifying in all cases resort to Chapter 11, we can confidently say the circumstances here fall outside those bounds. Because LTL was not in financial distress, it cannot show its petition served a valid bankruptcy purpose and was filed in good faith under Code § 1112(b).[19]

* * * *

III. CONCLUSION

Our decision dismisses the bankruptcy filing of a company created to file for bankruptcy. It restricts J&J's ability to move thousands of claims out of trial courts and into bankruptcy court so they may be resolved, in J&J's words, "equitably" and "efficiently." But given Chapter 11's ability to redefine fundamental rights of third parties, only those facing financial distress can call on bankruptcy's tools to do so. Applied here, while LTL faces substantial future talc liability, its funding backstop plainly mitigates any financial distress foreseen on its petition date.

* * * *

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.

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. For here the debtor was in no financial distress when it sought

---

[18] Some might read our logic to suggest LTL need only part with its funding backstop to render itself fit for a renewed filing. While this question is also premature, we note interested parties may seek to "avoid any transfer" made within two years of any bankruptcy filing by a debtor who "receive[s] less than a reasonably equivalent value in exchange for such transfer" and "became insolvent as a result of [it]." 11 U.S.C. § 548(a). So if the question becomes ripe, the next one might be: Did LTL receive reasonably equivalent value in exchange for forgoing its rights under the Funding Agreement?

[19] Because we conclude LTL's petition has no valid bankruptcy purpose, we need not ask whether it was filed "merely to obtain a tactical litigation advantage." *BEPCO*, 589 F.3d at 618. Yet it is clear LTL's bankruptcy filing aimed to beat back talc litigation in trial courts. Still "[i]t is not bad faith to seek to gain an advantage from declaring bankruptcy—why else would one declare it?" *In re James Wilson Assocs*., 965 F.2d 160, 170 (7th Cir. 1992). While we ultimately leave the question unaddressed, a filing to change the forum of litigation where there is no financial distress raises, as it did in *SGL Carbon*, the specter of "abuse which must be guarded against to protect the integrity of the bankruptcy system." 200 F.3d at 169.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Chapter 11 protection. To ignore a parent (and grandparent) safety net shielding all liability then foreseen would allow tunnel vision to create a legal blind spot. We will not do so. . . .

Ralph Brubaker
Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy (Part II)
43 BANKR L. LETTER NO. 4 (Apr. 2023)

Introduction

The Third Circuit abruptly disrupted the Texas Two-Step mass-tort bankruptcy strategy with its recent decision of *In re LTL Management, LLC* ("*LTL I*"), 64 F.4th 84 (4th Cir. 2023), ordering dismissal of the Chapter 11 case filed (in bad faith, the court held) by the Johnson & Johnson (J&J) entity, LTL Management, formed to succeed to all of the corporate talc liability. Less than three hours after that case was dismissed by the bankruptcy court, though, LTL filed a new Chapter 11 case in the same district, which case was assigned to the same bankruptcy judge that had just dismissed the first LTL case.

. . . *LTL I* raises intriguing questions about the continuing viability of the Texas Two-Step bankruptcy as a means of resolving mass-tort liability, and the second LTL filing ("*LTL II*") provides a concrete case study in which to explore some of those questions. First, though, let us set the stage for that analysis by reviewing . . . why the Third Circuit held that LTL's initial Chapter 11 case was filed in bad faith.

The most obvious aspect of the Third Circuit's *LTL I* holding is that the financial-distress requirement for a good-faith Chapter 11 filing *only* applies to the corporate entity that has actually filed a petition, and *not* affiliated entities who have not themselves filed bankruptcy. Less apparent, but likely of even *more* importance for the continuing viability of Texas Two-Step bankruptcies going forward (including *LTL II*), the Third Circuit *rejected* the view that exposure to a sufficiently massive number of present and future tort claims is, ipso facto, sufficient financial distress to justify a Chapter 11 filing to resolve that mass-tort liability.

* * * *

The Larger Stakes for Mass-Tort Litigation Generally

Before analyzing the formal doctrinal grounds on which the Third Circuit reversed the bankruptcy court, it is helpful to contextualize that decision within a complex and consequential set of larger systemic issues regarding how best (and in what forum) to resolve mass-tort obligations generally. The simplified version of the basic question, which engenders considerable controversy and debate, is this: Is the bankruptcy system or the nonbankruptcy tort system "better" at resolving mass torts? The *LTL I* bankruptcy court explicitly "assess[ed] the merits of the competing judicial systems" as an integral part of its refusal to dismiss the case . . . . And the bankruptcy court's lengthy analysis and ultimate conclusion claiming a relative superiority for the bankruptcy system undoubtedly influenced the way in which it interpreted and applied the Third Circuit's good-faith filing jurisprudence.

Judge Ambro's very respectful and tactful opinion does not directly address this aspect of the bankruptcy court's decision, but it certainly does not endorse the bankruptcy court's views.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Moreover, and as we shall see, several aspects of the opinion seem to, at least implicitly, disavow those views. And, of course, it is indisputable that, at the end of the day, the Third Circuit was unconvinced that any comparison of the competing systems' relative merits could justify "J&J's ability to move thousands of claims out of trial courts and into bankruptcy court so they may be resolved, in J&J's words, 'equitably' and 'efficiently.' " *LTL I*, 64 F.4th at 110.

The *LTL II* filing was propelled by precisely the same claim of purported bankruptcy superiority, and thus, the Third Circuit may be forced to more directly address whether that supposition is a legitimate basis for a Chapter 11 filing. . . . First, though, let us consider what the Third Circuit said about that, even if only implicitly, in *LTL I*.

Bankruptcy Is Only Appropriate as a Response to Financial Distress

Whether a Chapter 11 filing is in response to the debtor's financial distress has always been a prominent feature of the good-faith filing doctrine. . . . To the extent it was at all unclear before, the unmistakable message of *LTL I* is that financial distress (or its absence) is *not* merely one factor among many in the case-by-case totality-of-circumstances inquiry that determines good (or bad) faith in filing for Chapter 11 relief. Rather, financial distress is an essential, necessary prerequisite for a Chapter 11 petition to be filed in good faith. Absence of financial distress, in and of itself, establishes bad faith.

* * * *

Given pre-existing Third Circuit precedent, *LTL I*'s emphatic reaffirmation that financial distress is an absolutely necessary component of a good-faith Chapter 11 filing [is] hardly [even] noteworthy . . . . The truly novel questions addressed in *LTL I*, therefore, concerned how to apply that financial-distress requirement to a Texas Two-Step filing.

Only the Financial Distress of the Chapter 11 Petitioner Can Justify a Bankruptcy Filing

The entire objective of the Texas Two-Step strategy is to ensure that Defendant's business operations are *not* subjected to the bankruptcy process. Thus, *only* BadCo files Chapter 11, and GoodCo remains outside bankruptcy. Nonetheless, in considering the existence of the financial distress that justifies a good-faith Chapter 11 filing, the *LTL I* bankruptcy court "consider[ed] the financial risks and burdens facing both [Defendant] Old JJCI *and* [BadCo] Debtor," LTL, the only entity that actually filed Chapter 11. *LTL I*, 637 B.R. at 407. The Third Circuit, however, held that this was legal error requiring reversal . . . .

The bankruptcy court's only explanation for expanding the financial-distress inquiry to consider an entity that had *not* filed bankruptcy (and, indeed, that no longer existed) was that the divisional merger of Old JJCI "and the ensuing bankruptcy filing [of LTL] should be viewed by this Court as 'a single, pre-planned, integrated transaction' comprised of independent steps." *LTL I*, 637 B.R. at 407 (citation omitted). As the Third Circuit pointed out, though, the former simply does not follow from the latter: "It strains logic . . . to say the condition of a defunct entity should determine the availability of Chapter 11 to the only entity subject to it." *LTL I*, 64 F.4th at 106.

Indeed, extending the financial-distress inquiry beyond the BadCo debtor is fundamentally inconsistent with the very essence of the divisional merger itself and the "single, pre-planned, integrated" Texas Two-Step stratagem—the entire purpose of which is to ensure that BadCo (and *only* BadCo) will be subject to the bankruptcy process. Pinpointing that central contradiction is

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

one of the pivotal insights upon which Judge Ambro's masterful *LTL I* opinion is constructed . . . .

Mass-Tort Litigation, In and Of Itself, Does Not Constitute Financial Distress

As I noted in my previous *Bankruptcy Law Letter* analysis of the Texas Two-Step, "one could easily read the [*LTL I* bankruptcy] court's opinion as saying that the magnitude of mass-tort litigation itself is all that matters—that sufficiently massive tort litigation *always* causes a defendant ' '*some*' degree of financial distress,' no matter the defendant or the defendant's resources." Ralph Brubaker, *Assessing the Legitimacy of the Texas Two-Step Mass-Tort Bankruptcy*, 42 Bankr. L. Letter No. 8, at 7 (quoting *LTL I*, 637 B.R. at 420 (emphasis added)). That supposition is bolstered by the *LTL I* bankruptcy court's lengthy exegesis on why the bankruptcy system is purportedly superior to the tort system for resolving mass torts. And the bankruptcy court's ultimate statement regarding the existence of sufficient financial distress supposedly legitimating the initial LTL bankruptcy filing was this:

> At the end of the day, this Court concludes that the weight of evidence supports a finding that J&J and Old JJCI were in fact facing a torrent of significant talc-related liabilities for years to come.

LTL I, 637 B.R. at 421.

Indeed, the bankruptcy court in another Texas Two-Step case, *Bestwall* (involving Georgia-Pacific's asbestos liability), quoted with approval by the *LTL I* bankruptcy court, *id.* at 408 & n.9., explicitly opined that "[t]he volume of current asbestos claims . . . as of the Petition Date, coupled with the projected number of claims to be filed through 2050 and beyond, is sufficient financial distress . . . to seek" bankruptcy relief in Chapter 11. *In re Bestwall LLC*, 605 B.R. 43, 49 (Bankr. W.D. N.C. 2019). And the *Bestwall* court reached that conclusion in spite of the fact that the court simultaneously found (in the very next paragraph) that "Bestwall has the full ability to meet all of its obligations (whatever they may be) through its assets and [Georgia-Pacific]'s assets, which are available through the Funding Agreement, and to continue as a going concern." *Id*. (record citation omitted).

The second blockbuster feature of the *LTL I* holding (with implications for *LTL II* . . .) is that the Third Circuit flatly *rejects* that view, that sufficiently voluminous mass-tort litigation against a defendant (particularly if the defendant faces significant exposure to future claims), in and of itself, supplies sufficient financial distress for a good-faith bankruptcy filing: "[Previous] cases show that mass tort liability can push a debtor to the brink. *But to measure the debtor's distance to it,* ***courts must always weigh*** *not just the scope of liabilities the debtor faces, but also* ***the capacity it has to meet them***.*LTL I*, 64 F.4th at 104 (emphasis added).

Taking into account a putative debtor's ability to satisfy its obligations in determining the existence of sufficient financial distress for a good-faith Chapter 11 filing will, of course, prevent bankruptcy filings (whether via a Texas Two-Step or otherwise) to resolve the mass-tort liability of eminently solvent defendants, who face no "clear and present threat to entity viability and full payment of all claimants." Ralph Brubaker, *The Texas Two-Step and Mandatory Non-Opt-Out Settlement Powers*, Harvard Law School Bankruptcy Roundtable (July 12, 2022) [hereinafter Brubaker, *Texas Two-Step*], https://bankruptcyroundtable.law.harvard.edu/2022/07/12/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-the-texas-two-step-and-mandatory-non-opt-

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

out-settlement-powers/. (That is, unless the eminently solvent defendant (*not* experiencing any financial distress) can use the bankruptcy filing of a co-defendant (who *is* experiencing financial distress) to obtain a nonconsensual nondebtor (or third-party) "release" of its mass-tort liability. *See generally* Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 YALE L.J.F. 960, 981-92 (2022).)

As applied to a Texas Two-Step bankruptcy, though, it is the *combination* of the two foregoing, crucial elements of the *LTL I* holding that is particularly potent: (1) *only* the financial distress of the petitioning debtor can establish a good-faith filing, *and* (2) being the target of massive tort litigation, in and of itself, is *not* sufficient to establish the existence of financial distress. Those two precepts are particularly important in determining the good faith of a Texas Two-Step bankruptcy filing because *both* the resources *and* the potential distress of the BadCo debtor may well be very different than GoodCo's (or Defendant's, pre-divisional merger). And the *LTL I* Texas Two-Step provides a great illustration of that.

How a Texas Two-Step BadCo's Potential For Financial Distress Can Differ From Defendant's or GoodCo's

As discussed above, the *LTL I* bankruptcy court seemed to be of the opinion that the immense scale of mass-tort litigation, in and of itself, *can* produce sufficient financial distress to justify resort to Chapter 11 relief. It is not at all surprising, then, that the court would, indeed, focus primarily (if not exclusively) upon the extent and expense of the talc litigation against Old JCCI, because

> Debtor [LTL] is the successor to Old JCCI and has been allocated its predecessor's talc-based liabilities . . . . One cannot distinguish between the financial burdens facing Old JCCI and Debtor [LTL]. At issue in this case is Old JJCI's talc liability (and the financial distress that liability caused), now the legal responsibility of Debtor [LTL].

LTL I, 637 B.R. at 417.

However, if (like the Third Circuit in *LTL I*) one (1) rejects the view that sufficiently massive tort liability can, in and of itself, constitute financial distress, and (2) insists that only financial distress of the entity that filed Chapter 11 can justify that filing, then focusing upon the available resources to meet those mass-tort obligations necessarily requires a differentiation between the various entities. As the Third Circuit stated: "Even were we unable to distinguish the financial burdens facing the two entities, we can distinguish their vastly different sets of available assets to address those burdens." *LTL I*, 64 F.4th at 105.

The resources available to LTL and Old JJCI to pay talc obligations were "vastly different" because of the funding agreement, under which not only New JJCI, but *also J&J* had obligated itself to pay LTL's talc liabilities up to a floor amount of at least $61.5 billion.

* * * *

Indeed, the fact that J&J was also an obligor under the funding agreement essentially rendered New JJCI entirely irrelevant, along with any financial distress that New JJCI might encounter by virtue of its obligations under the funding agreement. . . .

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

Thus, while the *LTL I* bankruptcy court "acutely focused on how talc litigation affected *Old [JJCI]*," that court "did not consider the full value of LTL's [funding] backstop when judging its financial condition." *Id.* at 107 (emphasis in original). Indeed, consistent with the view (rejected by the Third Circuit) that massive litigation itself can produce sufficient financial distress, irrespective of the petitioning debtor's resources, "the Bankruptcy Court hardly considered the value of LTL's payment right[s]" under the funding agreement at all. *Id.* And the Third Circuit held that "[t]his misdirection was legal error." *Id.*

Considering BadCo's Ability to Meet Its Mass-Tort Obligations Requires a Careful Assessment of the Realistic Extent of Those Obligations

The Third Circuit, therefore, disagreed with the Bankruptcy Court's assessment of the importance of "[t]he value and quality of [LTL']s assets" in determining the existence of the financial distress required for a good-faith bankruptcy filing, in particular, the Bankruptcy Court's underappreciation of LTL's "roughly $61.5 billion payment right against J&J." But even beyond available assets, on the liability side of the equation the Third Circuit also took issue with "the casualness of the calculations supporting the [Bankruptcy] Court's projections" regarding the extent of LTL's monetary liability from the talc litigation, suggesting that those estimates were not "factual findings at all, but instead back-of-the-envelope forecasts of hypothetical worst-case scenarios." *Id.* at 108.

Of course, if one is simply screening for sufficiently substantial mass litigation that somehow justifies taking that litigation out of the "inferior" tort system so that it can be more "equitably" and "efficiently" resolved by the "superior" bankruptcy system, then back-of-the-envelope forecasts of hypothetical worst-case scenarios are likely all one needs to make that call. Because the Third Circuit *rejected* that view of what constitutes sufficient financial distress, though, a more searching inquiry of LTL's realistic liability was necessary, in order to determine LTL's realistic ability to satisfy those obligations.

In particular, the Third Circuit called out the canard characteristically invoked by those who contend that it is simply impractical (or impossible) to effectively or fairly resolve mass torts outside the bankruptcy system, to wit: (1) Take the number of pending (or pending and projected future) cases, (2) posit an estimated time and/or litigation costs of litigating an individual case through trial and to judgment and/or a notional judgment amount, and then (3) multiply (1) X (2). The product in step (3) is invariably a staggeringly large figure. But it is also an irrelevant straw man, because it is as true for mass-tort litigation as it is for civil litigation in general that *the vast majority of all filed claims are ultimately resolved* ***without*** *going to trial*, most frequently by settlement. Recognizing that obvious truism, the Third Circuit held that the Bankruptcy Court's projections regarding LTL's talc liability, to the extent "they were factual findings" at all "were clearly erroneous," because "th[o]se projections ignore[d] . . . the possibility of meaningful settlement, as well as successful defense and dismissal, of claims by assuming most, if not all, would go to and succeed at trial." *Id.* at 108, 107.

What's more, the bankruptcy "settlement" touted by its enthusiasts does not somehow magically erase the need to individually liquidate *each and every* tort claim for purposes of determining each and every claimant's distribution amount. In fact, liquidating each and every claim in the bankruptcy system must occur by the very same means as in the nonbankruptcy tort system: either (1) the parties settle on mutually agreeable terms, often facilitated by standard

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

settlement matrices and various ADR mechanisms (established via a plan of reorganization or a nonbankruptcy aggregate settlement mechanism), or (2) the claimant litigates the case, which in the case of a personal injury claim includes the right to a jury trial, even when the resolution process is in the bankruptcy system. *See* 28 U.S.C. §§ 157(b)(5); 1411(a).

When it comes to resolving individual claims, then, the *only* meaningful difference between the bankruptcy aggregate settlement process and the available nonbankruptcy aggregate settlement processes is that bankruptcy provides defendant-debtors an opportunity (via various means) to *deny* claimants payment in full, even for so-called "full payment" plans of reorganization. *See* Brubaker, 42 Bankr. L. Letter No. 8, at 11-17. Embedded in the financial-distress requirement for a good-faith bankruptcy filing, then, is the eminently sound and just conviction that a defendant should *not* be able to deprive claimants of their right to payment in full via a bankruptcy filing unless the defendant is actually facing a "clear and present threat to entity viability and full payment of all claimants," the "problems that bankruptcy is designed to address." Brubaker, *Texas Two-Step*.

* * * *

A BadCo Specifically Designed to Be Able to Seamlessly Pay All Claimants in Full Is Not in Financial Distress at Its Inception

The Third Circuit in *LTL I* concluded that LTL simply did not realistically face any clear and present threat to entity viability or full payment of all claimants that would qualify as genuine financial distress that was "not only *apparent*, but . . . *immediate* enough to justify a filing." *LTL I*, 64 F.4th at 102. In fact, it did not even present a close case. The divisional merger was undoubtedly undertaken with an acute awareness of the risks that fraudulent conveyance law presented for that transaction, which was obviously structured so that LTL would not be insolvent, nor left with "an unreasonably small capital," *nor* would those who structured or approved the divisional merger intend or "believe[] that [LTL] would incur[] debts that would be beyond [LTL]'s ability to pay as such debts matured." *See* 11 U.S.C. § 548(a)(1)(B)(ii)(I)-(III); Uniform Voidable Transactions Act (UVTA) §§ 5(a), 4(a)(2)(i)-(ii); Uniform Fraudulent Transfer Act (UFTA) §§ 5(a) , 4(a)(2)(i)-(ii); Uniform Fraudulent Conveyance Act (UFCA) §§ 4-6. [Any of those circumstances would satisfy the financial-vulnerability requirement for a constructively fraudulent transfer. Insolvency is also a "badge of fraud" that supports an inference of "actual intent to hinder, delay or defraud" creditors. 11 U.S.C. § 548(a)(1)(A); UVTA/UFTA § 4(a)(1); UFCA § 7. *See* UVTA/UFTA § 4(b)(9). And the latter two financial-vulnerability circumstances likely also provide evidence in support of an inference of "actual intent to hinder, delay, or defraud" creditors.] That [fraudulent-transfer] risk also exposes individuals (including attorneys) who participate in the planning, structuring, approval, and execution of an actual-intent fraudulent transfer to potential civil and criminal liability, and for attorneys, potential professional discipline.

Little wonder, then, that the evidence presented to the Bankruptcy Court *by LTL itself* made "clear that, on its filing, LTL did not have any likely need in the present or the near-term, or even in the long-term, to exhaust its funding rights to pay talc liabilities." *LTL I*, 64 F.4th at 108. . . .

The Elephant in the Room: A Bad-Faith "Litigation Tactic" Bankruptcy

The Third Circuit's reliance *solely* upon the lack of financial distress in ordering dismissal in *LTL I* has led many to believe that financial distress is the *only* relevant inquiry in determining

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

whether a petitioner has filed Chapter 11 in good faith. Indeed, that seems to be the major premise upon which the *LTL II* filing is basing its (hotly contested) claim of good faith. That, however, is a misreading of both Third Circuit precedent and *LTL I*. As I pointed out in Part I of this series of articles, the Third Circuit's *BEPCO* decision made clear that "[f]inancial distress is . . . *necessary* for a good-faith filing *but **not** sufficient*." Brubaker, 42 BANKR. L. LETTER No. 8, at 7. Likewise, *LTL I* confirms that the good-faith filing inquiry requires "testing the nature and immediacy of a debtor's financial troubles, ***and** examining its good faith more generally*." *LTL I*, 64 F.4th at 103 (emphasis added). "The takeaway here is that when financial distress *is* present, bankruptcy *may be* an appropriate forum for a debtor to address its mass tort liability," but "because LTL was *not* in financial distress, it *cannot* show its petition . . . was filed in good faith." *Id.* at 104, 110 (emphasis added).

Indeed, recall that the financial distress inquiry is simply part-and-parcel of the larger and ultimate good-faith question of "whether the petition serves a valid bankruptcy purpose." *LTL I*, 64 F.4th at 100-01 (quoting *BEPCO*, 589 F.3d at 618 (quoting *Integrated Telecom*, 384 F.3d at 120)). Because the Bankruptcy Code in its entirety, and Chapter 11 in particular, "assumes a debtor in financial distress," *Integrated Telecom*, 384 F.3d at 128, the absence of financial distress is *per se* bad faith, i.e., *whatever* the petitioner's purposes are for filing Chapter 11, they simply cannot be valid bankruptcy purposes.

Notice, then, that the *per se* nature of the bad faith of a petitioner who is *not* experiencing financial distress means that the court need *not* identify what that petitioner's reasons for filing bankruptcy actually are, nor explain why those purposes are illegitimate. And that is precisely the way in which the *LTL I* opinion carefully limited its holding. Judge Ambro simply let the absence of financial distress do its work in establishing an irrebuttable presumption of bad faith: "Because LTL was not in financial distress, *it cannot show* its petition served *a valid bankruptcy purpose* and was filed in good faith." *LTL I*, 64 F.4th at 110 (emphasis added).

Narrowly relying upon the *per se* bad faith established by a lack of financial distress greatly simplifies the bad-faith determination. Of course, it can also obscure exactly what it is that is improper and illegitimate about the petitioner's resort to bankruptcy relief. It is not difficult, however, to identify the *illegitimate* purpose that was the impetus for the *LTL I* filing, which Judge Ambro himself strongly hinted at in . . . footnote [19.]

That unaddressed question likely cannot be left unanswered now, however, given the almost-instantaneous *LTL II* filing . . . . If the *LTL I* filing was a bad-faith "litigation tactic," which it most certainly was, then so too is the *LTL II* filing because, as LTL openly admits, its purposes and objectives in filing the second bankruptcy case are exactly the same as they were in the first case.

As the foregoing discussion reveals, the obvious objective of a Texas Two-Step bankruptcy in cases such as *LTL* is to enable an eminently solvent entity to impose a mandatory no-opt-outs settlement (and hard cap) of its aggregate mass-tort liability on all tort claimants (present and future), whether or not they all agree to that settlement. Such a mandatory no-opt-outs settlement would be impermissible and unconstitutional outside of bankruptcy. The precursor phenomenon, that led the way in using bankruptcy to impose mandatory no-opt-outs settlements that are

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

otherwise impermissible and unconstitutional, is a controversial practice known as a nonconsensual nondebtor (or third-party) "release" (i.e., discharge) of the liability of an entity or individual who has not filed bankruptcy. The courts consider various factors in deciding whether to approve such a nondebtor discharge (and implementing permanent injunction). The most popular compilation of the relevant factors is:

> (1) There is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate.
>
> (2) The non-debtor has contributed substantial assets to the reorganization.
>
> (3) The injunction is essential to reorganization. Without the [sic] it, there is little likelihood of success.
>
> (4) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment.
>
> (5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

In re Master Mortgage Inv. Fund, Inc., 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994).

Note, that the availability of a nonconsensual nondebtor release is also a critical component of the Texas Two-Step strategy. Do you see how? What nondebtor entity will want a liability release in a Texas Two-Step bankruptcy? What role does the funding agreement play in the nondebtor release calculus? Consider those questions as you read the following excerpt, in which Professor Brubaker explains and critiques nonconsensual nondebtor releases.

Ralph Brubaker
Mandatory Aggregation of Mass Tort Litigation in Bankruptcy
131 YALE L.J.F. 960 (2023)

INTRODUCTION

[We are] in the midst of a collective epiphany regarding the astonishing means by which federal bankruptcy courts impose mandatory settlements of mass tort liabilities. Of course, with respect to an insolvent debtor's liability, such a power has always been incident to collective insolvency proceedings, even before the enactment of the current Bankruptcy Code. What is remarkable (and profoundly disturbing) about th[is so-called] bankruptcy grifter phenomenon . . ., however, is that bankruptcy courts have, entirely at their own behest, invented the immense, extraordinary power to impose mandatory non-opt-out settlements of mass tort victims' claims against eminently solvent *non*debtors, who have *not* filed bankruptcy themselves.

. . . [T]he first big bankruptcy grift involve[ed] the Dalkon Shield contraceptive device manufactured by A.H. Robins. Those who succeeded in discharging their liability exposure in the Robins bankruptcy case included a long list of alleged joint tortfeasors: Robins's insurer (Aetna), members of the Robins family, and other officers, directors, employees, and attorneys for Robins. Personal injury claimants asserted that Robins and Aetna affirmatively concealed from the public

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

the dangers of the Dalkon Shield and that individual actors personally participated in defrauding the public through the marketing of the Dalkon Shield.

The pending Purdue Pharma bankruptcy, implicating the Sackler family's personal responsibility for the ravages of the opioid OxyContin, initially unfolded as essentially a replay of the A.H. Robins case. But the Robins bankruptcy grift went largely unnoticed, except in the insulated community of bankruptcy professionals, who aggressively exploited the precedent, fueling the proliferating and rapidly accelerating system of bankruptcy grifting. The prospect of liability releases for the Sacklers in the Purdue Pharma case, however, finally awakened a wider realization, even and perhaps particularly among the general public, with all of the shock, disbelief, and outrage that bankruptcy grifting should have elicited from its infancy. [*See* Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154 (2022); Gerald Posner & Ralph Brubaker, *The Sacklers Could Get Away With It*, N.Y TIMES (July 22, 2020).]

. . . [Some are] resigned to the inevitability of the highly controversial practice that makes bankruptcy grifting possible: so-called nonconsensual nondebtor (or third-party) "releases," which extinguish creditors' claims against a nondebtor without the consent (and even over the objection) of creditors in the same way that a bankruptcy discharge extinguishes a bankruptcy debtor's debts. Such nondebtor-release provisions most frequently appear in the terms of a Chapter 11 debtor's plan of reorganization. And in confirming a plan containing such a nondebtor-release provision, the court will typically enter an order permanently enjoining assertion of the released claims (now commonly known as a "channeling" injunction), replicating the effect of the Bankruptcy Code's statutory discharge injunction (which is, of course, applicable to only *the debtor's* discharged debts). 11 U.S.C. § 524(a).

. . . [T]he ever-larger waves of bankruptcy grifting and the degree to which grifting disadvantages claimants is a significant and urgent problem, one that I believe warrants the attention of the Supreme Court. Indeed, there is a prominent, longstanding circuit split over the propriety of nondebtor releases that begs for resolution. Moreover, nondebtor releases pose much larger questions than the typical statutory-interpretation disputes that comprise the bulk of the Supreme Court's bankruptcy jurisprudence. . . . [T]he fundamental illegitimacy of nondebtor releases is of a constitutional magnitude, implicating constraints imposed by the separation-of-powers dimensions of both the Bankruptcy Clause and *Erie*'s constitutional holding.

Moreover, the process by which bankruptcy courts approve non-debtor releases departs dramatically from the baseline requirements for resolving disputed nonbankruptcy claims and causes of action, in ways that raise serious due-process concerns. Giving bankruptcy courts the unique power to impose mandatory non-opt-out settlements of tort victims' claims against nondebtors—settlements that are otherwise impermissible and unconstitutional—requires an explanation of why this extraordinary settlement power with respect to claims against a solvent nondebtor should exist only when a codefendant happens to be a bankruptcy debtor. . . . [T]he only proffered justification is nothing more than empty, false rhetoric—what I dub bankruptcy's "necessity" fiction. Nondebtor releases do not advance any legitimate bankruptcy policy; they simply provide a contrived means for solvent nondebtors to impose extraordinary mandatory settlements of their mass tort liabilities upon nonconsenting victims.

Efficient (and fair) joint settlements of both debtors' and nondebtors' mass tort liability will still be possible, even (and particularly) if nonconsensual nondebtor releases are prohibited. . . . [T]he essential architecture for facilitating powerful aggregation and corresponding settlement

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

of tort victims' claims against nondebtors already exists in the bankruptcy jurisdiction, removal, and venue provisions of the Judicial Code. And a much-needed rationalization of the scope of federal bankruptcy jurisdiction would unleash bankruptcy's full aggregation potential.

As a practical and institutional matter, the Supreme Court is the one body that can (relatively quickly and within the confines of existing law) both end the disturbing bankruptcy grifting we are now witnessing and preserve bankruptcy as a viable forum for comprehensive, efficient, and fair resolutions of nondebtors' mass tort liability. . . .

I. THE ILLEGITIMACY AND UNCONSTITUTIONALITY OF NONDEBTOR RELEASES

One of the principal justifications courts rely upon to approve a non-consensual nondebtor release—one of the so-called *Master Mortgage* or *Dow Corning* factors—is that the released "non-debtor has contributed substantial assets to the reorganization." *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002). Nothing in the Bankruptcy Code expressly authorizes a "release" or discharge of a nondebtor's liability on this basis (or any other). Nonetheless, such power purportedly flows from bankruptcy courts' general equitable powers under § 105(a) of the Bankruptcy Code. But such a judicially designed discharge of debt is an unconstitutional judicial usurpation of a quintessential legislative function, as revealed by both *Erie*'s constitutional holding and the Bankruptcy Clause itself.

. . . [Moreover], even as a matter of statutory interpretation, . . . fundamental principles of constitutional structure guide and inform the appropriate construction of the Bankruptcy Code. The separation-of-powers implications of *Erie* and the Bankruptcy Clause provide substantive constitutional canons of statutory interpretation that cogently elucidate why nothing in the Bankruptcy Code can plausibly be read to authorize nonconsensual nondebtor releases.

* * * *

The Supreme Court's famous reasoning in the bankruptcy case *Butner v. United States*, 440 U.S. 48 (1979), was simply an unattributed expression of the *Erie* doctrine . . . .

* * * *

Moreover, th[e] *Erie*/*Butner* limitation on bankruptcy courts' creation of substantive federal common law is directly incorporated into the Supreme Court's jurisprudence restraining bankruptcy courts' equitable powers, as the *Butner* decision itself made clear: "The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations," but "undefined considerations of equity provide no basis for adoption of a . . . federal rule" giving a party substantive "rights that are not his as a matter of state law," such as the right to a discharge of his debts without filing bankruptcy. Thus, the same constitutional constraint that restricts federal bankruptcy courts' power to create substantive federal common law for such third-party "related to" claims under *Erie* and *Butner*—and in service of the same constitutional values of federalism and separation of powers—provides a constitutional meta-norm (or a so-called substantive canon of statutory construction) that likewise prohibits alteration of the parties' state-law substantive rights and obligations via the vague equitable-powers provision of the Bankruptcy Code. . . .

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The federal courts are illicitly creating substantive federal common law through their jurisprudence authorizing nondebtor releases. Indeed, that is apparent from the list of criteria—exclusively the product of judicial imagination—that supposedly trigger bankruptcy courts' power to grant discharge relief for nondebtors. With respect to the third-party nondebtor claims extinguished via nondebtor releases, *Erie*'s constitutional holding is that the parties' substantive state-law rights and obligations must be respected in federal bankruptcy proceedings, notwithstanding the grant of "related to" jurisdiction over such claims, in the absence of any explicit congressional authorization of nonconsensual nondebtor releases. Extinguishing the parties' substantive state-law rights and obligations via mere judicial edict is unconstitutional under *Erie*. Moreover, such a judicially crafted, federal common-law discharge power is also unconstitutional under the separation-of-powers limitations implicit in the Bankruptcy Clause itself.

* * * *

At the heart of Congress's Bankruptcy Power is determining the appropriate distribution of someone's assets that warrants discharge of their obligations. But nondebtor-release practice, as evidenced by the judicially divined factors or requisites for approval—including the requirement that a discharged nondebtor "has contributed substantial assets to the reorganization"—presumes to lodge plenary authority for such a determination in the courts. Therefore, the distribution-discharge scheme effectuated via nondebtor release violates the separation-of-powers principle embedded in the text of the Bankruptcy Clause, which provides for legislative supremacy over matters of distribution and dis-charge.

The Supreme Court's jurisprudence limiting bankruptcy courts' equitable powers also directly incorporates this structural constitutional bulwark for Congress's core legislative prerogatives. As the Court has directed, exercise of bankruptcy courts' equitable powers "must not occur at the level of policy choice at which Congress itself operated in drafting the [Bankruptcy] Code." *U.S. v. Noland*, 517 U.S. 535, 543 (1996). An exercise of equitable powers "that takes place at the legislative level of consideration" is "tantamount to a legislative act and therefore" is "beyond the scope of judicial authority." *U.S. v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 229 (1996). The Bankruptcy Clause's separation-of-powers dimension, therefore, also supplies a nondelegation substantive canon of statutory construction limiting the scope of bankruptcy courts' equitable powers under § 105(a) of the Bankruptcy Code.

Moreover, one of the larger systemic implications of the Court's important decision in *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017), is that implicit authority for such legislative-order determinations does not reside in the interstices of other vague Bankruptcy Code authorizations either. Discharge of debt is the "greatest" power granted to Congress by the Bankruptcy Clause. *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 186 (1902) (quoting *In re Klein*, 14 F. Cas. 716, 718 (C.C.D. Mo. 1843) (No. 7,865) (Catron, Circuit Justice)). Hence, a general statutory "necessary and proper" authorization "is too weak a reed upon which to rest [delegation of] so weighty a power." *Jevic*, 580 U.S. at 466. As is equally true with the distribution priority issue the Court addressed in *Jevic*, given that the Bankruptcy Code does not explicitly authorize discharge of a nondebtor's obligations, "such statutory silence should be interpreted as denying bankruptcy courts any power to authorize" such a nondebtor discharge. *Id.* at 465.

* * * *

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

There is no common-law discharge power. Nonconsensual nondebtor releases are an unconstitutional encroachment upon the exclusive "competency and discretion of Congress" concerning discharge of indebtedness. *Moyses*, 186 U.S. at 186. Nondebtor releases contravene the constitutional restrictions that both *Erie* and the Bankruptcy Clause place upon the lawmaking powers of the federal courts.

II. JUSTIFYING AN EXTRAORDINARY MANDATORY SETTLEMENT POWER ONLY IN BANKRUPTCY

. . . [T]he judicially decreed criteria for approval of nonconsensual nondebtor releases do not replicate the Bankruptcy Code's substantive and procedural protections for the third-party nondebtor claims being discharged thereby. For example, in conjunction with a Chapter 11 debtor's discharge, each and every creditor has the right to insist that it receive at least as much under the debtor's plan of reorganization as that creditor would receive in a liquidation of the debtor's assets. *See* 11 U.S.C. § 1129(a)(7). Indeed, . . . if the courts were to impose such a requirement in conjunction with nondebtor releases, particularly for solvent nondebtors, many (if not all) releases could never be approved. And for individual nondebtors, releases shield the individual from liability (and, indeed, from even being sued and the accompanying public scrutiny) for alleged fraud and other intentional misconduct, which the Bankruptcy Code provides can*not* be discharged. *See, e.g., id.* § 523(a)(2), (6).

Equally if not more importantly, though, approval of nondebtor releases also does not replicate nonbankruptcy standards for resolution of disputed claims. As the [foregoing] discussion . . . reveals, by simply granting the federal courts "related to" bankruptcy jurisdiction over third-party nondebtor claims [in 28 U.S.C. § 1334(b)], the statutory design (pursuant to *Erie*) is for those claims to be heard and adjudicated in federal court, if at all, according to applicable nonbankruptcy substantive law and the incident procedural apparatus for adjudicating those claims, such as the Federal Rules of Bankruptcy Procedure (which incorporate nearly all of the Federal Rules of Civil Procedure). The extraordinary resolution of those claims effected via nondebtor release, however, is unknown to any of those governing sources of substantive or procedural law. And there is no bankruptcy-unique normative or policy justification for nondebtor releases' exceptional alteration of the parties' nonbankruptcy rights and obligations.

A. Mandatory Settlement via Nondebtor Release

Nondebtor releases are often clothed in the rhetoric of "compromise" and "settlement" of the third-party nondebtor claims at issue. Given the nonconsensual nature of the nondebtor releases of concern, though, the "settlement" effectuated via nondebtor release departs from the fundamental baseline norm that settlement of a claim cannot be imposed on a party without that party's consent. That principle is undoubtedly borne of constitutional due-process guaranties, as "part of our 'deep-rooted historic tradition that everyone should have his own day in court.' " *Martin v. Wilks*, 490 U.S. 755, 762 (1989) (quoting 18 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4449, at 417 (1st ed. 1981)).

Nondebtor releases, therefore, work a kind of representational settlement, akin to a class-action settlement, in which someone else is negotiating and compromising creditors' claims against released nondebtors. As I have noted before, nonconsensual nondebtor releases impose a mandatory non-opt-out settlement of creditors' third-party nondebtor claims, wholly without

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

regard to whether such a mandatory non-opt-out settlement is appropriate, permissible, or even constitutional. *See* Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 974-80.

The approval process for nondebtor releases does not adhere to the constitutional due-process requirement of an adequate unconflicted litigation representative for the third-party nondebtor claims compromised thereby. *See Taylor v. Sturgell*, 553 U.S. 880, 900-01 (2008); *Richards v. Jefferson Cnty.*, 517 U.S. 793, 798-82 (1996); *Hansberry v. Lee*, 311 U.S. 32, 40-46 (1940). Even more significantly, claimants are not provided any opportunity to opt out of the "settlement" imposed on them via nondebtor release. In a series of decisions over the last thirty-five years, the Supreme Court has repeatedly and strongly suggested, if not explicitly held, that for the kinds of money damages claims typically compromised via nondebtor release, the "absence of . . . opt out violates due pro-cess." *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338, 362-63 (2011); *see AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 349 (2011); *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 847-48 (1999); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 811-12 (1985). Within the due-process triad of exit, loyalty, and voice [i.e., the right to appear and be heard], then, nonconsensual nondebtor releases deny claimants both loyalty and by definition exit. In addition to their facial unconstitutionality on separation-of-powers grounds, nondebtor releases thus raise grave due process concerns.

* * * *

It is worth reemphasizing the unique and extraordinary nature of these nonconsensual nondebtor release "settlements," which simply *cannot* occur in any other context. Why, then, should this extraordinary mandatory settlement power exist *only* in cases in which a codefendant has filed bankruptcy? After asking and diligently exploring that question for over twenty-five years, I have yet to receive or discover a credible response.

B. Bankruptcy's "Necessity" Fiction

The truth about nonconsensual nondebtor releases and the mandatory settlements they impose on claimants is that they are a manifestation of a more general deceit indulged throughout the bankruptcy reorganization system, in order to disregard cornerstone principles governing parties' fundamental distributional entitlements. I will call this bankruptcy's "necessity" fiction. And . . . bankruptcy's necessity fiction (via the bankruptcy grifter phenomenon) is now also distorting the tort system.

The bankruptcy reorganization process is extremely complex and, by design, incredibly flexible and fluid. That is its genius. Those who administer the system, particularly judges and lawyers, do so with an earnest and ever-present desire to, whenever possible, preserve the debtor's business intact and prevent the value destruction, job loss, and other unfortunate collateral consequences that would accompany a fire-sale liquidation.

However, in many different contexts throughout the bankruptcy reorganization process, parties with significant control over that process seize upon and opportunistically exploit the exigencies surrounding the debtor's financial difficulties in order to alter various parties' distribution rights, as expressed in the Bankruptcy Code's explicit priority and distribution provisions. The various judicial doctrines created to approve these priority-altering distribution

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

techniques frequently rely upon the justification (and even required factual findings) that doing so is "important," "necessary," or "essential" to the debtor's successful reorganization and, at least in the earliest stages of the institutionalization of these practices, that the variation is an "exceptional" one that is to be approved in only "rare" circumstances. That is the necessity fiction, which time and eventual institutionalization of these practices expose as little more than a rote incantation of magic words.

Nonconsensual nondebtor releases follow the same pattern in altering the fundamental rights of creditors with respect to their claims against released nondebtors. As pronounced by the Courts of Appeals, such releases "should be reserved for those unusual cases in which such an order is necessary for the success of the reorganization." *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1078 (11th Cir. 2015). That standard for approval, however, and the dynamics of the context in which these releases are bargained for and approved, ensure that nonconsensual nondebtor releases will not be limited to rare or exceptional cases.

Given the extraordinary nature of the relief at stake and the supposed rarity of its grant, one might legitimately expect that the concept of "necessary to successful reorganization" means reorganization in the sense of saving the debtor's business from destruction. But that is not what it means, according to the necessity fiction. Consider, for example, the *Blitz* case (and Walmart's nondebtor release therein) . . . , which involved the liquidation of a defunct business's assets.

If successful reorganization does not mean saving the debtor's business, then all it means is confirming a plan of reorganization, the terms of which are the product of negotiations among the dominant players. In practice and as applied, therefore, "necessary to successful reorganization" for purposes of the necessity fiction simply means necessary to do the deal embodied in the plan of reorganization. Moreover, given that a successful reorganization is the product of negotiations, nondebtor-release beneficiaries themselves, as key participants in the negotiations, can always manufacture the "evidentiary" record required for approval, merely through their negotiation behavior.

To understand why that is the case, consider the negotiations over a nonconsensual nondebtor release, given in exchange for a nondebtor's contribution to a settlement fund. In order for a judge to approve the release as "necessary to successful reorganization," the judge will have to find that the only means of procuring the nondebtor's contribution to the settlement fund is by giving the nondebtor a nonconsensual liability release. Therefore, the negotiation position of the nondebtor is preordained by the operative legal rule. The nondebtor will absolutely insist upon receiving a nonconsensual nondebtor release as an inviolable deal-breaker condition of making any contribution to the settlement fund, and when the resulting release is presented to the bankruptcy court for approval, will enthusiastically testify accordingly. And truthfully so, since the operative legal rule itself turns on a negotiating position. Even the most obvious bluff, on the stand and under oath, does not risk punishable perjury, because the nondebtor is not so much testifying about objectively verifiable past facts as the nondebtor is testifying about its negotiating position: "I will not contribute anything to a settlement without a nonconsensual nondebtor release."

Permitting the practice of approving nonconsensual nondebtor releases that are "necessary to successful reorganization," while "preach[ing] caution" (as Courts of Appeals have done) is simply extreme naivete—especially if the hope is that this approach will exert any principled restraint on the practice. *See In re Ingersoll, Inc.*, 562 F.3d 856, 864 (7th Cir. 2008). "Necessary

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

to successful reorganization" is a negotiating position proffered by a nondebtor who will directly benefit from that which it insists is essential to any settlement deal. By positively inviting the nondebtor to manufacture the "evidence" necessary for approval, through its negotiating behavior, this standard virtually guarantees that approval will not and cannot be limited to "rare" and "unusual" cases, which the growing prevalence of the bankruptcy grifter phenomenon vividly illustrates.

As Justice Breyer's opinion in the *Jevic* case insightfully observes, in striking down an extra-statutory priority deviation approved on the basis of the necessity fiction, such a standard "will lead to similar claims being made in many, not just a few, cases," which "threatens to turn a 'rare case' exception into a more general rule." *Jevic*, 580 U.S. at 469-70. "[O]nce the floodgates are opened, [the negotiating parties] can be expected to make every case that 'rare case.' " *Id.* at 470 (quoting Frederick F. Rudzik, *A Priority Is a Priority Is a Priority—Except When It Isn't*, 34 AM. BANKR. INST. J., Sept. 2015, at 16, 79). Indeed, bankruptcy judges are intimately familiar with this "transformation of relief circuit courts describe as 'extraordinary' into a routine part of nearly every chapter 11 case." *In re Astria Health*, 623 B.R. 793, 801 n.25 (Bankr. E.D. Wash. 2021).

This is not to say that requested nondebtor releases are always approved, but it does demonstrate that the determining factors for when they will be approved are not transparent. Given the influence of the Chapter 11 forum-shopping phenomenon, one suspects that a "big case" dynamic may be operative. Because necessary to reorganization means nothing more than necessary to do the deal, nondebtor releases will often be necessary to reorganization in an ex post sense: if the court does not approve the nondebtor-release deal embodied in the plan of reorganization, the deal will fall apart, and the parties will have to start over in trying to negotiate a new deal. The larger the case, the more consequential this "necessity" will be. In extremis, this ex post "necessity" of saving the deal could even present the prospect that the costs of negotiating a new deal (when added to the costs already incurred in negotiating the nondebtor-release deal) would completely exhaust the incremental going concern value of the debtor entity (over and above liquidation value), necessitating liquidation in order to maximize creditor recoveries. That, however, is a "necessity" produced solely by the rule permitting nondebtor-release deals. That "necessity" will never exist if nondebtor releases are prohibited because the parties simply will not negotiate nondebtor-release deals.

The emptiness of the necessity fiction lays bare the absence of any legitimate justification for giving bankruptcy courts the unique, extraordinary power to impose mandatory non-opt-out settlements (that are otherwise impermissible and unconstitutional) of tort victims' claims against solvent entities who have not themselves filed bankruptcy. Non-consensual nondebtor releases are not about saving an operating debtor's business or any other bankruptcy-unique policy objective. In mass tort bankruptcies, they are all about creating an alternative system for resolving the mass tort liability of solvent nondebtors—an ad hoc system that adheres to neither bankruptcy nor nonbankruptcy norms for achieving fair aggregate settlements.

With nondebtor releases and bankruptcy grifting, bankruptcy's necessity fiction, and its artful manipulation of parties' distributional rights vis-à-vis a bankruptcy debtor, has jumped from the bankruptcy system into the tort system, where it is trampling core tenets of compensatory and procedural justice in connection with victims' claims against bankruptcy grifters. The availability of this ad hoc and superpowerful mandatory non-opt-out settlement device only in bankruptcy, combined with the well-known and rapidly escalating phenomenon of unrestricted forum shopping

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

(and now even judge shopping) in corporate Chapter 11 filings, is causing a migration of mass tort litigation out of the tort system and into the bankruptcy system. . . .

III. MANDATORY BANKRUPTCY AGGREGATION WITHOUT NONDEBTOR RELEASES

* * * *

The most important element of any judicial process that can facilitate comprehensive aggregate resolutions is getting all claims into one court, which can then bring to bear the full range of judicial-management techniques for producing efficient, fair, and comprehensive resolutions. In that regard, there is tremendous untapped potential for mandatory bankruptcy *consolidation* of tort victims' claims against both debtors and nondebtors to replace the bankruptcy grifter system of mandatory bankruptcy *settlements* through nonconsensual nondebtor releases. And the essential architecture for such mandatory consolidation already exists in the bankruptcy jurisdiction, removal, and venue provisions of the Judicial Code.

A. Tort Victims' Claims Against the Debtor

With respect to creditors' claims against bankruptcy debtors, including the disputed, unliquidated claims of tort victims, bankruptcy is a powerful aggregation device. Many components work together to produce bankruptcy's immense aggregation power. At the heart of it is bankruptcy's extremely broad definition of the bankruptcy "claims" that are eligible to receive a distribution from the debtor's bankruptcy estate, which expressly include not only "disputed" and "unliquidated" tort claims, but also the "contingent" claims of future claimants who have not yet been (but will be) injured from the debtor's prebankruptcy conduct. 11 U.S.C. § 101(5)(A).

Bankruptcy's statutory automatic stay immediately enjoins assertion of any "claim" against the debtor outside of the bankruptcy court. *Id.* § 362(a). This leaves filing a "proof of claim" against the debtor's bankruptcy estate in the bankruptcy court in which the debtor's bankruptcy case is pending as creditors' only recourse with respect to their claims against the debtor. *See id.* § 501(a). Confirmation of a plan of reorganization establishes the aggregate distribution "fund" available to pay each class of creditor claims. Each individual creditor's pro rata distribution from that "fund" (which is typically a less than payment-in-full distribution for general unsecured creditors such as tort victims) is then determined by the claims "allowance" process. *See id.* § 502.

The plan of reorganization may well establish various alternative-dispute-resolution processes for voluntary settlement of disputed claims. But the Bankruptcy Code also provides creditors recourse to a judicial claims allowance determination by the bankruptcy judge, in a "summary" proceeding without a jury. In the case of personal injury and wrongful death claims, however, the tort victim has a statutory right to a jury trial in a federal district court. *See* 28 U.S.C. §§ 157(b)(2)(B), (O), 157(b)(5), 1411(a).

The ultimate aggregative power of bankruptcy comes from the fact that confirmation of a plan of reorganization not only fixes creditors' distribution rights from the debtor's bankruptcy estate, it also "discharges" the debtor from any pre-bankruptcy claim, "whether or not a proof of the claim . . . is filed" or "such claim is allowed." 11 U.S.C. § 1141(d)(1)(A)(i)-(ii). All creditors (broadly defined to include even future, unknown, uninjured claimants) are thus bound to the distribution rights established by the confirmed plan of reorganization, whether or not they file a

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

claim or otherwise appear and participate in the bankruptcy proceedings—and they cannot thereafter assert their discharged claims against the debtor or the debtor's property. *See id.* §§ 363(f), 1141(c). Indeed, another automatic statutory injunction, the discharge injunction, enjoins creditors from doing so. *Id.* § 524(a)(2). And the bankruptcy court's territorial jurisdiction to bind creditors extends to any and all who have "minimum contacts" with the United States of America [because n]ationwide service of process is available in all federal bankruptcy proceedings. See FED. R. BANKR. P. 7004(d), 9014(b).

That is bankruptcy's "special" statutory preclusion design to which the Supreme Court has alluded, most recently in *Taylor v. Sturgell*, 553 U.S. 880, 895 (2008) (quoting *Martin v. Wilks*, 490 U.S. 755, 762 n.2 (1989)). Like class actions, that preclusion mechanism is how bankruptcy effectuates its powerful aggregation of all prebankruptcy claims against a bankruptcy debtor of every stripe, including disputed tort claims. Indeed, bankruptcy claims aggregation, which is a form of mandatory aggregation by preclusion, functions in precisely the same manner as settlement of a mandatory class action in achieving *universal* aggregation.

In combination, those are the means by which bankruptcy "channels" creditors' claims: (1) out of the various otherwise available nonbankruptcy state and federal fora and into one court, the federal bankruptcy court presiding over the debtor's bankruptcy case, and (2) away from the debtor and toward and against only the "fund/s" the plan establishes for payment of creditors' claims.

B. Tort Victims' Claims Against Nondebtors

1. Mandatory, Universal Settlement via Nondebtor Release

By replicating the effects of the bankruptcy discharge and discharge injunction for creditors' claims against solvent nondebtors, nonconsensual nondebtor releases and permanent injunctions allow nondebtors to get in on bankruptcy's mandatory, universal aggregation by preclusion. Most importantly from the perspective of both nondebtors and tort victims, that mandatory, universal aggregation by preclusion puts a hard cap on released nondebtors' liability exposure at the amount of the "substantial assets [contributed] to the reorganization." *Dow Corning*, 280 F.3d at 658. But that criterion for approval of a nondebtor release is extremely (and troublingly) vague. Indeed, "nothing in the process by which releases are approved requires contributions by released non-debtors to approximate the value of the released claims" nor any other meaningful review of the structural or substantive fairness of the nondebtor release deal. Brubaker, 1997 U. ILL. L. REV. at 992.

In the taxonomy of aggregation devices, mandatory universal aggregation by preclusion is the most powerful and thereby carries the most potential to ride roughshod over individual claimants' substantive, procedural, and constitutional rights, as nonconsensual nondebtor releases and the resulting bankruptcy grifter phenomenon amply illustrate. But a range of other aggregation mechanisms exist. And with respect to the third-party nondebtor tort claims resolved via nondebtor release (i.e., mandatory *settlement*), bankruptcy contains another very powerful aggregation structure for mandatory *consolidation*.

2. Mandatory, Universal Consolidation of Personal Injury Claims

The essential architecture for mandatory consolidation of mass tort claims against nondebtors is already present in existing bankruptcy law. Section 157(b)(5) of the Judicial Code

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

provides for single-district consolidation of all creditors' related personal injury claims against a nondebtor, in a manner similar to an MDL consolidation. But a § 157(b)(5) bankruptcy consolidation of personal injury claims is even more powerful than an MDL consolidation in two significant respects. First, unlike an MDL consolidation, which can only consolidate cases pending in the federal courts, a § 157(b)(5) bankruptcy consolidation can centralize claims pending in both federal and state courts, through the broader removal power available under the bankruptcy removal statute. 28 U.S.C. § 1452(a). Second, unlike an MDL consolidation, which is solely "for coordinated or consolidated pretrial proceedings," *id.* § 1407(a), a § 157(b)(5) bankruptcy consolidation is for *all* purposes, including trial in a federal district court.

* * * *

For example, imagine hundreds or thousands of personal injury suits against two alleged joint tortfeasors (*D* and *ND*) are pending in state and federal courts all over the country, and one of those alleged joint tortfeasors (*D*) files Chapter 11. All the tort claims against *D* now become subject to the mandatory, universal bankruptcy aggregation process previously discussed. In addition, though, as long as the pending tort claims against *ND* are "related to" *D*'s bankruptcy case, *ND* can immediately remove all of those pending tort claims from state court into federal court, and any such claims that are subsequently filed in state court will likewise be immediately removable.

* * * *

[Section] 157(b)(5) [then] gives one district-court judge in *D*'s home-court bankruptcy district a discretionary power, much like the MDL statute gives to the Judicial Panel on Multidistrict Litigation (JPMDL), to impose mandatory consolidation in one federal district of all of the "related to" tort claims against *ND*. And just like the tort claims against bankruptcy debtor *D*, which are subject to bankruptcy's universal, mandatory aggregation process, a § 157(b)(5) mandatory consolidation of the tort claims against *ND* can also be universal, encompassing any and all of the "related to" tort claims that have been or will be filed against *ND* in any court in the country.

Such a § 157(b)(5) consolidation can not only capture the efficiencies and settlement facilitation potential from consolidating all of the tort claims against *ND* in one court, but also enable the *joinder* efficiencies and settlement facilitation from placing the claims of all victims whose claims are against both *D* and *ND* in the same court. And each and every victim will have the right to a jury trial in a federal district court in *D*'s home-court bankruptcy district for both of its claims—its proof of claim against bankruptcy debtor *D* and its third-party "related to" claim against nondebtor *ND*.

To say that a mandatory, universal consolidation of all "related to" claims against *ND can* occur via § 157(b)(5) is, of course, not to say that the district court *should* order consolidation of those claims in *D*'s bankruptcy case. But the district court would have at its disposal the same kinds of considerations the JPMDL weighs in deciding whether to order an MDL consolidation. Moreover, if the district court decides that a § 157(b)(5) consolidation is not appropriate, the district court can also order a mandatory, universal *remand* of all removed state-law claims under bankruptcy's unique discretionary abstention and remand provisions.

There is also tremendous underexplored potential in hybrid approaches, similar to the originally intended operation of the MDL statute, that exploit the efficiency and settlement

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

advantages of pretrial centralization, but that permit any individual trials to occur in victims' local communities. . . . The flexible, discretionary nature of both § 157(b)(5) and the bankruptcy abstention and remand provisions can accommodate all manner of such creative hybrid-resolution models.

IV. THE ROLE OF THE SUPREME COURT

* * * *

Were the Supreme Court to prohibit nonconsensual nondebtor releases, there are credible indications that § 157(b)(5) bankruptcy consolidations would fill the space created by prohibition of nonconsensual nondebtor releases. Even in a world in which nonconsensual nondebtor releases are permissible, codefendants have on occasion, with mixed results, attempted the bankruptcy removal and consolidation strategy outlined in Part III.

The only significant obstacle to fully effective use of § 157(b)(5) consolidations is the circuits' disagreement over the scope of third-party "related to" bankruptcy jurisdiction, which was consciously designed to be as broad as the Constitution permits. Here, too, the Supreme Court can and should resolve this critical issue of federal jurisdiction, whose importance transcends mass tort bankruptcies and pervades the entirety of bankruptcy courts' dockets, including even the most prosaic consumer bankruptcy cases.

* * * *

If third-party "related to" jurisdiction is a grant of conventional supplemental jurisdiction, then there is federal bankruptcy jurisdiction over any third-party "claims [that] arose from the same nucleus of operative fact" as a claim by or against the debtor's bankruptcy estate. *UMW v. Gibbs*, 383 U.S. 715, 728 (1966). In my previous example, then, all of the tort claims against *ND* undoubtedly would be within "related to" bankruptcy jurisdiction, and a § 157(b)(5) bankruptcy consolidation is permissible.

Crucially, this mandatory, universal consolidation of the personal injury claims against *ND* could even include any future claim of an as-yet-uninjured victim, to the extent that a future claimant's related claim against *D* is a bankruptcy "claim" within the meaning of the Bankruptcy Code, eligible for a distribution and subject to discharge (and thus mandatory, universal aggregation) in *D*'s bankruptcy case. The inability to aggregate such future claims is one of the principal shortcomings of other aggregation devices. But bankruptcy has the means—entirely within its existing statutory structure—to aggregate not only future claims against the debtor, but also future claims against nondebtors via § 157(b)(5).

Under *Pacor*'s interpretation, which concludes that third-party "related to" bankruptcy jurisdiction is not supplemental jurisdiction, the absence of any federal bankruptcy jurisdiction over the tort claims against *ND* is an absolute nonstarter for a § 157(b)(5) consolidation. By correcting the severe systemic flaw that *Pacor* introduced into the critical infrastructure of federal bankruptcy jurisdiction, therefore, the Supreme Court would, in the process, also open the door to maximally effective § 157(b)(5) consolidations and aggregate settlements. Indeed, one of the prominent policy rationales for modern transactional supplemental jurisdiction is facilitating joinder of related claims in one court and, thereby, settlement of complex disputes. In fact, § 157(b)(5) consolidations would be an immensely more powerful and fairer centralization process than MDL consolidations.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.

The comprehensiveness of a § 157(b)(5) consolidation will be particularly appealing to nondebtor defendants, who would be the necessary drivers of the centralization process, through exhaustive removals and § 157(b)(5) consolidation motions. Even more importantly, § 157(b)(5) consolidations should prove more advantageous to tort claimants than MDL consolidations.

MDL consolidations are hamstrung by the inability of MDL transferee courts to try transferred cases without the consent of all parties. Moreover, remands to transferor courts for trial are exceedingly rare. MDL consolidations, therefore, have become a procedure focused almost exclusively upon settlement, in which plaintiffs cannot wield their most effective settlement cudgel: a credible threat of taking cases to trial. This "sharply skews the MDL bargaining process in favor of defendants." *Delaventura v. Columbia Acorn Tr.*, 417 F. Supp. 147, 153-54 (D. Mass. 2006). A § 157(b)(5) bankruptcy consolidation, by contrast, in which every personal injury claimant would have a statutory right to a jury trial on their claims against *ND* in the transferee federal district court (where *D*'s bankruptcy case is pending), could restore a more level playing field for both aggregate settlement negotiations with *ND* and resolution of residual "opt out" cases against *ND*.

CONCLUSION

. . . As a practical matter, the Supreme Court is the only institution that can put a stop to bankruptcy grifting, by prohibiting nonconsensual nondebtor releases. By reversing *Pacor*'s error, the Supreme Court can also pave the way for a fairer bankruptcy process for aggregate resolution of mass tort claims against nondebtors.

Copyright © 2023 Carolina Academic Press, LLC. All rights reserved.