AMERICAN BANKRUPTCY INSTITUTE

Mid-Atlantic Bankruptcy Workshop

Financial Distress/Good Faith

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CONCURRENT WORKSHOP

2024

FINANCIAL DISTRESS/GOOD FAITH WORKSHOP

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I. Overview

a. Bankruptcy Code Section 1112(b)

Section 1112(b) of the Bankruptcy Code provides that Chapter 11 bankruptcy petition may be dismiss for "cause". Cause is defined to include 16 non-exclusive factors, including, (i) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation, (ii) gross mismanagement, (iii) failure to comply with a court order, and (iv) and failure to timely file a plan or disclosure statement. A lack of good faith (or the presence of bad faith) is not specifically enumerated within section 1112(b) as a form of "cause." Nevertheless, federal courts have instead interpreted "cause" to include bad faith, or lack of good faith, and they have adopted their own separate standards for dismissal thereunder.

b. Competing Bad Faith and Lack of Good Faith Standards Between the Third and Fourth Circuits[1]

In the Third Circuit, "Chapter 11 bankruptcy petitions are 'subject to dismissal under 11 U.S.C. § 1112(b) unless filed in good faith.'" *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84, 100 (3d Cir. 2023) (quoting *In re 15375 Mem'l Corp. v. Bepco, L.P.*, 589 F.3d 605, 618 (3d Cir. 2009)). This determination is made under the totality of the circumstances, and while subjective intent may be relevant, the analysis is more focused on whether a debtor objectively leaves the equitable limitations of Chapter 11. *Id.* Two guiding principles are whether the petition serves a valid bankruptcy purpose and whether the petition was filed to obtain a tactical litigation advantage. *Id.* at 100-01. "[A] debtor who does

[1] These materials will discuss the relevant standards in the Third and Fourth Circuits. The Third and Fourth Circuits were chosen not only because of their geographic relevance to this Workshop, but also because they are the circuits that have addressed Two Step bankruptcies.

not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith." *Id.* at 101.

In addition to the guiding principles set by the Third Circuit, the Bankruptcy Court for the District of Delaware relies on the *Primestone* factors as indicia of bad faith. *See Primestone Inv. Partners L.P. v. Vornado PS, L.L.C. (In re Primestone Inv. Partners)*, 272 B.R. 554, 557 (D. Del. 2002). In *Primestone*, the court set forth thirteen factors for courts to consider:

> (a) Single asset case; (b). Few unsecured creditors; (c) No ongoing business or employees; (d) Petition filed on eve of foreclosure; (e) Two party dispute which can be resolved in pending state court action; (f) No cash or income; (g) No pressure from non-moving creditors; (h) Previous bankruptcy petition; (i) Prepetition conduct was improper; (j) No possibility of reorganization; (k) Debtor formed immediately prepetition; (l) Debtor filed solely to create automatic stay; and (m) Subjective intent of the debtor.

No single factor is determinative of a lack of good faith. *Id*. at 558. The Delaware Bankruptcy Court has also recognized "the debtor's post-petition misconduct" (*In re Team Sys. Int'l LLC*, 2022 WL 961567, at *10 (Bankr. D. Del. Mar. 30, 2022)), as well as a lack of financial distress as indicia of bad faith prior to *LTL Mgmt., LLC* (*In re Rent-A-Wreck of Am., Inc.*, 2018 WL 889345 (Bankr. D. Del. Feb. 13, 2018)).

The Fourth Circuit, on the other hand, applies a distinct standard set forth in *Carolin Corp. v. Miller*. 886 F.2d 693 (4th Cir. 1989); *see also Bestwall LLC v. Off. Comm. of Asbestos Claimants (In re Bestwall LLC)*, 71 F.4th 168, 182 (4th Cir. 2023), *cert. denied sub nom. Comm. of Asbestos Claimants v. Bestwall LLC*, No. 23-675, 2024 WL 2116275 (U.S. May 13, 2024), and *cert. denied sub nom. Esserman v. Bestwall LLC*, No. 23-702, 2024 WL 2116276 (U.S. May 13, 2024) (noting the Third Circuit and the Fourth Circuits apply different standards); *see also LTL Management LLC*, 64 F.4th at 98 & n. 8 (distinguishing the "more stringent" *Carolin* standard). Under the *Carolin* standard, courts in the Fourth Circuit will not dismiss a bankruptcy petition

unless it was filed in bad faith, and they will not make such a finding unless (1) the reorganization would be objectively futile and (2) the debtor filed in subjective bad faith. *Id.* (quoting *Carolin*, 886 F.2d at 700-01). For a filing to be objectively futile, there must be "no going concern to preserve" and "no hope of rehabilitation." *In re Bestwall LLC*, 605 B.R. 43. 48 (Bankr. W.D.N.C. 2019) (quoting *Carolin*, 866 F.2d at 701-02).

c. Traditional Examples of Bad Faith Dismissal

- Filing bankruptcy, when unnecessary, simply to avoid an obligation or to avoid consequences of prior misconduct. *See, e,g.*, *In re Nat'l Rifle Ass'n of Am. & Sea Girt, LLC*, 628 B.R. 262 (Bankr. N.D. Tex. May 11, 2021) (finding that the National Rifle Association's bankruptcy was filed to gain an unfair litigation advantage and avoid a state regulatory action brought by the New York Attorney General, which is not valid bankruptcy purpose).

- Absence of legitimate debt or financial distress. *See, e,g.*, *In re SGL Carbon Corporation*, 200 F.3d 154 (3d Cir. 1999) (dismissed because debtor had no "valid reorganizational purpose and consequently lack[ed] good faith" in part because debtor had "no financial difficulty," "nor any significant managerial distraction"); *In re Nat'l Rifle Ass'n of Am. & Sea Girt, LLC*, 628 B.R. 262 (Bankr. N.D. Tex. May 11, 2021) (finding bad faith where NRA was solvent, litigation did not pose imminent financial threat, and there was no evidence suggesting that the NRA filed bankruptcy to reduce operating costs, address burdensome executory contracts or leases, or otherwise to obtain a breathing spell).

- Absence of a likelihood of rehabilitation. *See Carolin Corp. v. Miller*, 886 F.2d 693, 700–02 (4th Cir. 1989) (holding a petition lacks good faith if the bankruptcy case is objectively futile and if petitioner displays subjective bad faith).

- Bankruptcy used as a vehicle to resolve two-party disputes. *See, e.g.*, *In re GVS Portfolio I B LLC,* No. 21-10690 (CSS), 2021 WL 2285285 (Bankr. D. Del. June 4, 2021) (dismissing case based on *Primestone* factors where the case was filed due to a two-party dispute on the eve of a foreclosure sale, it was a single asset case, there were only two unsecured creditors, and there is no ongoing business.); *In re Indian Rocks Landscaping of Indian Rocks Beach, Inc.*, 77 B.R. 909, 911 (Bankr. M.D. Fla. 1987) (finding that a bankruptcy case should be dismissed when it "involves nothing more than a two-party dispute.").

- Use of bankruptcy merely to frustrate rights of creditors and/or merely for the purpose of invoking the automatic stay. *See, e.g.*, *Phoenix Piccadilly, Ltd. V. Life Ins. Co. of Va. (In re Phoenix Piccadilly, Ltd.)*, 849 F.2d 1393, 1394 (11th Cir. 1988) (affirming dismissal of chapter 11 case filed by owner of apartment complex that was subject to foreclosure action filed by secured creditors prior to bankruptcy filing); *State St. Houses, Inc. v. N.Y. State*

Urban Dev. Corp. (In re State St. Houses, Inc.), 356 F.3d 1345, 1346-47 (11th Cir. 2004) (same); *In re Premier Auto. Services, Inc*., 492 F.3d 274 (4th Cir. 2007) (finding bad where debtors filed bankruptcy solely to delay a landlord's recovery of real property); *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 298-99 (Bankr. D. Del. 201) (case was filed in bad faith where debtor had only one asset, the petition was filed on the eve of foreclosure, and the petition was filed "solely to obtain the benefit of the automatic stay, which is not a valid purpose for seeking bankruptcy relief").

- Concealment, evasion, and violations of the Bankruptcy Code or court orders. *See, e.g.*, *In re Kerr*, 908 F.2d 400, 404 (8th Cir. 1990) (requiring "a pattern of concealment, evasion, and direct violations of the Code or court order which clearly establishes an improper motive before allowing dismissals for bad faith").

II. Divisional/Divisive Mergers

The good faith issue has been fiercely litigated in the context of the so-called "Texas Two Step" divisional merger restructuring. LTL Management LLC's attempts to restructure through a Two Step bankruptcy have been stymied in the Third Circuit. Fourth Circuit Two Steps have faired better to date. This section will provide a brief overview of relevant decisions and status updates on each case.

a. LTL Management LLC

LTL Management LLC involved a divisional merger relating to asbestos related claims pertaining to the sale of talc, which had been sold by Johnson & Johnson ("J&J") since 1894. *In re LTL Management LLC*, 637 B.R. 396, 400 (Bankr. N.J. 2022). In the relevant period, a New Jersey based J&J subsidiary named Johnson & Johnson Consumer Inc. ("Old JJCI") owned the talc business. *Id.* From 1894 to 2010, those claims had been "limited" and "isolated." *Id.* at 401. These numbers rapidly spiked beginning in 2013, and Old JJCI faced over 1,300 talc-related lawsuits by the end of 2015. *Id.* By January 2020, a lawsuit was allegedly filed against Old JJCI's successor-in-interest on average more than once an hour. *Id.* Talc litigation payments would rise

to account for 122% of Old JJCI's pre-tax cash flows, and Old JJCI's income before tax would fall from a $2.1 billion profit in 2019 to a $1.1 billion loss in 2020. *Id.*

In an effort to address the foregoing, Old JJCI underwent a divisional merger, which resulted in two new entities: Johnson and Johnson Consumer Inc. ("New JJCI") and LTL Management LLC ("LTL"). *Id.* LTL held the talc liability, a funding agreement backstopped by J&J and New JJCI, and approximately $373 million in other assets, such as cash and ownership of a business with ongoing intellectual property licensing cash flow. *Id.* at 402. The funding agreement was worth the value of New JJCI, and it had a floor of $61.5 billion. *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84, 100 (3d Cir. 2023).

Shortly after the merger, LTL initiated a chapter 11 bankruptcy case ("*LTL I*"). *Id.* at 98. The talc claimants moved to dismiss and the bankruptcy court denied the motion. *Id.* The Third Circuit reversed. *Id.* at 111. In so doing, the Third Circuit held that "a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith." *Id.* at 101. While the Third Circuit did not define financial distress, it held the value of the funding agreement and the J&J backstop precluded a finding of financial distress in these circumstances. *Id.* at 106-10.

Approximately two hours after its first case was dismissed, LTL filed another petition seeking bankruptcy protection ("*LTL II*"). *In re LTL Mgmt., LLC*, 652 B.R. 433, 439 (Bankr. D.N.J. 2023). LTL entered *LTL II* with plan support agreements with J&J as well as approximately 58,392 claimants. *Id.* LTL also entered *LTL II* with different funding agreements than in *LTL I.* Those agreements only obligated J&J to fund a trust in bankruptcy, otherwise New JJCI would be the only obligated party. *Id.* at 440. LTL again faced motions to dismiss. *Id.* at 441. The court

took care to note that neither it nor the Third Circuit "has taken issue with the propriety of the corporate restructuring, nor found that J&J had an independent obligation to satisfy the Debtor's talc liability prior to the bankruptcy." *Id.* at 448 & n. 15. However, the court held the change in financial condition was not enough to satisfy the financial distress requirement articulated by the Third Circuit in *LTL I.* *Id.* at 448-49. The court held that it "smells smoke, but does not see the fire." *Id.* The court therefore dismissed the bankruptcy. *Id.* at 456.

On May 22, 2024, a putative class action was filed against J&J, LTL, and others, alleging *inter alia* that the foregoing constituted a fraudulent transfer. ECF No. 1, *Love v. LTL Mgmt., LLC*, No. 3:24-cv-06320-MAS-RLS (D.N.J.). That case remains pending as of July 9, 2024.

b. Bestwall LLC

Bestwall LLC ("Bestwall") is currently in chapter 11 proceedings before Judge Beyer in the United States Bankruptcy Court for the Western District of North Carolina. It was born out of a Texas divisional merger, and it entered bankruptcy holding asbestos liability, certain assets, and a funding agreement between itself and its post-merger twin Georgia-Pacific LLC ("New GP"). *In re Bestwall LLC*, 658 B.R. 348, 352 (Bankr. W.D.N.C. 2024). To date, Bestwall has survived no fewer than four motions to dismiss its bankruptcy case. *See Id.*

The Official Committee of Asbestos Claimants (the "Committee") filed its first motion to dismiss on August 15, 2018. *Id.* The bankruptcy court denied that motion under the two-pronged *Carolin* standard discussed above. *See id.* at 352-53. In so doing, the court held (1) that seeking to established a section 524(g) trust was a valid reorganizational purpose, (2) insolvency was not a requirement to seek bankruptcy protection, especially in the mass tort context, and (3) the volume of asbestos-related claims and projected claims made seeking a 524(g) trust a valid bankruptcy

purpose. *Id.* The Committee sought leave for direct appeal to the Fourth Circuit. *Id.* at 353. The bankruptcy court certified the appeal, but the Fourth Circuit denied the petition. *Id.*

The Committee filed a second motion to dismiss on August 16, 2019, alleging a failure to prosecute the case. *Id.* at 354-55. That motion was denied. *Id.* at 355.

The Committee's third motion to dismiss alleged a lack of constitutional subject matter jurisdiction on the grounds that Bestwall was "not an eligible subject of bankruptcy pursuant to the Bankruptcy Clause of the Constitution because it lacks sufficient financial distress." *Id.* The Committee argued that *Carolin* must be construed within this purported framework. *Id.* In factual support, the Committee relied *inter alia* upon additional developments during the life of the case, arguing "Bestwall has created and funded a $1 billion qualified settlement trust; New GP's equity value has increased by $7.1 billion to $27.8 billion; and New GP has upstreamed over $5 billion in dividends to its ultimate parent." *Id.* To the extent the Committee attempted to re-argue application of the *Carolin* standard, the court determined its decision on the first motion to dismiss was the law of the case and did not revisit the matter. *Id.* at 361. On the issue of the Bankruptcy Clause, the court began its analysis with an overview of the history of bankruptcy in England, the colonies, and the United States. *Id.* at 361-68. The court determined that "the Bankruptcy Clause does not require bankruptcy as practiced in 1787." *Id.* at 368. Reviewing the text of the Bankruptcy Clause and Supreme Court precedent, the court likewise determined that Congress's power under the Bankruptcy Clause is broad and potent. *Id.* at 369. After its review, the court held "the absence of support for the Committee's argument is conspicuous," and "[t]here are simply no cases at any level (of which this court is aware) that explicitly endorse the proposition that bankruptcy courts do not have subject matter jurisdiction unless a debtor has a sufficient degree of financial distress." *Id.* at 370-71. The court denied the motion, concluding:

> After analyzing the Bankruptcy Clause of the Constitution and its interpretation by the Supreme Court, other courts, and outside commentators, the court is confident that the Constitution does not require debtors to have financial distress in order for bankruptcy courts to have subject matter jurisdiction. The court's conclusion is buttressed by the complete lack of support for the Committee's novel argument in the relevant case law, the practical problems with a jurisdictional financial distress requirement, the policy decision to encourage potential debtors to file their cases early, the Supreme Court's recent approach to issues of subject matter jurisdiction, and the ability of bankruptcy courts to use other tools to address the problem asserted by the Committee.

Id. at 380. The Fourth Circuit has granted the Committee's petition for direct review in Fourth Circuit Case No. 24-170.

The fourth motion to dismiss (the "Buckingham Motion") was filed by an individual who argued "case must be dismissed because it does not meet the good-faith threshold established by the Fourth Circuit in Carolin, the Debtor is not eligible for bankruptcy relief because it is neither in financial distress nor facing "overwhelming liabilities," and it cannot confirm a § 524(g) plan of reorganization." *Id.* That individual pointed to, among other things, the Third Circuit's decision in *LTL I* to argue an intervening change of law occurred between the Committee's first motion to dismiss and the Buckingham Motion. *Id.* at 359. The court held:

> Neither the new facts cited by Mr. Buckingham nor the new law issued since the court entered its Opinion and Order cause this court to conclude that its earlier decision to deny the First Motion to Dismiss was either erroneous or works a manifest injustice, extraordinary circumstances do not exist which cause this court to revisit its earlier decision, and the court concludes that the Opinion and Order continues to be the law of this case.

Id. The court therefore denied the motion. *Id.* at 380.

It is worth noting that, while the above motions practice was occurring, the Fourth Circuit affirmed the imposition of a preliminary injunction in the Bestwall bankruptcy. *See Bestwall LLC v. Off. Comm. of Asbestos Claimants (In re Bestwall LLC)*, 71 F.4th 168 (4th Cir. 2023), *cert. denied sub nom. Comm. of Asbestos Claimants v. Bestwall LLC*, No. 23-675, 2024 WL 2116275

(U.S. May 13, 2024), and *cert. denied sub nom. Esserman v. Bestwall LLC*, No. 23-702, 2024 WL 2116276 (U.S. May 13, 2024). In so doing, the Fourth Circuit held:

> [T]his Court applies a more comprehensive standard to a request for dismissal of a bankruptcy petition for lack of good faith [than the Third Circuit]; that is, the complaining party must show both "subjective bad faith" and the "objective futility of any possible reorganization." The Claimant Representatives have made no showing to this Court of either required element.

Id. at 182 (internal citation omitted).

c. Aldrich Pump LLC & Murray Boiler LLC

Aldrich Pump LLC and Murray Boiler LLC are each in chapter 11 proceedings before Judge Whitely in the Western District of North Carolina. As in *Bestwall*, they were born in divisional mergers under Texas law and have faced motions to dismiss under the Fourth Circuit's *Carolin* standard and the Bankruptcy Clause. *In re Aldrich Pump LLC*, No. 20-30608, 2023 WL 9016506, at *1, 2023 Bankr. LEXIS 3043, at **8-9 (Bankr. W.D.N.C. Dec. 28, 2023). Judge Whitley, like Judge Beyer, as rejected such challenges. *See* 20-30608, 2023 WL 9016506, at *4, 2023 Bankr. LEXIS 3043, at *14. Judge Whitely added the additional nuance that the Bankruptcy Clause arguments were not jurisdictional, holding "a challenge to the propriety of a particular petitioner seeking bankruptcy, even one that asserts constitutional arguments, does not typically make those arguments jurisdictional." 2023 WL 9016506, at *13, 2023 Bankr. LEXIS 3043, at *38. Unlike Bestwall, the Fourth Circuit rejected a petition for direct appeal in the Aldrich/Murray case in Fourth Circuit Case No. 24-128.

III. Group Discussion Points: Considerations Moving Forward

- How can a debtor filing in the Third Circuit demonstrate financial distress?
- What does the caselaw developed in the Two-Step context mean for debtors not facing mass tort liability?
- For enterprises facing mass torts, what are the pros and cons of a Two-Step versus a more traditional corporate restructuring?
- In the Third Circuit, do funding agreements do more harm than good for debtors?
- What does the Supreme Court's recent *Purdue* decision mean for good faith and bad faith filings?

Faculty

Steven D. Adler is an associate at Bayard, P.A. in Wilmington, Del., where he concentrates his practice in the areas of corporate bankruptcy and restructuring. He has represented corporate debtors, official committees, creditors, lenders, asset-purchasers and other significant parties in interest in various bankruptcy court proceedings and out-of-court restructurings. He also has experience handling commercial and corporate litigation matters. Prior to joining Bayard, Mr. Adler pursued his practice for several years in the Delaware office of an international law firm. Prior to law school, he worked in the banking and finance industry. Mr. Adler received his B.S. in finance *cum laude* from the University of Delaware in 2010, and his J.D. *cum laude* from Temple University Beasley School of Law, during which he served as a judicial intern to Hon. Mary Walrath of the U.S. Bankruptcy Court for the District of Delaware and as the lead research editor for the *Temple International & Comparative Law Journal*.

Hon. Rosemary J. Gambardella was sworn in as a U.S. Bankruptcy Judge on May 3, 1985, in the District of New Jersey in Newark, becoming the first woman to serve on its bankruptcy court. From 1980-85, she was senior staff counsel to Hugh M. Leonard, then U.S. Trustee for the Districts of New Jersey and Delaware. Judge Gambardella served as Chief Judge of the U.S. Bankruptcy Court for the District of New Jersey from Aug. 12, 1998, to Aug. 11, 2005. She is a member of the Lawyers Advisory Committee of the U.S. Bankruptcy Court for the District of New Jersey, a member and former president of the New Jersey Bankruptcy Inn of Court, and a member of the Bankruptcy Committee of the Third Circuit Task Force on Equal Treatment in the Courts - Gender Commission. In addition, she is a member of the National Association of Women Judges, the National Conference of Bankruptcy Judges, ABI and the Turnaround Management Association, and is a former member of the Bankruptcy Judges Advisory Group for the Administrative Office of the U.S. Courts. Judge Gambardella was the bankruptcy judge representative to the Judicial Conference of the United States (2009-11) and is a Fellow of the American College of Bankruptcy. She received the Rutgers School of Law – Newark Distinguished Alumni Award in 2012, the New York Institute of Credit Women's Division Judge Cecelia H. Goetz Award, the William J. Brennan, Jr. Award in 2013 and the Conrad B. Duberstein Memorial Award in 2015. Judge Gambardella earned her B.A. in history in 1976 from Rutgers University, where she was elected to Phi Beta Kappa. After receiving her J.D. from Rutgers Law School-Newark in 1979, Judge Gambardella served as law clerk to the late Chief Bankruptcy Judge Vincent J. Commisa from 1979-80.

K. Elizabeth Sieg is a partner in McGuireWoods LLP's Restructuring & Insolvency Department in Richmond, Va., where her practice focuses on corporate restructuring, creditors' rights, complex commercial litigation and financial services litigation. She is experienced in bankruptcy litigation and appellate matters, including as counsel for DIP and other secured lenders, asset-purchasers, chapter 11 debtors, and other stakeholders in corporate restructuring cases and as national counsel to banks and other financial services companies in bankruptcy and related litigation matters. Ms. Sieg received dual B.S. degrees from the Georgia Institute of Technology and her J.D. from the University of Richmond, and she clerked for Hon. Kevin R. Huennekens, U.S. Bankruptcy Judge for the Eastern District of Virginia, before joining McGuireWoods.

Aaron H. Stulman is a partner in the Wilmington, Del., office of Potter Anderson & Corroon LLP in its Bankruptcy, Restructuring & Creditor's Rights practice. For over a decade, he has counseled clients in a wide range of industries to navigate the distressed waters of insolvent companies, both in and out of court. Mr. Stulman regularly represents debtors, official and ad hoc committees, secured lenders, liquidation trusts, asset-purchasers, individual creditors and other significant stakeholders in chapter 11, chapter 7 and chapter 15 bankruptcy proceedings before the U.S. Bankruptcy Court for the District of Delaware. He also has extensive experience litigating in bankruptcy court, including prosecuting, defending and mediating avoidance actions under chapter 5 of the Bankruptcy Code. Mr. Stulman partners with co-counsel, GCs, CROs, financial advisors and other restructuring professionals to help clients find the optimal path through the bankruptcy process. He is listed in *Chambers USA*'s "Up and Coming" list for 2024, was listed in *Delaware Super Lawyers* as a "Rising Star" from 2018-22, and has been listed in *The Best Lawyers in America* since 2023. He also participated in the National Conference of Bankruptcy Judges' NextGen Program in 2017 and was selected in the Delaware Chapter of the Federal Bar Association's Bankruptcy Trial Practice Seminar that same year, and he is vice chair of the Bankruptcy Litigation Subcommittee of the ABA's Business Law Section. In addition, he is a member of ABI, the Turnaround Management Association and the Delaware State Bar Association, and he is a Barrister of the Delaware Bankruptcy Inn of Court. Mr. Stulman received his B.A. from Franklin and Marshall College and his J.D. *magna cum laude* from Widener University Delaware Law School.