ALM | LAW.COM

THE NATIONAL LAW JOURNAL

Appellate Ruling Underscores Divide on Limits of Bankruptcy Protections

By Avalon Zoppo
June 27, 2023

What You Need to Know

- The Fourth Circuit's 2-1 split highlights a deeper divide among appellate judges across the country.
- The dissenting judge described Georgia-Pacific's use of its restructuring as "little more than a shell game."

A sharply divided U.S. Court of Appeals for the Fourth Circuit ruling shielding a nondebtor in bankruptcy proceedings from asbestos lawsuits underscores the wider and growing divide among judges across the country on the bounds of Chapter 11 protection and corporations' use of the "Texas two-step" to address mass tort litigation.

Breaking from his colleagues in the majority, Judge Robert King said a bankruptcy judge lacked jurisdiction to pause asbestos lawsuits against an affiliate of Chapter 11 debtor Bestwall, calling the company's use of its restructuring to seek broader protection "little more than a shell game."

"The decision, which was a 2-1 split decision, underscores the competing tensions of policy among the courts when addressing mass tort claims," said George Singer, a partner at

Credit: Vitalii Vodolazskyi/Shutterstock.com

Holland & Hart who has represented both business debtors and creditors in bankruptcy proceedings.

"The Texas two-step and the use or attempted use of bankruptcy processes to deal with mass tort litigation situations, I think this [Fourth Circuit opinion] is just manifesting that it's a very complex and divisive issue," said John J. Sparacino, a principal at McKool Smith.

The bankruptcy began in 2017, after paper product manufacturer Georgia-Pacific Industries spun off its asbestos litigation liabilities using a Texas divisional merger statute into Bestwall and its assets into another subsidiary given the same name but referred

Courtesy photo

Judge Robert King of the U.S. Court of Appeals for the Fourth Circuit.

to as "New GP." An automatic stay then halted asbestos litigation against Bestwall, and the subsidiary asked for an order to pause claims against New GP, too.

Judges G. Steven Agee and Henry Hudson, who sits in the Eastern District of Virginia, said the bankruptcy judge properly granted the injunction because Bestwall showed that asbestos litigation against New GP could conceivably affect its own bankruptcy estate. Upholding the injunction promotes the "equitable, streamlined, and timely resolution of claims" in one place, Agee wrote.

But King said the parent company impermissibly manufactured jurisdiction through its use of the Texas statute.

"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 entity either," King wrote. "Yet that is exactly what Old GP did here—it reformed its corporate existence precisely so that its principal successor entity, New GP, could be afforded bankruptcy relief without ever having to file for bankruptcy."

Jones Day partner Noel Francisco, who argued for Bestwall, did not immediately return a request for comment. Attorneys for the Official Committee of Asbestos Claimants challenging the injunction also did not return a request for comment. The committee is represented by the firms Robinson & Cole and Young Conawa, Stargatt & Taylor.

'Lack of Uniformity'

In 2017, Bestwall took on much of Georgia-Pacific's asbestos liabilities while New GP was entrusted with most of the company's assets. The company faced tens of thousands of claims alleging its plaster construction products contained asbestos and caused cancer.

Robert Miller, a University of South Dakota bankruptcy professor, said the ruling highlights a lack of uniformity among appellate judges on the standard for extending automatic stays to third-party entities, and the incentive for companies in bankruptcy facing mass tort claims to forum shop.

Under Fourth Circuit precedent, debtors don't have to overcome a high standard to extend automatic stays to third parties, Miller said.

But earlier this year, the Seventh Circuit seemed skeptical of adopting the same permissive rule in debtor Aearo Technologies' bid to halt litigation against its parent company, 3M, over allegedly defective military earplugs. Judges Diane Wood and Frank Easterbrook pushed back against an Aearo attorney's argument that the Seventh Circuit had already endorsed the Fourth Circuit's lenient standard.

"It's important to stitch together these different cases," Miller said. "How they have progressed is in large part due to the lack of uniformity. … There are a lot of places where bankruptcy is not uniform, even at the circuit level. And that creates these types of disparate opinions where you have important cases

which come down differently depending on where they're filed."

King, in his dissent, also linked Bestwall's case to the Third Circuit dismissing a bankruptcy petition by Johnson & Johnson subsidiary LTL Management for lack of good faith earlier this year. The court held that LTL, which had a $61 billion funding agreement with J&J, was not in financial distress when it was created under the Texas divisional merger statute and filed for bankruptcy in an attempt to handle claims alleging its baby powder product caused cancer.

King said both Bestwall and LTL maneuvered to isolate unwanted asbestos liabilities and resolve them through bankruptcy, but such attempts aren't "guaranteed to result in smooth sailing." Meanwhile, the majority noted the Fourth Circuit has a more comprehensive standard than the Third Circuit for dismissing bankruptcy petitions for lack of good faith that Bestwall met, though dismissal wasn't at issue here.

In the Bestwall case, a cancer patient has asked the North Carolina bankruptcy court handling the Chapter 11 proceedings to dismiss the case altogether. U.S. Bankruptcy Judge Laura Beyer has not yet ruled on that motion, but denied another dismissal request in 2019.

And while it's not binding, Singer said lawyers will cite King's dissent in other jurisdictions to fight the Texas two-step bankruptcy strategy.

King said Bestwall did not hire employees or "do much of anything" after the merger and said New GP was designed solely to receive protection "with no need to submit to the bankruptcy court's oversight or to suffer the burdens appurtenant to a Chapter 11 filing."

"It'll take some time for the law to develop further and maybe a case will ultimately end up at the Supreme Court, but until that time … counsel in future cases will need to evaluate the situation to determine the jurisdiction that will provide hopefully the most favorable result," said Singer, the Holland & Hart partner. "Now, you've got [another] Fourth Circuit appellate court decision that counsel can rely on applying a less stringent standard than the Third Circuit did in In re LTL Management."

Alan Morrison, a George Washington University law professor, predicted that the Official Committee of Asbestos Claimants will seek review of the Fourth Circuit's recent ruling given the high stakes.

LTL already said it plans to ask the U.S. Supreme Court to reconsider the Third Circuit's decision, and has refiled for bankruptcy.

"The effect in all these cases is the same. They're trying to get a solvent company to be able to spin off a debtor that can go through bankruptcy and get all these claims," Morrison said. "These Texas two-steps are new devices. … From what I have seen, the companies are doubling down and they're going to take it as far as they have to take it … to get a resolution."