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The 2024 Nancy C. Dreher Lecture on Bankruptcy Law and Practice

TOO SOLVENT TO BE IN BANKRUPTCY COURT?

James L. Baillie and Katherine A. Nixon*

The following are "Cliff Notes" on bankruptcy concepts that underlie this program. Additionally, attached is a copy of an article from the Fredrikson & Byron, P.A. *Restructuring Report*[1] that was the basis for choosing this topic for the April 16, 2024 Nancy C. Dreher Lecture on Bankruptcy Law and Practice.

The topic primarily stems from a decision of the Third Circuit Court of Appeals which dismissed a bankruptcy case after finding that the debtor, LTL Management, did not have sufficient financial distress to continue its chapter 11 case. *See In re LTL Mgmt., LLC*, 64 F.4th 84, 93 (3d Cir. 2023).

FRAUDULENT TRANSFER / FRAUDULENT CONVEYANCE. A transfer from a debtor may be recovered from the transferee if the transfer was made with actual intent to hinder, delay, or defraud creditors (actual fraud). 11 U.S.C. §§ 548(a)(1)(A) and 550. Similarly, a transfer from a debtor who is insolvent or is made insolvent by the transfer may be recovered from the transferee if the consideration for the transfer was less than the reasonably equivalent value of the property transferred (constructive fraud). *Id.* §§ 548(a)(1)(B) and 550. State statutes also have a similar scheme. In Minnesota, the relevant statutory scheme is referred to as the Minnesota Uniform Voidable Transactions Act ("MUVTA"). *See* Minn. Stat. §§ 513.44–.45.

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[1] In hindsight, the authors would modify the title of the article as its clear a petition can be filed. The question is whether the debtor's bankruptcy case is allowed to proceed.

PREFERENCES. The Bankruptcy Code provides for the recovery of transfers made within a short time before the filing of a bankruptcy case even when the transfer was made in payment of a legitimate debt on the theory that the transferees were unfairly preferred. 11 U.S.C. §§ 547 and 550. State laws also sometimes provide for the recovery of preferences but are usually not as comprehensive as the Bankruptcy Code.

PONZI SCHEME. The perpetrator of a Ponzi scheme may receive investments or deposits from persons who expect to be able to withdraw their investments together with earnings. However, repayments are made with later investments made by other victims and not from earnings, which are not enough to support the withdrawals. The largest and most famous Ponzi scheme was perpetrated by Bernie Madoff. A very large Ponzi scheme in Minnesota was perpetrated by Thomas Petters. In a bankruptcy case, litigation focuses on whether the withdrawals made within a certain time period before the filing of the case are recoverable as fraudulent transfers or as preferences.

VENUE. Under 28 U.S.C. § 1408, bankruptcy cases may be filed in the district "in which the domicile, residence, or principal place of business in the United States of the person or entity that is the subject of such case have been located . . . or in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership." Under earlier interpretations of that same language, "domicile" was understood to be synonymous with "principal place of business." Nevertheless, under more recent interpretations "domicile" is read to mean the state in which a business is incorporated.

Bankruptcy cases are often filed in the District of Delaware or other locations whose corporate law was used for incorporation. In the alternative, an affiliate that exists or is formed for venue purposes may file first in the desired district followed by all the affiliates, including the corporate parent. Consequently, companies effectively can choose to file anywhere. This has resulted in a highly disproportionate number of filings in the District of Delaware or the Southern District of New York. More recently, some other districts have been preferred for specific reasons including the applicable law in the circuit (whether state law, if applicable, or interpretation of the Bankruptcy Code). The court in the district where the case(s) are filed may transfer the case(s) to a more appropriate venue, but that is relatively rare. *Id.* § 1412. Legislation to change the venue laws to force the filing in the district of the parent's principal place of business has been pending in several sessions of Congress. The Minnesota State Bar Association has adopted resolutions supporting proposed venue change laws.

MASS TORTS. This is not a technical term but is descriptive of situations in which many persons are injured and would have tort claims that could be, or have been, brought in applicable state or federal courts. A question arises as to whether it is practical or even possible to adjudicate these cases one-by-one or in groups. This is especially problematic when it is not possible to identify all the persons who would have such claims. Efforts to settle such claims in class actions have been rebuffed by the United States Supreme Court because, among other things, settlements that purport to bind claimants who are not identified and able to participate are denied due process.

MULTIDISTRICT LITIGATION ("MDL"). An alternative to class actions is the use of multidistrict litigation procedures. *See* 28 U.S.C. § 1407. A major issue in these bankruptcy cases is whether the Bankruptcy Code provides a unique and indispensable vehicle for resolving mass tort cases and whether the MDL procedures provide an adequate or even superior alternative. The bankruptcy court decision in the *LTL* case contains an argument for bankruptcy court resolution of mass tort cases. *See In re LTL Mgmt., LLC*, 637 B.R. 396, 414 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), and *rev'd and remanded*, 64 F.4th 84 (3d Cir. 2023).

Asbestos exposure was the original and largest problem. Asbestos fibers can cause mesothelioma, lung cancer, and other serious diseases. These diseases can have a very long latency period—40 years or more. While the sale of asbestos building materials mainly ended in the early 1970s, there are still individuals being diagnosed with these asbestos-related diseases. The largest manufacturer of those building materials, Johns-Manville Corporation, filed bankruptcy and emerged in 1984. Bankruptcy Judge Burton R. Lifland confirmed a plan which involved a "future claims representative" to represent the unknown claimants. The plan involved a trust which would make payments to the known claimants, and over time to the future claimants as their diseases manifested.

SECTION 524(g). Because the *Johns-Manville* resolution included several features of uncertain legality, proponents of the settlement convinced Congress to add a section of the Bankruptcy Code that explicitly authorizes the procedures used in *Johns-Manville*, but only in asbestos cases. Many subsequent mass tort cases have used the 11 U.S.C. § 524(g) model even though they are not asbestos cases. This would seem to suggest further legislation using the 11 U.S.C. § 524(g) model for other kinds of mass torts, but that has not occurred. There have been less than 100 asbestos cases since. In Minnesota, there has been only one—*API, Inc*.

Other notable mass tort claims arise from opioids. The *Purdue Pharma* case is perhaps the most well-known opioid-related bankruptcy case.

Another area has been sexual abuse, particularly claims against the Catholic Church and affiliated entities. The largest number of abuses occurred in the 1970s and before. The application of statutes of limitation has been uncertain and has varied. As of April 2024, 38 Catholic religious organizations in the United States have filed chapter 11 bankruptcy cases. In 2013, the Minnesota legislature opened a three-year statute of limitations through May 25, 2016. Multiple cases were filed, and six chapter 11 cases followed.

THIRD-PARTY RELEASES. The Bankruptcy Code expressly provides for a "discharge" for debtors. Plans of reorganization often provide for releases or the protection of injunctions for others. That often includes persons who have made contributions to the resolution of the case or who have entered into settlements. A prime example is settlement of claims against insurance companies that have issued policies that may cover the survivors' claims. In addition, some of these cases have involved potential claims (often joint claims) against others and plans provide releases for these third parties. For example, Catholic parishes are separate legal entities that could have liability jointly with their diocese. Rather than having them file their own cases, they seek a third-party release in the diocese's bankruptcy case. Courts in some circuits have refused to confirm plans with those releases. Courts in other circuits have been willing to do so under what they describe as "extraordinary circumstances." Among the factors taken into consideration are whether the party receiving a release would have a contribution claim against the debtor, the size of a contribution to the plan trust from the released party, and a super-majority vote in favor of the plan by the survivors who would be losing their potential claims against those third parties.

The Eighth Circuit does not have a circuit-level decision on this topic, but the bankruptcy court decision in *In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994) and the (Minnesota) bankruptcy court decision in *In re Archdiocese of St. Paul & Minneapolis*, Case No. 15-30125 (Bankr. D. Minn. Sept. 25, 2018), ECF No. 1278 confirmed plans with this feature. In fact, *Master Mortgage* is much cited and provides the rationale for Third Circuit (Delaware) authority.

The *Purdue Pharma* case provides releases for its owners, members of the Sackler family, in return for a contribution of $6 billion. That case has been argued before the Supreme Court and will likely result in a very important decision before the end of May.

TEXAS TWO-STEP / DIVISIVE OR DIVISIONAL MERGER. A Texas statute authorizes a divisive merger in which rather than two or more entities merging together, one entity may be divided into two or more entities, without the transaction being treated as a fraudulent transfer. This has been used in a number of situations to place the liabilities and related assets in one company, the "bad company," and the other assets and the productive businesses in another, the "good company." The bad company then files a chapter 11 case with the good company entering into a funding support agreement. Johnson & Johnson utilized the divisive merger when faced with potential liabilities in the billions of dollars from lawsuits claiming that talcum powder contained asbestos that causes cancer. This the backstory for the *LTL* case.

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The Restructuring Report

Is Insolvency a Prerequisite to Filing a Chapter 11 Case?

02.12.2024 | James L. Baillie | Katherine A. Nixon

Conventional wisdom suggests there is no requirement that a debtor be "insolvent" to file a case under Chapter 11 or any other chapter of the Bankruptcy Code. No Code provision explicitly imposes such a requirement. Yet in 2023, several courts addressed the issue, and two courts directed the dismissal of massive Chapter 11 cases imposing what may fairly be characterized as an insolvency requirement. One of those courts, *In re LTL Mgmt., LLC* (LTL 1), stated there must be "financial distress," and the other court, *In re Aearo Techs. LLC*, indicated there must be a "need" for reorganization. In a factually similar situation, a third court, *In re Bestwall LLC*, declined to reverse a bankruptcy court which had issued a preliminary injunction supporting a prospective reorganization. This report will describe the rulings in *LTL 1*, *Aearo*, and *Bestwall* and will provide updates on the status of those cases. All three are mass tort cases, which are significant in terms of the dollar amounts at issue and the claims involved, and in their cutting-edge issues.

In *LTL 1*, the most famous of the three cases, a Third Circuit panel ordered the dismissal of the Chapter 11 case of LTL Management LLC, an entity created through a "divisional merger" or "Texas Two-Step." The decision received heightened attention because the author was the Honorable Thomas Ambro, a highly respected bankruptcy lawyer in Delaware before his appointment to the circuit court bench. After facing numerous talc lawsuits, Johnson & Johnson Consumer Inc., a wholly owned subsidiary of Johnson & Johnson, split into two new entities. One of those entities was LTL Management LLC, or the "bad company," which held the liabilities relating to talc litigation and a funding support agreement from its corporate parents. Prospective costs and liabilities measured in the billions of dollars. The other entity, or the "good company," held the business assets previously held by Johnson & Johnson Consumer Inc. Just a couple days after LTL Management LLC's corporate inception, it filed a Chapter 11 case. Talc claimants filed motions to dismiss the bankruptcy case for "cause" under § 1112(b) asserting the case was not filed in good faith. The bankruptcy court denied the motions to dismiss, reasoning in part that LTL Management LLC had a valid bankruptcy purpose as the funding support agreement would fund a trust under § 524(g) of the Code for victims of asbestos diseases attributed to the exposure to talc. In ruling that "[o]nly a putative debtor in financial distress" can meet the intended purposes of the Code, the Third Circuit reversed and remanded with instructions to dismiss the case.

On remand, the bankruptcy judge dutifully, but we sense not cheerfully, dismissed the case. Negotiations continued, changes were made to a plan, the pot was sweetened, and more talc claimants joined in support. Two hours after the dismissal of *LTL 1*, a new Chapter 11 case was filed (LTL 2). The bankruptcy judge faced additional motions to dismiss the bankruptcy case for "cause" under § 1112(b). He concluded *LTL 2* was not different enough to escape the dictates of the Third Circuit in *LTL 1*, and therefore, dismissed the case. The dismissal of *LTL 2* is now on appeal and in the briefing stage.

Just a few weeks after the *LTL 1* decision, several interested parties filed motions to dismiss the *Aearo* case for "cause" under § 1112(b) asserting a lack of good faith. Aearo Technologies LLC developed and sold devices meant to protect the hearing of users from loud noises such as those encountered in war. 3M purchased and continued the business. Thousands of tort claims followed; 336,000 at the high point, such that they constituted 30% of all the cases in the federal court system. The cases were consolidated into a multi-district litigation (MDL) case. Unlike in *LTL 1*, there was no divisional merger, but the structure was similar. On July 26, 2022, Aearo Technologies LLC filed a Chapter 11 case. 3M did not file, but it did enter into an uncapped funding agreement for Aearo Technologies LLC's bankruptcy case. On June 9, 2023, a bankruptcy court in the Seventh Circuit ordered the dismissal of the case, relying heavily on the just published *LTL 1* decision. While recognizing that "a debtor need not be insolvent to seek Chapter 11 protection," the bankruptcy court nonetheless concluded that "a debtor's 'need' for relief under the Chapter 11 is central to" the inquiry of good faith and whether the case serves a "valid reorganizational purpose." After the Chapter 11 case was dismissed, 3M agreed to provide $6 billion to settle the claims in the MDL process providing that 98% of the claimants did not opt-out. While *Aearo* was appealed to the Seventh Circuit, the appeal has been stayed pending implementation of the settlement.

The third case, the *Bestwall* case, which was decided just a few weeks before *Aearo*, involved a divisional merger by Georgia-Pacific LLC. Georgia-Pacific LLC had sold joint compounds and plaster that contained asbestos. This led to numerous tort cases. Georgia-Pacific LLC then split into two new entities. Bestwall, the "bad company" with asbestos assets and liabilities, filed a Chapter 11 case with a funding support agreement from Georgia-Pacific Holdings LLC. The bankruptcy court issued preliminary injunctions protecting third parties, including the "good company," Georgia-Pacific LLC, against pending cases. That decision was first appealed to the district court, which affirmed the bankruptcy court, and then was appealed to the Fourth Circuit. The Fourth Circuit panel affirmed. However, the Fourth Circuit panel was divided. One of the judges, Judge King, filed a dissent in part expressing vehement opposition to divisional mergers. While the fact pattern was similar to *LTL 1* and *Aearo*, the legal issue was different. The *Bestwall* decision addresses the authority of the bankruptcy court to issue a preliminary injunction protecting third parties. One might speculate that a motion to dismiss would have been based on § 1112(b) and the absence of good faith if the *LTL 1* decision had been issued prior. A petition for a writ of certiorari has now been filed with the United States Supreme Court.

As indicated above, § 1112(b) of the Code provides for the dismissal of bankruptcy cases for "cause." But "cause" is not defined. § 1112(b)(4) does provide a non-exclusive list of circumstances that constitute "cause," though none of those 16 circumstances are based on the insolvency or lack of insolvency of the debtor. As compared to other countries, such as Mexico, Germany, and many others that require insolvency as a precondition for a bankruptcy-type process, it has long been taught that the United States does not require insolvency to file bankruptcy and does not mandate a filing upon insolvency. The flexibility is presented as an advantage of our system. (One of the authors has long taught an International Bankruptcy course as an adjunct professor at the University of Minnesota Law School, a course designed and primarily presented by the American College of Bankruptcy.)

Earlier cases have been dismissed under § 1112(b) as "bad faith" filings, or stated in the opposite way, as not "good faith" filings. However, they did not focus primarily on the solvency issue. Moreover, just as a requirement of a form of insolvency was read into the statute in *LTL 1* and *Aearo*, the concept of "good faith" is nowhere in the statute. But a body of law has developed around this concept. Some courts have found there is no basis under the Code for dismissal for lack of good faith, but most courts have found that it is implied in the Code and that § 105(a) authorizes courts to make "any determination" needed to prevent an "abuse of process." The body of law surrounding this topic lacks cohesion, and some say lacks an underlying rationale at all. It is hard to resist, as an aside, noting the *Aearo* bankruptcy judge's reference in a footnote to the statement of Bankruptcy Judge Queenan in declining to read a good faith standard into § 1112(b). Judge Queenan described the good faith standard as "an amorphous gestalt, devoid of reasoning and impenetrable to understanding."

A number of courts have approached the problem of what constitutes lack of good faith by presenting a long list of factors that a court should take into consideration. For example, the court in *In re Tekena USA, LLC*, lists 14 factors. That approach may be criticized as presenting an unhelpful unweighted multifactor test; but in any event, such lists have generally not included as a ground for dismissal that the debtor is not insolvent. Which is not to say there is no precedent at all for *LTL 1* and *Aearo*.

Although the bankruptcy court was the finder of fact, in *LTL 1* the Third Circuit panel utilized *de novo* review applying an "ultimate fact" standard to overrule the fact finding of the bankruptcy court. It cited its own decisions finding a lack of good faith to be "cause" under § 1112(b). The court wrote, "Because the Code's text neither sets nor bars explicitly a good-faith requirement, we have grounded it in the 'equitable nature of bankruptcy' and the 'purposes underlying Chapter 11.'" Two particularly relevant inquiries are: "(1) whether the petition serves a valid bankruptcy purpose; and (2) whether it is filed merely to obtain a tactical litigation advantage." In *Integrated Telecom Express, Inc.*, an earlier circuit case, the Third Circuit determined that a valid bankruptcy purpose "assumes a debtor in financial distress." In addition to relying on *Integrated Telecom Express, Inc.*, the Third Circuit in *LTL 1* also relied on its decision in *In re SGL Carbon Corp.* These are two decisions where the case seemed to have more to do with protection from on-going litigation than with financial restructuring. Finding the bankruptcy court had abused its discretion, the *LTL 1* court held, "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."

In *Aearo*, the court looked to the then recent *LTL 1* decision, the Third Circuit precedents described above, and other cases in stating, "Courts have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11." In referencing *LTL 1*, the *Aearo* court concluded:

The Court ultimately finds this logic persuasive. While the Court would rather frame the issue in terms of a debtor's "need" rather than "financial distress," (lest "financial distress" be interpreted too literally and ignore the Code's lack of an insolvency requirement), the inquiry will often be the same: are the problems the debtor is facing within the range of difficulties envisioned by Congress when it crafted Chapter 11?

It may be argued that earlier cases that had mentioned absence of insolvency did so in conjunction with the lack of a valid reorganizational purpose. That is, the situations expressly or impliedly involved an improper purpose. *LTL 1* and *Aearo*, however, highlighted no improper purpose. The companies sought to reorganize due to the existence of massive financial liabilities and costs due to pending tort claims. One thing that differs from most cases is that the claims remain unliquidated. What these courts have done now is deny access to the bankruptcy court, even in the absence of an apparent improper purpose. This adds a requirement of a measure of severity and immediacy of insolvency standing by itself. That can also be garnered from the statements in the cases as to the need to let more time pass, for the tort process to continue longer, in order to enable the court to determine a degree of financial distress before the gates of the bankruptcy system may be opened.

It may be relevant to understanding how these decisions came to be to note that the context of these cases includes other boundary pushing issues not yet resolved by the courts, including the divisional mergers (which beg a fraudulent transfer analysis), third-party releases (which is an issue before the Supreme Court now), and sometimes venue manipulation, even though they are not given as reasons in the decisions here discussed. It may be that these courts are really saying, "This is just too much." But now that this form of separate solvency requirement is clearly and strongly expressed, it will be interesting to see how far this doctrine spreads. For instance, *In re Aldrich Pump LLC*, the bankruptcy court declined to apply the *LTL 1* "financial distress" standard, finding that the Fourth Circuit standard was narrower. In *In re Bootjack Dairy M&D, LLC*, the bankruptcy court dismissed a Chapter 12 case for lack of good faith and relied on the traditional factors, including financial distress, though not giving it special weight as the Ninth Circuit had not adopted the *LTL 1* standard.

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The decisions in *LTL 1* and *Aearo* run contrary to the conventional understanding that a debtor need not be insolvent to file bankruptcy. Both cases acknowledge the lack of an insolvency requirement in the Code but then impose a standard that is functionally equivalent, a particular form of insolvency. Perhaps the law of *LTL 1* and *Aearo* is best understood as adding another factor to the list pertinent to the good faith inquiry: "Debtor is not (or may not be) currently insolvent, and any prospective future insolvency is too speculative to support the current use of the bankruptcy system."