

Written Testimony of Hon. Judith Klaswick Fitzgerald (Ret.)

Before the Senate Committee on the Judiciary, Subcommittee on Federal Courts, Oversight,
Agency Action and Federal Rights

“Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy”

February 8, 2022

3:00 P.M.

Witness Background Statement

The Honorable Judith Klaswick Fitzgerald is a retired United States Bankruptcy Judge who sat in the Western District of Pennsylvania from 1987 – 2013 and served as the Chief Judge for five years. She also sat by designation in the District of Delaware (20 years), the Eastern District of Pennsylvania (8 years) and the District of the U.S. Virgin Islands (9 years). While on the bench, she presided over more asbestos mass tort bankruptcy cases than any other bankruptcy judge.

Judge Fitzgerald is now a shareholder at the Pittsburgh-based law firm of Tucker Arensberg, P.C., and a Professor in the Practice of Law at the University of Pittsburgh School of Law where she teaches courses in Bankruptcy and Advanced Bankruptcy. She has also served as a Law Clerk, an Assistant United States Attorney and a tenured Professor of Law at Indiana Tech Law School, teaching courses in Contracts, Commercial Transactions and Bankruptcy. She is a co-author of Rutter's National Bankruptcy Practice Guide.

Judge Fitzgerald holds a J.D. from the University of Pittsburgh School of Law and both a B.S. (Psychology) and a B.A. (English Writing) from the University of Pittsburgh. Among other honors, she has been awarded the American Inns of Court Bankruptcy Alliance Distinguished Service Award and the Lawrence P. King Award for Excellence in the Field of Bankruptcy (Commercial Law League of America).

Judge Fitzgerald is a confidential consultant concerning bankruptcy matters, but not about the Texas Divisive Merger Statute, with law firms and parties, some of which have entered appearances in bankruptcy cases that arose from divisive mergers. She has not received any Federal grants or any compensation in connection with her testimony, and she is not testifying on behalf of any organization. The views expressed in her testimony are solely her own.

Witness Statement

Chairman Whitehouse, Ranking Member Kennedy and Members of The Committee on the Judiciary Subcommittee on Federal Courts, Oversight, Agency Action and Federal Rights:

Thank you for the opportunity to testify in your inquiry into “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” I am honored to appear before you, and to provide this written testimony.

In my testimony, I’ll describe some of the general goals of the Chapter 11 of the Bankruptcy Code,¹ as applicable here, and several features of the bankruptcy process related to today’s topic. I’ll then discuss the Texas Divisive Merger law, colloquially referred to as the “Texas Two-Step.” I’ll argue that the law can be beneficial in some contexts and abusive in others, and I will offer my own views from my experience and understanding of the interplay between the Texas Two-Step and bankruptcy.

Chapter 11²

Chapter 11 provides an “honest but unfortunate debtor”³ suffering financial distress the opportunity to reorganize its business, pay creditors and discharge unsecured claims that are not paid through the bankruptcy. The discharge is limited to the debtor.⁴ In the case of a Chapter 11 corporate debtor, to receive a discharge, the debtor must remain in business and retain all or substantially all of its property.⁵ Because bankruptcy is for the honest but unfortunate debtor, an entity must file its case in good faith. “To be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder— outside of bankruptcy.”⁶

A principal purpose of Chapter 11 in large corporate bankruptcy cases is to provide a collective solution to financial distress which enables a debtor to maximize the value of its estate to pay its creditors and/or to preserve going-concern value.⁷ Creditors want to be paid and understand that, outside the bankruptcy process, the first of them who wins the “race to the courthouse” may get paid. But late-comers are more likely to end up with nothing. Bankruptcy solves this problem by putting all of a debtor’s creditors into one collective forum to help a debtor remedy its financial concerns. Bankruptcy initially protects a struggling business by stopping its

¹ The Bankruptcy Code is codified as Title 11, U.S.C. § 101, *et. seq.*

² This section is not intended to address all of the purposes of bankruptcy. Rather, the intent is to focus on particular aspects relevant to my testimony.

³ The full quotation is: “[s]ince the Code limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor by exempting certain debts from discharge, it is unlikely that Congress would have fashioned a proof standard that favored an interest in giving the perpetrators of fraud a fresh start over an interest in protecting the victims of fraud.” *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 655, 112 L. Ed. 2d 755 (1991).

⁴ 11 U.S.C. § 524(e).

⁵ 11 U.S.C. § 1141(d)(3).

⁶ *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 129 (3d.Cir. 2004).

⁷ *See, e.g., In re Integrated Telecom Express, Inc.*, *supra*, note 6, 384 F.3d at 119-20 (3d.Cir. 2004) (*citing Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 453, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999)).

creditors from efforts to collect by imposing the automatic stay.⁸ The stay affords all parties time to (i) access information about the debtor’s business, assets and liabilities; (ii) assess what the debtor is worth and able to pay; and (iii) negotiate the most effective and efficient resolution of the debtor’s financial problems. Typically, the portions of unsecured claims that are not paid through the bankruptcy are discharged⁹ and the debtor is no longer responsible for their payment.

Bankruptcy provides a debtor with certain tools to assist in formulating a reorganization and paying creditors. As relevant here, the Bankruptcy Code has provisions that permit the debtor to claw back into the estate for distribution to classes of creditors payments that were made on the eve of bankruptcy to particular creditors (known as “preferences”)¹⁰ and to recapture payments from particular creditors who engaged in prebankruptcy transactions intended to defraud creditors or for which an insolvent debtor did not receive reasonably equivalent value. These actions are generally described, respectively, as “actual fraudulent conveyances”¹¹ and “constructive fraudulent conveyances.”¹² As the United States Supreme Court has stated: “Chapter 11 also embodies the general Code policy of maximizing the value of the bankruptcy estate.”¹³

Creditors benefit from bankruptcy because they will share in distributions from the debtor according to the priority provisions Congress has enacted. Rather than one or a few creditors capturing all of a debtor’s value, distributions are pro rata within each class. With respect to a valid claim, this distribution will occur without the necessity for a creditor to file suit, prove entitlement, chase the debtor to find assets, and spend time and money trying to collect.

At the risk of over-simplification, when the system is used as intended, bankruptcy provides appropriate remedies for debtor’s financial burden by giving creditors the debtor’s liquidation value or the distribution creditors negotiate. As the Court of Appeals for the Third Circuit noted: “Chapter 11 vests [debtors] 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.”¹⁴ These are appropriate when “financially troubled [debtors] seek a chance to remain in business . . . [b]ut this is not so when a [debtor’s] aims lie outside those of the Bankruptcy Code.”¹⁵ In other words, “[c]hapter 11 was not designed for the purpose of protecting assets and interests of non-debtor parties under the guise of a legitimate plan of reorganization.”¹⁶

The Texas Divisive Merger Law

As have other states, the State of Texas passed a statute by which corporations can merge or split their business operations. Texas enacted the Texas Business Corporation Act (“TBCA”)

⁸ 11 U.S.C. § 362.

⁹ 11 U.S.C. § § 524, 727, 1141(d).

¹⁰ 11 U.S.C. § 547.

¹¹ 11 U.S.C. § 548(a)(1)(A).

¹² 11 U.S.C. § 548(a)(1)(B).

¹³ *Toibb v. Radloff*, 501 U.S. 157, 163, 111 S. Ct. 2197, 2201, 115 L. Ed. 2d 145 (1991).

¹⁴ *In re SGL Carbon Corp.*, 200 F.3d 154, 164 (3d Cir. 1999). Note that the opinion uses the term “bankruptcy petitioner” or “petitioner” to refer to the debtor.

¹⁵ *Id.* at 165.

¹⁶ *In re Davis Heritage GP Holdings, LLC*, 443 B.R. 448, 462 (Bankr. N.D. Fla. 2011).

in 1989 which changed the definition of a merger.¹⁷ The goal of the legislature was to modernize and streamline the merger provisions, and make Texas's merger provisions attractive among jurisdictions.¹⁸ Through the TBCA, it is now possible to divide a single corporation into two or more entities.¹⁹ The main goal of adding the divisive merger provisions to the TBCA was to allow Texas corporations greater flexibility in effectuating restructuring and merger transactions.²⁰

There are two relevant features of the Texas law which have enabled corporations to split into two entities, one that takes the troublesome liabilities with few assets (“BadCo”) and the other that takes the vast majority of assets with few liabilities (“GoodCo”).

First:

(a) When a merger takes effect:

(1) the separate existence of each domestic entity that is a party to the merger, other than a surviving or new domestic entity, ceases;

(2) all rights, title, and interests to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger without:

(A) reversion or impairment;

(B) any further act or deed; or

(C) any transfer²¹ or assignment having occurred;

(3) all liabilities and obligations of each organization that is a party to the merger are allocated to one or more of the surviving or new organizations in the manner provided by the plan of merger;

(4) each surviving or new domestic organization to which a liability or obligation is allocated under the plan of merger is the primary obligor for the liability or obligation, and, except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-code organization created under the plan of merger is liable for the debt or other obligation;

¹⁷ H.B. 472, 1989 Leg., 71st Reg. Sess., at 23 (Tex. 1989).

¹⁸ Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109, 110–11 (1989).

¹⁹ *Id.* at 110.

²⁰ *Id.* at 115-16.

²¹ A transfer is defined as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance. The term does not include a transfer under a disclaimer filed under Chapter 240, Property Code.” Tex. Bus. & Com. Code Ann. § 24.002.

...²²

Second:

This code does not affect, nullify, or repeal the antitrust laws or abridge any right or rights of any creditor under existing laws.²³

There are legitimate business reasons why a corporation may want to implement a divisive merger. The difficulty is not with the statute itself or its use as a proper business tool. The difficulty comes into play when BadCo, the company vested with the liabilities, seeks bankruptcy relief while GoodCo, the Company that received the assets, does not. As a bankruptcy judge with over 25 years' experience with mass tort cases and now as consultant in the system across all constituencies (debtors, creditors and trusts), I am aware of the perceived unfairness of this type of action, which is seen as gaming the system when a divisive merger is followed by a bankruptcy of only BadCo.

The Interplay Between Bankruptcy Law and the Texas Divisive Merger Law

To understand the problems that can arise when BadCo files bankruptcy but GoodCo does not, it is important to understand that the bankruptcy court has jurisdiction over the assets (i.e., property of the estate) and liabilities of the debtor as they exist on the day the case is filed. The assets and liabilities that will be disclosed in the bankruptcy schedules and statement of financial affairs are those of the debtor, and *only* those of the debtor. The court has no jurisdiction over property of a non-debtor or over claims that lie solely against the non-debtor.

Absent the divisive merger, the original company ("OldCo") that instituted the divisive merger, would retain all the assets and all the liabilities. Should OldCo file bankruptcy, all of OldCo's assets and liabilities would be listed in its filed pleadings, and the bankruptcy court would have jurisdiction over all. But the divisive merger separates out the assets from the liabilities. It permits OldCo to create GoodCo, which will keep the major assets, and BadCo, which will get the liabilities and nominal assets. Then, when BadCo files bankruptcy, all that is disclosed to the bankruptcy court and parties are the assets and liabilities of BadCo. This step shelters GoodCo's assets from oversight.

The BadCo companies that have filed bankruptcy to date generally have had no business operations; few, if any, employees to protect; and insufficient assets to pay the claims, as BadCo's purpose is solely to hold the liabilities and to file bankruptcy. Typically, a BadCo debtor takes steps to have the automatic stay applied to GoodCo and other affiliates and/or to have an injunction entered in favor of those affiliates to prevent creditors from pursuing their claims against the non-debtor parties. This further shelters GoodCo's assets as there is no corresponding request to stop GoodCo from depleting its assets as it chooses.

Although GoodCo receives benefits by BadCo's bankruptcy, there is nothing in the Bankruptcy Code that requires GoodCo to divulge its assets or net worth, even though GoodCo's

²² Tex. Bus. Orgs. Code Ann. § 10.008 (West).

²³ Tex. Bus. Orgs. Code Ann. § 10.901 (West).

creation was the flip-side of the transaction that left BadCo holding the bag of creditor claims. The effect is that the bankruptcy judge cannot preside over the case the same way she would have, had the split not occurred and had OldCo filed bankruptcy. Without the split, all the assets and liabilities would be in the same company, and all would have to be disclosed in the bankruptcy schedules under penalty of perjury. With the split, only BadCo reveals what it owns and what it owes. In addition, no creditor or party in interest can see any information about GoodCo, because it will not be part of the court record.

As I mentioned, bankruptcy law offers debtors methods of recapturing assets that were transferred fraudulently. However, a BadCo debtor has no incentive to undertake any action to recover the assets. BadCo is still part of the original corporate family and typically has a board and officers that are controlled by a legacy company. That board is unlikely to take action against the company that undertook the divisive merger or its parent or affiliates. Even if a court authorized a creditors' committee, in lieu of a debtor, to bring an action, there is a long delay before any fraudulent transfer litigation gets underway and discovery battles are fought. This type of litigation is time-consuming and costly, which disincentivizes efforts to claw back the assets. That disincentive provides substantial leverage to the debtor to negotiate settlements that pay creditors - who of course want to be paid for their claims - cents on a dollar rather than the full value of their claims.

At the same time, the automatic stay is still in place, and the ensuing delay in any effort to recover the transfers is itself harmful to creditors. In the mass tort context, delay is even more harmful to creditors where thousands of individuals are sick and many die while the bankruptcy goes on, often resulting in a total loss of ability of the injured party to receive compensation. A review of the dockets in several of the Texas Two-Step bankruptcy cases indicates that there is delay in the cases resulting from disputes over efforts to relieve non-debtor parties of asserted liabilities without undergoing their own bankruptcies. The sick and dying claimants receive nothing until a plan is confirmed, so the longer the case runs without a confirmed plan, the longer it takes to provide victims with compensation.

Efforts to recoup the assets left in GoodCo are further complicated when BadCo was formed under the Texas statute, because the statute states that there is no transfer in a divisive merger,²⁴ even though the assets and liabilities are clearly moved from one company into two.²⁵ Bankruptcy law looks askance at prebankruptcy maneuvers by a debtor that prejudice or harm the creditors. However, the currently available options that creditors have are not adequate to reverse the harm when they can look only to BadCo for payment.

²⁴ Tex. Bus. Orgs. Code Ann. § 10.008(a)(2)(C) (West).

²⁵ The Texas statute also says that the split does not jeopardize the rights of creditors. To date, I have not found a case that reconciles these provisions or explains how a creditor can pursue efforts to reclaim assets under a fraudulent transfer theory when the statute defines the transaction as though there were no transfer. *But see In re Aldrich Pump, LLC*, 2021 WL 3729335 (Bankr. W.D. N.C. Aug. 23, 2021) (discussing the issue).

LTL Management LLC

The LTL Management LLC bankruptcy²⁶ has been pointed out by one scholar as an illustration of the financial harm that mass tort creditors face when only BadCo files bankruptcy.²⁷ LTL is the “BadCo” entity that was formed when Johnson & Johnson Consumer, Inc. (“JJCI”), a subsidiary of Johnson & Johnson (“J&J”), used the Texas Divisive Merger law to temporarily move into Texas and split into what eventually became LTL and [New] JJCI (the “GoodCo”).²⁸

[New] JJCI received all of the assets – except those put into LTL – and none of the talc liabilities. LTL had no employees, no business office of its own, no business at all, was undercapitalized with approximately \$2 billion in assets, and received all 38,000+ talc claims, “which could climb into the tens of billions of dollars.”²⁹ The assets were equity in Royalty A&M, which owns the right to receive the proceeds of certain royalty streams (but not to renegotiate or otherwise alter the underlying royalty agreements), some cash, insurance, and a promise from JJCI and J&J, assuming that LTL can confirm a plan, to fund a trust to pay talc victims up to the value of New JJCI, which has been stated at different amounts in different proceedings but is possibly worth \$60 billion.

In other words, [New] JJCI is worth about \$60 billion and has none of the billions of dollars of liability for talc-related debt that the original JJCI held, whereas LTL has all of the billions in talc debt and only \$2 billion in assets.³⁰

LTL filed bankruptcy two days after it was incorporated, but [New] JJCI did not *and has not* filed, leaving the court with jurisdiction over \$2 billion in assets. That \$2 billion in assets would have been \$62 billion if both BadCo LTL and GoodCo [New] JJCI had filed. The effect, in essence, enables J&J (a solvent and well-capitalized company with a reported net worth as of February 4, 2022 of \$454.81 billion)³¹ to avoid subjecting itself to bankruptcy court oversight

²⁶ Bankruptcy Case No. 21-30589 (MBK) pending in the District of New Jersey. In essence, in October 2021, J&J, through JJCI, performed a series of transactions under Texas law that dissolved JJCI and resulted in two entities: (i) LTL, which succeeded to all of Old JJCI’s talc-related liabilities and received limited assets; and (ii) [New] JJCI, which received Old JJCI’s most valuable assets.

²⁷ See, *inter alia*, Michael A. Francus, *Texas Two-Stepping Out of Bankruptcy*, Michigan Law Review Online (Jan. 20, 2022), <https://ssrn.com/abstract=4021502>.

²⁸ Once the divisive merger was accomplished, LTL and [New] JJCI left Texas. LTL became a North Carolina entity and [New] JJCI went back to New Jersey. For a description of the complex transactions that led to the formation of LTL and [New] JJCI, see David Warfield, *Johnson & Johnson: The Texas two-step and talc-related liabilities*, Thompson Coburn LLP (Nov. 23, 2021), <https://www.jdsupra.com/legalnews/johnson-johnson-the-texas-two-step-and-9551060/>.

²⁹ Vince Sullivan, *Resistance to J&J’s Bankruptcy Gambit May Be Futile*, Law360 (Oct. 15, 2021 6:10 PM EDT), <https://www.law360.com/health/articles/1431485>.

³⁰ One commentator explains the asset transfer under the divisive merger as: “When the dust settled, the Debtor LLC was responsible for all talc-related liabilities, and New JJCI owned all non-talc assets and was responsible for non-talc liabilities. To be sure, the divisive merger did not leave the Debtor LLC saddled with all of the talc liabilities without any assets whatsoever. The Debtor LLC estimated in its bankruptcy filing that it holds \$373.1 million in assets due to the allocation made in the divisive merger. Moreover, New JJCI has agreed to fund the Debtor LLC’s Chapter 11 case and contribute \$2 billion into a settlement trust for the benefit of the talc claimants as part of a Chapter 11 reorganization plan.” Warfield, *supra*, note 28.

³¹ Johnson & Johnson Net Worth 2006-2021 | JNJ, Macrotrends (Feb. 5, 2022), <https://www.macrotrends.net/stocks/charts/JNJ/johnson-johnson/net-worth>.

while relieving itself of any liability for claims based on use of J&J's talc products. LTL has no reorganizational purpose because it has no business to reorganize. The bankruptcy was not initiated to maximize LTL's assets for the benefit of the talc claims transferred into it; the assets are insufficient to pay those claims. There is no need to preserve LTL's going-concern value because it is not a going concern. LTL was created solely to protect J&J, and to accomplish that goal by filing bankruptcy and obtaining the extension of the automatic stay, a channeling injunction, and non-debtor third party releases for J&J's benefit – all without J&J acknowledging responsibility or liability for talc claims.³²

Moreover, LTL's bankruptcy is not like other mass tort bankruptcies. LTL's bankruptcy is enabling J&J as an alleged tortfeasor in its own right to escape accountability for its tortious conduct. In the case of a debtor who acknowledges responsibility for manufacturing or distributing hazardous products, the bankruptcy does not become a shield behind which the company hides. There, the debtor has disclosed its conduct, the problems with its product, its assets and its liabilities for the world to see. It pays the price of reputational injury and must address the concerns of its workforce and its lenders and stockholders. It pays fees to the United States Trustee and files monthly operating reports. It bears the cost of all professional assistance to other parties such as the creditors' committees and the future claims representative – and these costs often run into the tens of millions of dollars. These, and others, are real burdens that are part of the price for the benefits bankruptcy offers to debtors.

But in the case of LTL, J&J and [New] JJCI are not subject to any of those burdens. As noted, J&J denies that its talc contained asbestos and claims its products were safe. Nonetheless, it saw the need to vest all that liability in LTL without vesting sufficient assets to pay it, and to escape resolution of its liability and defenses in the tort system. If J&J is correct that its products did not contain asbestos and were safe, then creating a GoodCo and a BadCo to shield GoodCo and J&J from any liability represents deep skepticism in the validity of litigation to determine the facts.

³¹ *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

³² J&J has continually denied that its talc products contain asbestos and cause ovarian cancer or mesothelioma. *See, inter alia*, Tucker Higgins, POLITICS, *Supreme Court rejects Johnson & Johnson's appeal of \$2 billion penalty in baby powder cancer case*, (Jun. 1 2021 10:40 am EDT Updated, Jun. 1 2021 12:36 pm EDT) <https://www.cnbc.com/2021/06/01/supreme-court-rejects-johnson-johnsons-appeal-of-2-billion-baby-powder-penalty.html> (Quoting J&J: "Decades of independent scientific evaluations confirm Johnson's Baby Powder is safe, does not contain asbestos, and does not cause cancer."); Brian Mann, *J&J is using a bankruptcy maneuver to block lawsuits over baby powder cancer claims* (October 21, 2021 2:11 pm ET) <https://www.npr.org/2021/10/21/1047828535/baby-powder-cancer-johnson-johnson-bankruptcy> ("In 2018, separate investigations by Reuters and The New York Times revealed documents showing Johnson & Johnson fretted for decades that small amounts of asbestos lurked in its baby powder, without telling regulators. J&J has repeatedly denied the claim. . .").

J&J contends that its talc products are safe. *See* Johnson & Johnson Form 10-Q (Oct. 29, 2021) at p. 31, available at <https://johnsonandjohnson.gcs-web.com/static-files/511bb3de-22b0-4acb-b9d4-b016599f1d90>. However, rather than defending its position through litigation, J&J took the steps that led to LTL's bankruptcy. Immediately after it filed and without first filing a pleading seeking to extend the stay to J&J, LTL filed notices "in thousands of pending tort cases around the country" that all claims against [New] JJCI and J&J were also stayed. *See* Objection To Debtor's Emergency Motion To Enforce The Automatic Stay Against Talc Claimants Who Seek To Pursue Their Claims Against The Debtor And Its Non-Debtor Affiliates, In re LTL Management, Inc., Case 21-30589-MBK, Doc. 53 at ¶ 2.

Perceived or actual corporate misbehavior that harms real people, and abuse of the bankruptcy process, are really what the issues center on; *i.e.*, the use of a statute by a well-capitalized company, not for legitimate business purposes, but to avoid the consequences of prior business practices without enduring the ramifications that flow from bankruptcy jurisdiction and oversight. As Judge Friendly noted years ago, “[t]he conduct of bankruptcy cases not only should be right but must seem right.”³³ Of paramount concern to judges and legislators alike is preserving the integrity of the bankruptcy process and assuring that all parties who come before the bankruptcy courts are assured of due process in cases filed by debtors acting in good faith. If the pre-merger company is so inundated with claims from victims of the company’s wrongdoing that it faces economic ruin, it should use the statute that Congress has passed and file its own bankruptcy - put its assets and its liabilities up for public scrutiny and court supervision. If that company wants the benefits that Congress has provided through the bankruptcy system, then it should shoulder the burdens that Congress has imposed on debtors. The bankruptcy system should not be used by a non-debtor as an artifice or stratagem to escape the requirements Congress has instituted to relieve the honest but unfortunate debtor from true financial woes.

Personally Injured Tort Claimants

When a bankruptcy is filed, the automatic stay³⁴ protects a debtor against litigation while the bankruptcy progresses. Stopping efforts to litigate against the debtor is what filing bankruptcy does for the debtor, and sometimes, on court order, for affiliates and others that may have co-liability with the debtor. The effect of extending the stay to non-debtors deprives creditors of the ability to test the validity of their claims of independent liability against the non-debtors. LTL, as the debtor, was entitled to the operation of the automatic stay and successfully convinced the court that the stay should also apply to [New] JJCI and J&J. But in LTL, not only was litigation stopped against [New] JJCI and J&J, but an additional 670 entities benefitted from the ruling without any evidence of record as to why each and every one of 670 entities needed the automatic stay extended to them. To be clear, there was evidence produced in court, but that evidence was general evidence, not evidence that specifically related to each of the 670 entities. Although creditors were prohibited from pursuing claims against 670 third-party non-debtors, none of those parties was prohibited from transferring its money and other assets to other creditors or corporate affiliates. This one-sided protection benefitted no creditors at all.

Because LTL successfully had the court extend the automatic stay and issue a preliminary injunction preventing actions against [New] JJCI, J&J, and 670 other entities, the talc victims have not had many opportunities in the state trial courts or in the MDL pending in New Jersey to prove J&J’s or [New] JJCI’s responsibility for the illnesses that they allege. Trials are important. One successful litigant³⁵ before LTL filed bankruptcy received a judgment of \$4.69 billion³⁶ on behalf

³³ *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

³⁴ 11 U.S.C. § 362.

³⁵ *See Ingham v. Johnson & Johnson*, 608 S.W.3d 664, 724-25 (Mo. App. E.D. 2020).

³⁶ This judgment contrasts with J&J and [New] JJCI’s promises to put an initial \$2 billion into a trust formed pursuant to a confirmed LTL plan for payment of 38,000 talc claims that now reside in LTL and future claims.

of 22 talc victims and their families.³⁷ In June of 2021, the Supreme Court denied a petition for certiorari³⁸ of the reduced award, which was \$500 million in actual damages against Old JJCI, \$125 million against J&J jointly and severally with Old JJCI, \$900 million in punitive damages against Old JJCI, and \$715,909,091 in punitive damages against J&J (a total exceeding \$2.1 billion, which J&J paid).³⁹ LTL was formed in October 2021 for the specific purpose of filing bankruptcy to form a trust that would pay talc victims through a limited fund.

One impetus to reorganizing in bankruptcy is to bring into the bankruptcy estate all claims against the debtor, so that the debtor can address them all as part of its reorganization. Not many creditors are pleased to be in that situation, but the situation is fairer than a race to the courthouse would be. Having a single adjudicative forum is necessary to make bankruptcy effective and to have whatever assets can be liquidated to pay claims made available to creditors on a fair basis. To the extent that creditors are left with recovering from the debtor's assets, that is the policy choice Congress has made to keep our economy going and return the distributable value of the debtor to creditors, all conducted under the bright sunshine of public scrutiny with robust disclosure regarding assets and liabilities. None of that, however, is disclosed by the GoodCo that gets the assets in a divisive merger and stays out of bankruptcy, or by any other affiliates.

The bankruptcy estate is limited to property of and claims against the debtor. When a debtor or a creditor tries to add in claims that lie solely against non-debtor entities, those claims must be disallowed.⁴⁰ And there is a real, practical downside to efforts to include claims against non-debtors. The third parties who tag along with the debtor but who never have to account for what they actually are able to contribute, and who get released as part of confirmation, get off the hook, while the person who was injured or who contracted cancer has lost the ability to prove the claim against the third parties and recover from them. Even with contributions to fund the plan coming from third parties, tort victims are not paid 100% of what they could prove they are owed if they succeeded at trial. Bankruptcy settlements of mass tort claims resolve all of them, collectively, so that everyone in the class of tort claimants essentially is able to recover the same amount as everyone else who has the same type of claim. When the tort claimants agree to that resolution, a plan that structures the payments can be confirmed.

The economic impact of imposing releases on victims who do not agree to give up their rights against a non-debtor but who will not be fully compensated - despite losing their opportunity to sue the non-debtor entity - is not the subject of much commentary. But it should be, and these hearings are an appropriate forum to discuss the issue. For example, if a talc victim contracts ovarian cancer and dies, her children will be left without a mother and potentially without a means to survive other than on the public dole. And even if the woman does not die immediately, if she has inadequate health insurance or none at all, society at large may bear responsibility to pay for

³⁷ Daniel Fisher, *A Bale Of Hay And A Block Of Cheese: How Mark Lanier Won \$4.7 Billion Talcum Powder Verdict*, Forbes (Oct. 3, 2018, 6:10am EDT), <https://www.forbes.com/sites/legalnewsline/2018/10/03/a-bale-of-hay-and-a-block-of-cheese-how-mark-lanier-won-4-7-billion-talcum-powder-verdict/?sh=7c792cc31c10>.

³⁸ *Johnson & Johnson v. Ingham*, 141 S. Ct. 2716, 210 L. Ed. 2d 879 (2021).

³⁹ *Johnson & Johnson Form 10-Q* (Oct. 29, 2021), at p. 31, available at <https://johnsonandjohnson.gcs-web.com/static-files/511bb3de-22b0-4acb-b9d4-b016599f1d90>.

⁴⁰ 11 U.S.C. § 502(b)(1).

her treatment, care and eventual funeral. The emotional cost to children and survivors of the deceased is unmeasurable. That strain can only be magnified if putting food on the table is part of their loss.

The bankruptcy of BadCo, resulting from a divisive merger, is intentionally designed to be an end run around Congressional policies requiring (i) full disclosure and transparency and (ii) making use of the bankruptcy process available to the honest but unfortunate debtor. It has enabled solvent companies to reap the benefits of bankruptcy without bearing any of its burdens. It affords an escape from accountability by the entities who are responsible for the harms caused and able to pay for them. It delays or entirely eliminates the ability of injured people to pursue non-debtors who are alleged to be independently liable for the injuries. It removes assets from the purview of the court, which, absent the merger, would have been part of the bankruptcy estate.

Brain-storming Remedies

The focus of my testimony is to identify some of the problems that can arise when BadCo files bankruptcy. If Congress determines that there are abuses that should be corrected, there are possible solutions. The bankruptcy process depends on transparency. Requiring more transparency, examining the practice of extending the automatic stay to non-debtors, or limiting BadCo's eligibility to be a debtor are possible subjects to begin a conversation. For example, Congress could consider:

1 - requiring GoodCo to file the same schedules and statement of financial affairs that BadCo must file to help assure transparency in the bankruptcy process;

2 - limiting the ability of a BadCo to file bankruptcy for a set period of time after undergoing a divisive merger, in order to help assure that the purpose of the divisive merger is something other than avoiding (i) OldCo's liability to creditors and (ii) any oversight of the bankruptcy system;

3 - requiring specific proof as to each and every entity that the debtor asks to benefit from an extension of the automatic stay or issuance of a temporary or preliminary injunction, supported by findings of fact and conclusions of law regarding, *inter alia*, each such entity's relationship with the debtor, *what the entity will contribute to the bankruptcy*, and why granting this privilege to each such entity is necessary to the debtor's reorganization; or

4 - amending the automatic stay to clarify that, by operation of law, the stay applies only to a debtor and extending it to any other entity requires court approval after notice, served on all parties, and a hearing.

These are just a few of the many possibilities that Congress could explore. The ideas provided here certainly require more nuanced discussion and analysis to assess their viability and any unintended consequences. But any Congressional action would be a first step and send a signal that Congress recognized a problem that harms the people Congress serves, and addressed it.

Conclusion

When a BadCo entity formed as the result of a divisive merger files bankruptcy, creditors can be harmed by the inability to pursue all of the assets that the original company held. The Bankruptcy Code does not require GoodCo (the entity that received the valuable assets without any of the associated liabilities) to make the types of disclosures that are required of a debtor. The lack of disclosure and the inadequacy of available bankruptcy tools to recover the assets placed into GoodCo are worthy subjects for review. The end-run around bankruptcy laws that Congress has enacted – an end-run by well-capitalized non-debtors who tag along with a debtor created solely for the purpose of filing bankruptcy - is ripe for discussion. The Bankruptcy Code should not be used in ways that violate the very principles that Congress, through the Bankruptcy Code, has established.