Senate Judiciary Committee Subcommittee Hearing on "Evading Accountability: Corporate Manipulation of Chapter 11 Bankruptcy": A Recap

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On September 19, 2023, the U.S. Senate Judiciary Committee held a hearing on whether corporations manipulate Chapter 11 bankruptcy to evade accountability for mass tort cases, with a particular focus on Johnson & Johnson's ("J&J") use of the "Texas Two-Step" to tackle its baby powder liability.

The witnesses included:

- Erik Haas, J&J's Worldwide Vice President of Litigation
- Stephen Hessler, Partner at Sidley Austin LLP
- Melissa Jacoby, Graham Kenan Professor of Law, University of North Carolina at Chapel Hill
- Lori Knapp (Speaking about her stepfather's experience of diagnosed of mesothelioma and seeking compensation from Georgia-Pacific)
- Samir D. Parikh, Robert E. Jones Professor of Advocacy and Ethics at Lewis & Clark Law School

Bankruptcy as a Forum for Resolving Mass Torts

The overarching theme of the hearing was whether bankruptcy was a proper forum to resolve mass tort liabilities or if the system is being abused to enable corporate tortfeasors to "evade accountability." Many of the committee's members, both Democrats and Republicans, adopted lines of questioning that revealed varying degrees of disquiet and outrage at the way corporations have dealt with mass tort liability through bankruptcy. Senator Dick Durbin (D-IL), chair of the committee, characterized maneuvers like divisive mergers (discussed below) as a way for companies to seek all the benefits of bankruptcy with none of the costs, while Senator Sheldon Whitehouse (D-RI) went further, calling it a "dirty trick" designed to move assets out of reach and mire tort claimants in protracted bankruptcy proceedings or deny them their "day in court."

Professor Melissa Jacoby of the University of North Carolina at Chapel Hill argued that using the bankruptcy process to resolve mass tort liabilities creates an alternative justice system and cuts off other civil processes in a way that was not intended. She noted the difference between using the automatic stay to stop debt collection while a debtor is in bankruptcy and using it to stay jury trials to determine liability in the first place. Professor Jacoby further argued that Congress did not create bankruptcy courts to be the forum to evaluate the science behind tort liability or envision lawsuits being stripped out of operating companies prior to filing. She emphasized the need for additional guardrails if bankruptcy were to continue to be a forum to resolve tort claims.

Lewis & Clark Law School Professor Samir D. Parikh, on the other hand, strongly advocated for this use of the bankruptcy system and suggested that it is not merely a proper venue, but the optimal one for resolving mass torts. He argued that providing meritorious claimants compensation on the shortest possible timeline should be the goal in any mass tort resolution system. Relative to class action or multi-district litigation processes, bankruptcy offers a global settlement with finality for companies and is able to serve both current and future claimants. Mr. Stephen Hessler, Partner at Sidley Austin LLP, added that the negative narrative showed an incomplete picture of the bankruptcy system. He stressed that the existing Code does push accountability and transparency through disclosure requirements, judicial oversight, and other procedural and substantive tools that actually make the process difficult to manipulate.

In the case of J&J, Mr. Haas, J&J's vice president of litigation, stressed the struck-down agreement with a majority of claimants in the LTL bankruptcy provided for greater recovery for current and tort victims than would otherwise be available to them. He noted that J&J has prevailed in the majority of cases related to its baby powders that have been tried and emphasized that the sheer volume of cases means that resolution via the tort system would take thousands of years and billions of dollars. In his view, a bankruptcy resolution is the only way to provide equitable resolution for current and future claimants.

The hearing also stressed the human element of this debate. Ms. Lori Knapp spoke of her stepfather's battle with mesothelioma and his struggle to seek recourse from Georgia-Pacific, who made the industrial products that lead to him and many of his co-workers developing the rare cancer. Others referred to the cancer victims making claims against J&J; servicemembers claiming harm from defective combat earplugs made by 3M; the survivors of child abuse at the hands of USA Gymnastics; and all those harmed by opioids made by Purdue Pharma.

Texas Two-Step / Divisive Mergers

The hearing focused on J&J's use of the Texas Two-Step to solve its product liability. J&J Consumer Inc. ("Old Consumer"), a wholly owned subsidiary of J&J, produced baby powder products with talc, which allegedly caused mesothelioma, ovarian cancer, and other injuries. In October 2021, Old Consumer underwent a restructuring and formed two new entities, LTL Management and J&J Consumer Inc ("New Consumer"), through a divisive merger under Texas state corporate law. Old Consumer assigned all of its existing talc liabilities to LTL, while New Consumer retained all of Old Consumer's operating assets. Old Consumer then ceased to exist. In addition, J&J entered a funding agreement with LTL, promising to cover any talc and bankruptcy-related expenses up to $61.5 billion. Two days later, LTL filed for Chapter 11 bankruptcy in North Carolina. This strategy has become widely known as the “Texas Two-Step.”

Senator Durbin first questioned the legitimacy of J&J’s use of the Texas Two Step, as it allowed a tremendously profitable company to file only part of the company for bankruptcy and resolve its liabilities. Mr. Durbin questioned Mr. Haas, “How can you have it both ways?” “How can you have a profitable corporation with that much money and say these meritless claims were worth $8.9 billion and you shouldn’t be responsible for them?” Mr. Durbin emphasized that: “In October 2021—when [LTL Management] first filed for bankruptcy—J&J had a market capitalization of approximately $420 billion. In 2022—the year following LTL’s bankruptcy filing—J&J generated $94.9 billion in sales and $63.9 billion in gross profit.” Mr. Haas responded that the bankruptcy court had determined that J&J’s financial position was irrelevant to assessing the financial distress of New Consumer, as a parent corporation has no general obligation to fund the liabilities of an independent subsidiary.

Ms. Knapp also questioned the legitimacy of economically solvent corporations’ use of divisive merger to shield themselves from liability. “Bankruptcy is for people and companies that can’t pay their bills,” Ms. Knapp said. “These Texas Two-Step fake bankruptcies have turned the bankruptcy courts into a sham where profitable companies go to avoid responsibilities they are fully capable of paying.”

Senator Mazie Hirono (D-HI) urged her colleaguesto establish a “minimum standard” to prevent corporations from abusing divisive merger to avoid liability. Ms. Hirono questioned whether fraudulent transfer rules under federal bankruptcy laws would allow the Texas Two-Step to be implemented. In response, Professor Jacoby mentioned that if a case is properly “within the domain” of the bankruptcy system, federal fraudulent transfer law can apply to the Texas Two-Step bankruptcy cases, as the U.S. Bankruptcy Court for the Western District of North Carolina previously decided. Professor Jacoby suggested that even if state law allows divisive mergers, Congress has the authority to implement federal laws to prevent the bankruptcy regime from being abused.

Nonconsensual Third-Party Releases

The hearing also covered the permissibility of nonconsensual third-party releases, anissue central to the Purdue Pharma bankruptcy currently pending before the Supreme Court. Nonconsensual third-party releases typically involve a non-debtor third-party contributing new money to fund a bankruptcy plan in exchange for the extinguishment of claims held by other non-debtor third-parties, without their consent.

Senator Chris Coons (D-DE) questioned Professors Jacoby and Parikh on their views and queried whether there was room for Congress to act given the circuit split on this issue.

Professors Jacoby and Parikh were similarly split, with Professor Jacoby arguing against the permissibility of such releases and Professor Parikh arguing for it. Professor Jacoby advocated for individual claimants to have the option to consent to having their rights altered or to opt out, a choice they may not have in the bankruptcy system where the majority of a class can bind all claimants. She also highlighted the difficulty in finding all tort victims to determine the proper number of claimants in the class and how many constitutes a majority. She noted that it behooves those facing mass tort liability to find a number of claimants, however well or poorly vetted, and deem them to be a sufficient number to constitute a majority. Professor Parikh maintained that the Code does provide for nonconsensual third-party releases and emphasized that such releases are essential to resolving cases and improving tort victim recoveries. Still, he urged Congress to act to make the language of the Code clearer with respect to this issue.

Employee and Pensioners' Protections

Senator Klobuchar was particularly concerned about the protection of employees and pensioners under the bankruptcy regime. Ms. Klobuchar referred to the bankruptcy of Yellow Corp. and its negative impacts on the company's employees, and inquired what changes could be made to ensure that employees and pensioners are well-protected under bankruptcy law. In response, Professor Jacoby argued that the bankruptcy law should perform better in respecting the priority of employee claims and administrative priority claims. At the same time, Jacoby warned that employee protection can sometimes be used as a justification to request concessions beyond the scope of the bankruptcy regime. These requests can encompass rapid sales of companies as a going concern and the acceptance of high-interest rate loans, all predicated on the pretext of preserving employment opportunities.