AMERICAN COLLEGE OF BANKRUPTCY
2023 SEVENTH CIRCUIT EDUCATION PROGRAM

Liability Management and Attorney Liability: Civil, Criminal, and Professional Ethics

Thursday September 21, 2023

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Additional reference readings:

Thomas Moers Mayer, *Will the Lawyers Pay? Counsel's Ethical, Civil and Criminal Exposure for Creating Asset Protection Trusts*, ALI-CLE Course Materials (May 4, 2015)

George W. Kuney, *Unethical Protection? Model Rule 1.8(h) and Plan Releases of Professional Liability*, 83 Am. Bankr. L.J. 481 (2009)

DISCUSSION PROBLEM

Until recently Sabi, Inc. was an integrated sand provider to various industries in need of sand products, with mining, glass manufacturing, transportation, refining, and delivery divisions. The mining division operated about 100 sand mining operations located in multiple states. The glass division operated three plants in different states to manufacture products for the auto industry and commercial construction industry. Two years ago, Sabi sold all of its sand products operations to Wabi, Inc.

A Proposed Texas-Two Step Bankruptcy Filing

Both Wabi and Sabi have recently become targets of the plaintiffs' bar and are increasingly being named as defendants in personal injury suits alleging exposure to silica dust. Sabi's long-time counsel is Dewey Cheatham & Howe LLP ("DCH"). DCH partner Curly Howard has urged the Sabi board of directors to consider a so-called Texas Two-Step bankruptcy filing as a means to manage its silica litigation exposure. That would involve using a state divisional merger statute to split Sabi into two new corporations: Sabi-B, Inc. and Sabi-L, Inc. In the divisional merger, Sabi-B would be allocated all of the former Sabi's assets and debts, except the Sabi silica litigation liability, which would be allocated to Sabi-L. In conjunction with the divisional merger, Sabi-B would execute a funding agreement undertaking to fully pay all of Sabi-L's expenses and liabilities, including those incurred and established in a contemplated Chapter 11 bankruptcy filing by Sabi-L. After the divisional merger, Sabi-L would immediately file Chapter 11 with the intention of confirming a plan that will pay Sabi's estimated silica liability in full. Sabi-B would continue Sabi's business operations uninterrupted without filing Chapter 11.

Should Curly advise Sabi's board to appoint one or more independent directors who would be vested with sole authority to represent Sabi-L's interests in connection with the proposed divisional merger? Should Curly recommend that the board be divided into two groups in connection with the proposed divisional merger—one representing Sabi-L's interests and the other representing Sabi-B's interests?

If DCH is the only professional advising Sabi in connection with the proposed divisional merger and wants to be retained as DIP counsel in Sabi-L's contemplated bankruptcy filing, will DCH have to disclose its involvement in the transaction in the retention application? Will DCH have an interest adverse to the estate? Will DCH be disinterested? Should Curly advise retention of multiple sets of counsel and other professional advisers—one set representing Sabi-L's interests and the other representing Sabi-B's? Would either set of professionals meet the § 327(a) retention standards in Sabi-L's contemplated bankruptcy filing?

If DCH is the only professional advising Sabi in connection with the proposed divisional merger and the entire Sabi board (without appointing any new directors or dividing the board) approves the divisional merger, should Curly advise the new Sabi-L board, before it files bankruptcy, to appoint new independent directors who will comprise a special committee that will retain its own separate counsel and other professionals and that will have the sole responsibility for investigating the divisional merger and recommending the appropriate course of action? If the special committee, after its investigation, recommends that Sabi-L file Chapter 11, will DCH meet the § 327(a) standards for retention as DIP counsel? What if Curly is the one who recommended the new independent directors and counsel for Sabi-L?

A Bad-Faith Dismissal of the Texas Two-Step Bankruptcy Filing

On Curly Howard's advice and with Curly "running the deal," Sabi consummates the divisional merger and Sabi-L files a Chapter 11 petition. An official silica personal injury claimants' committee ("OSPICC") is appointed and moves to dismiss the Sabi-L bankruptcy case as filed in bad faith. The bankruptcy court dismisses the case, finding that (1) Sabi-L was not experiencing any apparent and immediate financial distress and (2) the Sabi-L bankruptcy filing was a bad-faith "litigation tactic."

Does Curly have any personal exposure for civil or criminal liability, or for discipline for a professional ethics violation?

An Attorney Exculpation Provision in a Proposed Plan of Reorganization

Instead of dismissing the Sabi-L bankruptcy case, the bankruptcy court denies the OSPICC motion to dismiss the Sabi-L bankruptcy case. Sabi-L proposes a plan of reorganization, drafted by Curly Howard, that includes the following provision:

> *Section 10.8 Exculpation of Attorneys*
> Confirmation of the Plan shall constitute a release by the Reorganized Debtor, by Debtor Sabi-L, Inc., by Sabi-B, Inc., and by their predecessor-in-interest Sabi, Inc. of any claim or cause of action against their attorneys attributable in any way to services rendered by said attorneys on or before the Effective Date of the Plan, excepting only claims for willful or reckless misconduct (the "Exculpated Claims"). The Confirmation Order shall permanently enjoin any assertion of an Exculpated Claim.

Should the bankruptcy court confirm the proposed plan with Section 10.8 intact? If the plan is confirmed with Section 10.8 intact, does Curly have any personal exposure for a professional ethics violation? Does Curly have any personal exposure for a professional ethics violation if the bankruptcy court refuses to confirm any plan containing the proposed Section 10.8?

AMERICAN BAR ASSOCIATION
MODEL RULES OF PROFESSIONAL CONDUCT

Rule 1.8 Current Clients: Specific Rules

Client-Lawyer Relationship

* * * *

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

Bankruptcy Law Letter

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EXAMINING EXCULPATION'S ETHICS: RETHINKING THE ETHICAL DUTIES OF A DEBTOR'S ATTORNEY IN REORGANIZATION

*By Bruce A. Markell**

I. INTRODUCTION

Chapter 11 reorganizations often are long, drawn-out and messy. Good attorneys use this chaos to their client's advantage by strategically assembling coalitions of stakeholders aligned with their client's interests, and by isolating those opposed.

Chapter 11 cases also often proceed with speed. Time erodes value, and devil take the hindmost (or allocates to the laggers nothing or next to nothing). The extraordinary reorganization powers contained in chapter 11 leaven this mix, allowing the deft and adroit to forge a viable reorganized debtor.

This process often foments disgruntlement. Time and reflection can turn promising deals into ugly ones, and clients often blame their lawyers for the fallout. Often this is unjustified.

But sometimes it is not. Lawyers make mistakes. And in the reorganization cauldron, where speed, power and scarcity intermix, small mistakes can have outsized consequences.

Reorganization is not unique in this respect. The sad fact is mistakes by lawyers are not unusual. In the world outside of reorganization, the tort of legal malpractice provides rough compensation for victims of malpractice. But, as my mother used to say, an ounce of prevention is worth a pound of cure. Every state promulgates and curates rules of conduct for lawyers designed in part to lessen the incidence of harmful mistakes. Often referred to as rules of professional responsibility, these rules tell lawyers how they must act to retain the privilege of representing (and charging) clients.

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For this issue of the *Bankruptcy Law Letter*, I want to look at the rules related to a lawyer's conduct when lawyers seek to erase the mistakes they make in reorganization. In reorganization circles, this practice is often referred to as "exculpation."

Not to put too fine a point on it, but my basic point is that the process and effect of exculpation as reported in the cases is contrary to established rules of professional conduct. And most courts are letting lawyers get away with it.

I realize that these are bold and inflammatory statements. But by the end of this article, I hope to show their truth, and to suggest how the problem might be avoided.

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II. EXCULPATION

Exculpation arises in the context of a confirmed chapter 11 plan. The plan proponent will place language in the plan which exculpates—excuses—a certain class of entities from liability for their actions with respect to the debtor. If the court confirms the plan, the order confirming the plan will incorporate the exculpatory language, making it binding upon anyone who is bound by the order confirming the plan. Further, the plan will also typically contain language enjoining the commencement of any action covered by the exculpation clause.[1]

A. THE NATURE OF EXCULPATION

Much confusion arises over exactly what exculpation is. Start first, however, with what it is *not*: a release of claims *against* the debtor. Rather it is the converse: the *debtor's* release of claims it (or the estate) has against third parties.[2] As a result, exculpation does not interfere or implicate with the statutory discharge granted by Section 524.

As exculpation is not a discharge or release of claims against a debtor, it is also not a third-party release, which has been the subject of notoriety of late.[3] Rather, exculpation is an agreement by the estate, backed by a court order, giving up claims the debtor or the estate has against a class of entities. In short, the estate, for reasons explored below, is abandoning or settling a contingent asset—claims held against the exculpated entities. As a consequence, exculpation affects monetary rights the debtor's estate may have against the exculpated entities.

Some courts, however, view this differently. They state that exculpatory provisions do not release or relinquish property of the estate.[4] Rather these courts state these clauses "establish the standard of care that will trigger liability in future litigation by a non-releasing party against an exculpated party for acts arising out of a debtor's restructuring."[5] As no claims are affirmatively released or settled, there is no transfer of estate property.

Such an argument, however, is pure casuistry. Changing the standard of liability excludes some actions from recompense; it changes what was compensable into something noncompensable. That is a loss of a right for those actions. Stripped of legalize, exculpation clauses eliminate negligence claims against attorneys. As malpractice is grounded in negligence, malpractice claims are thus prohibited.[6] In any sane world, that is a loss of a chose in action, an intangible item of property.[7]

B. PREVALENCE

Who are the entities benefitting from exculpation? Not surprisingly, the class of entities exculpated in any plan is varied and may differ from case to case. In most cases, however, the estate agrees not to seek recourse against its professionals—its investment bankers, its accountants and, the focus of this article, its attorneys.

While there is a temporal aspect to exculpations in practice—many only relate to claims arising during the pendency of the debtor's case—that limitation is not universal. Many cases have permitted, for example, exculpations that extend to prepetition activities.[8]

And although early cases categorized exculpations as fit only for extraordinary cases, the extraordinary has become ordinary. As the Ninth Circuit recently noted, exculpatory clauses are "a commonplace provision in Chapter 11 plans."[9]

C. ATTORNEYS AND EXCULPATION

Many instances of commercial exculpation are unexceptional. Much like a plumber discounting her bill because her installation was not quite up to snuff, investment bankers might take less than their bill if they make a mistake or are found not to be credible.[10] In both cases, the service providers expect that to be the end of the matter. The dispute is compromised and settled. In a sense, that type of give-and-take is typical of all reorganizations.

But lawyers are not plumbers or even investment bankers. Lawyers are subject to codes of professional conduct. And these codes have bite: unlike aspirational codes of good behavior,[11] violation of attorney codes of professional responsibility can lead to the loss of one's license to practice.

III. ATTORNEY EXCULPATION OUTSIDE OF BANKRUPTCY

Given the disparity in knowledge and experience between lawyers and most of their clients, it is not surprising that these codes of professional conduct speak to the limitation and settlement of disputes over the quality of a lawyer's services. The main repositories of these principles are Rule 1.8(h) of the American Bar Association's Model Rules of Professional Responsibility,[12] and Section 54 of the American Law Institute's *Restatement (Third) of the Law Governing Lawyers*.[13] The ABA's Model Rules have been adopted (with relatively minor changes) by most state regulatory bodies as applicable to attorneys within that state.[14]

A. ABA RULE 1.8(h)

The Model Rules cover a lawyer's ability to regulate her relationship with her client. This regulation covers not only any contractual attempt to limit liability for future actions, but also attempts to compromise and settle claims against the lawyer for past actions.

The operative rule is Rule 1.8 of the Model Rules. It states:

> (h) A lawyer shall not:
>
> (1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or
>
> (2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.[15]

Rule 1.8(h)(1) is fairly simple. A lawyer cannot limit his liability to a client at the initiation of a representation unless the client is independently represented. This includes capping liability for malpractice to fees earned or paid, liquidated damages clauses, and the like.[16]

It does, however, permit contractual selection of the means to determine such liability. Arbitration clauses in retainer agreements are be permitted.[17] The rule also permits the limitation of the scope of services provides through so-called "bundling" ar-

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rangements,[18] as well as a firm's efforts to protect itself from the errors of individual attorneys through the use of limited liability entities, so long as various disclosure rules are met.[19]

Rule 1.8(h)(2) is somewhat more complex. It imposes requirements on the lawyer in order to resolve or settle "claim[s] or potential claim[s]" for malpractice the client may have against the lawyer. There are basically two such requirements: the lawyer must advise, in writing, of the "desirability" of seeking separate and independent counsel regarding such settlement and must give the client "a reasonable opportunity" to obtain such advice.

Rule 1.8(h)(2) exists to protect clients "in view of the danger that a lawyer will take unfair advantage of an unrepresented client or former client."[20]

B. ALI'S RESTATEMENT THIRD OF THE LAW GOVERNING LAWYERS

In 2000, the American Law Institute completed its third restatement of the *Law Governing Lawyers*. Written against the background of the ABA Model Rules, it contains greater burdens for lawyers who wish to contractually limit or reduce client claims.

Section 54 of the *Restatement* provides, in relevant part:

> (2) An agreement prospectively limiting a lawyer's liability to a client for malpractice is unenforceable.
>
> (3) The client or former client may rescind an agreement settling a claim by the client or former client against the person's lawyer if:
> (a) the client or former client was subjected to improper pressure by the lawyer in reaching the settlement; or
> (b) (i) the client or former client was not independently represented in negotiating the settlement, and (ii) the settlement was not fair and reasonable to the client or former client.
>
> (4) For purposes of professional discipline, a lawyer may not:
> (a) make an agreement prospectively limiting the lawyer's liability to a client for malpractice; or
> (b) settle a claim for such liability with an unrepresented client or former client without first advising that person in writing that independent representation is appropriate in connection therewith.

In addition to restating the basic requirements of Rule 1.8(h), section 54(4) of the *Restatement* adds substantive law consequences to failure to comply with the rules on settlement.[21] It grants to the client the ability to avoid a settlement in two circumstances: (1) if the client was unrepresented and the resulting settlement was not "fair and reasonable" to the client;[22] or (2) if the lawyer "subjected [the client] to improper pressure" in obtaining the settlement.[23]

What is a claim under the *Restatement*? Does it include any request to reduce fees? No. Comment *c* makes it clear that while "a claim includes requests for damages, fee forfeiture . . . or the like," it does not include "disputes as to disposition of documents or the amount of a lawyer's fee."[24]

C. KEY POINTS

From the above, it is an easy conclusion that the typical exculpation clause as reported in the cases qualifies as an attempt to settle any claim for malpractice. It seeks to preclude a client—the revested debtor—from bringing any action based on the professional's work rendered to the debtor or the estate. While there might be some exclusions—some exculpations exclude malpractice, others exclude willful misconduct or gross negligence[25]—the basic negligence action based on failure to adhere to duties owed to the debtor are terminated. Moreover, the typical plan will also combine exculpation with a plan injunction against even bringing an action based on the claims exculpated by the plan.

As such, were the exculpation provision presented to the client outside of bankruptcy, it is beyond cavil that attorneys would have to meet the requirements of the applicable version of Rule 1.8(h). Although the issue has been occasionally raised, usually by the Office of the United States Trustee,[26] there appear to be zero cases which apply the rule to confirmation of a chapter 11 plan. That is, no case has required separate counsel to advise the debtor. No case has required explicit written disclosure of that potential malpractice claims are being extinguished. No case has questioned why law firms do not discount their fees in return for exculpation (or question whether the debtor was informed of the intended inclusion of

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any exculpation clause when the law firm was initially retained).

In part, this failure can be explained by the somewhat mongrel basis for exculpation clauses in the first instance. Courts grapple with whether a plan may include such clauses, and that effort seems to overshadow the ethical nuances of their inclusion once authorized. The effort to legitimize exculpation clauses follows.

IV. PLANS AND EXCULPATION

The initial question is whether the Bankruptcy Code even authorizes exculpation clauses. Most courts have found that it does, albeit with some grumbling. The progress of provisions once deemed to be extraordinary to the commonplace has been described as "an example of the Lake Wobegon effect whereby many ordinary and average things are postured as extraordinary, causing the very concept of extraordinariness to lose meaning."[27]

A. THE JUSTIFICATIONS

Courts have used many bases to justify exculpation clauses. Cases from Delaware and the Third Circuit analogized such clauses to rights trustees and others have under common law;[28] such fiduciaries enjoy certain immunities and indemnification rights at common law. These courts thus viewed the exculpation clauses as somewhat redundant, sort of a match on a burning blaze.

The problem with this justification is that it can only reach fiduciaries such as the debtor, its lawyers and creditors' committees. It will not extend to other professionals, such as investment bankers and other financiers who undoubtedly contribute to the success of a confirmed plan. So other grounds have been explored.

In this search, courts have often relied on two "catch all" provisions to justify exculpation. As one might expect, Section 105(a), with its language giving the court the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title,"[29] has been a prime candidate for justification.[30] So too has Section 1123(b)(6), which permits a plan to include "any other appropriate provision not inconsistent with the applicable provisions of this title."[31] Although sweeping, invocation of these provisions requires answering other questions—what are the specific provisions that Section 105 is being used to "carry out"? Why are exculpation clauses "appropriate" provisions in a plan?

A more satisfactory basis might be Section 1123(b)(3)(A), which permits plan provisions that "provide for—(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate."[32] After all, exculpation affects contingent claims the estate holds against those exculpated, and thus it, at a minimum, "adjusts" those claims.

At this point, however, uniformity of justification dissolves. Not all circuits employ the same standard for approving settlements and their concomitant releases in plans.[33] Some use the so-called "*Master Mortgage* factors, which require the court to examine (1) an identity of interest between the debtor and nondebtor such that a suit against the nondebtor will deplete the estate's resources; (2) a substantial contribution to the plan by the nondebtor; (3) the necessity of the release to the reorganization; (4) the overwhelming acceptance of the plan and release by creditors and interest holders; and (5) the payment of all or substantially all of the claims of the creditors and interest holders under the plan."[34] Others permit a debtor to release or exculpate claims in a plan if the provision is a valid exercise of the debtor's business judgment, is fair, reasonable, and in the best interests of the estate.[35] Still others adopt the general requirements of Bankruptcy Rule 9019.[36]

More recently, a district court has proposed a new test under which an exculpation clause "(a) . . . must be limited to the fiduciaries who have performed necessary and valuable duties in connection with the bankruptcy case; (b) is limited to acts and omissions taken in connection with the bankruptcy case; (c) does not purport to release any prepetition claims; (d) contains a carve out for gross negligence, actual fraud or willful misconduct; and, (e) contains a gatekeeper function."[37]

B. REASONABLENESS AND REWARD?

The lack of an agreed standard for approval of

exculpation clauses is largely due to the lack of any statutory basis for such clauses combined with a lack of consensus as to their construction. Nonetheless, exculpation clauses are routinely approved, especially if confined to post petition activities (although there is some recent doubt there).[38]

The demand for such clauses is easy to understand. As stated by one court, "exculpation provisions are included so frequently in chapter 11 plans because stakeholders all too often blame others for failures to get the recoveries they desire; seek vengeance against other parties; or simply wish to second guess the decisionmakers in the chapter 11 case."[39]

As a result, court often point to the contributions to the reorganization effort made by those receiving the benefit of such clauses and intone that such effort would not have been made (or made with less vigor) if the promise of a lawsuit-free future were not made. They also point to the inclusion of such clauses as part of the grand bargains that usually produce confirmed plans, and the creditor approval of such plans as further justification for their approval.[40]

This may be acceptable for non-lawyers; this article makes no argument for or against exculpation of investment bankers and other non-lawyer professionals. Those professionals have their own codes of conduct for dealing with their clients, and that may be fodder for a future article.

But lawyers are different. They operate under defined rules that procedurally and substantively affect the settlement of any claim for misconduct in their representation. The pro forma extension of exculpation to lawyers presents issues in its very banality. Courts occasionally rail against this unthinking extension of exculpation and releases. As one court put it, "releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job. Doing positive things in a restructuring case—even important positive things—is not enough."[41]

That sentiment echoes the purpose of Rule 1.8 and the *Restatement Third*. Application of these ethical and substantive authorities make deals between lawyers, even run-of-the mill settlements consistent with deals offered to non-lawyers, subject to procedural and substantive checks to ensure fairness and disincentivize overreaching.[42]

This has significant repercussions in reorganizations. If, for example, a lawyer enters into a restructuring engagement with a debtor expecting or requiring exculpation on confirmation, that raises issues regarding Rule 1.8(h)(1) and the ban on limiting liability for future acts. If the plan exculpates lawyers with written notice to their clients and an independent review of the legal effect of the exculpation clause, that raises issues under Rule 1.8(h)(2). Both acts raise issues as to whether the exculpation, if not independently reviewed, was "fair and equitable" under Section 54 of the *Restatement Third*.

But many would assert that any state regulation, including regulation of professional responsibility, is preempted by the federal nature of bankruptcy proceedings. That question takes up the next section.

V. ARE ETHICAL RULES PREEMPTED?

Courts categorize and conceptualize confirmed reorganization plans as contracts between the affected parties.[43] That categorization is appropriate for a plan's use of exculpation clauses; such clauses act as a part of a more general contract under which the debtor's estate releases any claim it may have against those exculpated. If the parties exculpated include the estate's and the debtor's lawyers, then the effect is as if the estate settled or abandoned all contingent claim it may have had against its lawyers, including claims for malpractice. On its face then, Rule 1.8 should apply.

But it hasn't.[44] One obvious argument against applying Rule 1.8 is that bankruptcy courts are federal courts, and that the Bankruptcy Code is federal law, and these two points require preemption of Rule 1.8 and the substantive law principles outlined in the *Restatement*. A deeper review of this argument shows its frailties.

A. PREEMPTION GENERALLY

The Supremacy Clause of the United States Con-

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stitution prohibits states from enacting laws that are contrary to the laws of our federal government: "This Constitution and the Laws of the United States . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."[45] It is through this clause that the United States Congress may preempt state law.

There are three ways in which a state law may be preempted. First, state law may be preempted where the United States Congress enacts a provision which expressly preempts the state enactment. Likewise, preemption may be found where Congress has legislated in a field so comprehensively that it has implicitly expressed an intention to occupy the given field to the exclusion of state law. In these two instances, Congress can be said to have preempted the field; that is, the field defined by the scope of the congressional action.

Even if the field regulated is not completely occupied by federal action, a state enactment will still be preempted when it conflicts with a federal law. This conflict is usually found in one of two situations: when it is impossible to comply with both federal and state law,[46] or when the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[47]

The line between conflict and frustration has often been difficult to draw. As the Court recently stated in *Kansas v. Garcia*,[48] "[i]n all cases, the federal restrictions or rights that are said to conflict with state law must stem from either the Constitution itself or a valid statute enacted by Congress. 'There is no federal preemption in vacuo,' without a constitutional text, federal statute, or treaty made under the authority of the United States."[49]

Nevertheless, *Kansas v. Garcia* reiterated that it has long been established that preemption may also occur by virtue of restrictions or rights that are inferred from statutory law.[50]

B. NO FIELD PREEMPTION

In determining whether a state regulation is preempted by federal law, courts start "with the assumption that the historic police powers of the States [are] not to be superseded by . . . Federal Act unless it [is] the clear and manifest purpose of Congress."[51] In the area of professional responsibility, most courts have found that, even in areas of exclusive federal jurisdiction, the field of state regulation is not preempted.

Bankruptcy is not the only federal practice area. Specialized courts often have their own rules. For example, there are special rules for attorneys practicing in the patent and trademark area, in immigration courts, and in military tribunals.[52] Although case law is thin, no case has held that the establishment of specialized courts preempts all manner of state attorney regulation.

Bankruptcy practice presents an even easier case for dismissing field preemption. Although Congress did establish a separate bankruptcy court system, it did not provide any statutory guidance as to the lawyer regulation in those courts. Indeed, many (if not all) bankruptcy courts will adopt or incorporate state rules of professional responsibility into bankruptcy court practice.

C. NO CONFLICT PREEMPTION: INCORPORATION

When Congress has not preempted the field, conflict analysis is appropriate. But even before that analysis is undertaken, there is good reason to believe Rule 1.8 should apply in every reorganization. Why? Because most every bankruptcy court has, by its local rules, adopted the relevant state rules of professional responsibility as applicable to their court.

Delaware Local Bankruptcy Rule 1001-1(f),[53] for example, incorporates the District Court rules, and Rule 83.6(d) of those rules state:

> (d) Standards for Professional Conduct. Subject to such modifications as may be required or permitted by federal statute, court rule, or decision, all attorneys admitted or authorized to practice before this Court, including attorneys admitted on motion or otherwise, shall be governed by the Model Rules of Professional Conduct of the American Bar Association ("Model Rules"), as amended from time to time.[54]

No local rule exempts Rule 1.8.

The same appears to be true for the Southern

District of New York. The Second Circuit has indicated that New York's Rules of Professional Conduct "govern[] the conduct of attorneys in federal courts sitting in New York as well as in New York state courts."[55] The District Court explicitly refers to discipline for violation of these rules.[56]

As a result, no preemption analysis should be required. Bankruptcy courts should enforce Rule 1.8 as written, which would mean that they should require disclosure and separate representation for plans that contain attorney exculpation and should question or sanction attorneys who do not comply. It is simply a matter of enforcing their own rules.

Of course, adoption of the Model Rules only affects attorney discipline. No bankruptcy court seems to have adopted anything like Section 54 of the *Restatement*. To the extent that a court approves an exculpation clause propounded in violation of Rule 1.8, a knotty problem arises with respect to the validity of that clause. Outside of bankruptcy, Section 54 would require a finding that the clause is "fair and equitable" and that the debtor was separately represented; otherwise, the debtor could avoid the clause. If the bankruptcy court is acting pursuant to its powers to approve transfers under Section 1123(b)(3), there would seem to be power and ability to effectuate that transfer. As stated in the comments to Section 54, "[w]hatever the nature of the claim, once a settlement has been implemented in court through such means as entry of a judgment, it can be challenged only as permitted by applicable procedural rules."[57]

D. NO CONFLICT PREEMPTION: STATE INTEREST IN ATTORNEY REGULATION VS FEDERAL INTEREST IN FACILITATING REORGANIZATION

Even if bankruptcy courts had not bound themselves to follow the Model Rules, the issue would arise as to whether attorneys practicing in those courts would still be subject to Rule 1.8. The issue is one of conflict preemption; that is, whether there is a conflict with a federal statutory or regulatory scheme. Conflict, in turn, requires comparison; a conflict exists only to the extent that compliance with a state scheme impairs the ability of the federal scheme to achieve its purposes.

The comparison starts with traditional deference in preemption analysis to state exercise of police powers, especially with respect to regulation of the legal profession. When a court is presented with a matter that by long tradition has been left to state regulation, federal preemption will be found only if intervening events demonstrate that "that [is] the clear and manifest purpose of Congress."[58] As the Supreme Court has noted with respect to lawyer regulation:

> Since the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States and the District of Columbia within their respective jurisdictions. The States prescribe the qualifications for admission to practice and the standards of professional conduct. They also are responsible for the discipline of lawyers.[59]

This deference requires a strong and explicit federal interest before state regulation is preempted. And that is not the case with professional responsibility and bankruptcy. A lawyer's conduct rarely impacts the validity of any adjustments to the debtor-creditor relationship.[60] In short, how an attorney behaves rarely impacts the enforceability of liability adjusted by a plan of reorganization.

This distinction between how an attorney acts and the enforceability of her client's debts should apply with respect to Rule 1.8 and its application to reorganization attorneys. Exculpation, as explored above, has no specific authorization in the Bankruptcy Code. Indeed, many courts approve such clauses under "catch-all" provisions such as Sections 105(a) and 1123(b)(6). But even when justified under the settlement provisions of Section 1123(b)(3), the various standards for approving settlements indicate a role for state rules governing the lawyers' actions. This can be seen under either Rule 1.8(h)(1) regarding future liability, and Rule 1.8(h)(2) regarding settlement.

The federal interest in exculpation, if any, would seem to be in ensuring that debtors and other professionals paid by the estate have competent and experienced counsel. But the tradeoff between increased competency and loss of recourse is difficult to measure. It is not unlike removing warranty protection for a car or its parts—the manufacturer has done all it can, and it remains to be seen whether time can verify quality.

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But the tradeoff can be taken too far; I doubt any court would approve a law firm's retention if they conditioned their representation on placing the debtor's president's mother in chains, and holding her in a basement, until all fees were paid. Indeed, there is a perverse reverse incentive here: since Rule 1.8(h)(1) otherwise prohibits limiting liability as a condition of retention, allowing an exception to that rule for bankruptcy would draw those who would rely on such a provision, thereby either reducing the incentive and consequences for competent practice, or increasing the risks the lawyer might be willing to take.

The same analysis applies to Rule 1.8(h)(2). The genesis of Rule 1.8(h)(2) lies in the asymmetry of knowledge and experience between lawyer and client. That imbalance is, if anything, greater in reorganization, given reorganization's—hopefully—once in a lifetime occurrence. As a result, the need for intelligent and well-informed decisions regarding releases of contingent assets is heightened.

A lawyer's ability to dispose of any existing claims of malpractice without compliance with Rule 1.8 presents another example of perverse incentives. It removes the risk of a subsequent dispute (especially if the exculpation clause is backed by plan injunctions), and deprives the reverted debtor (and, depending on the reorganization, its creditors) of a potential recovery without the examination Rule 1.8(h)(2) requires.

E. CONSEQUENCES

It should be stated that Rule 1.8 and the *Restatement* rules do not affect a bankruptcy court's power to confirm plans with exculpation clauses. The reason is simple: they cannot. States do not have the power granted Congress under the Bankruptcy Clause of the Constitution so long as title 11 is law. By the same token, however, by simply enacting the Bankruptcy Code, Congress has not preempted the states' ability to regulate attorneys practicing in bankruptcy law in bankruptcy tribunals. This lack of preemption should not be surprising as there is ample precedent for states to apply their rules of professional responsibility to local attorneys practicing in other federal tribunals.[61]

Indeed, in criminal prosecutions in federal court, Congress has reaffirmed the primacy and application of state regulation through the McDade Act,[62] which requires that "[a]n attorney for the Government shall be subject to State laws and rules, and local Federal court rules, governing attorneys in each State where such attorney engages in that attorney's duties, to the same extent and in the same manner as other attorneys in that State." Regulations under this statute state that it "should not be construed in any way to alter federal substantive, procedural, or evidentiary law."[63] This has caused the Justice Department to challenge state rules of professional responsibility for certain practices, albeit with limited success.[64] The general result, however, is that state ethics rules can be "enforced by the state defendants against federal prosecutors."[65]

Moreover, if there is perceived conflict between the state rules and federal practice, Congress or federal agencies can always attempt to specifically invoke preemption.[66] And this has occurred. The Army, for example, has noted that Rule 1.8 is inconsistent with congressional limitation on malpractice claims against Army attorneys, and has chosen not to adopt it with respect to Army attorneys practicing in military tribunals.[67]

Unlike practice before patent, immigration and military tribunals, there are no national rules regulating attorney conduct in bankruptcy court. Indeed, as shown above, most bankruptcy courts have simply adopted the rules of the state in which they sit. This relationship underscores the continued applicability of state rules of responsibility, and state rules regarding the law of lawyers, in bankruptcy court practice.

The recent Third Circuit case of *In re Boy Scouts of America*[68] is not contrary to this analysis. There, an insurance company contended that a law firm which represented it had violated Rule 1.7 regarding conflicts of interest when that law firm took on the representation of a debtor it insured.[69] Based on this contention—which the lower counts declined to determine[70]—the insurance company contended the law firm should be disqualified under Section 327 from representing the debtor.

The Third Circuit, speaking through Judge

Ambro, rejected the claim. Judge Ambro focused on Section 327 and its concern that lawyers should not have conflicts with the estate. That was a different focus from conflicts between creditors of the estate. On that point—conflicts with other creditors—Judge Ambro indicated Section 327 was indifferent, and so long as there were no disqualifying conflicts *with the estate*, Section 327 would not support disqualification.[71] And the lower courts had not decided that there was such a conflict.[72]

Judge Ambro did go on to indicate that Section 327 would not interfere with disputes between the debtor's counsel and the insurance company over the law firm's bankruptcy representation of the debtor, which apparently were subject to a pending arbitration.[73] That recognition impliedly assumed that there was no preemption. As a result, the opinion is consistent with the notion that bankruptcy does not preempt the field of regulating attorneys' conduct in bankruptcy proceedings and consistent with the point that state regulation of such conduct is only an issue when, as *Kansas v. Garcia* indicates, there is a federal text—regulation, statute or constitutional provision—which conflicts with the state regulation.

VI. CONCLUSION

Bankruptcy courts have been strangely silent on the applicability and effect of Rule 1.8 to exculpation clauses. This silence is odd given the relatively straightforward application of Rule 1.8's terms: lawyers cannot limit their liability prospectively and can't terminate their contingent liability for malpractice without giving their clients written notice of what's going on, and a realistic opportunity to obtain separate counsel to assess the fairness of the proposal. Although less clear, the failure to adhere to these rules, or to obtain specific findings compliant with non-bankruptcy law as restated in the *Restatement* runs the risk that such exculpation clauses will be avoided and for naught.

I acknowledge that compliance would be sticky and time-consuming. Two solutions, however, suggest themselves. The first is that plans could exempt malpractice from the scope of any proposed exculpation.[74] The second is that lawyers could try to justify exculpation by seeking findings that their value as reorganization lawyers exceeds the cost to the revested debtor of exculpation (that is, the benefit of any malpractice litigation).[75] Since the former essentially guts the value of exculpation to lawyers, and the latter requires a reduction of fees to reflect the benefit of being freed of malpractice risk, these solutions are not likely to be implemented any time soon.

ENDNOTES:

[1]This article only examines the interplay between exculpation clauses and professional responsibility rules. The effect of such rules on plan injunctions and upon claim and issue preclusion issues in final fee orders is not addressed and is reserved for future articles.

[2]In this article, I used "debtor" and "estate" interchangeably. Exculpation clauses seek to deprive the estate of claims the estate would have against third parties. These claims are typically claims arising during case administration, and thus are property of the estate under 11 U.S.C.A. § 541(a)(7). Some aggressive uses of exculpation additionally also seek to reach claims held by the debtor prepetition, and these claims would be property of the estate under 11 U.S.C.A. § 541(a)(1). As a result, at confirmation, the issue is over the fate of claims for relief or choses in action held by the estate. After confirmation, however, to the extent that such claims are not dealt with by the confirmed plan, they would usually revert to the reorganized debtor, and pursued by that entity. My analysis does not depend on when exculpation is challenged, and thus the interchangeability of the reference to the claim's owner.

[3]See, e.g., Lindsey Simon, Bankruptcy Grifters, 131 Yale L.J. 1154 (2022) (discussing abuse of nonconsensual nondebtor releases); Adam J. Levitin, Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances, 100 Tex. L. Rev. 1079, 1155 n.103 (2022).

Of course, the Bankruptcy Law Letter's fearless leader, Ralph Brubaker, has long decried the legitimacy of such releases, Ralph Brubaker, Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations, 1997 U. Ill. L. Rev. 959, and recently renewed his objections in these pages, Ralph Brubaker, An Incipient Backlash Against Nondebtor Releases? (Part I): The "Necessary to Reorganization" Fallacy, Bankruptcy Law Letter (Feb. 2022). There is some recent indication of judicial backlash consistent with these critiques. See, e.g., Patterson v. Mahwah Bergen Retail Group, Inc., 636 B.R. 641 (E.D. Va. 2022); In re Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021).

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[4]See, e.g., In re Murray Metallurgical Coal Holdings, LLC, 623 B.R. 444 (Bankr. S.D. Ohio 2021). Such statements seem to be contrary to the plain nature of such claims for relief. See note 1 supra.

[5]In re Murray Metallurgical Coal Holdings, LLC, 623 B.R. 444 (Bankr. S.D. Ohio 2021); In re Health Diagnostic Laboratory, Inc., 551 B.R. 218, 232 (Bankr. E.D. Va. 2016) ("The practical effect of a proper exculpation provision is not to provide a release for any party, but to raise the standard of liability of fiduciaries for their conduct during the bankruptcy case.").

[6]"[L]egal malpractice is essentially an application of general tort law to particular contexts that happen to involve lawyers." Geoffrey C. Hazard, Jr., W. William Hodes & Peter R. Jarvis, The Law of Lawyering § 5.01 (4th ed. 2014).

[7]As stated by Justice Douglas, "[i]t has been commonly accepted in the federal courts that 'property' within the meaning of this [Bankruptcy Act § 77(a)] includes intangibles such as choses in action." Baker v. Gold Seal Liquors, Inc., 417 U.S. 467, 476, 94 S. Ct. 2504, 2510, 41 L. Ed. 2d 243 (1974).

[8]See. e.g., In re Murray Metallurgical Coal Holdings, LLC, 623 B.R. 444 (Bankr. S.D. Ohio 2021).

[9]Blixseth v. Credit Suisse, 961 F.3d 1074, 1085, 68 Bankr. Ct. Dec. (CRR) 224 (9th Cir. 2020), cert. denied, 141 S. Ct. 1394, 209 L. Ed. 2d 132 (2021).

[10]See, e.g., In re Las Vegas Monorail Co., 462 B.R. 795, 804, 55 Bankr. Ct. Dec. (CRR) 231 (Bankr. D. Nev. 2011) (finding investment banker's testimony not credible).

[11]See, e.g., Morgan Stanley, Code of Conduct 2022, available at morganstanley.com/about-us-governance/code-of-conduct; Paul Clark, Bad behaviour is integral to an investment banking career—and this isn't changing, efinancialcareers (Nov. 29, 2013), available at https://www.efinancialcareers.com/news/2013/11/bad-behaviour-is-integral-to-an-investment-banking-career-and-this-isnt-changing.

[12]Model Rules of Pro. Conduct (Am. Bar Ass'n 2020), available at https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents/. This article cites the rules contained in this code as "Rule X.X." The Model Rules replaced the earlier Model Code of Professional Responsibility and its Disciplinary Rules. Model Code of Pro. Resp. (Am. Bar Ass'n 1980).

[13]Restatement (Third) of the Law Governing Lawyers § 54 (2000). This article cites the sections contained in the Restatement as "Res3d § X."

[14]See George W. Kuney, Unethical Protection? Model Rule 1.8(H) and Plan Releases of Professional Liability, 83 Am. Bankr. L.J. 481, 484 n.4 (2009). Professor Kuney's article was one of the first to note the problems mentioned in this article but seems to have fallen on deaf ears since its publication. See also Kurt F. Gwynne, Indemnification and Exculpation of Professional Persons in Bankruptcy Cases, 10 Am. Bankr. Inst. L. Rev. 711, 725 (2002).

[15]Rule 1.8.

[16]See, e.g., Feacher v. Hanley, 2014 WL 119382 (D. Utah, Jan. 13, 2014) (lawyer contract with client cannot limit liability to amount of fees charged or include liquidated damages clause for particular breaches).

[17]Rule 1.8, cmt. 17 ("This paragraph does not, however, prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement.").

[18]Rule 1.8, cmt. 17 ("Nor does it prohibit an agreement in accordance with Rule 1.2 that defines the scope of the representation, although a definition of scope that makes the obligations of representation illusory will amount to an attempt to limit liability.").

[19]Rule 1.8, cmt. 17 ("Nor does this paragraph limit the ability of lawyers to practice in the form of a limited-liability entity, where permitted by law, provided that each lawyer remains personally liable to the client for his or her own conduct and the firm complies with any conditions required by law, such as provisions requiring client notification or maintenance of adequate liability.").

[20]Rule 1.8, cmt. 18.

[21]The comment indicates that an agreement limiting liability prospectively is "against public policy because it tends to undermine competent and diligent legal representation. Also, many clients are unable to evaluate the desirability of such an agreement before a dispute has arisen or while they are represented by the lawyer seeking the agreement" Res3d § 54, cmt. b.

[22]Illustrative cases cited by the *Restatement* include Swift v. Choe, 242 A.D.2d 188, 674 N.Y.S.2d 17 (1st Dep't 1998) (release invalid when client had severe vision problem and lawyer failed to explain); Ames v. Putz, 495 S.W.2d 581 (Tex. Civ. App. Eastland 1973), writ refused, (Sept. 19, 1973) (release invalid when client not informed of its legal consequences and did not know of lawyer's malpractice);

[23]Improper pressure can include the "refusal to return documents or funds except upon release of the malpractice claim." Res3d § 54, cmt. c. This pressure exists "even if the client was independently represented, because representation does not necessarily dispel improper pressure." *Id.*

[24]Res3d § 54, cmt. c.

[25]See Sally McDonald Henry, Ordin on Contest-

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ing Confirmation § 18.11 Exculpation Clauses (7th Edition 2022-1 Supplement). See also In re Reader's Digest Ass'n, No. 09-23529 (RDD), 2010 Bankr. LEXIS 5550, at *35-36 (Bankr. S.D.N.Y. Jan. 19, 2010); In re Extended Stay Inc., No. 09-13764, 2010 WL 6561113 (Bankr. S.D.N.Y. July 20, 2010).

[26]See, e.g., In re Stearns Holdings, LLC, 607 B.R. 781 (Bankr. S.D.N.Y. 2019); In re Winn-Dixie Stores, Inc., 356 B.R. 239 (Bankr. M.D. Fla. 2006).

[27]In re Astria Health, 623 B.R. 793, 801 n.25, 69 Bankr. Ct. Dec. (CRR) 195 (Bankr. E.D. Wash. 2021).

[28]See In re Washington Mutual, Inc., 442 B.R. 314, 350-51 (Bankr. D. Del. 2011) ("The exculpation clause must be limited to the fiduciaries who have served during the chapter 11 proceeding: estate professionals, the Committees and their members, and the Debtors' directors and officers.").

[29]11 U.S.C.A. § 105(a).

[30]In re Airadigm Communications, Inc., 519 F.3d 640, 657, 49 Bankr. Ct. Dec. (CRR) 179, Bankr. L. Rep. (CCH) P 81123 (7th Cir. 2008) (describing section 1123(b)(6) as working in tandem with section 105(a) to ensure "a bankruptcy court is also able to exercise [its] broad equitable powers within the plans of reorganization themselves").

[31]11 U.S.C.A. § 1123(b)(6). See, e.g., U.S. v. Energy Resources Co., Inc., 1990-2 C.B. 263, 495 U.S. 545, 549, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 20 Bankr. Ct. Dec. (CRR) 840, 22 Collier Bankr. Cas. 2d (MB) 1093, Bankr. L. Rep. (CCH) P 73381, 90-1 U.S. Tax Cas. (CCH) P 50281, 65 A.F.T.R.2d 90-1078 (1990) (explaining that then section 1123(b)(5)—currently section 1123(b)(6)—provides "residual authority" for bankruptcy courts to approve plans containing features that are not explicitly authorized by statute "consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); In re Adelphia Communications Corp., 441 B.R. 6, 19, 53 Bankr. Ct. Dec. (CRR) 267 (Bankr. S.D. N.Y. 2010) ("Section 1123(b)(6), by its terms, is plainly a broad grant of authority. As previously noted, reorganization plans, after they get the requisite assent, may allocate and distribute the value of debtors' estates by a broad array of means.").

[32]11 U.S.C.A. § 1123(b)(3)(A).

[33]See 7 Collier on Bankruptcy ¶ 1123.02[3] (Henry Sommer & Richard Levin, eds., 16th ed. 2022) for a collection of cases.

[34]In re Master Mortg. Inv. Fund, Inc., 168 B.R. 930, 937, 31 Collier Bankr. Cas. 2d (MB) 240 (Bankr. W.D. Mo. 1994). See, e.g., *In re rue21, inc.,* 575 B.R. 314, 324, 64 Bankr. Ct. Dec. (CRR) 168 (Bankr. W.D. Pa. 2017) (if the release is so intertwined within the plan terms that it is not easy to distinguish where the settlement ends and the plan begins, it should be evaluated under the Master Mortgage factors).

[35]In re Spansion, Inc., 426 B.R. 114, 143 (Bankr. D. Del. 2010) (section 1123(b)(3)(A) permits a debtor to release claims in a plan if the release is a valid exercise of the debtor's business judgment, is fair, reasonable, and in the best interests of the estate); In re DBSD North America, Inc., 419 B.R. 179, 217 (Bankr. S.D. N.Y. 2009), aff'd, 2010 WL 1223109 (S.D. N.Y. 2010), judgment aff'd in part, rev'd in part, 627 F.3d 496 (2d Cir. 2010), opinion issued, 634 F.3d 79, 65 Collier Bankr. Cas. 2d (MB) 201, Bankr. L. Rep. (CCH) P 81933 (2d Cir. 2011) (1123(b)(3) permits a debtor to include a settlement of any claims it might own as a discretionary provision in its plan); In re Hercules Offshore, Inc., 565 B.R. 732, 755-56 (Bankr. D. Del. 2016) (release of secured lender appropriate when lender agreed to concessions under a settlement that provided for the payment in full of all unsecured claims, consideration to equity holders and a reduction in estate liabilities).

[36]In re Astria Health, 623 B.R. 793, 800, 69 Bankr. Ct. Dec. (CRR) 195 (Bankr. E.D. Wash. 2021) ("In the Ninth Circuit, bankruptcy courts reviewing settlements are generally to consider (1) the probability of success in potential litigation; (2) the difficulties, if any, to be encountered in the matter of collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.").

[37]Patterson v. Mahwah Bergen Retail Group, Inc., 636 B.R. 641, 702 (E.D. Va. 2022). See also In re Health Diagnostic Laboratory, Inc., 551 B.R. 218, 234 (Bankr. E.D. Va. 2016) (exculpation provision approved if it "(a) is narrowly tailored to meet the needs of the bankruptcy estate; (b) is limited to parties who have performed necessary and valuable duties in connection with the case (excluding estate professionals); (c) is limited to acts and omissions taken in connection with the bankruptcy case; (d) does not purport to release any pre-petition claims; and (e) contains a gatekeeper function by which the Court may, in its discretion, permit an action to go forward against the exculpated parties.").

[38]See, e.g., In re Murray Metallurgical Coal Holdings, LLC, 623 B.R. 444, 504 (Bankr. S.D. Ohio 2021) ("exculpation need not be limited to postpetition conduct.").

[39]In re Chemtura Corp., 439 B.R. 561, 610 (Bankr. S.D. N.Y. 2010).

[40]See, e.g., In re Winn-Dixie Stores, Inc., 356 B.R. 239, 257 (Bankr. M.D. Fla. 2006). Indeed, the acceptability of such justifications lead the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 to suggest changes to the

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Bankruptcy Code to specifically authorize exculpation clauses in Chapter 11 plans. Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, 2012—2014 Final Report and Recommendations, 23 Am. Bankr. Inst. L. Rev. 1, 271–79 (2015).

[41]In re Aegean Marine Petroleum Network Inc., 599 B.R. 717, 726-27 (Bankr. S.D. N.Y. 2019).

[42]Comment c to Res3d § 54 lists several illustrative cases, such as Cohen v. Surrey, Karasik & Morse, 427 F.Supp. 363 (D.D.C. 1977) (upholding release by wealthy and sophisticated clients, one a lawyer, given in exchange for reduction in unpaid fee); Donnelly v. Ayer, 228 Cal. Rptr. 764 (Cal.Ct.App.1986) (upholding release given after client-lawyer relationship ended and client consulted malpractice lawyer); Ames v. Putz, 495 S.W.2d 581 (Tex. Civ. App.1973) (release invalid when client not informed of its legal consequences and did not know of lawyer's malpractice); Marshall v. Higginson, 813 P.2d 1275 (Wash. Ct. App.1991) (release set aside despite compliance with Rule 1.8(h), because lawyer obtained release by saying he would not testify for former client without it).

[43]See, e.g., Harper v. Oversight Comm. (In re Conco, Inc.), 855 F.3d 703, 711 (6th Cir. 2017) ("In interpreting a confirmed plan, courts use contract principles, since the plan is effectively a new contract between the debtor and its creditors. … State law governs those interpretations." (quoting In re Dow Corning, Corp., 456 F.3d 668, 674-75 (6th Cir. 2006). See also 7 Collier on Bankruptcy ¶ 1129.01 (Henry Sommer & Richard Levin, eds., 16th ed., 2022).

[44]Courts have rebuffed efforts to apply Rule 1.8 to plan confirmations. See, e.g., In re Stearns Holdings, LLC, 607 B.R. 781, 791 (Bankr. S.D.N.Y. 2019) ("the Court declines to grant the UST's request that the Amended Plan be modified to include a caveat that the exculpation provision is consistent with Rule 1.8(h)(1), as such caveat is neither warranted nor required."); In re Fraser's Boiler Service, Inc., 593 B.R. 636, 641 (Bankr. W.D. Wash. 2018). This issue is not new. It was flagged over a decade ago by Professor George Kuney. George W. Kuney, Unethical Protection? Model Rule 1.8(H) and Plan Releases of Professional Liability, 83 Am. Bankr. L.J. 481 (2009).

[45]U.S. Const. art. VI, cl.2.

[46]Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43, 83 S. Ct. 1210, 10 L. Ed. 2d 248 (1963).

[47]Hines v. Davidowitz, 312 U.S. 52, 67, 61 S. Ct. 399, 85 L. Ed. 581 (1941).

[48]Kansas v. Garcia, 140 S. Ct. 791, 206 L. Ed. 2d 146 (2020).

[49]Kansas v. Garcia, 140 S. Ct. 791, 801, 206 L. Ed. 2d 146 (2020) (quoting Puerto Rico Dept. of Consumer Affairs v. Isla Petroleum Corp., 485 U.S. 495, 503, 108 S. Ct. 1350, 99 L. Ed. 2d 582 (1988)).

[50]Kansas v. Garcia, 140 S. Ct. 791, 801, 206 L. Ed. 2d 146 (2020) (citing Osborn v. Bank of U.S., 22 U.S. 738, 865, 6 L. Ed. 204, 1824 WL 2682 (1824) (rejecting argument that a federal exemption from state regulation "not being expressed, ought not to be implied by the Court"), as well as Arizona v. U.S., 567 U.S. 387, 400-408, 132 S. Ct. 2492, 183 L. Ed. 2d 351, 115 Fair Empl. Prac. Cas. (BNA) 353, 95 Empl. Prac. Dec. (CCH) P 44539 (2012); Kurns v. Railroad Friction Products Corp., 565 U.S. 625, 630-631, 132 S. Ct. 1261, 182 L. Ed. 2d 116, 33 I.E.R. Cas. (BNA) 577, Prod. Liab. Rep. (CCH) P 18789, 78 A.L.R. Fed. 2d 677 (2012); PLIVA, Inc. v. Mensing, 564 U.S. 604, 617-618, 131 S. Ct. 2567, 180 L. Ed. 2d 580, Prod. Liab. Rep. (CCH) P 18642 (2011).

[51]Cipollone v. Liggett Group, Inc., 505 U.S. 504, 516, 112 S. Ct. 2608, 120 L. Ed. 2d 407, Prod. Liab. Rep. (CCH) P 13199, 17 U.C.C. Rep. Serv. 2d 1087 (1992) (citing Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230, 67 S. Ct. 1146, 91 L. Ed. 1447 (1947)). See also Office Of Disciplinary Counsel v. Marcone, 579 Pa. 1, 855 A.2d 654, 664 (2004).

[52]See, e.g., 35 U.S.C.A. § 2(b)(2)(D) (authorizing rules for practice before patent tribunals); 37 C.F.R. § § 11.101-.901 (2013) (promulgated rules for practice before patent tribunals); 8 U.S.C.A. § 1103 (authorizing rules for practice in immigration tribunals); 8 C.F.R. § 1003.101-.111 (2017) (rules applicable to attorneys practicing in immigration courts); 32 C.F.R. § 776.18-.71 (2022) (rules of professional responsibility for military tribunals).

[53]Bankr. D. Del. R. 1001-1(f)(2021).

[54]D. Del. R. 83.6(d) (2016).

[55]See S.E.C. v. Gibraltar Global Securities, Inc., 2015 WL 2258173 at *2 (S.D. N.Y. 2015); see also In re Bruno, 327 B.R. 104, 108 (Bankr. E.D. N.Y. 2005) ("Bankruptcy courts in New York apply New York's Code of Professional Responsibility to ethical disputes.") (citing Kittay v. Kornstein, 230 F.3d 531, 537, 36 Bankr. Ct. Dec. (CRR) 259, 48 Fed. R. Serv. 3d 429 (2d Cir. 2000)).

[56]Local Civil Rule 1.5(5) of the Local Rules of the United States District Courts for the Southern and Eastern Districts of New York, state:

> Discipline or other relief . . . may be imposed, by the Committee on Grievances . . . if any of the following grounds is found by clear and convincing evidence: [¶] (5) In connection with activities in this Court, any attorney is found to have engaged in conduct violative of the New York State Rules of Professional Conduct as adopted from time to time by the Appellate Divisions of the State of New York.

[57]Res3d § 54, cmt. c.

[58]Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230, 67 S. Ct. 1146, 91 L. Ed. 1447 (1947). See also

Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 31, 116 S. Ct. 1103, 134 L. Ed. 2d 237 (1996) (noting that such intent may be expressed explicitly in the language of a statute, or implicitly through passage of a statutory scheme that extensively occupies the field, or where the purpose and objectives of federal law would be frustrated by state law).

[59]Leis v. Flynt, 439 U.S. 438, 442, 99 S.Ct. 698, 58 L.Ed.2d 717 (1979). See also Bradwell v. Illinois, 16 Wall. 130, 83 U.S. 130, 139, 21 L.Ed. 442 (1872) ("[U]nless we are wholly and radically mistaken . . ., the right to control and regulate the granting of license to practice law in the courts of a State is one of those powers which are not transferred for its protection to the Federal government . . . .") See also Castellanos-Bayouth v. Puerto Rico Bar Ass'n, 483 F. Supp. 2d 167, 175-76 (D.P.R. 2007)

[60]A comparison might be made to 29 U.S.C.A. § 959(b) and its requirement that a debtor in possession observe all non-bankruptcy laws. Of course, the section only applies to debtors in possession, and not their attorneys, but it would be odd to continue state law restrictions on debtors but suspend them for its counsel.

[61]In Attorney Grievance Comm'n of Maryland v. Tatung, 476 Md. 45, 258 A.3d 234 (2021), for example, a Maryland court applied the Maryland rules of professional responsibility to actions taken by a lawyer in Maryland with respect to an immigration proceeding before a federal tribunal in Texas. And, in Max-Planck-Gesellschaft ZUR Foerderung Der Wissenschaften E.V. v. Wolf Greenfield & Sacks, PC, 661 F. Supp. 2d 125, 128 (D. Mass. 2009), the court stated that "the authority of states to punish attorneys who violate ethical duties under state law" extended to actions of attorneys appearing before federal patent tribunals. Id. (quoting Kroll v. Finnerty, 242 F.3d 1359, 1364 (Fed. Cir. 2001). See also State ex rel. York v. West Virginia Office of Disciplinary Counsel, 231 W.Va. 183, 44 S.E.2d 293 (2013) (holding that federal law authorizing the United States Patent and Trademark Office to regulate the conduct of patent attorneys did not preempt state's attorney disciplinary proceeding against attorney).

[62]28 U.S.C.A. § 530B(a).

[63]28 C.F.R. § 77.1(b).

[64]Compare United States v. Colo. Supreme Court, 189 F.3d 1281, 1288-89 (10th Cir. 1999) (holding that Colorado's Rule of Professional Responsibility 3.8 regarding compelled lawyer testimony prescribed "broad normative principles of attorney self-conduct," and that "the rule in its current incarnation is a rule of ethics applicable to federal prosecutors by the McDade Act," and that that Rule 3.8 could be "enforced by the state defendants against federal prosecutors") with United States v. Supreme Court of New Mexico, 839 F.3d 888 (10th Cir. 2016) (finding *Colorado Supreme Court* was limited to application of Rule 3.8 to trial subpoenas, and holding it preempted as to grand jury subpoenas).

[65]United States v. Colo. Supreme Court, 189 F.3d 1281, 1288-89 (10th Cir. 1999).

[66]While it is doubtful that a single bankruptcy judge could invoke conflict preemption regarding exculpation in a single chapter 11 case, that doubt itself becomes doubtful were Congress or even the Bankruptcy Rules Committee to promulgate such a rule. No doubt that is why the American Bankruptcy Institute's Commission suggested Congress address the exculpation issue. Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, 2012—2014 Final Report and Recommendations, 23 Am. Bankr. Inst. L. Rev. 1, 279 (2015).

[67]Although the Army has adopted most of the American Bar Association's Model Rules, it specifically has excluded Rule 1.8. See Comment 14 to Rule 1.8, Rules of Professional Conduct for Lawyers, Army Regulation 27–26, at 37 (June 2018) ("ABA Model Rule 1.8(h) is not adopted into Army Rule 1.8 because it is doubtful that Army lawyers would find it necessary to obtain prospective malpractice liability releases from clients such as the ones provided for in ABA Model Rule 1.8(h).").

[68]In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643 (3d Cir. May 24, 2022).

[69]In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643, at *1-*3 (3d Cir. May 24, 2022).

[70]In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643, at *2-*3 (3d Cir. May 24, 2022).

[71]"Save the "any other reason" catchall, the focus dead ends at the debtor and especially its estate." In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643, at *4 (3d Cir. May 24, 2022). See also id. at *8 ("In holding that the Bankruptcy Court permissibly allowed BSA to retain Sidley as its restructuring counsel, our concern is primarily whether it could effectively represent BSA in its bankruptcy case.").

[72]"Century [the insurance company] has not meaningfully challenged the Bankruptcy Court's factual finding that Sidley [debtor's counsel] did not have an interest adverse to the estate." In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643, at *5 (3d Cir. May 24, 2022).

[73]"In holding that the Bankruptcy Court permissibly allowed BSA to retain Sidley as its restructuring counsel, our concern is primarily whether it could effectively represent BSA in its bankruptcy case. Whether it did so in Century's reinsurance matters is a separate question that Century can independently challenge in its arbitration proceeding with Sidley." In re Boy Scouts of Am., No. 21-2035, 2022 WL 1634643, at *8 (3d Cir. May 24, 2022).

[74]Indeed, that is what some plans have provided.

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See, e.g., In re Reader's Digest Ass'n, No. 09-23529 (RDD), 2010 Bankr. LEXIS 5550, at *35-36 (Bankr. S.D.N.Y. Jan. 19, 2010); In re Extended Stay Inc., No. 09–13764, 2010 WL 6561113 (Bankr. S.D.N.Y. July 20, 2010).

[75]Given the multiplicity of standards for approving exculpation explored above, it would not seem to add much to the mix to require lawyers comply with Rule 1.8 at the disclosure statement stage. This was the early suggestion of Professor Kuney. George W. Kuney, Unethical Protection? Model Rule 1.8(h) and Plan Releases of Professional Liability, 83 Am. Bankr. L.J. 481 (2009).

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PREDATORY LENDING, TWYNE'S CASE AND DEAN v. DAVIS

*by Bruce A. Markell**

You cannot read far in the law of fraudulent conveyances before you come to *Twyne's Case.*[1]

I. INTRODUCTION

People form groups and societies for all sorts of reasons. Rotarians form clubs to promote service to others. Creditors in a bankruptcy form committees to better serve their interests against a larger debtor.[2] And lenders form syndicates to provide, and profit from, large extensions of credit.

Organizers of these groups understand that not all members will agree on everything all the time. So Rotarians have a constitution which contains voting specifications.[3] Most, if not all creditor committees, have committee by-laws.[4]

Lenders? They have their credit agreements or their syndicate agreements.[5] It is all pretty much contractual.

But contracts are subject to interpretation, and lawyers have earned a reputation for being able to squeeze plausible interpretations out of contracts that likely were never contemplated by the parties at signing.[6]

A spotlight has shone on this verity recently. Syndicated lenders to such household names as J. Crew, Serta and Revlon have been subject to predatory lending tactics, sometimes called "creditor on creditor" violence, a crude phrase used to describe the use of complex contract terms to benefit some syndicate members over others in ways arguably never contemplated at syndicate formation. Thus far, the clever have outmaneuvered the unsuspecting, with courts generally declining to intervene when subgroups collide.

Much of this acquiescence seems to be based on a laissez faire approach to contracts: courts figure that the parties signed the syndication agreement and thus had the last best chance to agree or disagree on provisions with the potential to harm them. If the syndication agreement arguably permits the actions taken, that ends the inquiry. By not

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taking action before they signed, those surprised by their fellow lenders' actions can stew in their own juices.

This issue of the *Bankruptcy Law Letter* takes a different approach. After an examination of some of the key cases in this trend and a brief look at the puzzling contractual response of most courts to date, it looks at these transactions not from the contractual perspective, but from the creditor perspective. The lens used is the law of fraudulent transfers and over 400 years of history interpreting its modern progenitor, the Statute of Elizabeth.[7] It sketches some avenues for reexamining these transactions, using *Twyne's Case* and the 1917 Supreme Court case of *Dean v. Davis*.

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II. A (NOT SO) BRIEF DESCRIPTION OF THE PREDATIONS

Predatory actions by some loan syndicate members[8] against other syndicate members appear to be relatively recent.[9] And it has attracted a lot of attention from practitioners and academics.[10]

These transactions typically start with the financial distress of the debtor, and the recent causes of such distress—COVID-19 restrictions, rising interest rates, and more—have been numerous. Such distress calls for changes—changing maturities, extensions of payment dates and, importantly, increases in credit extended.

As Professor Diane Dick points out,[11] the received wisdom until recently was that the syndicate should work cooperatively and by consensus. In the last decade, that's changed. Whether it is the introduction of new types of lenders—such as hedge funds or lenders (such as originators of collateralized loan obligations) who have vastly different investment criteria—or something else, the range of possible consensus solutions has narrowed. One consequence is that syndicate members now look for options that don't require consensus, and which often isolate and exclude other syndicate members.

Two types of transactions have been broadly identified as tools for these independent solutions: the so-called "drop down" financing, and the "uptiering" refinance. These are briefly described below.

A. J. CREW AND DROP-DOWN TRANSACTIONS

"Drop-down" financings depend on flaws or unintended loopholes in complex financing and syndication documents. These financings exploit contractual clauses which permit the debtor to take certain financial actions without the need for unanimous lender approval. These actions might initially be permitted for tax or international compliance requirements, but in the main permit the movement of assets without the consent of all syndicate members.

That freedom is then exploited by a minority of syndicate members to move assets to so-called "unrestricted" subsidiaries, who then grant priority or security based on those assets to the predatory lenders.

The result is that while the existing loan structure is maintained, the dropping down of assets which then are earmarked for the predatory lenders effects a structural subordination which favors the minority and prejudices the excluded lenders.

This format was popularized by transactions involving the clothing company J. Crew. As described by Professor Dick:

> Specifically, the company had transferred certain portions of the lenders' most valuable intellectual property collateral—including the "J. Crew" branding—to new, wholly-owned subsidiaries that would not be considered debtors or guarantors under the loan agreement. At the time of the transfer, the intellectual property assets were estimated by J. Crew to be worth approximately $250 million, while the aggrieved lenders would later assert that these assets were worth upwards of $1 billion. Following the transfer, the company promised to redirect $59 million per year to the new subsidiary to compensate it for the use of the intellectual property for branding and merchandising purposes. . . .
>
> J. Crew would [then] use the new, asset-rich, unrestricted subsidiaries to entice certain junior, unsecured bondholders to exchange their debt for new secured bonds of lesser principal amount and longer maturities. Meanwhile, the company solicited senior secured lenders to consent to the transactions . . .. To sweeten the proverbial pot, the company offered to purchase up to $150 million of the senior secured debt at par even though the loans were then trading at seventy cents on the dollar. The lenders were given three days to decide. . . . Lenders who collectively held approximately 88% of the outstanding loans voted to accept the restructuring terms.[12]

This transaction was so notorious that lenders victimized by later copying of it in other deals have been said to be "J. Crewed."[13]

B. REVLON, SERTA AND UPTIER TRANSACTIONS

Drop-down restructurings are not the only way in which debtors and predatory lenders conspire to benefit at the expense of others. "Uptier" transactions rely on interpretation of complex contractual provisions which allow the debtor to issue new super-priority debt which favors only the predatory lenders. These new extensions of credit typically roll up the loans of some of the existing lenders, essentially resulting in an intra-class subordination of some of the senior debt.

1. REVLON AND "PERMITTED" DEBT EXCHANGES

Revlon is a classic example. The excluded lenders in Revlon not only were "J. Crewed," but then received a double whammy with an uptier closer. After Revlon had dropped intellectual property into a subsidiary, leased back the right to use it to its former owners, and then granted a subset of its lenders rights based upon that intellectual property, it proposed a radical restructuring of its remaining debt. Again, as ably described by Professor Dick:

> This time around, Revlon proposed issuing nearly $900 million in new debt, secured by a first-priority lien on the intellectual property. $200 million of the new debt would be used to pay off the debt issued in the smaller J. Crew maneuver that the company had previously completed. Additionally, the new facility would roll up approximately $950 million of debt under the 2016 facility, granting these participating lenders second and third priority liens. Excluded lenders would have no liens at all in the intellectual property. And, while they would continue to have liens on the company's remaining assets, their interest would be diluted by a pari passu lien securing the new tranches.[14]

But this proposal faced opposition from lenders that normally would have constituted a majority of its lenders, and thus a group able to address such shenanigans. But Revlon responded with a gerrymandering scheme, again as described by Professor Dick:

> To overcome this opposition, Revlon exercised its right under the loan agreement to issue new, unfunded revolver commitments (later described by senior lenders as "not real loans, just empty promises to loan"):
>
> > [Revlon] took the position that these new "lenders" would then be afforded the right to vote (even though they had no economic stake or standing to do so), thereby conjuring up a false majority consent for the 2020 Transaction. These fake commitments rigged the math: [Revlon] would issue the exact amount of commitments necessary to inch over the 50.0% consent threshold. The new revolver commitments served no legitimate business purpose; rather, they were created solely to manipulate and gerrymander voting on the Proposed Amendment so that [Revlon] could consummate its scheme to siphon away substantially all of the collateral from the 2016 Term Lenders.[15]

The new debt gave the instigators a .05% edge; that was all they needed. With the manufactured majority, the instigators changed the syndication documents to ratify their plan.

2. SERTA AND OPEN MARKET TRANSACTIONS

Sometimes a drop-down transaction isn't necessary, and the Revlon technique of issuing more debt to a favored few with near-immediate payment is not desired. Are there other ways to favor the few? Disadvantaged lenders to Serta, the mattress retailer, found out the hard way.

In Serta, the debtor and the predatory lenders conceived of a two-step scheme to favor some, but not all, of the syndicated lenders. This scheme focused on two clauses: the ability to create new incremental debt with equivalent priority to existing debt,[16] and the use of an open market clause, a clause found in most syndicated credit agreements,[17] which then permitted syndicate members to purchase their own debt, on non-cash terms at par, without the consent of the group.[18]

Serta's plan was as follows: first, it issued new debt in the amount of $200 million to the favored lenders by using the syndication agreement's incremental equivalent debt provisions. This changed the set of lenders constituting majority approval. Then, with the consent of the newly constituted majority lenders,[19] Serta amended the syndication agreement's provisions which prohibited senior liens and which required that incremental equivalent debt not be senior to the existing debt.

After that amendment, Serta and favored lenders executed a second facility in which Serta issued $875 million in new debt in a non-cash exchange, in which the preferred lenders exchanged their existing first and second lien loans in consideration for the new debt on a "non pro rata basis as part of an open market transaction."

In short, Serta effectively subordinated the non-participating lenders by first obtaining consent from a simple majority of lenders to create or increase super senior debt capacity under their existing credit agreements. The lenders then used the open market repurchase language in those credit agreements to offer to favored lenders the opportunity to exchange their existing debt for super senior debt, thus leapfrogging the lenders who were excluded from the transactions.

III. A TWO-PARTY ANALYSIS: CONTRACT LAW

To date, most litigation regarding these predatory transactions have been cast as presenting traditional contract issues. Was the predatory action permitted by the syndication agreement? If so, then the victims of the predatory practices assumed that risk when they signed up to the credit.

And litigation has dragged on, despite the seeming applicability of standard contract doctrine: application of the implied covenant of good faith and fair dealing, a factor in every contract.[20]

There is no doubt that the implied covenant is implied in every contract.[21] This includes contracts made under New York law, which does recognize the implied covenant. As recently described by the New York Court of Appeals in *Singh v. City of New York*:[22]

> Broadly stated, the implied covenant "embraces a pledge that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract' " . . . [and] encompasses only those "promises which a reasonable person in the position of the promisee would be justified in understanding were included"[23]

The court went on to state, however that "the implied covenant 'is not without limits.' Courts will imply an obligation of good faith only 'in aid and furtherance of other terms of the agreement of the parties.' "[24]

The main contractual issue in the predatory lending transactions discussed in this issue is whether actions pursuant to a contract's terms, known to be (and indeed, intended to be) beneficial to some and detrimental to other parties to the contract, can be taken if there is no express prohibition against those actions. Keep in mind when framing this issue that the governing contracts are long and detailed. The initial syndication agreement in Serta, with exhibits, runs 476 pages; the First Amendment runs 326 pages, and the agreement for the "open market" purchases runs another 324 pages.[25] Over a 1,000 pages of single-spaced contract language; quite a lot to digest.[26]

Also to be considered is the commercial notion, in syndicated loans, of "sacred rights." As explained by a leading law firm:

> Credit agreements typically have a list of items, commonly referred to as "sacred rights," which can only be modified by the vote of all lenders or all affected lenders. The purpose of the sacred rights is to protect minority lenders from having their critical rights or investment fundamentally altered by the majority. Sacred rights are typically limited to changes that extend the maturity, delay scheduled payments, reduce interest margins, change pro rata sharing of distributions and payments, release all or substantially all of the collateral or guarantors, or adversely affect the sacred rights. But for those limited items, all other credit agreement provisions can be amended with just the consent of lenders holding a majority of the loans and commitments.[27]

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One might first think that amending syndication agreements by unilaterally subordinating one subgroup of lenders to another or by functionally eliminating pro rata distribution would be action "in a manner that would deprive the other party of the right to receive the benefits of their agreement."[28] Further, as New York courts have recognized, the general understanding regarding "sacred rights" would limit discretion to change provisions indirectly but substantially affecting those "sacred rights"; after all, the general implied covenant to act in good faith encompasses "any promises which a reasonable person in the position of the promisee would be justified in understanding were included."[29] In short, the mandatory obligation to act in good faith would seem to subsume an obligation not to take actions under that very same contract to intentionally lessen the benefits of that contract.

But that is not how New York courts, and courts interpreting New York law, apparently see the matter. Again as noted in 2020 by a leading law firm:

> The sacred right on release of collateral has been read by courts as not applying to subordination of liens, even if such subordination might render the liens worthless. Further, the pro rata sharing provisions of the credit agreement only apply to payments under the agreement and do not impact debt issued under a separate agreement, as is the case in many pre-approved incremental debt provisions . . .
>
> Priming transactions illustrate that if a matter is not expressly covered by a sacred rights provision, it is not a term that minority lenders can rely on for protection, particularly in distressed situations.[30]

This prediction from 2020 has proved correct. Recently, in Revlon[31] and Serta,[32] courts accepted the contract arguments predatory lenders have made, in some cases issuing summary judgment on what the predatory lenders contended "open market purchases" means.[33]

IV. A MULTI-PARTY ANALYSIS: CREDITOR RIGHTS UNDER FRAUDULENT TRANSFER LAW

The above indicates that contract-based analysis will have a difficult time redressing the effects of predatory lending. But there is a potentially different approach, one which has only glancingly been used thus far. As the victims of predatory lending are indisputably creditors, they would have standing as such to categorize, attack and avoid the tactics used by predatory lenders as actual intent fraudulent transfers.

This approach has been spurned by commentators. As indicated in a recent analysis:

> Allegations of actual fraud require the plaintiff to show that the uptier exchange was made "with actual intent to hinder, delay, or defraud any creditor of the debtor." Although certain "badges of fraud" may be considered in determining fraudulent intent, it is unlikely that a creditor will find clear evidence of actual fraud, especially when debtors are sophisticated financial entities.[34]

To the extent this excerpt refers to representational or inducement fraud—fraud in which a person knowingly misrepresents a fact intending to induce another to rely on that misrepresentation to their detriment[35]—it probably is accurate.

But that observation is incomplete. Under either a historical or plain meaning view, the tactics and actions typically taken by predatory lenders are intentional fraudulent transfers.

A. THE STATUTES INVOLVED

Current fraudulent transfer law has two main sources: the state-law Uniform Voidable Transfer Act (UVTA) and the federal Bankruptcy Code.

The UVTA has been enacted in 45 states.[36] Section 4(a)(i) of the UVTA states that a creditor may avoid "[a] transfer made or obligation incurred by a debtor" to the extent that the transaction was made "with actual intent to hinder, delay, or defraud any creditor of the debtor."[37]

If the debtor/transferor files bankruptcy, Section 548(a)(1)(A) of the Bankruptcy Code allows an estate representative to avoid and transfer or obligation to the extent the debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."[38]

Common to both statutes is the description of the intent required: the transfer or obligation must be made with the intent to "hinder, delay or defraud" creditors. These words are the current incarnation of the intent specified in what is considered the progenitor of modern fraudulent transfer law: the Statute of 13 Elizabeth, c. 5.[39]

These words—hinder, delay or defraud—describe

an animating intent that has a rich historical meaning. Even if that history is minimized or ignored,[40] however, modern courts have interpreted them disjunctively—with the consequence that avoidance does not require representational fraud. Each of these is examined below.

B. THE HISTORICAL UNDERSTANDING

Intent is notoriously difficult to prove with any certainty—fraudsters rarely admit their nefarious deeds. Indeed, one can categorize the 400+ years of case law since the passage of the Statute of Elizabeth as a quest to find a durable definition of the intent that will allow avoidance of a transaction. This history moves us then to look at how "hinder, delay or defraud" was originally and historically understood so as to apply it today consistently with its past.

1. GOOD CONSIDERATION BUT BAD FAITH: THE REMAINING STRAND OF TWYNE'S CASE

Our understanding of the intent required—what the intent to "hinder, delay or defraud" means—traditionally starts with *Twyne's Case*, a 1602 case from England's Star Chamber.[41] For most of the 400+ years since the case was decided, the focus was on the fraudulent nature of a transfer of title without a change of possession.[42]

But *Twyne's Case* has more to offer. In that case, Pearce, the debtor and transferor, actually owed a debt to Twyne; that is, Pearce's transfer of all his goods to Twyne would today be held to be a transfer for good consideration under contract law. And in part because of this, the transfer of the property to Twyne, while fraudulent as to Pearce's creditors, was likely good as between the Twyne and Pearce.[43] In short, the transfer satisfied Pearce's debt to Twyne; it was consideration for the extinguishment of the debt.

Lord Coke, who wrote the account of *Twyne's Case* and was also the chief prosecutor, acknowledges this conclusion. The Star Chamber, however, did not think that Pearce's provision of valuable consideration made a difference under the Statute of 13 Elizabeth. As Coke's report states:

> notwithstanding here was a true debt due to Twyne, and a good consideration of the gift, yet it was not within the proviso of the said Act of 13 Eliz. . . . for although it is on a true and good consideration, yet it is not bona fide, for no gift shall be deemed to be bona fide within the said proviso which is accompanied with any trust[44] . . ..

Here, the trust existed apparently due to the nature of the arrangement between Twyne and Pearce. Coke's report never quite spells out what this arrangement was, but the inference is that it was an arrangement different from that described in the documentation, and full of hidden understandings. In somewhat confusing language, Coke gave a hypothetical illustrating why the transaction was not bona fide:

> if a man be indebted to five several persons, in the several sums of twenty pounds, and hath goods of the value of twenty pounds, and makes a gift of all his goods to one of them in satisfaction of his debt, but there is a trust between them, that the donee shall deal favourably with him in regard of his poor estate, either to permit the donor, or some other for him, or for his benefit, to use or have possession of them, and is contented that he shall pay him his debt when he is able; this shall not be called bona fide within the said proviso.[45]

At the time, Coke was concerned with the text of the Statute of 13 Eliz. that stated that

> this act or anything therein contained shall not extend to any . . . goods or chattels, had, made, conveyed or assured, or hereafter to be had, made, conveyed or assured, which estate or interest is or shall be, upon good consideration and bona fide[46] . . ..

Coke's response was to imply that secrecy and the clandestine nature of the transfer implied an intent to hinder, delay, or defraud. As he stated, "the proviso [from the Statute of Eliz.] saith on a good consideration, and bona fide; so a good consideration doth not suffice, if it be not also bona fide."[47] He followed this with a stern admonition to the reader: "therefore, reader, when any gift shall be to you in satisfaction of a debt, by one who is indebted to others also; 1st, Let it be made in a public manner, and before the neighbours, and not in private, for secrecy is a mark of fraud."[48] Additional admonitions included having the property appraised before transfer, and changing possession after the transfer.[49]

2. BONA FIDE CONSIDERATION AFTER TWYNE

As indicated above, the great bulk of cases construing *Twyne's Case* were not concerned with the bona fide nature of the consideration. Lord Mansfield, however, emphasized it some 175 years later in dicta:

> But if the transaction be not bonâ fide, the circumstance of its being done for a valuable consideration, will not alone take it out of the statute. I have known several

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> cases where persons have given a fair and full price for goods, and where the possession was actually changed; yet being done for the purpose of defeating creditors, the transaction has been held fraudulent, and therefore void.
>
> One case was, where there had been a decree in the Court of Chancery, and a sequestration. A person with knowledge of the decree, bought the house and goods belonging to the defendant, and gave a full price for them. The Court said, the purchase being with a manifest view to defeat the creditor, was fraudulent, and therefore, notwithstanding a valuable consideration, void.-So, if a man knows of a judgment and execution, and, with a view to defeat it, purchases the debtor's goods, it is void: because, the purpose is iniquitous. It is assisting one man to cheat another, which the law will never allow.[50]

As a result, not only did there have to be valuable consideration, but the consideration given had to be bona fide. American courts embraced this tenet of *Twyne's Case*. Orlando Bump's 1872 treatise lists five cases for this proposition;[51] the fourth edition of that treatise, published in 1896, lists 14.[52] And the drafters of the initial Uniform Fraudulent Conveyance Act (UFCA), working between 1915 and 1918, did not exclude the concept when retaining the "hinder, delay or defraud" concept. Indeed, it carried the concept into its innovation invention of constructive fraudulent conveyances; the definition of "fair consideration," a requirement to validate an insolvent's transfer, required "good faith" in addition to the exchange of a fair equivalent.[53]

By the time of the promulgation of the Uniform Fraudulent Transfer Act in 1984 (UFTA), the concept remained, but the focus had shifted to defenses available to transferees. No longer was good faith an element of consideration. Under Section 8(a) of the UFTA, the recipient of a transfer made with the actual intent to hinder, delay or defraud had a full defense to avoidance if he or she had given reasonably equivalent value and was in good faith.[54] The UVTA retained this structure.[55]

Section 548(c) differs in form, but not in substance. That section requires good faith as well, but only allows a defense *to the extent of value given* (with the change being between the numerical difference between full value and "reasonably equivalent value").[56]

Modern statutes thus preserve this aged concept. Transactions subject to fraudulent transfer laws must be undertaken with good faith, even if they otherwise would be supported by common law consideration. This covers situations such as *Twyne's Case*, in which the transfer of property from Pearce to Twyne was supported by Twyne's cancellation of Pearce's debt. That's a perfectly good and valid transaction, so long as there is no intent to hinder, delay or defraud Pearce's creditors (as by allowing Pearce to continue in possession and to run his farm with no notice of the exchange and as if no exchange had taken place).

3. LENDING TO FINANCIALLY DISTRESSED DEBTORS AFTER TWYNE: DEAN V. DAVIS RE-EXAMINED

A more obvious but overlooked application, however, may lie in distressed or rescue financing. The relevant case is over 100 years old, and is from the Supreme Court: *Dean v. Davis*.[57] In *Dean*, one Jones found himself in financial trouble. He had given unsecured notes to a bank upon which there were forged endorsements. The bank discovered the fraud and demanded payment, and apparently also insinuated Jones might be criminally liable for forgery. Jones, a farmer who also ran a country store, did not have the cash, and so he pleaded with his brother-in-law, Dean, to lend him $1,600. Jones also offered to give Dean a mortgage on everything he owned if the money could be found.

After talking it over with Jones and his father-in-law, Dean lent the money pursuant to several cross-defaulted notes and took the security. There was valuable consideration for this transaction; Dean lent funds, and Jones promised to repay, and backed his promise by a grant of security.

By the time the mortgages were recorded, however, the first note in the amount of $100 was overdue, and thus the cross default clauses caused all of the remaining notes, representing the entire $1,600, to come due. Dean then took possession of everything, and would have foreclosed but for an involuntary bankruptcy filed against Jones.

Davis was appointed Jones' bankruptcy trustee and contested the mortgage—it turned out that although Jones had assured Dean that the property would be worth five times the amount of the loan, a sale of the assets only yielded $1,634, roughly the amount of the notes Dean took. So unless the mortgage was invalidated, Dean would be repaid in full while other creditors would receive nothing.

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The case was tried on both preference and fraudulent conveyance grounds.[58] Dean defeated the preference action, but lost on the fraudulent conveyance claim.[59] The Supreme Court summarized the evidence in favor of Jones' intent to hinder, delay or defraud, and of Dean's complicity as follows:

> Jones knew that he was insolvent. He knew that he was making a preferential payment. He must have known that suspension of his business and bankruptcy would result from giving and recording a mortgage of all his property to secure a note which had matured before the mortgage was executed. The lower courts were justified in concluding that he intended the necessary consequences of his act; that he willingly sacrificed his property and his other creditors to avert a threatened criminal prosecution; and that Dean, who, knowing the facts, cooperated in the bankrupt's fraudulent purpose, lacked the saving good faith.[60]

The Court thus affirmed that Jones had the requisite intent to "hinder, delay or defraud" creditors by offering and giving security when insolvent, and by engineering the conversion of the bank's unsecured claims into a secured debt.

In short, the Court, without citing *Twyne's Case* or Coke's report on it, had before it the modern day equivalent of Coke's hypothetical involving five creditors and £20. Here, Jones had property that ultimately turned out to be worth about $1,600. He mortgaged—essentially gave—that property to Dean in consideration for Dean paying an equivalent amount to the bank, and Dean, as a good brother-in-law, then did "deal favorably with him in regard of his poor estate."[61]

Much has been written about *Dean*, especially with respect to its relationship to preference law.[62] But the fraudulent conveyance aspects are more relevant to *Twyne's Case*, and would seem to be enduring.[63] At the time of the transaction, the statutes relevant to both state law and federal bankruptcy law simply attacked conveyances made with the intent "to hinder, delay or defraud." The UFCA had not yet been enacted, and section 67e of the 1898 Bankruptcy Act did not address consideration, fair or otherwise, with respect to the formulation of the malign intent. Rather, it separated the transferee's defense from the actions and intent that would lead to avoidance.[64]

If *Twyne's Case* still has validity, this could be troubling for predatory lending. If an insolvent's grant of security to pay one creditor and short others is, under *Twyne's Case* and *Dean v. Davis,* evidence of an intent to hinder, delay or defraud, then lenders of last resort must focus on what good faith is, and is not—a subject that itself has enduring but not necessarily endearing qualities.

C. THE MODERN DISJUNCTIVE INTERPRETATION

If the historical view is ignored or discarded, current views of statutory interpretation lead to the same conclusion. The critical phrase is an intent to "hinder, delay or defraud." There are at least two consequences to reading this as if it had no history: it is in the disjunctive, so an intent to hinder, or an intent to delay, or an intent to defraud are each sufficient. The second consequence is that only one of these intents mentions fraud, thus permitting a finding of the necessary intent through something other than representational fraud.

The Supreme Court has recognized this second consequence. In *Husky International Electronics v. Ritz*,[65] the Court had to decide whether a fraudulent conveyance made without the intent to defraud was "fraud" for nondischargeability purposes.

The Court answered in the affirmative. "The degree to which this statute remains embedded in law related to fraud today clarifies that the common-law term 'actual fraud' is broad enough to incorporate a fraudulent conveyance."[66] In short, the Court held that "actual fraud" meant "any fraud that 'involv[es] moral turpitude or intentional wrong,' " or "anything . . . done with wrongful intent" including "deception or trickery generally."[67]

The Court recognized that the fraud discussed did not involve a lie or a misrepresentation. Fraudulent conveyances "are not an inducement-based fraud."[68] The Court found that "fraudulent conduct . . . [exists] in the acts of concealment and hindrance."[69] As such, the "recipient of the conveyed assets was liable for fraud even though the recipient of a fraudulent conveyance of course made no representation, true or false to the debtor's creditor."[70]

District and bankruptcy courts have also recognized that the use of "or" in the statutes means that representational fraud is not required, that acts of hindrance and delay can supply the necessary intent.[71] As stated in *In re TransCare Corp.*:[72]

> [A] "deliberate attempt to stave off creditors by putting property in such a form and place that creditors cannot

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> reach it, even when the purpose of that action is not to defraud them of ultimate payment but only to obtain enough time to restore the debtor's affairs," or for some other purpose, "comes within the meaning of 'hinder' and 'delay.'[73]

This would seem to fit predatory lending tactics snugly. The predatory lenders use a common contract's terms to hinder and delay (if not eliminate) the recoveries of those not included. As *TransCare* points out, the assertion that the transaction was necessary "to obtain enough time to restore the debtor's affairs, or for some other purpose" is insufficient to negate the intent specified in the various statutes.

V. EXCLUDED LENDERS AS CREDITORS: THE FRAUDULENT TRANSFER ANALYSIS

In a sense, establishing the existence of an intent to hinder, delay or defraud in predatory lending situations is easy. The lenders initiating the exclusionary transfers and obligations would only engage in those transactions if they were to benefit, and their benefit is the non-participating lenders' loss. But are other aspects of fraudulent transfer law present? They are.

A. THERE ARE TRANSFERS MADE AND OBLIGATIONS INCURRED

For fraudulent transfer law to apply, there must be either a "transfer" or the incurrence of an "obligation." Both are present in predatory transactions.

A transfer is generally defined as "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property."[74] This definition easily includes any creation of a security interest in the debtor's property to secure the securities issued in an uptier transaction, and the conveyance or assignment of property in a drop-down transactions.

"Obligation" is not defined in either the Bankruptcy Code or the UVTA,[75] but commercial debt issued and incurred by a debtor would undoubtedly qualify. Such debt, valid as between the debtor and the predatory lenders as a contract under common law, is a charge or duty that, if paid on its terms, could or would reduce the recoveries of other creditors.

As a result, both the debt incurred to the predatory lenders and any security for it would be the transactions that would be subject to avoidance as a fraudulent transfers. Comment 3 to § 3 of the UVTA confirms this: "If the debt is a voidable obligation under this Act, a transfer to secure it as well as the obligation would be vulnerable to attack as voidable."[76]

B. NO NEED TO PROVE WHO WAS THE TARGET OF INTENT

Once the requisite intent to hinder, delay or defraud is present, and the transfers and obligations that are the instruments of that scheme are identified, excluded lenders in a predatory scheme will have completed their prima facie case. There is no need to show that the predatory lenders had a target in mind or that there was specific intent to harm the excluded lenders. All that is required is a general intent to hinder, delay, or defraud.[77]

C. AUTHORITY UNDER FRAUDULENT TRANSFER LAWS

Plaintiffs in fraudulent transfer cases are generally unpaid creditors. They have debt claims against the debtor which the debtor has taken steps to frustrate. Fraudulent transfer law gives a cause of action or a claim for relief over and above the claim a creditor has for its debt, and provides additional defendants—those receiving the transfers or the benefit of the obligations—for the collection of that debt.

As a result, unless debt instruments can somehow validly waive the ability to challenge future fraudulent transactions—a dubious proposition, but one that requires more space that this issue permits—the excluded lenders in a predatory transaction will always have the authority to commence a fraudulent transfer action against the debtor.[78]

In short, the excluded lenders are "creditors" under the UVTA based upon their claims under the pre-transactions syndication agreement.[79] As creditors, they have standing to seek to avoid transfers and obligations made with the intent to hinder, delay, or defraud.[80]

1. AUTHORITY UNDER UVTA OUTSIDE OF BANKRUPTCY

It is thus beyond doubt that excluded lenders are "creditors" of the debtor under the UVTA based upon their claims under the pre-transactions syndication agreement.[81] As creditors, they thus have authority under the UVTA to seek to avoid transfers and obligations made with the intent to hinder, delay, or defraud.[82]

2. AUTHORITY IN A BANKRUPTCY CASE

Once a debtor files bankruptcy, a creditor's ability to commence an action under the UVTA is suspended. As stated in *Collier on Bankruptcy*:

> [C]reditors have no ability or standing to prosecute such an action in their own right and for their own benefit, even if they would have had standing to do so outside of bankruptcy. Any attempt by the creditor to pursue the action is barred by the automatic stay of section 362(a), either under the theory that the action is property of the estate, or constitutes a power and benefit vested initially and primarily in the estate representative.[83]

What is more, the estate representative has the power to compromise or abandon any UVTA claims creditors of the estate may have.

This presents significant issues for creditors, as the connivance of the debtor is essential for any predatory transaction; it is the entity transferring the property and incurring the obligations that excluded lenders would seek to avoid.

Moreover, the predatory lenders may be in a privileged position to offer a debtor post-petition financing in which they could either "roll up" the questionable debt, or make its validity a condition of the extension of credit.

Creditors have some recourse. In limited circumstances, courts permit an official committee to bring a fraudulent transfer action[84] or may permit a creditor to bring the action on behalf of the estate.[85]

In predatory lending cases, a court should seriously consider preserving the rights of such excluded creditors (indeed, the rights of all creditors) by permitting such derivative authority on behalf of creditors generally. Indeed, the debtor in possession, encumbered by a fiduciary duty to all creditors,[86] would seem to be compromised significantly in making any compromise or release of predatory lenders.[87] Without such a reservation, however, the claims outlined in this issue may well go without redress.

D. REMEDIES

The remedy at the end of a fraudulent transfer action is "avoidance." With transfers, the application of avoidance is relatively easy: the transfer can be ignored by creditors. With respect to the transfers in a predatory lender action that are the creation of security interests or other liens, the security interests can simply be extinguished, rendering the remaining debt unsecured.

Avoidance of an obligation is trickier. Standard doctrine is that while a creditor may avoid an obligation, it remains valid as between the debtor and the transferee. As a consequence, if an obligation is avoided, then what does the defendant transferee have? Nothing? Not quite. As noted by the comments to the UVTA:

> It follows that "avoidance" of an obligation under subsection (a)(1) likewise should not mean its cancellation, but rather a remedy that recognizes the existence of the obligation and the superiority of the plaintiff creditor's interest over the obligee's interest. Ordinarily that should mean subordination of the obligation to the plaintiff creditor's claim against the debtor. That would entail disgorgement by the obligee of any payments received or receivable on the obligation, to the extent necessary to satisfy the plaintiff creditor's claim, with the obligee being subrogated to the plaintiff creditor when the latter's claim is paid.[88]

The consequence of subordination would thus be to place the predatory lenders in the position they attempted to place the excluded lenders: claims surrogated to the full payment of those creditors who were subject to the fraudulent transfer. That is close to poetic justice.

VI. CONCLUSION

Predatory lending has taken center stage in some cases in which insolvent debtors attempt to reorganize. Although its methods seem harsh and underhanded, the response of most courts has been to tolerate the transactions, and treat them as if they were no different that debt incurred in the debtor's ordinary course.

This article surmises that the cause of this judicial response has been the lack of a proper fraudulent transfer attack. Predatory lending is undertaken with the express purpose of hindering, delaying and perhaps even defrauding excluded lenders—at least as fraud in fraudulent conveyances has been historically understood.

This issue of the *Bankruptcy Law Letter* has attempted to shine a light on two strands of interpretation of the words "hinder, delay and defraud" as they appear in fraudulent transfer statutes. Each of these strands—the historical understanding stemming from *Twyne's Case* and *Dean v. Davis*, and the plain meaning interpretation of modern statutory interpreta-

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tion—leads to the conclusion that both drop-down and uptier transactions are transactions undertaken with the intent to hinder, delay and defraud creditors.

If taken seriously, these views of actions taken with the intent to hinder, delay or defraud creditors offer a glimmer of hope for excluded lenders dealing with devious and deceitful debtors and with the predatory lenders with whom they collude.

ENDNOTES:

[1]Garrard Glenn, The Rights and Remedies of Creditors Respecting Their Debtor's Property § 69, at 54 (1915).

[2]Debtors thrown in debtors' prison in the 18th Century wrote constitutions governing their activities while imprisoned. See generally Bruce H. Mann, Republic of Debtors: Bankruptcy in the Age of American Independence (2003).

[3]At its annual convention, each individual Rotary Club has one vote, and an additional vote given for every additional 50 members. See Art. 8, § 3 of Constitution of Rotary International, *available at* https://www.dacdb.com/Rotary/Accounts/6580/assets/constitution_ri_en.pdf.

[4]See examples at Practical Law, https://practicallawconnect.thomsonreuters.com/w-002-8217?accessType=linkBuilder.

[5]There is a trade association, the Loan Syndications & Trading Association, which distribute news and provides form agreements. See https://www.lsta.org/.

[6]Indeed, over 600 years ago, Chaucer's Man of Law was lauded because he could prevent such pettifoggery: "Therto he koude endite and make a thyng, ther koude no wight pynche at his writyng . . .." Geoffrey Chaucer, The Canterbury Tales, The General Prologue, description of the Sergeant of the Lawe (1388-1392), reprinted in The Riverside Chaucer 28 (Larry D. Benson, general ed., 3d ed. 1987) ("Furthermore, he knew how to compose and draw up a legal document// So that no one could find a flaw in his writing;").

[7]An Acte agaynst fraudulent Deedes Gyftes Alienations, &c, 13 Eliz. c. 5 (1571) (Eng), repealed by The Law of Property Act, 15 Geo. 5, c. 20, sch 7 (1925).

[8]Large loans to large debtors almost always are made by a group of lenders, known generically as a "syndicate." In this issue, I refer to the loan agreements and the inter creditor agreements signed by the debtor and lenders in such arrangements as "syndication agreements," even though that term technically is much narrower. For purposes of this issue, however, the various agreements can be lumped together under one term.

[9]Diane Lourdes Dick, Hostile Restructurings, 96 Wash. L. Rev. 1333, 1336 (2021) [hereinafter, "Dick, Hostile Restructurings"].

[10]See generally Sneha Pandya & Eric L. Talley, Debt Textualism and Creditor-on-Creditor Violence: A Modest Plea to Keep the Faith, European Corporate Governance Institute - Law Working Paper No. 673/2023 (2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4317353; Vincent S.J. Buccola, Sponsor Control: A New Paradigm for Corporate Reorganization, 90 U. Chi. L. Rev. 1 (2023); Stephen J. Lubben, Taking Corporate Bankruptcy Fiduciary Duties Seriously, 49 J. Corp. L. (forthcoming 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4420161; Samir D. Parikh, Creditors Strike Back: The Return of the Cooperation Agreement, 72 Duke Law Journal Online ___ (forthcoming 2023); Jackson Skeen, Uptier Exchange Transactions: Lawful Innovation or Lender-on-Lender Violence?, 40 Yale J. on Reg. 408 (2023); Vincent S.J. Buccola, Sponsor Control: A New Paradigm for Corporate Reorganization, 90 U. Chi. L. Rev. 1 (2023); Vincent S.J. Buccola, Efficacious Answers to the Non-Pro Rata Workout, 170 U. Pa. L. Rev. ___ (forthcoming 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4340761; Vincent S.J. Buccola and Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions, June 22, 2022, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4143928; Marc S. Kirschner, Manish Kumar, Kana'i Hanohano, James H. Millar and Andrew N. Page, A Market Based Theory to Demonstrate Lack of Reasonably Equivalent Value for Abusive Debt Exchange Offers, 2022 Norton Ann. Surv. of Bankr. Law 9; Stephen J. Lubben, Holdout Panic, 96 Am. Bankr. L.J. 1 (2022); Douglas S. Mintz, Ned S. Schodek, Peter J. Amend, Recent Challenges to Uptiering Transactions, Am. Bankr. Inst. J. 32, Dec. 2022, at 32; Kenneth Ayotte and Christina Scully, J. Crew, Nine West, and the Complexities of Financial Distress, 131 The Yale Law Journal Forum 363 (Nov. 10, 2021); Mitchell Mengden, The Development of Collateral Stripping by Distressed Borrowers, 16 Capital Markets Law Journal 56 (2021); Dick, Hostile Restructurings, supra; Jared A. Ellias & Robert J. Stark, Bankruptcy Hardball, 108 Calif. L. Rev. 745 (2020).

[11]Dick, Hostile Restructurings, at 1339-45.

[12]Dick, Hostile Restructurings, at 1364-65.

[13]Dick, Hostile Restructurings, at 1366, quoting Peter Coy, In Finance, 'J. Crew' Is a Verb. It Means to Stick It to a Lender, Bloomberg Businessweek (June 17, 2019, 2:00 a.m.), https://www.bloomberg.com/news/articles/2019-06-17/infinance-j-crew-is-a-verb-it-means-to-stick-it-to-a-lender [https://perma.cc/AA6R-R3JS].

[14]Dick, Hostile Restructurings, at 1367.

[15]Dick, Hostile Restructurings, at 1367-68, quoting Complaint at 6, UMB Bank, Nat'l Assoc. v. Revlon, Inc., No. 1:20-cv-06352 (S.D.N.Y. Aug. 12, 2020).

[16]Subject to numerous certain conditions, the relevant portion of the agreement nonetheless dispensed with unanimous approval. The relevant exception was contained in Section 2.22(a)(iii), and read:

> [N]o Incremental Facility or Incremental Loan (nor the creation, provision or implementation thereof) shall require the approval of any existing Lender other than

> in its capacity, if any, as a lender providing all or part of any Incremental Commitment or Incremental Loan . . . .

Section 2.22(a)(iii) to First Lien Term Loan Agreement, dated Nov. 6, 2016, available as Document 1-1 to Complaint, Serta Simmons Bedding LLC et al v. AG Centre Street Partnership et al, Docket No. 4:23-ap-09001 (Bankr. S.D. Tex. Jan. 24, 2023), at 80.

[17]Ashurst, Nothing's Serta-in (Dec. 20, 2020), available at https://www.ashurst.com/en/news-and-insights/legal-updates/nothing-s-serta-in/ ("it is expected that the vast majority of existing New York law-governed credit agreements (and bond indentures as well) contain open market purchases language similar to that which was used to effect the Serta Simmons . . . transaction[], which, at least in theory, would leave the door wide open for similar non-pro rata uptier debt exchanges to become a standard tool in the restructuring playbook.").

[18]The clause provided, subject to certain conditions, the following:

> (g) Notwithstanding anything to the contrary contained herein, any Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis (A) through Dutch Auctions open to all Lenders holding the relevant Term Loans on a pro rata basis or *(B) through open market purchases, in each case with respect to clauses (A) and (B), without the consent of the Administrative Agent*; . . . .

Section 9.05(g) to First Lien Term Loan Agreement, dated Nov. 6, 2016, available as Document 1-1 to Complaint, Serta Simmons Bedding LLC et al v. AG Centre Street Partnership et al, Docket No. 4:23-ap-09001 (Bankr. S.D. Tex. Jan. 24, 2023), at 144 (emphasis supplied).

[19]The agreement provided generally that amendments be approved by the "Required Lenders," defined to be those lenders holding 50% of all total loans and commitments, including loans made under the incremental loan provision of Section 2.22 reprinted above. Section 9.02(b) to First Lien Term Loan Agreement, dated Nov. 6, 2016, available as Document 1-1 to Complaint, Serta Simmons Bedding LLC et al v. AG Centre Street Partnership et al, Docket No. 4:23-ap-09001 (Bankr. S.D. Tex. Jan. 24, 2023), at pp. 137 (text of § 9.02(b)), 49 (definition of "Required Lenders") & 3 (definitions including additional loans as part of amounts counted for "Required Lenders").

[20]Under New York law, "[e]very contract is assumed to incorporate a covenant of good faith and fair dealing *unless* such obligation is expressly disclaimed." Commerzbank AG v. U.S. Bank National Association., 277 F. Supp. 3d 483, 498 (S.D. N.Y. 2017) (quoting Phoenix Light SF Limited v. U.S. Bank National Association, 2016 WL 1169515, at *10 (S.D. N.Y. 2016)) (emphasis in original). I was unable to find any indication that syndication agreements generally or specifically disclaim the implied obligation of good faith and fair dealing.

[21]Restatement (Second) of Contracts § 205 (1981).

[22]Singh v. City of New York, 2023 WL 3098734, 2023 N.Y. Slip Op. 02141 (N.Y. April 27, 2023).

[23]Singh v. City of New York, 2023 WL 3098734, 2023 N.Y. Slip Op. 02141, at 7 (N.Y. April 27, 2023) (quoting 511 W. 232nd Owners Corp., 98 N.Y.2d at 153, 746 N.Y.S.2d 131, 773 N.E.2d 496 (2002) and Dalton v. Educational Testing Serv., 87 N.Y.2d 384, 389, 639 N.Y.S.2d 977, 663 N.E.2d 289 (1995)).

[24]Singh v. City of New York, 2023 WL 3098734, 2023 N.Y. Slip Op. 02141, at 7-8 (N.Y. April 27, 2023) (quoting Murphy v. Am. Home Prods. Corp., 58 N.Y.2d 293, 304, 461 N.Y.S.2d 232, 448 N.E.2d 86 (1983)).

[25]Documents 1-1, 1-2 & 1-3 to Complaint, Serta Simmons Bedding LLC et al v. AG Centre Street Partnership et al, Docket No. 4:23-ap-09001 (Bankr. S.D. Tex. Jan. 24, 2023).

[26]To be fair, the parties decided to leave one page for each signatory, so a little over 10% of the page count is signature pages. But since these pages also often state the commitment of the lender identifies on that page, they are still relevant.

[27]Jeff Norton, et. al., O'Melveny Alerts and Updates: Priming Transactions Update: Don't Sleep on Serta (Dec. 10, 2020), available at https://www.omm.com/resources/alerts-and-publications/alerts/priming-transactions-update-dont-sleep-on-serta/.

[28]Dalton v. Educational Testing Service, 87 N.Y.2d 384, 389, 639 N.Y.S.2d 977, 663 N.E.2d 289 (1995).

[29]Cordero v. Transamerica Annuity Service Corporation, 2023 WL 3061503, at *5 (N.Y. 2023) ("In discerning what is 'reasonable,' the Court looks to what the parties would have expected under the contract: the Court will infer that contracts 'include any promises which a reasonable person in the position of the promisee would be justified in understanding were included' at the time the contract was made") (quoting Rowe v. Great Atlantic & Pac. Tea Co., Inc., 46 N.Y.2d 62, 69, 412 N.Y.S.2d 827, 385 N.E.2d 566 (1978)).

[30]Jeff Norton, et. al., O'Melveny Alerts and Updates: Priming Transactions Update: Don't Sleep on Serta (Dec. 10, 2020), available at https://www.omm.com/resources/alerts-and-publications/alerts/priming-transactions-update-dont-sleep-on-serta/.

[31]Docket #113, Decision and Order Granting Debtor-Defendants' Motion to Dismiss All Claims Against Them and All Equitable Claims in the Complaint, AIMCO CLO 10 Ltd, et al. v. Revlon, Inc., et al., Adv. Pro. 22-01167-dsj (Feb. 14, 2023).

[32]Amelia Pollard, Serta Bankruptcy Judge Blesses Key Piece of Contested Debt Deal, Bloomberg Law: Bankruptcy (March 28, 2023, 7:44 p.m.), available at https://www.bloomberglaw.com/bloomberglawnews/bankruptcy-law/XFJC4STO000000?bna_news_filter=bankruptcy-law#jcite.

[33]Akin, Liability Management Litigation Update: Bankruptcy Court Holds That 2020 Serta Transaction Is an 'Open Market Purchase' (March 28, 2023), available at https://www.akingump.com/en/insights/alerts/liability-management-litigation-update-bankruptcy-co

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urt-holds-that-2020-serta-transaction-is-an-open-market-purchase.

[34]Marc S. Kirschner, Manish Kumar, Kana'i Hanohano, James H. Millar and Andrew N. Page, A Market Based Theory to Demonstrate Lack of Reasonably Equivalent Value for Abusive Debt Exchange Offers, 2022 Norton Ann. Surv. of Bankr. Law 9.

[35]See generally Restatement (Second) of Contracts §§ 161-165 (1981).

[36]The UVTA is the current successor to 1984's Uniform Fraudulent Transfer Act, which itself was a successor to 1918's Uniform Fraudulent Conveyance Act.

[37]UVTA § 4(a)(i).

[38]11 U.S.C.A. § 548(a)(1)(A).

[39]An Acte agaynst fraudulent Deedes Gyftes Alienations, &c, 13 Eliz. c. 5 (1571) (Eng), repealed by The Law of Property Act, 15 Geo. 5, c. 20, sch 7 (1925).

The statute, however, never uses the phrase "hinder, delay or defraud." The statute instead uses the phrases "delaye hynder or defraude" and "dysturbed hyndred delayed or defrauded." An Acte agaynst fraudulent Deedes Gyftes Alienations, &c, 13 Eliz. c. 5, § 1 (1571) (Eng).

[40]I have criticized elsewhere in these pages modern courts' trivialization of historical understandings of venerable commercial concepts in favor of plain meaning interpretation. See Bruce A. Markell, Right Place, Wrong Route: Good Faith, Madoff and the Second Circuit, Bankr. L. Letter (Dec. 2021) (criticizing the Second Circuit for using modern dictionaries to give meaning to "good faith" in fraudulent transfer statutes).

[41]Twyne's Case, 3 Co. Rep. 80b, 76 Eng. Rep. 809 (Star Ch. 1602). A thorough and entertaining recent examination of the case can be found in Emily Kadens, A New Light on Twyne's Case, 94 Am. Bankr. L.J. 1 (2020). Conflict of interest disclosure: I am married to Professor Kadens.

Twyne's Case is likely the oldest viable precedent in American jurisprudence. It was the oldest precedent in Smith's Leading Cases, 1 John William Smith, A Selection of Leading Cases, on Various Branches of the Law: With Notes 33 (J. I. Clark Hare and H. B. Wallace, Am. eds., 7th Am. ed. 1872). None of the other cases listed in that treatise are still viable.

[42]See generally 1 Grant Gilmore, Security Interests in Personal Property § 2.5 (1965). This aspect still lives on in non-finance cases—Section 2-402(2) of the Uniform Commercial Code does say that "[a] creditor of the seller may treat a sale or an identification of goods to a contract for sale as void if as against him a retention of possession by the seller is fraudulent under any rule of law of the state where the goods are situated" U.C.C. § 2-402(2). This was an adaptation of Section 26 of the Uniform Sales Act: "Where a person having sold goods continues in possession of the goods, or of negotiable documents of title to the goods, and such retention of possession is fraudulent in fact or is deemed fraudulent under any rule of law, a creditor or creditors of the seller may treat the sale as void."

[43]English case law did not appear to affirmatively state this proposition until the 19th Century. Baldwin v. Cawthorne, 2 Ves. Jun. Supp. 557, 34 Eng. Rep. 1225 (Ch. 1812). ("Any man assigning property, but keeping the possession thereof himself, is, within the doctrine of Twyne's case 3 Rep. 82, and Pauncefoot v. Blunt, there cited, guilty of a fraud, as against all persons not parties to the assignment, and who are prejudiced thereby; but as between the parties themselves the transaction is binding") (emphasis supplied).

[44]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602).

[45]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602). Today I suspect we would call this an insider preference. See UVTA § 5(b).

[46]13 Eliz., ch. 5, 2d (1571), repealed by The Law of Property Act, 15 Geo. 5, ch. 20, § 172 (1925).

[47]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602).

[48]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602).

[49]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602). This reasoning was picked up in a common treatise of the time on the preparation of deeds:

> So if in this case he give all his goods to B in satisfaction of his debt, and before any suit begun by A, with any express or implicit trust as to the intent that B shall be favourable to the debtor, or that if the debtor provide the money that he shall have the goods again, or that he suffer the debtor to enjoy and use the goods and pay him as he can; in these and the like cases the deeds shall be said to be fraudulent and void, for howsoever it be made upon good consideration, yet it is not made bonâ fide.

William Sheppard, The Touch-Stone of Common Assurances 66 (1648).

[50]Cadogan v. Kennett, 2 Cowp. 433, 434, 98 Eng. Rep. 1171, 1172 (K.B. 1776).

[51]Orlando F. Bump, Fraudulent Conveyances: A Treatise Upon Conveyances Made by Debtors to Defraud Creditors 230 n.3 (1872).

[52]Orlando F. Bump, A Treatise Upon Conveyances Made by Debtors to Defraud Creditors § 182, at 207 n.4 (James McIlvaine Gray rev., 4th ed. 1896).

[53]Unif. Fraudulent Conveyance Act § 3(a). Good faith was also made part of a transferee defense in § 67e of the 1898 Bankruptcy Act.

[54]UFTA § 8(a).

[55]Section 8(a) of the UVTA states that "[a] transfer or obligation is not voidable under Section 4(a)(1) against a person that took in good faith and for a reasonably equivalent value . . ."

[56]11 U.S.C.A. § 548(c) (emphasis supplied).

[57]Dean v. Davis, 37 S. Ct. 130, 61 L. Ed. 419 (1917).

[58]At the time, the bankruptcy fraudulent conveyance statute, found in § 67e of the Act, read as follows:

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> That all conveyances, transfers, assignments, or incumbrances of his property, or any part thereof, made or given by a person adjudged a bankrupt under the provisions of this Act subsequent to the passage of this Act and within four months prior to the filing of the petition, with the intent and purpose on his part to hinder, delay, or defraud his creditors, or any of them, shall be null and void as against the creditors of such debtor, except as to purchasers in good faith and for a present fair consideration . . .

[59]The bank was not party to the suit, and thus we do not know if it was ever part of the discussions regarding avoidance, as it had received full payment on an unsecured debt within the preference period.

[60]Dean v. Davis, 242 U.S. 438, 445, 37 S. Ct. 130, 61 L. Ed. 419 (1917).

[61]Twyne's Case, 3 Co. Rep. 80b, 81a, 76 Eng. Rep. 809, 814 (Star Ch. 1602). The main difference between the facts in Dean and in Twyne's Case is that the federal codification had given Dean, the transferee, a statutory defense of good faith. But Dean, although he denied it, seems to have been in on the scam, as the lower courts found. That deprived him of the good faith defense to the established avoidance.

[62]An excellent recent example is Emil A. Kleinhaus & Alexander B. Lees, Debt Repayments As Fraudulent Transfers, 88 Am. Bankr. L.J. 307 (2014).

[63]See, e.g., Dean v. Davis, 242 U.S. 438, 444, 37 S. Ct. 130, 61 L. Ed. 419 (1917) (equating an act whose "obviously necessary effect" is to hinder, delay, or defraud creditors with an act intended to hinder, delay, or defraud creditors).

[64]The UVTA has a similar defense. UVTA § 8(a).

[65]Husky Intern. Electronics, Inc. v. Ritz, 578 U.S. 356, 136 S. Ct. 1581, 194 L. Ed. 2d 655, 62 Bankr. Ct. Dec. (CRR) 156, 75 Collier Bankr. Cas. 2d (MB) 943, Bankr. L. Rep. (CCH) P 82943 (2016).

[66]Husky, 578 U.S. at 361.

[67]Husky, 578 U.S. at 360 (quoting Neal v. Clark, 95 U.S. 704, 709, 24 L. Ed. 586, 1877 WL 18562 (1877) and citing 1 J. Story, Commentaries on Equity Jurisprudence § 189, p. 221 (6th ed. 1853)).

[68]Husky, 578 U.S. at 361.

[69]Husky, 578 U.S. at 362.

[70]Husky, 578 U.S. at 362.

[71]See, e.g., Lippe v. Bairnco Corp., 249 F. Supp. 2d 357, 374 (S.D. N.Y. 2003), judgment aff'd, 99 Fed. Appx. 274 (2d Cir. 2004) ("As the use of the disjunctive 'or' makes clear, '[o]nly an actual intent to hinder and delay need be established, not an actual intent to defraud.' ") (quoting U.S. v. Carlin, 948 F. Supp. 271, 277, 97-1 U.S. Tax Cas. (CCH) P 50302, 80 A.F.T.R.2d 97-7810 (S.D. N.Y. 1996)); Drivetrain, LLC v. X. Commerce, Inc., 2023 WL 1804627, at *4 (Bankr. D. Del. 2023); In re Bayou Group, LLC, 396 B.R. 810, 826 (Bankr. S.D. N.Y. 2008), aff'd in part, rev'd in part on other grounds, 439 B.R. 284 (S.D. N.Y. 2010) ("The malicious intent sufficient to support a cause of action is set forth in the disjunctive—a plaintiff may avoid the transfer where it was made with intent 'to hinder, delay, or defraud.' ") (emphasis in original); In re Stanton, 457 B.R. 80, 93-94 (Bankr. D. Nev. 2011) ("As the statute's phrasing is in the alternative, a showing of any one of the three requisite states of mind—the intent to hinder, the intent to delay, or the intent to defraud—is sufficient to establish the intent element").

This is a long-standing interpretation. See In re Perlmutter, 256 F. 862, 869 (D.N.J. 1919), aff'd, 264 F. 957 (C.C.A. 3d Cir. 1920) ("It is not necessary that intent to defraud be proved. If the intent to hinder and delay exists, it is sufficient."), aff'd sub nom. Perlmutter v. Hudspeth, 264 F. 957 (C.C.A. 3d Cir. 1920).

[72]In re TransCare Corporation, 2021 WL 4459733 (S.D. N.Y. 2021).

[73]In re TransCare Corporation, 2021 WL 4459733, at *17 (S.D. N.Y. 2021) (quoting Rosa v. TCC Communications, Inc., 2017 WL 980338, at *5 (S.D. N.Y. 2017) and Flushing Sav. Bank v. Parr, 81 A.D.2d 655, 656, 438 N.Y.S.2d 374 (2d Dep't 1981)).

It is clear, though, that more than just an intent to prefer is required. See In re Lyondell Chemical Co., 554 B.R. 635, 650 (S.D. N.Y. 2016) ("the debtor must have had an intent to interfere with creditors' normal collection processes or with other affiliated creditor rights for personal or malign ends.") (quoting In re Lehman Brothers Holdings Inc., 541 B.R. 551, 575, 61 Bankr. Ct. Dec. (CRR) 178 (S.D. N.Y. 2015)).

[74]11 U.S.C.A. § 101(54)(D); see also UVTA § 1(16) (transfer Ies "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an assetIincludes payment of money, release, lease, license, and creation of a lien or other encumbrance.").

[75]Section 6(5) of the UVTA does not define what an obligation is, but simply indicates when it is incurred.

[76]Comment 3 to § 3 of the UVTA.

[77]In re Blatstein, 192 F.3d 88, 97, 34 Bankr. Ct. Dec. (CRR) 1198, 42 Collier Bankr. Cas. 2d (MB) 1350 (3d Cir. 1999); In re Adeeb, 787 F.2d 1339, 1343, 14 Bankr. Ct. Dec. (CRR) 715, 14 Collier Bankr. Cas. 2d (MB) 740, Bankr. L. Rep. (CCH) P 71108 (9th Cir. 1986) (rejected by, In re Davis, 911 F.2d 560, 20 Bankr. Ct. Dec. (CRR) 1532, Bankr. L. Rep. (CCH) P 73609 (11th Cir. 1990)); Tiab Communications Corp. v. Keymarket of Nepa, Inc., 263 F. Supp. 2d 925, 935 (M.D. Pa. 2003) ("Intent to defraud any creditor is sufficient . . .."); Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC), 396 B.R. 810, 826 (Bankr. S.D.N.Y. 2008) ("a plaintiff need not prove that the debtor intended to hinder, delay or defraud the transferee or any other particular creditor"), rev'd on other grounds, In re Bayou Group, LLC, 439 B.R. 284, 308-29 (S.D. N.Y. 2010).

[78]Even though the majority of predatory transactions select New York law, New York law may not provide the governing law. Under § 10(b) of the UVTA, added in 2014, "[a] claim for relief in the nature of a claim for relief under [the UVTA] is governed by the

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local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred." And a debtor is located "at its place of business," UVTA § 10(a)(2), or if it "has more than one place of business [it] is located at its chief executive office." UVTA § 10(a)(3).

The plaintiffs in the Tri-Mark predatory lending case missed this point, alleging applicability of New York law when the debtor was located in Massachusetts. For this error, their fraudulent transfer claims were dismissed. Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 72 Misc. 3d 1218(A), 150 N.Y.S.3d 894 (Sup 2021).

[79]UVTA §§ 1(3) (creditor is "person that has a claim"), 1(4) (claim consists of "right to payment").

[80]UVTA § 4(a)(1).

[81]UVTA §§ 1(3) (creditor is "person that has a claim"), 1(4) (claim consists of "right to payment").

[82]UVTA § 4(a)(1).

I use the word authority here to distinguish between the grant of a new cause of action and the ability to take advantage of that new cause of action. Put another way, the UVTA gives certain parties the authority to avoid specific types of transactions, and bestows that authority on creditors. See Grede v. Bank of New York Mellon, 598 F.3d 899, 900 (7th Cir. 2010).

[83]5 Collier on Bankruptcy ¶ 548.02[5] (Henry Sommers and Richard Levin, eds., 16th ed. 2023).

[84]See generally Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 41 Bankr. Ct. Dec. (CRR) 98, Bankr. L. Rep. (CCH) P 78861 (3d Cir. 2003) (en banc), cert. dismissed, 540 U.S. 1002, 124 S. Ct. 530, 157 L. Ed. 2d 407 (2003); 8 Collier on Bankruptcy ¶ 1103.05[6][a] (Henry Sommers and Richard Levin, eds., 16th ed. 2023).

[85]Although most courts hold that the same standard applies to creditors and committees, see, e.g., In re Housecraft Industries USA, Inc., 310 F.3d 64, 70-71, 40 Bankr. Ct. Dec. (CRR) 98, Bankr. L. Rep. (CCH) P 78740 (2d Cir. 2002), some courts, concerned about the need for any recovery to benefit all creditors generally, have set higher standards when a specific creditor wishes to prosecute a derivative avoidance action. See In re Perkey, 194 B.R. 846, 28 Bankr. Ct. Dec. (CRR) 1189 (Bankr. W.D. Mo. 1996).

If a committee already has been permitted to bring a derivative avoidance action, then an individual creditor may not do so. In re Sunbeam Corp., 287 B.R. 861 (S.D. N.Y. 2003).

[86]See Stephen J. Lubben, Taking Corporate Bankruptcy Fiduciary Duties Seriously, 49 J. Corp. L. (forthcoming 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4420161.

[87]If the debtor in possession declines to commence an action without good reason, the remedy might be the appointment of a trustee, rather than authorizing a committee or an individual to bring suit. See, e.g., Matter of Xonics Photochemical, Inc., 841 F.2d 198, 203, 17 Bankr. Ct. Dec. (CRR) 606, 18 Collier Bankr. Cas. 2d (MB) 711, Bankr. L. Rep. (CCH) P 72211 (7th Cir. 1988) (creditor could either move for appointment of trustee or seek permission to bring derivative action to avoid obligation if debtor in possession is reluctant to commence action).

[88]Comment 7 to § 7 of UVTA.

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ASSESSING THE LEGITIMACY OF THE "TEXAS TWO-STEP" MASS-TORT BANKRUPTCY

By Ralph Brubaker

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,[1] which proceeds essentially as follows:

Step 1. Mass-tort Defendant uses a state divisional merger statute (Texas's[2] 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 four such Texas Two-Step bankruptcies that have been filed in recent years, all of which are still *sub judice*, 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 late February.[3] 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. That decision (currently on appeal

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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.

THE TEXAS TWO-STEP BANKRUPTCIES (TO DATE)

1. BESTWALL (FROM GEORGIA-PACIFIC), DBMP (FROM CERTAINTEED), ALDRICH PUMP AND MURRAY BOILER (FROM TRANE)

All of the Texas Two-Step bankruptcies to date are asbestos-liability cases involving very large, well-known companies. The first came from Georgia-Pacific, one of the world's leading makers of tissue, pulp, packaging, and building products, whose asbestos liabilities are attributable to its 1965 acquisition of Bestwall Gypsum Co., and thereafter, Georgia-Pacific continued to manufacture and sell the Bestwall asbestos-containing products, principally joint compound. In a 2017 divisional merger, Georgia-Pacific spun off its asbestos liability into a BadCo named BestWall LLC, which filed Chapter 11 in the Western District of North Carolina about one month later. The official asbestos claimants' committee filed a motion to dismiss the case as a bad faith filing, but (unsurprisingly, given Fourth Circuit law on the issue, discussed below) that motion was denied.[4] And all of the subsequent Texas Two-Step bankruptcies were then also filed in the Western District of North Carolina.

The second Texas Two-Step case involves CertainTeed, a building products manufacturer whose asbestos liability is attributable to various piping and roofing products. Its October 2019 divisional merger produced a new BadCo named DBMP LLC, which filed Chapter 11 in the Western District of North Carolina three months later in January 2020.[5] A few months later, in May 2020, the two parents in the Trane corporate family, manufacturers of HVAC systems, shunted their respective asbestos liabilities (via divisional mergers) into two new BadCos named Aldrich Pump LLC and Murray Boiler LLC, which filed their Chapter 11 petitions in the Western District of North Carolina seven weeks later, in June 2020.[6]

2. J&J BEGETS LTL MANAGEMENT

The most recent and 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 the previous 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

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its baby products business, and in 1972 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,[7] 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).[8] 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 earlier this month 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,[9] and that value is estimated to be roughly $61 billion.

Two days later, LTL filed Chapter 11 in the Western District of North Carolina, but that court transferred venue of the case to the District of New Jersey, and the New Jersey bankruptcy court is the one that ultimately heard and denied the motion to dismiss the case as a bad-faith filing.

THE FOURTH CIRCUIT'S STRINGENT OBJECTIVE-FUTILITY STANDARD FOR A BAD-FAITH FILING

Had the *LTL* case remained in the Western District of North Carolina, the motion to dismiss the case likely would have been easily and expeditiously denied, which was the fate of a similar motion in the *Bestwall* case.[10] That is because the Fourth Circuit has adopted the most (and what many consider an unduly[11]) stringent standard for a bad-faith filing. The Fourth Circuit "require[s] that *both* objective futility *and* subjective bad faith be shown in order to warrant dismissal[] for want of good faith in filing" Chapter 11.[12] Thus, "even if subjective bad faith in filing could properly be found, dismissal is not warranted if [objective] futility cannot also be found."[13]

The Fourth Circuit's objective futility concept appears to be simply the converse of the statutory standard set forth in Code § 1112(b)(2)(A) "that there is a reasonable likelihood that a plan will be confirmed . . . within a reasonable period of time" or applicable statutory deadlines.[14] But confirming a plan is eminently feasible in all of the Texas Two-Step bankruptcies because BadCo's bankruptcy has been engineered to, if nothing else, accomplish one thing: resolve the mass-tort liability via a bankruptcy trust mechanism established through a confirmed plan of reorganization. Moreover, the funding agreement with GoodCo is designed to ensure that there will, in fact, be sufficient funding for that trust to meet all of its obligations to the mass-tort claimants (such as they may ultimately be—much more on this below). It is extremely difficult, therefore, to conclude that Texas Two-Step bankruptcies are objectively futile.

Concluding that BadCo does have a reasonable chance of confirming a plan is apparently all it takes to fend off a bad-faith filing challenge in the Fourth Circuit,[15] which explains why all of the Texas Two-Step bankruptcy cases were filed in the Fourth Circuit. It also explains why the venue transfer in the *LTL* case was such a significant development, notwithstanding the conceptual conundrum posed by the *LTL* bankruptcy court: "The Court cannot help but ponder how a bankruptcy filing, which took place in North Carolina and most likely satisfied the good faith standards under the applicable law in that jurisdiction, suddenly morphs post-petition into a bad faith filing simply because the case travels 400 miles up I-95

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to Trenton, New Jersey."[16] Of course, setting aside that space/time warp, there is really no puzzle at all: the bad-faith filing inquiry in Trenton, New Jersey, under governing Third Circuit law, is not so simple and straightforward as it is in a North Carolina bankruptcy court (applying Fourth Circuit precedent), which the *LTL* bankruptcy court's opinion amply illustrates.

SUBJECTIVE BAD FAITH

Unlike the Fourth Circuit, most courts (including the Third Circuit) conclude that a Chapter 11 case should be dismissed if it is *either* objectively futile in the sense required by the Fourth Circuit *or* the case was filed with subjective "bad faith." While there is some disagreement about the source of a bankruptcy court's authority to dismiss a Chapter 11 case as a bad-faith filing,[17] the explicit statutory standard of "cause" for dismissal under Code § 1112(b) is sufficiently elastic and open-ended[18] to subsume traditional and longstanding[19] good-faith filing requisites.[20] Indeed, the meaning of "good faith" in this context is every bit as vague and open-ended as the statutory "cause" standard itself.

The dictionary definition of "good faith" is "a state of mind indicating honesty and lawfulness of purpose."[21] 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?

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."[22] "Bad faith" Chapter 11 filings are those "that seek to achieve objectives outside the legitimate scope of the bankruptcy laws."[23] Just what are those legitimate bankruptcy purposes, though, and what purposes are illegitimate?

1. BANKRUPTCY IS ONLY APPROPRIATE AS A RESPONSE TO FINANCIAL DISTRESS

While the Third Circuit has stated that such a good-faith determination is an inherently "fact intensive inquiry,"[24] nonetheless, that court has repeatedly "focused on two inquiries that are particularly relevant to the question of good faith":[25] (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."[26] 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 a debtor."[27] 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.' "[28]

Moreover, financial distress is also the mediating force between proper and improper filings for the purpose of taking advantage of "rule changes" in bankruptcy.[29] "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."[30] 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.[31]

The legitimacy of Texas Two-Step bankruptcies under such a good-faith framework is highly dubious.[32]

2. WHOSE FINANCIAL DISTRESS?

As the *LTL* bankruptcy court acknowledged, a valid bankruptcy "purpose assumes an entity in distress,"[33] and the Third Circuit has indicated that "serious" distress "at the time of filing" is required.[34]

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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."[35]

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 case of *In re 15375 Memorial*, the Third Circuit recognized that debtors with no "business other than the handling of litigation" obviously "have no going concerns to preserve."[36]

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 Management, 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."[37] 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. As acknowledged by other courts, bankruptcy 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.[38]

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 Management, but rather was that of the *non*debtor 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."[39]

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.[40]

Whatever merit there is to permitting such a

partial, limited restructuring as a theoretical and policy matter,[41] 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.[42] That system ensures, for example, that *all* non-ordinary-course transactions must receive advance court approval,[43] with scrutiny from all creditors, to ensure that the full value of the operating business is available, first and foremost, to pay creditors' claims.[44] 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.[45] 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."[46]

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[47] at the root of the prominent and rapidly escalating phenomenon of "bankruptcy grifting" by nondebtors,[48] 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.
>
> 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.[49]

Accessing bankruptcy's claims resolution system indisputably is the <u>*only*</u> objective of a Texas Two-Step bankruptcy. As the debtor acknowledged in the *LTL* case, the <u>*entire*</u> 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."[50]

> 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.[51]

The *LTL* bankruptcy court enthusiastically, and at length, endorsed that objective as a perfectly legitimate, good-faith use of the bankruptcy system.[52] The Third Circuit's decision in the *15375 Memorial* case,[53] 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.

In *15375 Memorial*, the debtors (Memorial and Santa Fe) were subsidiaries (Memorial being a holding-company parent of only one corporation, Santa Fe, an operating company) in the GlobalSantaFe (GSF) corporate group, which is an oil and gas exploration giant. All of Santa Fe's assets were upstreamed to GSF in contemplation of a dissolution of Santa Fe. Before that dissolution could be fully effectuated, though, Santa Fe and others were sued by many individuals adversely affected by a groundwater contamination. After extensive discovery in that litigation (which exposed significant liability risk for both Santa Fe and GSF), Santa Fe and Memorial filed Chapter 11, which halted the litigation against both Santa Fe and GSF, since GSF's potential liability was derivative liability to Santa Fe.

The *15375 Memorial* debtors' only assets of any significance were insurance coverage available to

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pay any judgments in the groundwater litigation and derivative claims against GSF to also cover any judgments, and the only creditors of any significance were the groundwater plaintiffs and codefendants with contribution and indemnity claims. Like the BadCo debtors in the Texas Two-Step bankruptcies, then, Memorial and Santa Fe had no "business other than the handling of litigation" and thus "no going concerns to preserve."[54] The bankruptcy court refused to dismiss the case as a bad-faith filing, reasoning that "rather than attempting to resolve the pending and future claims in various jurisdictions throughout the United States, Debtors filed the Bankruptcy Cases to resolve all claims in a centralized forum and to distribute assets to legitimate creditors in an equitable manner," which "is a perfectly legitimate bankruptcy purpose."[55]

Both the district court and the Third Circuit, though, held that the case must be dismissed, notwithstanding the debtors' severe financial distress (having been stripped of all operating assets by GSF).[56] Financial distress is, therefore, necessary for a good-faith filing but not sufficient, and even for an entity in financial distress,

> an orderly distribution of assets, standing alone, is not a valid bankruptcy purpose. "Antecedent to any such distribution is an inquiry [into] whether the petition [was] filed in good faith, i.e., whether [it] serve[d] a valid bankruptcy purpose." In other words, the creation of a central forum to adjudicate claims against the Debtors is not enough to satisfy the good faith inquiry—the Debtors must show that bankruptcy has some "hope of maximizing the value of the [Debtors' estates]."[57]

However, given that the debtors' assets were simply the right to look to others for satisfaction of tort creditors' claims, "the Debtors [could] not identify 'assets that [were] threatened outside of bankruptcy . . . but that could be preserved or maximized in' " bankruptcy.[58] Thus, "[t]he purported benefits to the Debtors' estates identified by the Bankruptcy Court . . . were based on procedural benefits gained from bankruptcy that cannot be said to have maximized the value of the debtor's estates."[59] Because the Chapter 11 petitions "would shield the [nondebtor] GSF entities from litigation," the Third Circuit reasoned that it simply could "not escape the conclusion that the filings were a litigation tactic."[60]

Precisely the same analysis seems to fully apply to Texas Two-Step bankruptcies. Chapter 11 debtor, BadCo, is simply a pass-through litigation entity that must look to a nondebtor affiliate for the payment of tort creditors' claims, and the whole purpose of the Texas Two-Step bankruptcy filing is to shield that nondebtor affiliate from the tort litigation.[61] Indeed, the "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*."[62]

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.' "[63] 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,"[64] no matter the defendant or the defendant's resources.

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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."[65] Indeed, as discussed above, that is already the case in the Fourth Circuit, which requires *no* financial distress *at all* as a requisite to a "good faith" Chapter 11 filing.[66]

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.[67]

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"[68] and "maybe the gates indeed should be opened."[69] 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."[70]

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, as they are in the Fourth Circuit and perhaps also in the Third Circuit if the *LTL* decision is affirmed on appeal.

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.[71] Indeed, the July 26 Chapter 11 filing by 3M subsidiary Aearo Technologies LLC,[72] *solely* for the *admitted* purpose of shifting hundreds of thousands of earplug liability suits against Aearo and 3M, *out* of the largest federal multi-district litigation (MDL) proceeding ever and *into* bankruptcy court,[73] provides an arresting, almost-instantaneous illustration of the floodgates problem that the *LTL* bankruptcy court pooh-poohed.[74] The stated reasons for that Chapter 11 filing explicitly relied upon the authority of the *LTL* decision,[75] and conspicuously absent was any mention of financial distress for either 3M or Aearo, presumably because there is none.[76]

BANKRUPTCY SYSTEMATICALLY DISADVANTAGES MASS-TORT CLAIMANTS

Not only is a Texas Two-Step bankruptcy a baldfaced "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

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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.[77] 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.[78] Infringing claimants' property right to unfettered autonomy and control over their claims requires a compelling justification.[79]

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.[80] 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*[81] and *Wal-Mart Stores, Inc. v. Dukes*.[82] 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.[83]

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."[84] 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 violates due process"[85] Otherwise " 'limited fund' classes would emerge as the functional equivalent to bankruptcy."[86]

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."[87] 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 process by which a *solvent* defendant can impose a judicially-approved, mandatory, no-opt-outs settlement of its aggregate mass-tort liability on nonconsenting claimants. Such a process would unconstitutionally infringe individual claimants' due process rights.[88] 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*."[89]

> [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."[90]

"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."[91]

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 "limited fund" insufficient to fully satisfy its mass-tort obligations.[92] 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."[93]

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.[94] Indeed, the Constitution itself explicitly authorizes such a mandatory no-opt-outs settlement process in the Bankruptcy Clause.[95] 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' exercise of its Bankruptcy Power,[96] which of course, would mean that the Fourth Circuit's good-faith filing doctrine (which does not require *any* financial distress) is unconstitutional.

The *LTL* bankruptcy court seemed to recognize that a Texas Two-Step bankruptcy, and the resulting mandatory no-opt-outs settlement power, can be used by defendants to put a hard cap on their aggregate mass-tort liability in a way that simply is not possible outside bankruptcy, but essentially dismissed that as irrelevant to the good-faith filing inquiry:

> Throughout their submissions and oral argument, Movants have decried Debtor's (and its affiliated entities') efforts to "cap" the liabilities owing the injured parties. . . . Frankly, it is unsurprising that J&J and . . . JJCI management would seek to limit exposure to present and future claims. Their fiduciary obligations and corporate responsibilities demand such actions.[97]

Be that as it may, the question for the court was whether or not a Texas Two-Step bankruptcy is a legally permissible means of doing so. If there are courts that decide the Texas Two-Step strategy is legally permissible (even for an eminently solvent mass-tort defendant, as in the Fourth Circuit), then, yes, management of *any* mass-tort defendant (even an eminently solvent one) will be duty-bound to seriously consider filing a Texas Two-Step bankruptcy. Thus, the court's response to this gambit of a manifest "litigation tactic" bankruptcy filing to impose a hard cap on aggregate mass-tort liability, unavailable outside bankruptcy, simply begs the question as to whether such a "litigation tactic" bankruptcy should be legally permissible. Third Circuit precedent (discussed above) seems to indicate that it should not.

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."[98] Some academics hypothesize that eliminating opt-outs may, in certain circumstances, induce a mass-tort defendant to pay a "peace premium" to claimants.[99] 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

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captured entirely by [defendants] and the lead plaintiffs' lawyers who negotiate the [mandatory no-opt-outs] deal."[100] 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."[101]

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.

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.[102] 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."[103]

> 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.[104]

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."[105]

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,[106] 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."[107] 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.[108] 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.[109]

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.[110] If a creditor class does *not* vote to accept the plan, equity holders cannot receive or retain *anything* (i.e., their ownership interests must be completely wiped out) unless the plan provides for payment in full of each creditor in that rejecting class.[111]

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.[112]

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."[113] 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.[114] 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)."[115] And solvent mass-tort defendants' use of bankruptcy's unique mandatory settlement process to evade any liability for punitive damages is a common (although underappreciated) stratagem.[116]

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.[117]

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

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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."[118] 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.[119]

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.[120] 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."[121]

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."[122]

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),[123] and (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.[124] 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),[125] *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.[126] 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.[127] 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.[128] 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,[129] but § 524(g) likewise contains no dollar-weighting of claimant votes.

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 may have a greater propensity to "opt out" of proposed aggregate settlements.[130] 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 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).[131]

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).[132] 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

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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."[133] 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."[134] 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."[135]

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 distribution scheme effectuated by a confirmed plan of reorganization in Chapter 11."[136] 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.[137] 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.[138] The focus is "on whether a proposed class has sufficient unity" of interest.[139]

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,"[140] 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."[141] 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."[142]

> 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.[143]

Assuring present and especially future claimants "adequate structural protection"[144] 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."[145]

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.[146] That practice is deleterious because generally "the only . . . claimants capable of voting [are] present . . . claimants."[147] 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 equitable

> distribution amongst [the mass-tort] claimants, but rather is obtaining the requisite . . . voting approval of present . . . claimants.[148]

The bias this creates against the interests of future claimants is confirmed by our now-extensive experience with asbestos bankruptcies.[149] Moreover, separate representation of and advocacy for the interests of future claimants by a future claims representative 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.[150]

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),[151] 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).[152] 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.[153] 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* 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, 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."[154] "Bankruptcy poses a substantial risk of systematically undercompensating mass-tort claimants relative to a nonbankruptcy baseline, particularly for future claimants."[155] 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, as in the Fourth Circuit) 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* deci-

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sion 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:

> [W]e are cognizant that it is growing increasingly difficult to settle large scale litigation. *See, e.g., Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999); *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997). We recognize that companies that face massive potential liability and litigation costs continue to seek ways to rapidly conclude litigation to enable a continuation of their business and to maintain access to the capital markets. . . . [T]he Bankruptcy Code presents an inviting safe harbor for such companies. But this lure creates the possibility of abuse which must be guarded against to protect the integrity of the bankruptcy system and the rights of all involved in such proceedings. Allowing . . . bankruptcy under . . . circumstances [that are] a significant departure from the use of Chapter 11 to validly reorganize financially troubled businesses [invites that abuse].[156]

The Texas Two-Step bankruptcy is the apotheosis of that which the Third Circuit warned against.

ENDNOTES:

[1]The Texas Two-Step bankruptcy strategy is widely reputed to be the brainchild of Greg Gordon at Jones Day, https://www.jonesday.com/en/lawyers/g/gregory-gordon?tab=overview, who is debtor's counsel in all four of the pending Texas Two-Step cases. *See* Dan Levine & Mike Spector, *Going for Broke: How a Bankruptcy "Innovation" Halted Thousands of Lawsuits from Sick Plaintiffs*, Reuters Investigates (June 23, 2022, 2:59 p.m. GMT), https://www.reuters.com/investigates/special-report/bankruptcy-tactics-two-step/.

[2]*See* Tex. Bus. Orgs. Code § 1.002(55)(A) & tit. 1, ch. 10(A). The other states with divisional merger statutes are **Arizona**, Ariz. Rev. Stat. tit. 29, ch. 6; **Delaware**, Del. Code Ann. tit. 6, § 18-217(b)-(c); **Kansas**, Kan. Stat. Ann. § 17-7685a; and **Pennsylvania**, Pa. Cons. Stat. tit. 15, ch. 3(F).

[3]*In re* LTL Management, LLC, 637 B.R. 396 (Bankr. D. N.J. 2022).

[4]*In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D. N.C. 2019).

[5]*See In re* DBMP LLC, 2021 WL 3552350, at *1 (Bankr. W.D. N.C. 2021).

[6]*See In re* Aldrich Pump LLC, 2021 WL 3729335, at *1 (Bankr. W.D. N.C. 2021).

[7]*See* Lisa Girion, *Powder Keg: Johnson & Johnson Knew for Decades That Asbestos Lurked in Its Baby Powder*, Reuters Investigates (Dec. 14, 2018, 2:00 p.m. GMT), https://www.reuters.com/investigates/special-report/johnsonandjohnson-cancer.

[8]*See* Ingham v. Johnson & Johnson, 608 S.W.3d 663, 680, 724, Prod. Liab. Rep. (CCH) P 20934 (Mo. Ct. App. E.D. 2020), reh'g and/or transfer denied, (July 28, 2020) and transfer denied, (Nov. 3, 2020) and cert. denied, 141 S. Ct. 2716, 210 L. Ed. 2d 879 (2021).

[9]*See* Annex 2 to Declaration of John K. Kim in Support of First Day Pleadings at 4-6, *In re* LTL Mgmt. LLC, No. 21-30589 (Bankr. W.D.N.C. Oct. 14, 2021) [hereinafter *LTL Funding Agreement*] (Section 2(a) and definitions of "JJCI Value" and "Permitted Funding Use"). The JJCI Value cap is also increased by the value of any member distributions that JJCI makes after the divisional merger.

[10]*See supra* note 4 and accompanying text.

[11]*See, e.g.*, 7 Collier on Bankruptcy ¶ 1112.07[6][a] (Richard Levin & Henry J. Sommer eds., 16th ed. 2017).

[12]Carolin Corp. v. Miller, 886 F.2d 693, 700-01, 19 Bankr. Ct. Dec. (CRR) 1425, Bankr. L. Rep. (CCH) P 73071 (4th Cir. 1989) (emphasis added).

[13]*Id.* at 701.

[14]11 U.S.C.A. § 1112(b)(2)(A). *See, e.g.*, *In re* Premier Automotive Services, Inc., 492 F.3d 274, 280, 48 Bankr. Ct. Dec. (CRR) 112, 58 Collier Bankr. Cas. 2d (MB) 462, Bankr. L. Rep. (CCH) P 80966, 2007 A.M.C. 1535 (4th Cir. 2007) (stating that the debtor "clearly had no 'realistic possibility of an effective reorganization' " where debtor had "never filed a proposed plan of reorganization" and likely never would (quoting *Carolin*, 886 F.2d at 698)).

[15]*See, e.g.*, *Bestwall*, 606 B.R. at 49 ("Bestwall has the ability to reorganize and establish a trust that meets each of the statutory requirements . . . .").

[16]*LTL*, 637 B.R. at 406.

[17]Or whether such authority exists at all. *See, e.g.*, *In re* Victoria Ltd. Partnership, 187 B.R. 54, 27 Bankr. Ct. Dec. (CRR) 1210, Bankr. L. Rep. (CCH) P 76666 (Bankr. D. Mass. 1995); Janet Flaccus, *Have Eight Circuits Shorted? Good Faith and Chapter 11 Petitions*, 67 Am. Bankr. L.J. 401 (1993).

[18]Code § 1112(b)(4) lists various circumstances that constitute "cause" for dismissal, but explicitly provides that the list is nonexclusive by use of the term "includes" in the introductory clause. *See* 11 U.S.C.A. § 102(3) (" 'includes' and 'including' are not limiting").

[19]*See generally In re* Victory Const. Co., Inc., 9 B.R. 549, 7 Bankr. Ct. Dec. (CRR) 257, 3 Collier Bankr. Cas. 2d (MB) 655 (Bankr. C.D. Cal. 1981), order vacated, 37 B.R. 222, 11 Bankr. Ct. Dec.

(CRR) 749 (B.A.P. 9th Cir. 1984) and (rejected by, *In re* Victoria Ltd. Partnership, 187 B.R. 54, 27 Bankr. Ct. Dec. (CRR) 1210, Bankr. L. Rep. (CCH) P 76666 (Bankr. D. Mass. 1995)); Hon. Robert L. Ordin, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 Bus. Law. 1795 (1983).

[20]*See, e.g.*, *In re* SGL Carbon Corp., 200 F.3d 154, 162, 35 Bankr. Ct. Dec. (CRR) 116, 43 Collier Bankr. Cas. 2d (MB) 668, Bankr. L. Rep. (CCH) P 78084, 1999-2 Trade Cas. (CCH) ¶ 72739 (3d Cir. 1999) (holding that "a Chapter 11 petition is subject to dismissal for 'cause' under 11 U.S.C. § 1112(b) unless it is filed in good faith").

[21]*Good Faith*, Webster's Third New International Dictionary of the English Language, Unabridged 978 (2002).

[22]*In re* Integrated Telecom Express, Inc., 384 F.3d 108, 119, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004).

[23]*In re* 15375 Memorial Corp. v. Bepco, L.P., 589 F.3d 605, 618 n.8, 52 Bankr. Ct. Dec. (CRR) 146, Bankr. L. Rep. (CCH) P 81652 (3d Cir. 2009) (quoting *SGL Carbon*, 200 F.3d at 165 (quoting *In re* Marsch, 36 F.3d 825, 828, 31 Collier Bankr. Cas. 2d (MB) 1285, Bankr. L. Rep. (CCH) P 76093, 30 Fed. R. Serv. 3d 585 (9th Cir. 1994))).

[24]*SGL Carbon*, 200 F.3d at 162. And "no list is exhaustive of all the factors which could be relevant when analyzing a particular debtor's good faith." *15375 Memorial*, 589 F.3d at 618-19 n.8 (quoting *SGL Carbon*, 200 F.3d at 166 n.16 (quoting *In re* Laguna Associates Ltd. Partnership, 30 F.3d 734, 738, 25 Bankr. Ct. Dec. (CRR) 1492, 31 Collier Bankr. Cas. 2d (MB) 545, Bankr. L. Rep. (CCH) P 75997, 1994 Fed. App. 0270P (6th Cir. 1994), as amended on denial of reh'g and reh'g en banc, (Sept. 9, 1994))).

[25]*Integrated Telecom*, 384 F.3d at 119-20. Moreover, the Third Circuit has also stated that whether to dismiss a Chapter 11 petition as filed in bad faith is a "decision . . . committed to the sound discretion of the bankruptcy or district court" and is thus "review[ed] for abuse of discretion." *SGL Carbon*, 200 F.3d at 159. Yet, at the same time, the Third Circuit has made clear that lower courts' decisions as to whether a given set of facts (as found by the trial court) rises to the level of a bad-faith filing receives no deference whatsoever "and is subject to plenary review because it is, essentially, a conclusion of law." *15375 Memorial*, 589 F.3d at 616.

[26]*15375 Memorial*, 589 F.3d at 618, 625 (quoting *SGL Carbon*, 200 F.3d at 165 (quoting *In re* HBA East, Inc., 87 B.R. 248, 260, 17 Bankr. Ct. Dec. (CRR) 957 (Bankr. E.D. N.Y. 1988))).

[27]*Integrated Telecom*, 384 F.3d at 120-21 (quoting Furness v. Lilienfield, 35 B.R. 1006, 1013, 11 Bankr. Ct. Dec. (CRR) 1342, 10 Collier Bankr. Cas. 2d (MB) 930 (D. Md. 1983)).

[28]*Integrated Telecom*, 384 F.3d at 120 (quoting *SGL Carbon*, 200 F.3d at 165 (quoting *Marsch*, 36 F.3d at 828)).

[29]Accessing bankruptcy to get a "rule change" unrelated to the proper purposes of bankruptcy law is one of the principal evils animating the influential "creditors' bargain theory" of bankruptcy. *See* Thomas H. Jackson, The Logic and Limits of Bankruptcy 21-27, 33, 45-46, 193-201 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 100-01, 103-04 (1984).

[30]*Integrated Telecom*, 384 F.3d at 127-28.

[31]*Id.* at 128.

[32]*See* Michael A. Francus, *Texas Two-Stepping Out of Bankruptcy*, 120 Mich. L. Rev. Online 38, 44-47 (2022).

[33]*LTL*, 637 B.R. at 419.

[34]*SGL Carbon*, 200 F.3d at 164.

[35]*Integrated Telecom*, 384 F.3d at 120.

[36]*15375 Memorial*, 589 F.3d at 619.

[37]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*], http://blogs.harvard.edu/bankruptcyroundtable/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/.

[38]*LTL*, 637 B.R. at 425 (citing *Aldrich Pump*, 2021WL 3729335, at *8, and *DBMP*, 2021 WL 3552350, at *8).

[39]*LTL*, 637 B.R. at 419, 421.

[40]Brubaker, *Texas Two-Step*. *See* Anthony Casey & Jonathan Macey, *A Qualified Defense of Divisional Mergers*, Harvard Law School Bankruptcy Roundtable (June 28, 2022), http://blogs.harvard.edu/bankruptcyroundtable/2022/06/28/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-a-qualified-defense-of-divisional-mergers/.

[41]In 2014 and 2015, the National Bankruptcy Conference proposed statutory amendments that would codify a new chapter of the Bankruptcy Code for such a limited, partial restructuring of bond debt. *See* National Bankruptcy Conference, Report of the National Bankruptcy Conference Adopted at the 2014 Annual Meeting: Proposal for a New Chapter for Restructuring Bond and Credit Agreement Debt (Chapter 16) (2014); National Bankruptcy Conference, Proposal for a New Chapter 16 of the Bankruptcy Code for the Restructuring of Bond and Credit Agreement Debt (Dec. 18, 2015). Both proposals are available here: http://nbconf.org/wp-content/uploads/2015/07/Proposed-Amendments-to-Bankruptcy-Code-to-Facilitate-Restructuring-of-Bond-and-Credit-Agreement-Debt.pdf.

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[42]*See* 28 U.S.C.A. § 1344(e)(1).

[43]*See* 11 U.S.C.A. §§ 363-365.

[44]By contrast, for example, the only protection the LTL funding agreement provides in that regard, is that the cap on J&J's funding obligation (at no more than the value of JJCI) is increased to the extent of any JJCI member distributions. *See LTL Funding Agreement* at 4-5, 7 (definition of "JJCI Value" and Section 2(a)).

[45]There is a substantial scholarly consensus, however, that the opposite should prevail (as a theoretical and policy matter) and all other creditors should be subordinated to prior payment in full of tort victims. *See* Vincent S.J. Buccola & Joshua Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REG. 766, 781-83 (2021) (reviewing the literature).

[46]*See generally* Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1559 (2022) (reviewing DOUGLAS G. BAIRD, THE UNWRITTEN LAW OF CORPORATE REORGANIZATIONS (2022)).

[47]*See generally* Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 YALE L.J.F. 960 (2022).

[48]*See* Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 960 (2022).

[49]Brubaker, *Texas Two-Step*. *See* Brubaker, 131 YALE L.J.F. at 995-98.

[50]*LTL*, 637 B.R. at 404.

[51]*Id.* at 407.

[52]*See id.* at 406-17.

[53]Curiously, the *LTL* bankruptcy court did not attempt to distinguish (or even discuss the relevance of) the *15375 Memorial* decision.

[54]*15375 Memorial*, 589 F.3d at 619.

[55]*In re* 15375 Memorial Corp., 382 B.R. 652, 684, 166 O.G.R. 162 (Bankr. D. Del. 2008), order clarified on reconsideration, 386 B.R. 548, 168 O.G.R. 365 (Bankr. D. Del. 2008), rev'd, 400 B.R. 420, 168 O.G.R. 374 (D. Del. 2009), aff'd, 589 F.3d 605, 52 Bankr. Ct. Dec. (CRR) 146, Bankr. L. Rep. (CCH) P 81652 (3d Cir. 2009).

[56]The bankruptcy court found that the debtors' estates were administratively insolvent. *See 15375 Memorial*, 382 B.R. at 679-81.

[57]*15375 Memorial*, 589 F.3d at 622.

[58]*Id.* at 621.

[59]*Id.* at 625.

[60]*Id.* at 626.

[61]Indeed, the *LTL* bankruptcy court fully acknowledged that the manner in which the divisional merger and funding agreements were structured "on the eve of the bankruptcy filing [was] for the very purpose of extending the stay" of litigation to nondebtors J&J and JJCI. *In re* LTL Management, LLC, 638 B.R. 291, 306 (Bankr. D. N.J. 2022).

[62]*SGL Carbon*, 200 F.3d at 164 (emphasis added).

[63]*LTL*, 637 B.R. at 420 (quoting *In re* General Growth Properties, Inc., 409 B.R. 43, 61, 51 Bankr. Ct. Dec. (CRR) 280, 62 Collier Bankr. Cas. 2d (MB) 279 (Bankr. S.D. N.Y. 2009) (quoting U.S. v. Huebner, 48 F.3d 376, 379, Bankr. L. Rep. (CCH) P 76331, 95-1 U.S. Tax Cas. (CCH) P 50008, 74 A.F.T.R.2d 94-7427 (9th Cir. 1994) (bolded emphasis in *LTL* opinion))).

[64]*LTL*, 637 B.R. at 420 (emphasis added) (quoting *Integrated Telecom*, 384 F.3d at 121).

[65]Brubaker, *Texas Two-Step*.

[66]Even in the Fourth Circuit, though, because of the requirement that a debtor submit *all* of its assets and business operations to the direct jurisdiction and control of the bankruptcy court, the attendant direct and indirect costs of doing so provides some measure of self-regulating control on "litigation tactic" filings: the expected gains to those exercising the filing decision must exceed the expected bankruptcy costs they would suffer. The Texas Two-Step maneuver, though, by reducing the costs from a bankruptcy filing also reduces their deterrence of "litigation tactic" filings.

[67]*LTL*, 637 B.R. at 406.

[68]*Id.* at 414.

[69]*Id.* at 428.

[70]*Id.* at 422, 423.

[71]*See id.* at 428. The court reasoned as follows:

> Argument has been put forward . . . that allowing this case to proceed will inevitably "open the floodgates" to similar machinations and chapter 11 filings by other companies defending against mass tort claims. [F]or most companies, the complexity, necessary capital structure, and financial commitments required to lawfully implement a corporate restructuring as done in this case, will limit the utility of the "Texas Two-Step." Not many debtors facing financial hardships have an independent funding source willing and capable of satisfying the business's outstanding indebtedness.

LTL, 637 B.R. at 428. The floodgates fear, however, is *not* so much attributable to defendants "facing financial hardship." The concern is more about eminently *solvent* mass-tort defendants employing the Texas Two-Step strategy. A solvent mass-tort defendant, by definition, has the capability of paying all of its debts, including its mass-tort obligations and, therefore, can (also by definition) fully fund all of the obligations of the BadCo debtor it creates out of itself via a divisional merger. And now that the playbook has been opened to the world, *any* competent legal team could easily execute the Texas Two-Step for *any* mass-tort defen-

dant, particularly a solvent one.

[72]*See* Andrew Scurria & Alexander Gladstone, *3M Shifts Mass Earplug Claims to Bankruptcy Court, Its Favored Forum*, WALL STREET JOURNAL PRO BANKRUPTCY (July 26, 2022 9:31 p.m. ET), https://www.wsj.com/articles/3m-shifts-mass-earplug-claims-to-bankruptcy-court-its-favored-forum-11658885474; James Nani & Alex Wolf, *3M Unit Gets Debtor-Friendly Bankruptcy Venue in Indianapolis*, BLOOMBERG LAW (July 28, 2022 4:01 a.m.), https://news.bloomberglaw.com/bankruptcy-law/3m-unit-gets-debtor-friendly-bankruptcy-venue-in-indianapolis; Adam Levitin, *3M's Aearo Technologies' Bankruptcy: The Hoosier Hop*, CREDIT SLIPS (July 26, 2022 7:27 p.m.), https://www.creditslips.org/creditslips/2022/07/3ms-aearo-technologies-bankruptcy-the-hoosier-hop.html.

[73]*See* Information Br. of Aearo Techs. LLC at 42-57, *In re* Aearo Techs. LLC, No. 22-02890-JJG-11 (Bankr. S.D. Ind. July 26, 2022) [hereinafter *Aearo Information Br*.].

[74]*See LTL*, 637 B.R. at 428. It is also yet another illustration of the rapidly accelerating "bankruptcy grifter" phenomenon fueled by nonconsensual nondebtor releases, which "is causing a migration of mass tort litigation out of the tort system and into the bankruptcy system." Brubaker, 131 YALE L.J.F. at 992. *See Aearo Information Br*. at 57 (stating that a "cornerstone" of the "ultimate objective" of the Chapter 11 case is "a permanent channeling injunction and a third-party release of 3M" applicable to "all [earplug]-related claims" by "all potential [earplug] plaintiffs").

[75]*See* Debtor's Complaint at 2, *In re* Aearo Techs. LLC, Case No. 22-02890-11, Adv. Proc. No. 22-50059 (Bankr. S.D. Ind. July 26, 2022) (quoting *LTL*, 637 B.R. at 411) ("Addressing mass torts through a legislative scheme enacted by Congress within the bankruptcy system . . . provides a judicially accepted means of aggregating and resolving mass tort claims.").

[76]*See Aearo Information Br*. Indeed, the district-court judge presiding over the MDL proceedings contemporaneously characterized 3M as "a perfectly solvent defendant." Tr. of Show Cause Hearing and Status Conference at 16, *In re* 3M Combat Arms Earplub Prods. Liab. Litig., No. 3:19md2885 (N.D. Fla. July 27, 2022).

[77]*See* Tulsa Professional Collection Services, Inc. v. Pope, 485 U.S. 478, 485, 108 S. Ct. 1340, 99 L. Ed. 2d 565 (1988) ("a cause of action is a species of property . . . deserving due process protections").

[78]"[T]he authority that each [claimant] retains over the disposition of her right to sue . . . stems from notions of property—the premise that the client's right to sue is *her* right." RICHARD A. NAGAREDA, MASS TORTS IN A WORLD OF SETTLEMENT 60 (2007). *See generally* Ryan C. Williams, *Due Process, Class Action Opt Outs, and the Right Not to Sue*, 115 COLUM. L. REV. 599, 618-44 (2015).

[79]*See* Ortiz v. Fibreboard Corp., 527 U.S. 815, 846, 119 S. Ct. 2295, 144 L. Ed. 2d 715, 43 Fed. R. Serv. 3d 691 (1999) ("the burden of justification rests on the exception").

[80]*See* FED. R. CIV. P. 23.

[81]Amchem Products, Inc. v. Windsor, 521 U.S. 591, 117 S. Ct. 2231, 138 L. Ed. 2d 689, 37 Fed. R. Serv. 3d 1017, 28 Envtl. L. Rep. 20173 (1997).

[82]Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338, 131 S. Ct. 2541, 180 L. Ed. 2d 374, 112 Fair Empl. Prac. Cas. (BNA) 769, 94 Empl. Prac. Dec. (CCH) P 44193, 161 Lab. Cas. (CCH) P 35919, 78 Fed. R. Serv. 3d 1460 (2011).

[83]*See* FED. R. CIV. P. 23(b)(3) & (c)(2)(B)(v).

[84]Brubaker, *Texas Two-Step*. *See Ortiz*, 527 U.S. at 846-48.

[85]*Wal-Mart*, 564 U.S. at 362-63.

[86]*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)). Indeed, the mandatory no-opt-outs aspect of limited-fund class actions is functionally identical to a bankruptcy discharge, which is a foundational pillar of Congress' constitutional Bankruptcy Power. "The 'great' discharge power, in particular, provided the impetus for inclusion of the Bankruptcy Clause in the Constitution." Brubaker, 131 YALE L.J.F. at 977.

[87]28 U.S.C.A. § 1407(a).

[88]And such a process in federal court also "compromises their Seventh Amendment [jury trial] rights without their consent." *Ortiz*, 527 U.S. at 846.

[89]Brubaker, *Texas Two-Step*. Indeed, the two procedures share a common ancestry in the equitable receivership proceeding initiated by a creditors' bill filed in a federal district court. *See Ortiz*, 527 U.S. at 832-41 (describing the precursors to Rule 23(b)(1)(B) limited-fund class actions as including creditors' bill cases, such as the railroad equitable receivership in Nashville & Decatur R.R. Co. v. Orr, 85 U.S. (18 Wall.) 471 (1873)); Ralph Brubaker *On the Nature of Federal Bankruptcy Jurisdiction: A General Statutory and Constitutional Theory*, 41 WM. & MARY L. REV. 743, 832-34 (2000) (describing the origins of Chapter 11 corporate reorganizations in the equitable receivership process initiated by a creditors' bill).

[90]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).

[91]Brubaker, *Texas Two-Step*.

[92]*See Ortiz*, 527 U.S. at 848-53.

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[93]Brubaker, *Texas Two-Step*.

[94]*See* Taylor v. Sturgell, 553 U.S. 880, 895, 128 S. Ct. 2161, 171 L. Ed. 2d 155, 36 Media L. Rep. (BNA) 1801 (2008) (quoting Martin v. Wilks, 490 U.S. 755, 762 n.2, 109 S. Ct. 2180, 104 L. Ed. 2d 835, 49 Fair Empl. Prac. Cas. (BNA) 1641, 50 Empl. Prac. Dec. (CCH) P 39052, 14 Fed. R. Serv. 3d 1 (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")). *See generally* Brubaker, 131 Yale L.J. at 995-98.

[95]"At the heart of Congress's Bankruptcy Power is determining the appropriate distribution of someone's assets that warrants discharge of their obligations." Brubaker, 131 Yale L.J. at 978.

[96]*See, e.g.*, Thomas E. Plank, *Bankruptcy and Federalism*, 71 Fordham L. Rev. 1063, 1076-89, 1093-95 (2002) ("I conclude that the 'subject of Bankruptcies' means the subject of adjusting the existing relationship between a debtor who is insolvent in some sense and the debtor's creditors.").

[97]*LTL*, 637 B.R. 416.

[98]Brubaker, *Texas Two-Step*.

[99]*See generally* Francis E. McGovern & William B. Rubenstein, *The Negotiation Class: A Cooperative Approach to Class Actions Involving Large Stakeholders*, 99 Tex. L. Rev. 73, 104-06 (2020) (summarizing the literature).

[100]Brubaker, 131 Yale L.J.F. at 993.

[101]Brubaker, *Texas Two-Step*.

[102]*Ortiz*, 527 U.S. at 821.

[103]*Id.* at 848.

[104]*Id.* at 859-60 (footnote omitted).

[105]*Id.* at 839.

[106]*See id.* at 832-48.

[107]*Id.* at 837 n.17 (citing 1 Joseph Story, Commentaries on Equity Jurisprudence §§ 547-548 (I. Redfield 8th rev. ed. 1861)).

[108]*See* Brubaker, 41 Wm. & Mary L. Rev. at 932-34.

[109]*See generally* Ralph Brubaker, *Inter-Class Give-Ups in a Chapter 11 Plan of Reorganization: Remembering the Origins of the Absolute Priority Rule*, 25 Bankr. L. Letter No. 6, at 1 (June 2005).

[110]*See* 11 U.S.C.A. § 1129(a)(8).

[111]*See id.* § 1129(b)(2)(B).

[112]*See* Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership, 526 U.S. 434, 444-49, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999).

[113]11 U.S.C.A. § 1129(b)(2)(B)(i).

[114]*See* Ralph Brubaker, *Punitive Damages in Chapter 11: Of Categorical Disallowance, Equitable Subordination, and Subordination by Classification*, 25 Bankr. L. Letter No. 7, at 1, 3-5 (July 2005).

[115]*Id.* at 2, 4.

[116]*See id.* at 3-4 (discussing the disallowance of punitive damages claims in the Dalkon Shield contraceptive mass-tort bankruptcy of A.H. Robins and in the silicone gel breast implant mass-tort bankruptcy of Dow Corning); Brubaker, 131 Yale L.J.F. at 993 n.140 (discussing the air-bag mass-tort bankruptcy of Takata and how the mandatory no-opt-outs settlement produced by "nonconsensual nondebtor releases for Honda/Acura and Nissan/Infiniti gave them immunity from any liability for punitive damages").

[117]*See* Brubaker, 131 Yale L.J.F. at 996.

[118]11 U.S.C.A. § 1129(b)(2)(B)(i).

[119]*See In re* Dow Corning Corp., 211 B.R. 545, 572-73 (Bankr. E.D. Mich. 1997). As another example, if a plan provides for payment in full of all allowed tort claims, an estimate of the debtor's aggregate mass-tort liability is also necessary to determine compliance with the plan-feasibility requirement of Code § 1129(a)(11).

[120]*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, 987-88 n.102 (discussing the cap on aggregate mass-tort liability under the "full payment" plan in the *A.H. Robins* case); Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 83-84 (2006) (discussing the caps on aggregate mass-tort liability under the "full payment" plans in the *A.H. Robins* and *Dow Corning* cases).

[121]*LTL Funding Agreement* at 6. *See also* Exhibit A to Notice of Filing Annex 2 to Debtor's Submission in Lieu of Live Testimony at 5, *In re* Bestwall LLC, No. 17-31795 (Bankr. W.D.N.C. Oct. 13, 2018); Exhibit A to Stipulation Between the Debtor and CertainTeed LLC Regarding Second Amended Funding Agreement at 6, *In re* DBMP LLC, No. 20-30080 (Bankr. W.D.N.C. Jan. 5, 2022); Declaration of Ray Pittard in Support of First Day Pleadings at 29-30, 48-49, *In re* Aldrich Pump LLC, No. 20-30608 (Bankr. W.D.N.C. June 18, 2020) (definitions of "Permitted Funding Use" and "Section 524(g) Plan" and Section 2(e)).

[122]Brubaker, 1997 U. Ill. L. Rev. at 987-88 n.102.

[123]*See* Brubaker, 131 Yale L.J.F. at 995-98.

[124]*See, e.g.*, S. Elizabeth Gibson, Case Studies of Mass Tort Limited Fund Class Action Settlements &

BANKRUPTCY REORGANIZATIONS 5-6 (2000); Troy A. McKenzie, *Toward a Bankruptcy Model for Non-class Aggregate Litigation*, 87 N.Y.U. L. REV. 960, 1016-19 (2012).

[125]*See* 11 U.S.C.A. § 1129(b)(2)(B)(i).

[126]*See id.* § 1129(a)(8) & (b)(1).

[127]*See id.* § 1126(c).

[128]This was the procedure established in the *Johns-Manville* case, which was an early, seminal mass-tort bankruptcy under the Bankruptcy Code. *See In re* Johns-Manville Corp., 68 B.R. 618, 631 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd*, 843 F.2d 636, 646-49 (2d Cir. 1988).

[129]*See* 11 U.S.C.A. § 524(g)(2)(B)(ii)(IV)(bb).

[130]*See* McGovern & Rubenstein, 99 TEX. L. REV. at 85-90.

[131]*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).

[132]*See* Steven H. Case, *Some Confirmed Chapter 11 Plans Fail: So What?*, 47 B.C. L. REV. 59, 64-65 (2005); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 189 (2004); Michael St. James, *Why Bad Things Happen in Large Chapter 11 Cases: Some Thoughts About* Courting Failure, 7 TRANSACTIONS: TENN. J. BUS. L. 169, 182-84 (2005).

[133]Brubaker, 1997 U. ILL. L. REV. at 986.

[134]Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1, 12-13 (1995).

[135]11 U.S.C.A. § 1122(a).

[136]Brubaker, 35 BANKR. L. LETTER No. 1, at 11.

[137]FED. R. CIV. P. 23(a)(3)-(4).

[138]"The adequacy-of-representation requirement 'tend[s] to merge' with the . . . typicality criteria of Rule 23(a), which 'serve as guideposts for determining whether . . . the class claims are so interrelated that the interests of the class members' " are substantially the same. *Amchem*, 521 U.S. at 626 n.20 (quoting General Telephone Co. of Southwest v. Falcon, 457 U.S. 147, 157 n. 13, 102 S. Ct. 2364, 72 L. Ed. 2d 740, 28 Fair Empl. Prac. Cas. (BNA) 1745, 29 Empl. Prac. Dec. (CCH) P 32781, 34 Fed. R. Serv. 2d 371 (1982)).

[139]*Amchem*, 521 U.S. at 621.

[140]*Id.* at 627.

[141]*Ortiz*, 527 U.S. at 835 n.15.

[142]*Id.* at 856.

[143]*Amchem*, 521 U.S. at 626.

[144]*Ortiz*, 527 U.S. at 864.

[145]*In re* Combustion Engineering, Inc., 391 F.3d 190, 242 & n.57, 245, 43 Bankr. Ct. Dec. (CRR) 271, Bankr. L. Rep. (CCH) P 80206 (3d Cir. 2004), as amended, (Feb. 23, 2005).

[146]Adam and Eve ate the apple in the *Manville* case, "by declining to classify future claimants explicitly and then relying on the present claimants' overwhelming acceptance of the plan as a rough proxy for the interests of future claimants." Troy A. McKenzie, *The Mass Tort Bankruptcy: A Pre-History*, 5 J. TORT L. 59, 75 (2012).

[147]Ralph Brubaker, *Unwrapping Prepackaged Asbestos Bankruptcies (Part II): The Antithesis of Creditor Equality*, 25 BANKR. L. LETTER No. 2, at 1, 6 (Feb. 2005). "[T]he absence of future claimants . . . presents a difficult problem for achieving meaningful consent, because they cannot participate in the voting that is central to the plan confirmation process." McKenzie, 5 J. TORT. L. at 75.

[148]*Id.*

[149]*See generally* PETER KELSO & MARC SCARCELLA, DUBIOUS DISTRIBUTION: ASBESTOS BANKRUPTCY TRUST ASSETS AND COMPENSATION (Mar. 2018); S. Todd Brown, *How Long Is Forever This Time? The Broken Promise of Bankruptcy Trusts*, 61 BUFF. L. REV. 537 (2013).

[150]Brubaker, 25 BANKR. L. LETTER No. 2, at 5. *See generally* Samir D. Parikh, *The New Mass Torts Bargain*, 90 FORDHAM L. REV. (forthcoming 2022), https://ssrn.com/abstract=3649611; Mark D. Plevin, Leslie A. Epley & Clifton S. Elgarten, *The Future Claims Representative in Prepackaged Asbestos Bankruptcies: Conflicts of Interest, Strange Alliances, and Unfamiliar Duties for Burdened Bankruptcy Courts*, 62 N.Y.U. ANN. SURV. AM. L. 271 (2006); Frederick Tung, *The Future Claims Representative in Mass Tort Bankruptcy: A Preliminary Inquiry*, 3 CHAPMAN L. REV. 43 (2000).

[151]11 U.S.C.A. § 1129(a)(8). Although there is some uncertainty in the case law regarding the implications of an impaired class for which *none* of the holders of claims in that class have cast a vote on the plan, at least in this particular context, protection of the relative priority rights of future claimants (vis-à-vis both present claimants and equity interests) would seem to compel the conclusion that a class of future claimants (who are unable to participate in the plan process at all) simply cannot be *presumed* to have accepted the plan and, thus, should be entitled to the full panoply of cramdown protections.

[152]*See* 11 U.S.C.A. § 1129(b)(2)(B). That should also be the result in asbestos cases where the plan does not provide for full payment of all future asbestos claims, notwithstanding the fact that § 524(g)(2)(B)(i) only requires that, at a minimum, the trust established to pay future claimants must own a majority of the voting shares of the reorganized debtor entity, i.e., prebankruptcy equity can

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retain 49.9% ownership. Nothing in § 524(g), however, even purports to displace or override any of the basic confirmation requirements of §§ 1122(a) or 1129. Rather, if a debtor wants the *additional* relief afforded by § 524(g), "[t]o achieve this relief, a debtor must satisfy the prerequisites set forth in § 524(g) *in addition to* the standard plan confirmation requirements." *Combustion Eng'g*, 391 F.3d at 234 (emphasis added and footnotes omitted).

[153]*See id.* § 1129(b)(2)(B)(i).

[154]Brubaker, 131 Yale L.J.F. at 992.

[155]Brubaker, *Texas Two-Step*.

[156]*SGL Carbon*, 200 F.3d at 169.

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ASSESSING THE LEGITIMACY OF THE "TEXAS TWO-STEP" MASS-TORT BANKRUPTCY (PART II)

By Ralph Brubaker[*]

INTRODUCTION

The Third Circuit abruptly disrupted the Texas Two-Step mass-tort bankruptcy strategy with its recent decision of *In re LTL Management* ("*LTL I*"),[1] 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.

Before the Third Circuit's *LTL I* decision, I set forth my views on the legitimacy of the Texas Two-Step maneuver in the August 2022 issue of *Bankruptcy Law Letter*.[2] *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 the so-called Texas Two-Step bankruptcy strategy, in general, and 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.

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[*]The author is a consultant to counsel for one of the participants in a pending Texas Two-Step mass-tort bankruptcy case. The views expressed herein are solely his own.

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THE "TEXAS TWO-STEP" MASS-TORT BANKRUPTCY

The "Texas Two-Step" mass-tort bankruptcy[3] proceeds essentially as follows:

Step 1. Mass-tort Defendant uses a state divisional merger statute (Texas's[4] 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.

Four such Texas Two-Step bankruptcies have been filed in recent years, three of which are still pending. To date, the only case that has been dismissed was LTL's initial Chapter 11 filing.[5] LTL's second filing adds a "Hail Mary" (or perhaps more properly, a trick play) to the playbook, in an attempt to salvage J&J's bankruptcy stratagem for resolving its talc liability.

1. BESTWALL (FROM GEORGIA-PACIFIC), DBMP (FROM CERTAINTEED), ALDRICH PUMP AND MURRAY BOILER (FROM TRANE)

All of the Texas Two-Step bankruptcies have been asbestos-liability cases involving very large, well-known companies. The first came from Georgia-Pacific, one of the world's leading makers of tissue, pulp, packaging, and building products, whose asbestos liabilities are attributable to its 1965 acquisition of Bestwall Gypsum Co., and thereafter, Georgia-Pacific continued to manufacture and sell the Bestwall asbestos-containing products, principally joint compound. In a 2017 divisional merger, Georgia-Pacific spun off its asbestos liability into a BadCo named BestWall LLC, which filed Chapter 11 in the Western District of North Carolina about one month later. The official asbestos claimants' committee filed a motion to dismiss the case as a bad-faith filing, but that motion was denied.[6] And all of the subsequent Texas Two-Step bankruptcies were then also filed in the Western District of North Carolina.

The second Texas Two-Step case involves CertainTeed, a building products manufacturer whose asbestos liability is attributable to various piping and roofing products. Its October 2019 divisional merger produced a new BadCo named DBMP LLC, which filed Chapter 11 in the Western District of North Carolina three months later in January 2020.[7] A few months later, in May 2020, the two

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parents in the Trane corporate family, manufacturers of HVAC systems, shunted their respective asbestos liabilities (via divisional mergers) into two new BadCos named Aldrich Pump LLC and Murray Boiler LLC, which filed their Chapter 11 petitions in the Western District of North Carolina seven weeks later, in June 2020.[8]

2. J&J BEGETS LTL MANAGEMENT

The most recent and 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 the previous 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)—one that figured prominently in the Third Circuit's dismissal decision in *LTL I*.

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,[9] 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).[10] 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 this year.

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 ("Old JJCI") was divided into a new GoodCo (ultimately with the same JJCI name, "New JJCI") and BadCo (LTL Management). Nonetheless, J&J also executed the funding agreement as a party, jointly and severally liable to LTL along with New JJCI, for all of the JJCI asbestos liability assigned to LTL in the divisional merger. The funding agreement capped J&J's cumulative and aggregate liability thereunder at the fair saleable value of New JJCI (free and clear of New JJCI's obligations under the funding agreement) as of the date of a given funding request thereunder.[11] The minimum floor for that funding obligation, though, was set at the value of New JJCI on the date of the divisional merger,[12] and that value was estimated to be roughly $61.5 billion.

Two days later, LTL filed Chapter 11 in the Western District of North Carolina, but that court transferred venue of the case to the District of New Jersey, and the New Jersey bankruptcy court is the one that ultimately heard and denied the TCC's motion to dismiss the case as a bad-faith filing.[13] On direct appeal, though, the Third Circuit reversed and ordered dismissal, in a panel opinion authored by Judge Ambro, and the full court unanimously denied LTL's motion for rehearing *en banc*.

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:

> 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 estab-

> lished 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.[14]

And the bankruptcy court's lengthy analysis and ultimate conclusion claiming a relative superiority for the bankruptcy system[15] 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. 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.' "[16]

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. I will have more to say about that in Part III of this series. 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. "Courts, therefore, have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11."[17] 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.

"[T]he good-faith gateway asks whether the debtor faces the kinds of problems that justify Chapter 11 relief."[18] And Chapter 11 "was meant to 'deal[] with the reorganization of a financially distressed enterprise.' "[19] A petitioner experiencing no financial distress, therefore, "has no need to rehabilitate or reorganize, [and] its petition cannot serve the rehabilitative purpose for which Chapter 11 was designed."[20] "[A]bsent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose."[21] Filing Chapter 11 without financial distress is, therefore, bad faith *per se*.

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 would hardly be noteworthy were it not for the conventional wisdom (apparently mistaken) that financial distress is *not* required by the Fourth Circuit's good-faith filing jurisprudence (more on that in Part III of this series). 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.[22] The Third Circuit, however, held that this was legal error requiring reversal:

> [T]he financial state of LTL—a North Carolina limited liability company formed under state law and existing separate from both its predecessor company (Old [JJCI]) and its newly incorporated

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> counterpart company (New [JJCI])—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.[23]

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."[24] 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."[25]

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

> Even were we to agree 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.
>
> . . . 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.[26]

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."[27] 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.[28] 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.[29]

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,[30] 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.[31]

The second blockbuster feature of the *LTL I* holding (with implications for *LTL II*, as discussed in Part III of this series) 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***.[32]

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."[33]

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].[34]

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."[35]

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.

> Most important, . . . the [funding agreement] 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 . . . would be unable to satisfy their . . . obligations under the Funding Agreement. And, of course, J&J's primary, contractual obligation to fund talc costs was one never owed to Old [JJCI] . . . .[36]

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. As the Third Circuit noted:

> It may be that a draw under the Funding Agreement results in payments by New [JJCI] 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.[37]

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."[38] 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.[39] And the Third Circuit held that "[t]his misdirection was legal error."[40]

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

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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."[41] 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."[42]

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.[43] 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,"[44] 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."[45]

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 settlement matrices and various ADR mechanisms (established via a plan of reorganization[46] or a nonbankruptcy aggregate settlement mechanism[47]), 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.[48]

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.[49] 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,"[50] the "problems that bankruptcy is designed to address."[51]

"To take a step back," the Third Circuit explained, "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" and "can impose significant hardship on particular creditors," such that only "[w]hen *financially troubled* petitioners seek a chance to remain in business [is] the exercise of

those powers . . . justified."[52] "[G]iven 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."[53] "This safeguard ensures that claimants' pre-bankrutpcy remedies . . . are disrupted only when necessary."[54]

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."[55] In fact, it did not even present a close case.[56] The divisional merger was undoubtedly undertaken with an acute awareness of the risks that fraudulent conveyance law presented for that transaction,[57] which was obviously structured so that LTL would not be insolvent,[58] nor left with "an unreasonably small capital,"[59] ***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."[60]

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."[61] Thus, the Third Circuit concluded:

> 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 [for LTL] to have [stat]ed, in a prior court filing, 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*." 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." 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. . . .
>
> 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[JCCI]. 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.[62]

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 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[63] made clear that "[f]inancial distress is. . . *necessary* for a good-faith filing *but* ***not*** *sufficient*."[64] 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*."[65] "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,"[66] but "because LTL was *not* in financial distress, it *cannot* show its petition. . . was filed in good faith."[67]

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."[68] Because the Bank-

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ruptcy Code in its entirety, and Chapter 11 in particular, "assumes a debtor in financial distress,"[69] 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."[70]

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 a footnote:

> 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." 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?" 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."[71]

That unaddressed question likely cannot be left unanswered now, however, given the almost-instantaneous *LTL II* filing, which I will analyze in Part III of this series. Here, though, is the one-sentence executive summary: 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.

ENDNOTES:

[1]*In re* LTL Management, LLC, 64 F.4th 84 (3d Cir. 2023) [hereinafter *LTL I*].

[2]Ralph Brubaker, *Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy*, 42 Bankr. L. Letter No. 8, at 1 (Aug. 2022).

[3]The Texas Two-Step bankruptcy strategy is widely reputed to be the brainchild of Greg Gordon at Jones Day, https://www.jonesday.com/en/lawyers/g/gregory-gordon?tab=overview, who is debtor's counsel in all four of the pending Texas Two-Step cases. *See* Dan Levine & Mike Spector, *Going for Broke: How a Bankruptcy "Innovation" Halted Thousands of Lawsuits from Sick Plaintiffs*, Reuters Investigates (June 23, 2022, 2:59 PM GMT), https://www.reuters.com/investigates/special-report/bankruptcy-tactics-two-step/.

[4]See Tex. Bus. Orgs. Code § 1.002(55)(A) & tit. 1, ch. 10(A). The other states with divisional merger statutes are **Arizona**, Ariz. Rev. Stat. tit. 29, ch. 6; **Delaware**, Del. Code Ann. tit. 6, § 18-217(b)-(c); **Kansas**, Kan. Stat. Ann. § 17-7685a; and **Pennsylvania**, Pa. Cons. Stat. tit. 15, ch. 3(F).

[5]A similar, but slightly different permutation involving 3M's earplug liability has received a chilly reception from the bankruptcy court presiding over that case. *See In re* Aearo Technologies LLC, 642 B.R. 891 (Bankr. S.D. Ind. 2022); Brendan Pierson & Dietrich Knauth, *3M's Bid to Shield Itself from Earplug Lawsuits Faces Skeptical Judges*, Reuters (Apr. 5, 2023, 8:38 AM GMT), https://www.reuters.com/legal/3ms-bid-shield-itself-earplug-lawsuits-faces-skeptical-judges-2023-04-04/

[6]*In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D. N.C. 2019). The bankruptcy court certified that decision for direct appeal to the Fourth Circuit, but the Fourth Circuit declined to accept the direct appeal. *See In re* Bestwall LLC, Case No. 17-31795, Docket No. 987 (Bankr. W.D. N.C. Sept. 11, 2019), *petition denied*, No. 19-408, Docket No. 13 (4th Cir. Nov. 14, 2019). A motion for leave to appeal that (presumably interlocutory) decision is still pending in the district court. *See In re* Bestwall LLC, Civ. A. No. 19-396, Docket Nos. 2 & 3 (W.D. N.C. Aug. 12, 2019). Meanwhile, back in the bankruptcy court, the committee recently filed yet another motion to dismiss the case, on grounds of lack of subject-matter jurisdiction. *See In re* Bestwall LLC, Case No. 17-31795, Docket No. 2925 (Bankr. W.D. N.C. Mar. 30, 2023); Hayley Fowler, *Asbestos Claimants Take New Tack in Bestwall Dismissal Bid*, Law360 (Mar. 31, 2023, 7:28 PM EDT), https://www.law360.com/articles/1592508/.

[7]*See In re* DBMP LLC, 2021 WL 3552350, at *1 (Bankr. W.D. N.C. 2021).

[8]*See In re* Aldrich Pump LLC, 2021 WL 3729335, at *1 (Bankr. W.D. N.C. 2021).

[9]*See* Lisa Girion, *Powder Keg: Johnson & Johnson Knew for Decades That Asbestos Lurked in Its Baby Powder*, REUTERS INVESTIGATES (Dec. 14, 2018, 2:00 PM GMT), https://www.reuters.com/investigates/special-report/johnsonandjohnson-cancer.

[10]*See* Ingham v. Johnson & Johnson, 608 S.W.3d 663, 680, 724, Prod. Liab. Rep. (CCH) P 20934 (Mo. Ct. App. E.D. 2020), cert. denied, 141 S. Ct. 2716, 210 L. Ed. 2d 879 (2021).

[11]*See* Annex 2 to Declaration of John K. Kim in Support of First Day Pleadings at 4-6, *In re* LTL Mgmt. LLC, Case No. 21-30589 (Bankr. W.D. N.C. Oct. 14, 2021) [hereinafter *LTL Funding Agreement*] (Section 2(a) and definitions of "JJCI Value" and "Permitted Funding Use"). The JJCI Value cap is also increased by the value of any member distributions that JJCI makes after the divisional merger.

[12]*See LTL Funding Agreement* at 4-5 (definition of "JJCI Value").

[13]*In re* LTL Management, LLC, 637 B.R. 396 (Bankr. D. N.J. 2022) [hereinafter *LTL I*].

[14]*Id*. at 406 & n.8.

[15]*See id*. at 410-16.

[16]*LTL I*, 64 F.4th at 110.

[17]*LTL I*, 64 F.4th at 101 (quoting *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 122, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004) (quoting *In re* SGL Carbon Corp., 200 F.3d 154, 166, 35 Bankr. Ct. Dec. (CRR) 116, 43 Collier Bankr. Cas. 2d (MB) 668, Bankr. L. Rep. (CCH) P 78084, 1999-2 Trade Cas. (CCH) ¶ 72739 (3d Cir. 1999))).

[18]*LTL I*, 64 F.4th at 102.

[19]*Id.* at 104 (quoting *SGL Carbon*, 200 F.3d at 166 (quoting S. Rep. No. 95-989, at 9, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5795)).

[20]*LTL I*, 64 F.4th at 101 (quoting *Integrated Telecom*, 384 F.3d at 122 (quoting *SGL Carbon*, 200 F.3d at 166))).

[21]*LTL I*, 64 F.4th at 101.

[22]*LTL I*, 637 B.R. at 407.

[23]*LTL I*, 64 F.4th at 105.

[24]*LTL I*, 637 B.R. at 407 (citation omitted).

[25]*LTL I*, 64 F.4th at 106.

[26]*Id.* at 105-06 (citations omitted). Moreover, *LTL I*'s insistence upon a debtor-only focus has potentially far-reaching implications for a whole range of controversial Chapter 11 issues, including (most obviously) nonconsensual nondebtor (or third-party) releases. *See* Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 YALE L.J.F. 960 (2022), https://ssrn.com/abstract=3960117; Adam Levitin, *The Implications of LTL's Per-Debtor Analysis*, HARVARD LAW SCHOOL BANKRUPTCY ROUNDTABLE (Feb. 14, 2023), http://blogs.harvard.edu/bankruptcyroundtable/2023/02/14/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-postscript-and-analysis-of-third-circuit-dismissal-of-ltl-managements-bankruptcy/; Edward J. Janger & John Pottow, *Waltz Across Texas: The Texas Three-Step*, HARVARD LAW SCHOOL BANKRUPTCY ROUNDTABLE (Feb. 14, 2023), http://blogs.harvard.edu/bankruptcyroundtable/2023/02/14/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-postscript-and-analysis-of-third-circuit-dismissal-of-ltl-managements-bankruptcy/.

[27]Brubaker, 42 BANKR. L. LETTER No. 8, at 7 (quoting *LTL I*, 637 B.R. at 420 (emphasis added)).

[28]*See* Brubaker, 42 BANKR. L. LETTER No. 8, at 7-8 (discussing those aspects of the *LTL I* bankruptcy court opinion).

[29]*LTL I*, 637 B.R. at 421.

[30]*Id.* at 408 & n.9.

[31]*Bestwall*, 605 B.R. at 49; *see LTL I*, 637 B.R. at 408 (quoting that same paragraph of the *Bestwall* opinion). 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." *Bestwall*, 605 B.R. at 49 (record citation omitted).

[32]*LTL I*, 64 F.4th at 104 (emphasis added).

[33]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://blogs.harvard.edu/bankruptcyroundtable/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/. 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* Brubaker, 131 YALE L.J.F. at 981-92.

[34]*LTL I*, 637 B.R. at 417.

[35]*LTL I*, 64 F.4th at 105.

[36]*Id.* at 106.

[37]*Id.* at 109.

[38]*Id.* at 107 (emphasis in original).

[39]*Id*.

[40]*Id*.

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[41]*Id.* at 106.

[42]*Id.* at 108.

[43]*See generally* Elizabeth Chamblee Burch, Mass Tort Deals: Backroom Bargaining in Multidistrict Litigation (2019); Alexandra Lahav, In Praise of Litigation 92-98 (2019); Abbe R. Gluck & Elizabeth Chamblee Burch, *MDL Revolution*, 96 N.Y.U. L. Rev. 1, 15-16 (2021).

[44]*LTL I*, 64 F.4th at 108.

[45]*Id.* at 107.

[46]*See* Brubaker, 131 Yale L.J.F. at 996.

[47]*See generally* Howard M. Erichson, *A Typology of Aggregate Settlements*, 80 Notre Dame L. Rev. 1769 (2005); Francis E. McGovern, *The What and Why of Claims Resolution Facilities*, 57 Stan. L. Rev. 1361 (2005).

[48]*See* 28 U.S.C.A. §§ 157(b)(5); 1411(a).

[49]*See* Brubaker, 42 Bankr. L. Letter No. 8, at 11-17.

[50]Brubaker, *Texas Two-Step*. *Accord LTL I*, 64 F.4th at 102 ("Financial distress must not only be *apparent*, but it must be *immediate* enough to justify a filing." (emphasis added)).

[51]Brubaker, *Texas Two-Step*.

[52]*LTL I*, 64 F.4th at 103 (quoting *Integrated Telecom*, 384 F.3d at 120 (emphasis added)).

[53]*LTL I*, 64 F.4th at 110.

[54]*Id.* at 111.

[55]*Id.* at 102.

[56]*See id.* at 110 (stating that "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"). *LTL I* detractors are prone to portray the decision as announcing a "new" and "unmanageable" financial distress requirement, neither of which are credible claims, as Judge Fitzgerald has quite sensibly observed. Hon. Judith K. Fitzgerald (ret.), *Over-Thinking Ramifications of the Dismissal of LTL Management LLC's Bankruptcy*, Harvard Law School Bankruptcy Roundtable (Feb. 14, 2023), https://blogs.harvard.edu/bankruptcyroundtable/2023/02/14/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-postscript-and-analysis-of-third-circuit-dismissal-of-ltl-managements-bankruptcy/.

[57]That 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. *See generally* Thomas Moers Mayer, *Will the Lawyers Pay? Counsel's Ethical, Civil, and Criminal Exposure for Creating Asset Protection Trusts*, American Law Institute Continuing Legal Education Course Materials (May 4, 2015).

[58]*See, e.g.*, 11 U.S.C.A. § 548(a)(1)(B)(ii)(I). Uniform Voidable Transactions Act (UVTA) § 5(a); Uniform Fraudulent Transfer Act (UFTA) § 5(a); Uniform Fraudulent Conveyance Act (UFCA) § 4. Such insolvency not only satisfies the financial vulnerability requirement for a constructively fraudulent transfer, it is also a "badge of fraud" that supports an inference of "actual intent to hinder, delay or defraud" creditors. 11 U.S.C.A. § 548(a)(1)(A); UVTA/UFTA § 4(a)(1); UFCA § 7. *See* UVTA/UFTA § 4(b)(9).

[59]*Id.* § 548(a)(1)(B)(ii)(II); UVTA/UFTA § 4(a)(2)(i); UFCA § 5. That circumstance would satisfy the financial vulnerability requirement for a constructively fraudulent transfer and likely also provide evidence in support of an inference of "actual intent to hinder, delay, or defraud" creditors. 11 U.S.C.A. § 548(a)(1)(A); UVTA/UFTA § 4(a)(1); UFCA § 7. *See* UVTA/UFTA § 4(b)(9).

[60]*Id.* § 548(a)(1)(B)(ii)(III). *Accord* UVTA/UFTA § 4(a)(2)(ii); UFCA § 6. That circumstance would satisfy the financial vulnerability requirement for a constructively fraudulent transfer and also, presumably, strongly support an inference of "actual intent to hinder, delay, or defraud" creditors. 11 U.S.C.A. § 548(a)(1)(A); UVTA/UFTA § 4(a)(1); UFCA § 7.

[61]*LTL I*, 64 F.4th at 108.

[62]*Id.* at 108-09 (emphasis in original) (record citations omitted) (quoting *SGL Carbon*, 200 F.3d at 164).

[63]*In re* 15375 Memorial Corp. v. BEPCO, L.P., 589 F.3d 605, 52 Bankr. Ct. Dec. (CRR) 146, Bankr. L. Rep. (CCH) P 81652 (3d Cir. 2009)

[64]Brubaker, 42 Bankr. L. Letter No. 8, at 7 (emphasis added).

[65]*LTL I*, 64 F.4th at 103 (emphasis added).

[66]*Id.* at 104 (emphasis added).

[67]*Id.* at 110 (emphasis added).

[68]*Id.* at 100-01 (quoting *BEPCO*, 589 F.3d at 618 (quoting *Integrated Telecom*, 384 F.3d at 120)).

[69]*Integrated Telecom*, 384 F.3d at 128.

[70]*LTL I*, 64 F.4th at 110 (emphasis added).

[71]*Id.* at 110 n.19 (citations omitted) (quoting, respectively, *BEPCO*, 589 F.3d at 618; Matter of James Wilson Associates, 965 F.2d 160, 26 Collier Bankr. Cas. 2d (MB) 1673, Bankr. L. Rep. (CCH) P 74636 (7th Cir. 1992); and *SGL Carbon*, 200 F.3d at 169).

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SHAPIRO *v.* WILGUS ET AL., RECEIVERS.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

No. 40. Argued November 10, 1932.—Decided December 5, 1932.

1. To prevent disruption of his business by suits of hostile creditors and to cause the assets to be nursed for the benefit of all concerned, a debtor in Pennsylvania, where the law permits appointment of a receiver for the business of a corporation but not for that of an individual, caused a corporation to be formed in Delaware and conveyed to it all of his property in exchange for substantially all of its shares and its covenant to assume payment of his debts. Three days later, joined with a simple contract creditor, he sued the corporation in a federal court in Pennsylvania, invoking jurisdiction on the ground of diversity of citizenship, and, with the consent of the corporation, obtained on the same day a decree appointing receivers and enjoining executions and attachments. *Held:*

   (1) That the conveyance and the receivership were fraudulent in law as against non-assenting creditors. P. 353.

   (2) A creditor who shortly after the decree brought an action resulting in a judgment against the debtor in a Pennsylvania state court, was entitled to an order either for payment out of the assets held by the receivers or for leave to issue execution. P. 357.

   (3) Refusal to grant relief in either of these forms was an abuse of discretion. *Id.*

2. A conveyance made with intent to hinder and delay creditors, though with no intent to defraud them, is illegal under the Statute of Elizabeth (13 Eliz., c. 5) and under the Uniform Fraudulent Conveyance Act, adopted in Pennsylvania. P. 354.
3. In any case not covered by the Uniform Fraudulent Conveyance Act, in Pennsylvania, the Statute of Elizabeth is still the governing rule. *Id.*
4. It is a general rule in the federal courts that a creditor who seeks appointment of receivers must first reduce his claim to judgment and exhaust his remedy at law. P. 355.
5. Departures from this rule, though allowed in some cases where the defendant acquiesces, are to be jealously watched. P. 356.

55 F. (2d) 234, reversed.

CERTIORARI, 286 U. S. 538, to review the affirmance of an order refusing permission to levy an execution from a state court upon property in possession of receivers appointed by the federal court.

Mr. Jacob Weinstein for petitioner.

Mr. Sidney E. Smith for the respondents.

There was no attempt to substitute the corporation as debtor. Nothing was done which deprived, or was intended to deprive, any creditor of the security afforded by the assets as they existed immediately before the formation of the corporation. In the face of the assumption of the liabilities by the corporation, the petitioner could not claim that the property was placed beyond the reach of creditors.

The formation of the corporation and the transfer to it of the assets was not a "conveyance," as that word is used in §§ 2, 4 and 5 of the Uniform Fraudulent Conveyance Act. If, however, it be assumed that the legislature intended that the changing of one's method of doing business should be considered a "conveyance," in no way does this transaction fit the other requirements of the Act.

It is not asserted that Robinson was made insolvent by the transfer to the corporation. On the contrary, he was solvent after the transfer by the sum of $100,000.00.

Nowhere is it alleged that any fictitious value had been placed upon the assets transferred. He received two valuable considerations for this "conveyance": capital stock of the corporation, and the agreement of the corporation to assume all liability for and to pay every debt that Robinson owed.

Robinson did not evidence any intention to engage in any business or transaction other than the business in which he had theretofore been engaged. He maintained complete and sole control of the business. It is admitted

that his very purpose was to continue the business which he had theretofore carried on as an individual with exactly the same assets.

The application for the appointment of a receiver for the corporation is not evidence of an intent to defeat the claims of Robinson's creditors or to hinder and delay them fraudulently. The effect of the appointment was to make it impossible for Robinson or anyone else to remove the assets from the reach of creditors. All of the property, subject as it was to liability for all of the debts, was thereby placed in the hands of the Court which held it for the benefit of all parties interested and as their rights then existed.

The petitioner at the time of this action had no lien or claim against the specific property. Even if there had been a fraudulent transfer in fact, the petitioner would have been compelled to institute an action in order to acquire a lien against the fund. To say that under the circumstances this petitioner is entitled to the demand he makes, would be to controvert the thoroughly grounded rule that one of the purposes of a receivership is the restraining of indiscriminate levies and executions, in order that the property involved may be preserved from dissipation and waste and equal distribution be made to those entitled.

It is settled law in Pennsylvania that a transaction which has for its object the payment of all creditors, and which places them on an equal footing, is not fraudulent. *Wilt* v. *Franklin,* 1 Binn. 502, 513, 515; *Lippincott* v. *Barker,* 2 Binn. 174, 183, 184; *M'Allister* v. *Marshall,* 6 Binn. 338, 347; *M'Clurg* v. *Lecky,* 3 P. & W. 83, 91; *York County Bank* v. *Carter,* 38 Pa. 446, 453; *Bentz* v. *Rockey,* 69 Pa. 71, 76, 77; *Lake Shore Banking Co.* v. *Fuller,* 110 Pa. 156, 162, 163; *Werner* v. *Zierfuss,* 162 Pa. 360, 365, 366; *Miller* v. *Shriver,* 197 Pa. 191, 195; *Shibler* v. *Hartley,* 201 Pa. 286, 287, 288; *Love* v. *Clayton,* 287 Pa. 205, 215.

Some of the cases cited above go to the extent of holding that the transaction is valid notwithstanding that particular creditors are preferred.

The formation of the corporation did not operate to confer a colorable jurisdiction upon the district court of the United States. Jud. Code, § 37; U. S. C., Tit. 28, § 80, is inapplicable. *Black & White Taxicab Co.* v. *Brown & Yellow Co.,* 276 U. S. 518, 524, 525; *Re Metropolitan Ry. Receivership,* 208 U. S. 90, 110, 111.

Miller & Lux v. *East Side Canal Co.,* 211 U. S. 293; *Southern Realty Co.* v. *Walker,* 211 U. S. 603; *Lehigh Mining Co.* v. *Kelly,* 160 U. S. 327, are not applicable to the present case. In all of those cases there was an actual fraud on the court. In none was the nominal plaintiff the real party in interest. In all, control of the litigation and the property remained in the hidden parties. In the case at bar, both parties plaintiff had a real and substantial interest and were acting to protect their respective separate interests. Nothing appears to justify the contention that the formation of the corporation was for the purpose of obtaining a receivership. The reverse is demonstrated by the admitted fact that Robinson originally formed the corporation for the purpose of continuing in corporate form the business in which he had engaged. The parties are actual parties in interest and the subject matter presented in the application for appointment of the receivers was real and substantial.

The objection that the complainant McLean was improperly joined as a party complainant for the reason that he is a simple contract creditor is without foundation. *Pusey & Jones Co.* v. *Hanssen,* 261 U. S. 491.

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The petitioner, a judgment creditor of Herbert P. Robinson, made application in due form to a United States

District Court in Pennsylvania praying that leave be granted him to levy an execution upon property in the possession of receivers appointed by that court. An order refusing such leave was affirmed by the Circuit Court of Appeals for the Third Circuit. 55 F. (2d) 234. The case is here on certiorari.

From the record and the admissions of counsel these facts appear. Herbert P. Robinson was engaged in business in Philadelphia as a dealer in lumber. He was unable to pay his debts as they matured, but he believed that he would be able to pay them in full if his creditors were lenient. Indeed, he looked for a surplus of $100,000 if the business went on under the fostering care of a receiver. Most of the creditors were willing to give him time. Two creditors, including the petitioner, were unwilling, and threatened immediate suit. Thus pressed, the debtor cast about for a device whereby the business might go on and the importunate be held at bay. He had to reckon with obstructions erected by the local law. The law of Pennsylvania does not permit the appointment of a receiver for a business conducted by an individual as distinguished from one conducted by a corporation or a partnership. *Hogsett* v. *Thompson,* 258 Pa. St. 85; 101 Atl. 941. To make such remedies available there was need to take the title out of Robinson and put it somewhere else. The act responded to the need. On January 9, 1931, the debtor brought about the formation of a Delaware corporation, the Miller Robinson Company. On the same day he made a conveyance to this company of all his property, real and personal, receiving in return substantially all the shares of stock and a covenant by the grantee to assume the payment of the debts. Three days later, on January 12, 1931, in conjunction with a simple contract creditor, he brought suit against the Delaware corporation in the federal court, invoking the jurisdiction of that court on the ground of diversity of

citizenship. The bill of complaint alleged that creditors were pressing for immediate payment; that one had entered suit and was about to proceed to judgment; that the levy of attachments and executions would ruin the good will and dissipate the assets; and that the business, if protected from the suits of creditors and continued without disturbance could be made to pay the debts and yield a surplus of $100,000 for the benefit of stockholders. To accomplish these ends there was a prayer for the appointment of receivers with an accompanying injunction. The corporation filed an answer admitting all the averments of the bill and joining in the prayer. A decree, entered the same day, appointed receivers as prayed for in the complaint, and enjoined attachments and executions unless permitted by the court. Four days thereafter, on January 16, 1931, the petitioner began suit against Robinson in the Court of Common Pleas, and on February 4, 1931, recovered a judgment against his debtor for $1,007.65 upon a cause of action for money loaned. On February 26, 1931, he submitted a petition to the United States District Court in which he charged that the conveyance from Robinson to the corporation and the ensuing receivership were parts of a single scheme to hinder and delay creditors in their lawful suits and remedies, and he prayed that he be permitted to issue a writ of *fieri facias* against the chattels in the possession of the receivers and to sell them so far as necessary for the satisfaction of his judgment. The petition was denied, and the denial affirmed upon appeal.

The conveyance and the receivership are fraudulent in law as against non-assenting creditors. They have the unity of a common plan, each stage of the transaction drawing color and significance from the quality of the other; but, for convenience, they will be considered in order of time as if they stood apart. The sole purpose of the conveyance was to divest the debtor of his title and

put it in such a form and place that levies would be averted. The petition to issue execution and the answer by the receivers leave the purpose hardly doubtful. Whatever fragment of doubt might otherwise be left is dispelled by the admissions of counsel on the argument before us. One cannot read the opinion of the Court of Appeals without seeing very clearly that like admissions must have been made upon the argument there. After a recital of the facts the court stated in substance that the aim of the debtor was to prevent the disruption of the business at the suit of hostile creditors and to cause the assets to be nursed for the benefit of all concerned. Perceiving that aim and indeed even declaring it, the court did not condemn it, but found it fair and lawful. In this approval of a purpose which has been condemned in Anglo-American law since the Statute of Elizabeth (13 Eliz., ch. 5), there is a misconception of the privileges and liberties vouchsafed to an embarrassed debtor. A conveyance is illegal if made with an intent to defraud the creditors of the grantor, but equally it is illegal if made with an intent to hinder and delay them. Many an embarrassed debtor holds the genuine belief that if suits can be staved off for a season, he will weather a financial storm, and pay his debts in full. *Means* v. *Dowd,* 128 U. S. 273, 281. The belief, even though well founded, does not clothe him with a privilege to build up obstructions that will hold his creditors at bay. This is true in Pennsylvania under the Uniform Fraudulent Conveyance Act, which became a law in that state in 1921. Purdon's Pennsylvania Digest, Title 39, § 357. It is true under the Statute of Elizabeth (13 Eliz., ch. 5) which, in any case not covered by the later act, is still the governing rule. Purdon's Pennsylvania Digest, Title 39, § 361; *McKibbin* v. *Martin,* 64 Pa. St. 352, 356; *Stern's Appeal,* 64 Pa. St. 447, 450. Tested by either act, this conveyance may not stand. *Hogsett* v. *Thompson, supra; Mont-*

gomery Web Co. v. *Dienelt,* 133 Pa. St. 585; 19 Atl. 428; *Atlas Portland Cement Co.* v. *American Brick & Clay Co.,* 280 Pa. St. 449; 124 Atl. 650; *In re Elletson Co.,* 174 Fed. 859, affirmed 183 Fed. 715; *Kimball* v. *Thompson,* 4 Cush. 441, 446; *Dearing* v. *McKinnon Dash Co.,* 165 N. Y. 78; 58 N. E. 773; *Means* v. *Dowd, supra.*

The conveyance to the corporation being voidable because fraudulent in law, the receivership must share its fate. It was part and parcel of a scheme whereby the form of a judicial remedy was to supply a protective cover for a fraudulent design. *Harkin* v. *Brundage,* 276 U. S. 36; *Decker* v. *Decker,* 108 N. Y. 128, 135, 15 N. E. 307. The design would have been ineffective if the debtor had been suffered to keep the business for himself. *Hogsett* v. *Thompson, supra.* It did not gain validity when he transferred the business to another with a capacity for obstruction believed to be greater than his own. The end and aim of this receivership was not to administer the assets of a corporation legitimately conceived for a normal business purpose and functioning or designed to function according to normal business methods. What was in view was very different. A corporation created three days before the suit for the very purpose of being sued was to be interposed betweeen its author and the creditors pursuing him, with a restraining order of the court to give check to the pursuers. We do not need to determine what remedies are available for the conservation of the assets when a corporation has been brought into existence to serve legitimate and normal ends. Ordinarily a creditor who seeks the appointment of receivers must reduce his claim to judgment and exhaust his remedy at law. The Uniform Fraudulent Conveyance Act may have relaxed that requirement in many of the states (Purdon's Pennsylvania Digest, Title 39, §§ 351, 359, 360; cf. New York Debtor and Creditor Law, Article 10; Consol. Laws, c. 12; *American Surety Co.*

v. *Conner,* 251 N. Y. 1; 166 N. E. 783), but the rule in the federal courts remains what it has always been. *Pusey & Jones Co.* v. *Hanssen,* 261 U. S. 491, 497; *Scott* v. *Neely,* 140 U. S. 106; *Hollins* v. *Brierfield Coal & Iron Co.,* 150 U. S. 371, 379; *Matthews* v. *Rodgers,* 284 U. S. 521, 529. True indeed it is that receivers have at times been appointed even by federal courts at the suit of simple contract creditors if the defendant was willing to waive the irregularity and to consent to the decree. This is done not infrequently where the defendant is a public service corporation and the unbroken performance of its services is in furtherance of the public good. *Re Metropolitan Railway Receivership,* 208 U. S. 90, 109, 111. It has been done at times, though the public good was not involved, where legitimate private interests might otherwise have suffered harm. *United States* v. *Butterworth-Judson Corp.,* 269 U. S. 504, 513; *Krugsport Press* v. *Brief English Systems,* 54 F. (2d) 501; *Harkin* v. *Brundage, supra,* p. 52. We have given warning more than once, however, that the remedy in such circumstances is not to be granted loosely, but is to be watched with jealous eyes. *Michigan* v. *Michigan Trust Co.,* 286 U. S. 334, 345; *Harkin* v. *Brundage, supra.* Never is such a remedy available when it is a mere weapon of coercion, a means for the frustration of the public policy of the state or the locality. It is one thing for a creditor with claims against a corporation that is legitimately his debtor to invoke the aid of equity to conserve the common fund for the benefit of himself and of the creditors at large. *Hollins* v. *Brierfield Coal & Iron Co.,* 150 U. S. 371, 380. Whatever hindrance and delay of suitors is involved in such a remedy may then be incidental and subsidiary. It is another thing for a debtor, coöperating with friendly creditors, to bring the corporation into being with the hindrance and delay of suitors the very aim of its existence. The power to intervene before the legal

remedy is exhausted is misused when it is exercised in aid of such a purpose. Only exemplary motives and scrupulous good faith will wake it into action.

The receivership decree assailed upon this record does not answer to that test. We have no thought in so holding to impute to counsel for the debtor or even to his client a willingness to participate in conduct known to be fraudulent. The candor with which the plan has been unfolded goes far to satisfy us, without more, that they acted in the genuine belief that what they planned was fair and lawful. Genuine the belief was, but mistaken it was also. Conduct and purpose have a quality imprinted on them by the law.

There remains a question of procedure. The prayer of the petitioner was that he be permitted to issue execution upon his judgment in the state court. Cf. *Wiswall* v. *Sampson,* 14 How. 52. If there had been any substantial doubt that the conveyance and the receivership were voidable obstructions, the federal court might have refused to permit the tangle to be unraveled in the courts of the state. It might have retained the controversy in its own grasp and made a decision for itself. But in truth there was no substantial doubt as to the quality of conveyance and receivership, no genuine issue to be tried. In such circumstances the petitioner was entitled to an order in the alternative either for the payment of his judgment out of the assets in the hands of the receivers or in default thereof for leave to issue execution. The refusal to grant relief in one or other of these forms is a departure from the bounds of any legitimate discretion which is not without redress.

The decree is reversed and the cause remanded to the District Court for further proceedings in conformity with this opinion.

Reversed.

Shapiro v. Wilgus (p.401)

This case illustrates yet another dimension of actual fraudulent intent. Robinson had a lumber business which he conducted as a sole proprietor. He was having cash flow problems, and couldn't pay all his debts in the ordinary course as they came due. Nonetheless, he was convinced that if his creditors would hold off on their remedies, future income from his lumber business would be more than enough to pay them all in full, and he convinced almost all of his creditors of that. There were two holdouts, however.

Of course, as we've discussed, this sort of circumstance is precisely why Chapter 11 exists—stay individual creditor remedies that would shut down the business, preserve the going concern value of the business, give creditors a bigger recovery in the process, etc. Unfortunately, statutory reorganization proceedings were not a part of the federal bankruptcy law at that time. The first statutory reorganization process akin to present-day Chapter 11 was not enacted until 1934. Before 1934, though, federal courts had created a common-law precursor to statutory reorganization proceedings through equitable receivership proceedings, such as the one attempted in this case. A creditor, in cahoots with the debtor, would bring a diversity suit in a federal district court, the debtor would consent to judgment, and the judgment creditor would then invoke a state-law post-judgment creditor's remedy that we talked about early on—an equitable creditor's bill. And the creditor's bill would seek application of all the debtor's assets toward satisfaction of all creditors' claim and appointment of a receiver to manage the business for that purpose. The equivalent of a plan of reorganization would then be effected through the guise of an "execution sale" of the business to a new entity, with a capital structure for that new entity designed to redistribute the value of the

business among the debtor's prebankruptcy creditors and equity holders, in the same manner that a modern-day plan of reorganization does.

In the case of Robinson's business, though, there was one small problem—applicable Pennsylvania law said that receivers could only be appointed to manage and sell the business of a corporation or partnership and could not be appointed to manage and sell the business of an individual debtor. So Robinson transferred all of the assets of his lumber business to a newly formed corporation, in exchange for all of the stock in this corporation, and the corporation assumed liability on all of Robinson's debts in connection with the lumber business. The corporation and Robinson's shill creditor then went forward with the consent receivership in federal district court, and the distrct court appointed a receiver.

One of Robinson's holdout creditors then sued Robinson in state court and got a judgment against Robinson. Of course, since all of Robinson's business assets had been transferred to his new corporation, that made it difficult for the holdout creditor to try to execute on his judgment against Robinson. So the holdout creditor intervened in the federal district court, whose receiver now had possession and control of all of the new corporation's assets, invoking another state-law postjudgment creditor's remedy traditionally sought through an equitable creditor's bill—fraudulent conveyance. The holdout creditor challenged Robinson's transfer of all the assets of his lumber business to the newly formed corporation as a fraudulent transfer made with actual intent to hinder, delay, and defraud him, and the Supreme Court agreed.

The larger message of the *Shapiro v. Wilgus* case is a foreshadowing of the dual principles of federalism and separation of powers that we explored in the *Grupo Mexicano* case. Pennsylvania law said that a receivership was not a proper remedy as against an individual debtor, and Robinson was clearly just trying to end-run that limitation. For the federal district court to grant a receivership nonetheless, then, would improperly create a federal common law of postjudgment creditors' remedies that would improperly interfere with the "substance" of debtor-creditor law as established by Pennsylvania state law. And not only would the federal court's granting of a receivership in this case infringe upon Pennsylvania state law, the federal court was also creating a federal common law of reorganization, perhaps best left to Congress through the exercise of its constitutional Bankruptcy Power. *Shapiro v. Wilgus* is one of a number of Supreme Court cases, starting in the late 1920s, that began questioning the validity of these consent receiverships by which the federal courts were inventing the reorganization process, and ultimately, Congress did enact statutory reorganization proceedings as part of the federal bankruptcy law.

The narrower message of *Shapiro v. Wilgus*, though, speaks to the requisite intent necessary for a fraudulent transfer premised upon actual fraud. As the Court noted, Robinson's intent was not to prevent his creditors from being paid. In fact, it was just the opposite. His means for attempting to do so, however, necessarily required efforts to frustrate certain creditors in the lawful exercise of their legitimate remedies through a disposition of his assets. And a fraudulent conveyance consists not only of transfers designed to deny creditors any recovery, but also to "hinder" or "delay" creditors in the collection of their debts. When that is the purpose of the transfer at issue, it is avoidable. Thus, the holdout creditor was free to execute on the assets in the hands of the receiver as if the transfer to the corporation had never been made.