

When Does the Automatic Stay Protect Companies that are Not in a Bankruptcy Proceeding?

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In June 2022, Reuters published an article titled “How a “Bankruptcy Innovation” Halted Thousands of Lawsuits from Sick Plaintiffs.” The mechanism used to halt ongoing lawsuits was the automatic stay triggered by the bankruptcy filing of an affiliate of the defendant companies. The “bankruptcy innovation” is the so-called Texas Two-Step. The Texas Two-Step is not a lottery game or a country dance, or “a controversial legal maneuver,” as Investopedia calls it, but a statutorily established corporate transaction. It allows a company to complete a divisional merger under Texas corporate law, i.e. to separate assets and liabilities of a company into two different entities by creating a new entity and then liabilities and some assets are transferred into the newly created entity. The entity is then placed into bankruptcy to invoke the automatic stay. The main asset remaining with the entity that takes on the liabilities is a funding agreement, whereby the entity keeping the assets agrees to pay certain of the liabilities of the other (typically for mass tort claims). The primary benefit of the Texas Two-Step is that it keeps an operating company outside of bankruptcy but provides to the operating company the benefits of a bankruptcy filing.

The Reuters article highlights four companies that used the Texas Two-Step: Georgia-Pacific, Saint-Gobain, Trane Technologies and Johnson & Johnson. The company that is currently in the spotlight for using the Texas Two-Step is Johnson & Johnson (“J&J”), and in particular, one of J&J’s subsidiaries – Johnson & Johnson Consumer Inc. (“J&J Consumer”). Following certain pre-2015 intercompany transactions, J&J Consumer assumed responsibility for all claims alleging that J&J’s talc-containing baby powder and other products caused ovarian cancer and other diseases. In October 2021, J&J Consumer engaged in a divisional merger under the Texas corporate statute. As a result of the divisional merger, J&J Consumer ceased to exist and two new companies, LTL and Johnson & Johnson Consumer Inc (“New J&J Consumer”) were created. LTL assumed all talc-related liabilities of the old company and filed a bankruptcy petition (initially in North Carolina but the case was transferred to New Jersey in November 2021). The talc plaintiffs challenged the filing and the use of Texas Two-Step. The bankruptcy court ruled in favor of J&J/LTL and rejected the challenge. The bankruptcy court’s decision is now on appeal (review of this challenge will be included in one of our next issues).

Meanwhile, LTL had asked the bankruptcy court for permission to extend the automatic stay to thousands of cosmetic talc-related claims with respect to J&J, J&J Consumer, New J&J Consumer. The automatic stay serves to protect the debtor that filed a bankruptcy petition, by stopping all collection efforts, including not only halting pending lawsuits but any acts that constitute an attempt to exercise control over assets subject to bankruptcy protection, thereby giving the debtor a respite from creditors and a chance to attempt a repayment or reorganization plan. Technically, the stay is not extended. Rather, the bankruptcy court issues an injunction having the effect of “extending” the stay to the entity not in bankruptcy. Although the scope of automatic stay is broad, its protections typically apply only to debtors in bankruptcy, not non-debtor defendants.

Shortly after the commencement of the bankruptcy proceeding, the North Carolina bankruptcy court granted a temporary restraining order and enjoined the prosecution of talc claims against the non-debtors (“Initial PI Order”). After the case was

transferred to New Jersey, on February 25, 2022, the New Jersey bankruptcy court issued a decision that would extend the duration of relief granted under the Initial PI Order, including the issuance of a preliminary injunction for the duration of the Chapter 11 case, subject to the court revisiting continuation of the automatic stay and the preliminary injunction on June 29, 2022, and every four months thereafter. The court found that Section 362 of the Bankruptcy Code and Section 105 provide independent bases for granting an injunctive relief to non-debtor parties. The critical factor in the Court's analysis was the impact of the non-debtor litigation on the bankruptcy estate.

The Court concluded that continued litigation against the non-debtor parties would liquidate pending tort claims, as well as indemnification claims, against LTL outside of Chapter 11 and potentially deplete available shared insurance coverage, thereby frustrating the purpose of the automatic stay. Since the claims against the debtor and the non-debtor parties involved the same products, same time periods, same alleged injuries, and same evidence, continued litigation could prejudice the debtor.

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