Tort Reform, Texas-Two Step Style

A new style of unabashedly sleazy legal wrangling borrows its moniker from a fun, one-step country foxtrot

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In the proper setting, the Texas Two-Step is a fun, upbeat partners' dance with a "leader" and a "follower." When done in the court room, it is an unimaginable debacle in which the leaders are large corporate law firms and the followers are their multi-billion-dollar corporate clients seeking to avoid responsibility.

This sad "two-step" scene plays out in bankruptcy courts all around the country regularly. For example, to date, the Jones Day law firm has received in excess of $60 million in just court-approved fees from their representation in Texas two-step cases, as reported by Financial Times. Likewise, at the time of the Johnson & Johnson Bankruptcy filing, the company was worth almost a half a trillion dollars.

In recent years, numerous companies have followed the lead of mega firm Jones Day by waltzing into court and using the bankruptcy code -- as both a shield and sword -- to absolve themselves of billions of dollars of liability. The process works as follows: Johnson & Johnson Consumer, Inc., with substantial talcum powder liabilities, forms a new Texas subsidiary ("BadCo") and transfers their liabilities to the new subsidiary through a divisive merger. An additional subsidiary is forced to hold the assets ("GoodCo"). "BadCo" (LTL Management, LLC) then goes to North Carolina and files for Bankruptcy, while "GoodCo" returns to New Jersey with all the assets to continue with business as usual.

Now, this is not to say GoodCo gets away scot-free as there is often a funding agreement between GoodCo and BadCo with the stated intention of assuring the creditors of BadCo receive the same amount had the divisive merger not occurred. In fact,Texas law requires a divisive merger not abridge any right or rights of any creditor under existing laws." See Tex. Bus. Orgs. Code § 10.901. This statute was created to allow companies to continue operating while dealing with their liabilities. However, the way companies use it today defies what the legislature itended in 1989 when it was created. "Had we known in 1989 that provisions could be dubiously interpreted for entities to avoid known liabilities such as those causing severe and permanent injuries and deaths, it would never have passed with the "Texas two-step," said Steven Wolens, a former Texan lawmaker who wrote the bill. Curtis Huff, a former member of the Corporation Law Committee of the Texas State Bar that initially drafted the divisive merger amendments, said they were intended to create a more flexible business environment in Texas, not as a way to enable companies to avoid liabilities. While the concept of a funding agreement seems reasonable, the sole enforcer of the funding agreement is the debtor who is the newly formed subsidiary of the parent corporation. Therefore, in practical application, it fails to have any enforceability at all.

An additional and important benefit the parent company receives is a stay in all litigation proceedings. As a result, the parent company no longer must defend individual actions while the bankruptcy is pending, thus saving the company tens and sometimes hundreds of millions of dollars in legal fees. As we look at the stay issue as it relates to J&J, a unique issue arises that may not be found in all Texas two-step actions. In the underlying talcum powder cases, allegations are made as to the actions of not only Johnson & Johnson Consumer, Inc., the subsidiary that did the divisive merger, but also as to the actions of the parent Johnson & Johnson, Inc. While the bankruptcy stay certainly applies to Johnson & Johnson Consumer, Inc., it is arguable that the stay should apply to Johnson & Johnson, Inc. given their own sperate and distinct liabilities from the subsidiary. However, to date a stay remains in place as to both the subsidiary and parent.

What can be done to counter this maneuver? The first line of defense in the courtroom is a Motion to Dismiss. In February 2022, a weeklong mini-trial was help in front of Judge Michael Kaplan in New Jersey Federal Bankruptcy Court for the Johnson & Johnson/LTL bankruptcy. The attorneys at Bailey, Glasser, LLP along with co-counsel from Brown, Rudnick, LLP prosecuted the Motion to Dismiss trial to have the bankruptcy thrown out on grounds of bad faith. While there are numerus factors to look at in determining bad faith, the essence of the matter is the debtors must show that bankruptcy was not filed solely for a litigation tactic or that they were in financial distress at the time of filing.

The Creditors' Motion to Dismiss the bankruptcy centered on several points: It argued the bankruptcy (a) served no legitimate purpose, (b) was designed to provide a litigation advantage for non-debtors, (c) served only to deprive one group of creditors of access to assets available to satisfy their claims, and (d) sought to manipulate Texas law and the Bankruptcy Code in order to shield the Debtor's healthy non-debtor affiliates from direct and indirect tort liability, which J&J had admitted it was capable of paying.

Judge Kaplan issued his 56-page opinion on Feb. 25, 2022, just one week after the close of the trial. In the order Judge Kaplan took a policy approach to arriving at a decision. "No one can deny that there are situations in which tools and strategies have been abused and warrant critical review. Unfortunately, however, these commentators choose to focus on the limited failings of the system, as opposed to its innumerable successes. Every one of the Court's 370-plus colleagues on the bankruptcy bench can point to successful case outcomes where large and small businesses are reorganized, productive business relationships are maintained, jobs preserved and, most importantly, meaningful returns distributed to creditors—all in situations where outside of the bank-ruptcy system there would be fewer if any identifiable benefits, and the parties left to expensive and time-consuming litigation," Judge Kaplan said in his order. Further, Judge Kaplan held,"[a] strong conviction that the bankruptcy court is the optimal venue for redressing the harms of both present and future talc claimants in this case - ensuring a meaningful, timely, and equitable recovery." The judge said he "simply cannot accept the premise that continued litigation in state and federal courts serves best the interest of their constituency."

A bankruptcy court's responsibility is to apply the law and not to set policy. As this matter goes up on appeal, one of the key issues will be a plaintiff's right to a trial by jury. The trial by jury right as expressed in the 7th Amendment sits as the corner stone for which our legal system is based. To deny parties the right to trial by jury would place the entire legal system into jeopardy.

Dean Chemerinsky succinctly conveyed this notion to the court in the Amicus brief he filed in stating, "[Congress] lacks the power to strip parties contesting matters of private right of their constitutional right to a trial by jury" by assigning them to a bankruptcy court. *Granfinanciera, 492 U.S. at 51-52*. "[L]egal claims are not magically converted into equitable issues by their presentation to a court of equity," *Ross v. Bernhard, 396 U.S. 531, 538 (1970)*, "nor can Congress conjure away the Seventh Amendment by mandating that traditional legal claims be brought there or taken to an administrative tribunal." *Granfinanciera, 492 U.S. at 53-55* (holding that fraudulent conveyance action was a "private right" that was "not closely intertwined with a federal regulatory program" and had to be decided "by an Article III court"); see also *Beard v. Braunstein, 914 F.2d 434, 439-40 (3d Cir. 1990)*; cf. *Northern Pipeline, 458 U.S. at 90-91 (Rehnquist, J., concurring)*.

Coupling the violation of the 7th Amendment with the trouncing of due process rights ensured by the 14th Amendment cannot be allowed to stand. By using this sham bankruptcy process to force upon claimants a recovery through the bankruptcy system, to which they have not agreed or sought out, is not justice and is not what the framers of the constitution intended.

Proponents of the Texas two-step, in accord with Judge Kaplan's ruling, point to the bankruptcy system being fairer to the creditors, ensuring everyone receives a similar outcome. In addition, they argue the process creates a timelier resolution of litigation. However, one need not look too far for examples of bankruptcy claims involving personal injuries that have lasted must longer than the average civil court litigation. By way of example, in another Texas two-step bankruptcy, Certainteed filed for bankruptcy protection in 2017 as the created-for-bankruptcy-only entity "Bestwall." Five years later the bankruptcy is still pending with no end in sight. Consider also the Pittsburgh Corning Corporation Bankruptcy. Pittsburgh Corning filed for bankruptcy in 2000, did not begin accepting claims until 2017. and only started paying claimants in 2020. This clearly is not a process that provides expedient resolution.

While this process is highlighted by a multi-national, mega-corporation in the Johnson and Johnson scenario, it has application to every personal injury victim in the country. Setting aside the hundreds of thousands of individuals harmed by products every year, this process has the real possibility of being applied across the board to tortfeasors. If this process is allowed to become a viable solution for defendants facing lawsuits, there is nothing to stop trucking companies, medical facilities, nursing homes, etc. from using the tactic. Trucking companies need only set up a structure in a manner where they can divide their individual units from the parent, bankrupt the liability holding entity,

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and proceed along with business as usual. Individuals harmed by the actions of another deserve better, they deserve the right to go into court and confront the defendant, to have their day in court and to hold wrongdoers truly and wholly responsible.

An equally important line of defense is legislation. In Nov. 2021, the US Senate sent a letter to Johnson and Johnson stating the following: "A fundamental principle of our legal system is that people who have been harmed due to fraud, intentional misrepresentation, or the marketing and distribution of dangerous products have a right to seek restitution. An equally important principle is that people or corporations facing such claims have a right to defend themselves. However, in this case, Johnson & Johnson is not presenting a defense or objecting to the claims on their merits. Rather, it is attempting to deny tens of thousands of people their day in court by offloading its talc liabilities onto a new company created exclusively to protect Johnson & Johnson's assets and leave cancer victim claimants with pennies on the dollar…"

A few days before the Motion to Dismiss trial in the JNJ/LTL bankruptcy began, the Senate Judiciary Committee's Subcommittee of Federal Courts, Oversight, Agency Action, and Federal Rights held a hearing to discuss this critical issue. The Committee headed by Sen. Richard Durbin (D-IL.) heard testimony from both sides of the conflict including a former bankruptcy judge, bankruptcy law practitioner, a law professor and a mesothelioma claimant. The Nondebtor Release Prohibition Act would require "bankruptcy judges to dismiss cases filed by entities that have taken on liabilities in a divisional merger within 10 years before the filing." Sen. Durbin correctly pointed out, "There's a justice system for rich people and powerful corporations—and there's the system for everyone else, and many days, it seems that the gulf between those two systems of justice is getting wider and deeper."

Finally, as practitioners there are a few things that can be done to circumvent this type of abuse. Complaints need to be drafted to capture all wrongdoers, not just some of their entities or subsidiaries. If the parent corporation has their own wrongful conduct, that needs to be spelled out. Relying simply on a respondeat superior theory is not enough. Making certain that discovery is tailored to the specific case and not relying upon "canned" discovery requests will serve the practitioner well in solidifying facts. Most importantly, after developing the facts, the complaint must be amended to add proof of the independent liability. Finally, the practitioner must be committed to the legislative process and fighting side by side with the representatives to permanently cure this flawed process.