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Georgia-Pacific Ruling Furthers Texas Two-Step Challenges

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The U.S. Court of Appeals for the Fourth Circuit recently approved injunctive relief as part of a strategy for settling mass tort claims through the Chapter 11 bankruptcy case of Bestwall LLC, an entity created by Georgia-Pacific LLC.

A divided three-judge panel upheld a U.S. Bankruptcy Court for the Western District of North Carolina injunction that barred asbestos- injury claimants from continuing litigation against a nondebtor, finding that the bankruptcy court had jurisdiction and applied the appropriate standard for granting injunctive relief.

In Bestwall LLC v. Official Committee of Asbestos Claimants, the Fourth Circuit joins a growing body of recent decisions addressing the legality of tactics aimed at channeling mass tort claims to a subsidiary or an affiliate, and then orchestrating a bankruptcy filing for that entity to wall off and limit damages.

The two-step maneuver has been implemented in at least five notable bankruptcy cases involving blue-chip companies, and is colloquially referred to as the "Texas Two-Step."[1]

The body of law addressing issues arising in bankruptcy cases that have employed the Texas Two-Step is developing. Challenges to this type of filing have focused to date on dismissal motions brought for cause under Section 1112(b) of the U.S. Bankruptcy Code, the related good faith requirement for bankruptcy access and the appropriate scope of bankruptcy court jurisdiction.

Critics argue that healthy companies should not be able to use bankruptcy and the Texas Two-Step gambit as a tool to evade responsibility for tortious conduct.

Proponents contend that existing and future claimants in mass tort cases can benefit from the equitable resolution that a single proceeding affords all parties.

The race for judgments around the country is halted, and many of the goals of bankruptcy, including the preservation of value and equality of distribution, can be achieved in a restructuring process overseen by the

bankruptcy court.

Factual Background

Georgia-Pacific and its affiliates are among the world's leading manufacturers of paper, packaging, tissue and building materials. Products include household names such as Brawny paper towels and Quilted Northern toilet paper.

The company had a problem. Long ago, it merged with a business that manufactured asbestos-laden products that Georgia-Pacific sold until 1977. The company faced thousands of asbestos-related personal injury lawsuits — some 64,000 cases — based on its sale of those products and needed a solution.

In 2017, Georgia-Pacific implemented a divisional merger under Texas law, dividing its assets and liabilities between two entities, with Bestwall becoming solely responsible for liabilities that included all asbestos-related claims.

In addition, the two companies entered into a funding agreement that required Georgia- Pacific to pay expenses including the cost of funding a trust for the benefit of asbestos claimants in Bestwall's bankruptcy. Following the restructuring, claimants began pursuing Georgia-Pacific and naming the company as a defendant in lawsuits.

Bestwall commenced a Chapter 11 case in the Western District of North Carolina with a goal of consummating a plan of reorganization that would provide for the creation and funding of a trust to pay asbestos claims, and the issuance of a permanent injunction that would protect the debtor and its nonbankrupt affiliates from claims and liability.[2]

The Official Committee of Asbestos Claimants filed multiple unsuccessful motions to dismiss the bankruptcy case, calling for an end to the Chapter 11, arguing that Bestwall was "neither insolvent nor in need of bankruptcy for its survival."

The committee pointed to the funding agreement as one piece of evidence demonstrating that the debtor was a fully solvent entity that did not have any anticipated short or long- term inability to fully satisfy its obligations.[3] The committee characterized the bankruptcy filing as a sham and a farce designed to protect Georgia-Pacific from claims.

The debtor in the meantime filed an adversary proceeding seeking, among other things, a preliminary injunction under Section 105 of the Bankruptcy Code to enjoin the assertion of any asbestos-related claims against Georgia-Pacific.

The debtor contended that the relief was necessary to further the essential purpose of its bankruptcy, which would be rendered futile if claimants were allowed to proceed against Georgia-Pacific for the same claims being addressed in Bestwall's bankruptcy proceeding.

The committee urged the court to reject the requested relief, contending

that the bankruptcy court lacked jurisdiction to enjoin claims and effectively grant a bankruptcy stay for the benefit of a nondebtor.

Lower Courts Find Jurisdiction

The bankruptcy court rejected the committee's arguments. The court determined that it did in fact have related-to jurisdiction to enjoin the litigation against Georgia-Pacific because allowing these claims to proceed outside of the Bestwall bankruptcy proceeding could adversely affect the bankruptcy estate.[4]

The impact of inter-entity indemnification obligations would make judgments against Georgia-Pacific tantamount to judgments against the debtor. The distraction of the debtor's personnel who would still be required to participate in the litigation while also trying to reorganize was also viewed as material.

Further, the bankruptcy court determined that the fundamental purposes of Bestwall's reorganization would be defeated in the absence of an injunction.

The district court on appeal found that the bankruptcy court did not abuse its discretion in granting the preliminary injunction.

The court rejected the committee's jurisdictional argument as well as its contention that the bankruptcy court applied the incorrect legal standard in concluding that Bestwall had a reasonable likelihood of a successful reorganization.[5] The district court affirmed the bankruptcy court decision.

Fourth Circuit Majority Affords Protection

On appeal, the majority affirmed. The panel concluded that the bankruptcy court had jurisdiction to issue the injunction because of the broad test for "related to" jurisdiction: an exercise of jurisdiction is appropriate "if the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy."[6]

The asbestos-related claims against Bestwall are identical to the claims against Georgia- Pacific and coextensive in every respect. And, as conceded by committee's counsel in oral argument, litigating the same claims in thousands of state court cases that would be resolved within the Bestwall bankruptcy case could have an impact on the debtor's own bankruptcy estate.

The identity of claims was inextricably interwoven with the debtor and its bankruptcy estate and, therefore, their impact was sufficient to confer related-to jurisdiction. Moreover, upholding the injunction promoted the equitable, streamlined and timely resolution of claims in one forum.

The jurisdictional analysis also included a review of the committee's contention that the federal courts do not have jurisdiction over civil actions where the parties impermissibly attempt to manufacture jurisdiction. The committee argued that Georgia-Pacific and its affiliates orchestrated the structure and substance of the transactions at issue to take advantage of

bankruptcy laws.

Extending bankruptcy jurisdiction to such a contrivance and enjoining the prosecution of legitimate claims against a solvent nondebtor should not be countenanced.

The committee contended Bestwall's attempt to obtain relief from the bankruptcy court challenges guiding principles for determining who qualifies as a debtor and the breadth of bankruptcy jurisdiction. The Fourth Circuit rejected the committee's arguments.

The panel found that the corporate restructuring allowed under Texas law left the jurisdictional result the same, as parties may legitimately try to obtain the jurisdiction of federal courts as long as the mechanics are, as in this case, lawfully available.

The majority also determined that the bankruptcy court applied the correct standard in approving the injunction. The Fourth Circuit rejected the argument that the appropriate standard was whether the debtor has a likelihood of successfully obtaining a permanent injunction barring the claims at issue.

Such a standard would eliminate Chapter 11 reorganization as an option for many debtors. Instead, majority found that the relevant inquiry is whether the debtor has a likelihood of success in its efforts to reorganize.

Dissent Underscores Judicial Division

Breaking from the majority, the dissent called the debtor's restructuring as "little more than a corporate shell game."[7]

The debtor impermissibly manufactured jurisdiction through its use of the Texas Two-Step

Georgia-Pacific improperly and collusively engineered bankruptcy jurisdiction from whole cloth.[8]

> Put simply, it is elementary that the debtor in bankruptcy 'cannot write its own jurisdictional ticket' – and it logically follows that the debtor cannot make out such a 'ticket' for a distinct, non-debtor either.[9]

Yet, the dissent believed that is exactly what Georgia-Pacific did — it reformed its corporate existence so that it could obtain bankruptcy relief without ever having to file for bankruptcy.

The central purpose of Congress in enacting the Bankruptcy Code was to provide a framework by which insolvent debtors can reorder their affairs and obtain a fresh start. According to the Bestwall ruling:

> Yet in recent years, major and fully solvent business corporations have managed to skirt that debtor-centric objective and obtain shelter from sweeping tort litigation without having to file for bankruptcy themselves. It is precisely that sort of manipulation of the Bankruptcy Code—and by extension the Article I bankruptcy courts—that lies at

the heart of this important appeal.[10]

The dissent likened the Bestwall bankruptcy to the U.S. Court of Appeals for the Third Circuit's January decision in In re: LTL Management LLC, which dismissed the Chapter 11 bankruptcy case filed by Johnson & Johnson subsidiary LTL Management for lack of good faith.

The Third Circuit found in a Texas divisional merger case undertaken to isolate liabilities in one subsidiary that the debtor was not in financial distress.[11] The majority in Bestwall found that the context was different in LTL as the critical issue in this case was one of jurisdiction.

In any event, the Fourth Circuit applies a more comprehensive, and stricter, standard for dismissal of Chapter 11 cases — a standard for which the committee made no showing.

The dissent believed that the bankruptcy court's injunction was entered without any legitimate jurisdictional basis.

The majority's ruling sanctions the ability of an increasing number of "solvent, blue-chip companies faced with mass tort liability to take advantage of perceived loopholes that allow them to pick and choose among the debt-discharging benefits of bankruptcy without having to subject themselves to its creditor-protecting burdens."[12]

That, according to the dissent, was "the essence of these proceedings."[13]

Conclusion

While Congress may not have expected bankruptcy courts to become a forum for resolving mass tort claims when it enacted the Bankruptcy Code in 1978, bankruptcy can be an effective vehicle for resolving enterprise-threatening liability.

However, concerns about fairness and the proper use of bankruptcy as a tool for addressing these claims fuels an ongoing debate and quickly evolving case law with respect to the boundaries of Chapter 11 protection.[14]

The competing tensions are underscored by the 2-1 split decision in Bestwall.

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[1] The "Texas Two-Step" is a device made available under Texas state law that permits a company to divide into two or more entities—a divisive merger—and separate its assets and liabilities among the two entities.

Then, the liability burdened new entity seeks chapter 11 protection that affords a channeling injunction and third-party releases for its related, asset holding entities under a plan of reorganization.

[2] The Western District of North Carolina may likely have been selected as the forum for the bankruptcy filing due to a local ruling that capped a debtor's asbestos liability and the comparatively debtor-friendly, bad faith dismissal standard.

[3] See Hayley Fowler, Asbestos Claimants Take New Tack in Bestwall Dismissal Bid, Law360 (March 31, 2023).

[4] In re Bestwall LLC , 606 R. 243, 249-51 (Bankr. W.D.N.C. 2019). See 28 U.S.C. § 1334(b) (a bankruptcy court has jurisdiction over other civil proceedings "arising in or related to cases under title 11").

[5] In re Bestwall LLC, 3:20-cv-105-RJC, 2022 U.S. Dist. LEXIS 2996 (W.D.N.C. Jan. 6, 2022).

[6] Bestwall LLC v. Official Comm. of Asbestos Claimants (In re Bestwall LLC), Case 22-1127, 22-1135, 2023 U.S. App. LEXIS 15350 (4th Cir. June 20, 2023) (quoting Pacor, Inc. v. Higgins , 743 F.2d 984, 994 (3d Cir. 1984)).

[7] Id. *52 (King, J. dissenting).

[8] Id. at *40.

[9] Id.

[10] at *30.

[11] As the Third Circuit explained at the beginning of its decision: We start, and stay, with good faith. Good intentions—such as to protect the J&J brand or comprehensively resolve litigation—do not suffice What counts to access the Bankruptcy Code's safe harbor is to meet its intended purposes. Only a putative debtor in financial distress can do so. LTL was not. Thus we dismiss its petition. In re LTL Management, LLC , 64 F.4th 84, 93 (3d Cir. 2023). Accord In re Aero Techs. LLC, Case No. 22-02890-JJG-11, 2023 LEXIS 1519 (Bankr. S.D. Ind. June 9, 2023) (dismissing bankruptcy cased filed by subsidiaries of 3M finding the logic of the Third Circuit's ruling in LTL persuasive and indicating that the bankruptcy court cannot become "another court of general jurisdiction"). See Ryan Dahl, J&J Ch. 11 Ruling Highlights 'Texas Two-Step' Skepticism, Law360 (Feb. 13, 2023).

[12] In re Bestwall LLC, 2023 S. App. LEXIS 15350 at *53.

[13] Id.

[14] Brendan Best, The Texas Two-Step May Be Losing Steam, Law360 (June 15, 2023).