Notes

Debt End: The "Texas Two-Step" and the Constitution

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The "Texas Two-Step" is a novel means of forcing a settlement agreement on mass-tort claimants. Corporations utilize the Two-Step bankruptcy strategy using a state law merger statute to split itself in two. One half of the corporation retains all the value, and the other half retains all the liabilities associated with the mass tort claims. The shell-company, which inherits the liabilities and then files a bankruptcy petition, uses the Bankruptcy Code's powers to attempt a forced settlement on all current and future litigants and shield its financially healthy parent company in the process. Throughout this Note, I will survey the most significant Two-Step cases that have emerged in the last several years and argue that the Two-Step bankruptcy strategy is likely an unconstitutional use of the Bankruptcy Code. Eligibility for non-financially distressed, solvent debtors under section 109 of the Bankruptcy Code is likely unconstitutional as applied because it may (1) result in a regulatory taking; (2) deny mass tort claimants their due process rights under the Fifth Amendment; (3) qualify as a bad faith filing; and (4) exceed Congress' power under the Bankruptcy Clause. I will also discuss how bankruptcy's historical origins and the Framer's intent may help inform what constitutes a bad faith bankruptcy filing. Along the way, the Note discusses the intricacies of the Bankruptcy Code in relation to these complex Two-Step bankruptcies and in relation to how bankruptcy law has changed over time.

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TABLE OF CONTENTS

INTRODUCTION 245
II. BANKRUPTCY'S BACKGROUND AND FIFTH AMENDMENT LIMITATIONS 246
A. THE BANKRUPTCY CODE'S GOOD FAITH REQUIREMENT PREVENTS BANKRUPTCY FROM FUNCTIONING AS A TAKING UNDER THE FIFTH AMENDMENT 247
B. THE CODE SEEKS TO PROTECT CREDITOR PROPERTY INTERESTS AND PROMOTE HONESTY BETWEEN LITIGANTS 249
III. WHAT IS THE "TEXAS TWO-STEP"? 250
IV. CHALLENGING THE TWO-STEP AS A DUE PROCESS VIOLATION 252
A. *IN RE BESTWALL*—DEFENDING THE TWO-STEP 253
V. CHALLENGING THE "TWO-STEP" AS A REGULATORY TAKING 256
A. THE TWO-STEP FUNCTIONS AS A TAKING BY DEPRIVING CREDITORS OF THEIR CAUSES OF ACTION 258
B. BANKRUPTCY'S CLAIM ESTIMATION PROCESS RISKS TAKING THE CLAIMANTS' PROPERTY INTERESTS 259
C. DIFFICULTIES IN PINPOINTING THE TAKING 262
VI. CHALLENGING THE TWO-STEP WHERE THERE IS NO FINANCIAL DISTRESS, WHICH IS ARGUABLY REQUIRED FOR A GOOD FAITH FILING 264
A. THE STATE OF THE MODERN BIG CORPORATE BANKRUPTCY PRACTICE 265
B. *ALDRICH PUMP*—FINANCIAL DISTRESS AS A NON-DISPOSITIVE FINDING OF FACT 265
C. *LTL MANAGEMENT*—FINANCIAL DISTRESS AS A NECESSARY CONCLUSION OF LAW 268
VII. USING THE BANKRUPTCY CLAUSE'S BROAD SCOPE AND NARROW PREREQUISITE OF FINANCIAL DISTRESS TO CHALLENGE THE TWO-STEP 270
A. BANKRUPTCY'S HISTORICAL ORIGINS IN CURING INSOLVENCIES PLACE LIMITS ON THE CODE'S BROAD AND EVERCHANGING APPLICATION 271
VIII. DEBT END: THE FATE OF THE TWO-STEP 273

INTRODUCTION

The Bankruptcy Code (the "Code") provides a solution to the economic tragedy of the commons known as the multi-creditor problem. Outside of bankruptcy, when a firm or individual defaults on their debts, creditors rush to the courthouse to file claims in a competition to be first in line for repayment. But when a debtor files for bankruptcy, substantially all of the acts and proceedings against the debtor's estate are automatically stayed, solving the multi-creditor problem.[1] The Code, which affords debtors numerous protections and privileges, is intended to (1) save creditors the costs of a destructive race to the debtor's assets; (2) help individuals overburdened with debt; and (3) reorganize the capital structure of firms in financial distress, often by discharging certain debts altogether.[2] In addition to these maxims, corporate restructuring work is a complex and sophisticated legal practice that provides limitless opportunities for the creative brilliance and ingenuity of corporate reorganization professionals.[3] However, there is a fine line between brilliance and abuse.

One particularly creative strategy likely crosses that line. The new and controversial Two-Step bankruptcy strategy creates bankruptcy eligibility for financially healthy,[4] solvent debtors under section 109 of the Code. The Two-Step is likely unconstitutional as applied because it (1) constitutes a regulatory taking; (2) denies mass tort claimants their due process rights under the Fifth Amendment; (3) violates bankruptcy's "good faith filing" requirement; and (4) runs afoul of bankruptcy's historical purpose. An analysis of the Two-Step's constitutionality and the Code's historical origins will also help inform what constitutes a good faith bankruptcy filing.

In Part II, this Note discusses the basic aspects of a typical bankruptcy case and the Bankruptcy Code's implicit relationship with the Fifth Amendment. Part III outlines the Texas Two-Step bankruptcy strategy, and Part IV lays out

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1. 11 U.S.C. § 362(a). The "Automatic Stay" enjoins legal actions against the debtor including the exercise of remedies concerning collateral, enforcement of pre-bankruptcy petition judgments, litigation, any act to obtain possession of the bankruptcy estate's property, collection efforts, and acts to create, perfect, or enforce liens that were granted before the bankruptcy petition date. *Id.*

2. BARRY E. ADLER, ANTHONY J. CASEY & EDWARD R. MORRISON, BAIRD & JACKSON'S BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 29 (Saul Levmore, Daniel A. Farber, Heather K. Gerken, Samuel Issacharoff, Harold Hong Ju Koh, Thomas W. Merill, Robert L. Rabin & Hillary A. Sale eds., 5th ed. 2020).

3. Ralph Brubaker, *Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy*, BANKR. L. LETTER, Aug. 2022, at 1, 1.

4. Even though the Bankruptcy Code does not have a formal financial distress requirement, courts have construed the Code to require some degree of financial distress. *See, e.g.*, *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 124 (3d Cir. 2004) ("Because Integrated's economic difficulties do not establish that Integrated was suffering from financial distress, they do not, standing alone, establish that Integrated's petition was filed in good faith."); *In re* Capitol Food Corp., 490 F.3d 21, 25 (1st Cir. 2007) ("'A debtor need not be insolvent before filing a bankruptcy petition,' however, provided it is experiencing 'some type of financial distress.' []'The absence of an insolvency requirement encourages companies to file for Chapter 11 *before* they face a financially hopeless situation.'[]" (emphasis in original) (citation omitted) (quoting *In re Integrated Telecom*, 384 F.3d at 122)).

creditor due process concerns as well as the Fourth Circuit's defense of the Two-Step asserted in *In re Bestwall*. In Part V, this Note examines how the Two-Step likely constitutes a regulatory taking, running counter to bankruptcy's historical purpose. Parts VI presents the argument that the Two-Step cannot be considered a good faith filing, and Part VII of the Note discusses how the Two-Step circuit split could be resolved by requiring bankruptcy filers demonstrate a minimum showing of financial distress to be eligible for relief under the Code. Part VIII concludes with thoughts regarding the future of the Two-Step and modern bankruptcy law.

II. BANKRUPTCY'S BACKGROUND AND FIFTH AMENDMENT LIMITATIONS

A normal Chapter 11[5] bankruptcy filing follows a basic path.[6] First, an entity overleveraged with debt files a petition with the court requesting an order for relief under the Bankruptcy Code.[7] Once the bankruptcy petition is filed, the court implements an automatic stay, preventing creditors from exercising their rights against the debtor.[8] Thereafter, administration of the case kicks off with the "First Meeting of the Creditors" where both the creditors and debtors meet to analyze the debtor's financial position and confirm the facts represented by the debtor in the bankruptcy filing.[9] The Code then grants the debtor numerous administrative powers to reorganize the debtor's business and compensate creditors. The debtor's administrative powers include the right to sell property of the bankruptcy estate,[10] assume or reject[11] executory contracts,[12] and obtain financing.[13] The Code also governs the permissibility and priority[14] of creditor

5. "Chapter 11 embodies a policy that it is generally preferable to enable a debtor to continue to operate and to reorganize or sell its business as a going concern rather than simply to liquidate a troubled business. Continued operation may enable the debtor to preserve any positive difference between the going concern value of the business and the liquidation value." 7 COLLIER ON BANKRUPTCY ¶ 1100.01 (16th ed. 2024).

6. *Id.* ("The reorganization of a corporation is not a lawsuit in the ordinary sense of a procedure designed to settle issues between individual litigants, but a complex exercise of legal method, corporate finance, and business management.").

7. 11 U.S.C. § 301 (a)–(b). A voluntary bankruptcy commences when the debtor files its petition with the court. *Id.* The commencement of the case constitutes "an order for relief" under the Code. *Id.*

8. 11 U.S.C. § 362.

9. *See* 11 U.S.C. § 341.

10. 11 U.S.C. § 363(c)(1). The debtor can use, sell, or lease property in the ordinary course of business without court permission. *Id.*

11. 11 U.S.C. § 365. A debtor may "reject" (breach) a contract, which converts the creditor's rights under the contract to an unsecured claim for damages. The creditor will likely only receive cents on the dollar for the value of the contract because their claim becomes another claim in the bankruptcy case. Contrarily a debtor may assume a favorable contract, subject to court approval. A subsequent breach of an assumed contract provides the creditor a right to payment in full. *Id.*

12. NLRB v. Bildisco, 465 U.S. 513, 522 n.6 (1984) (An executory contract is a contract "on which performance remains due to some extent on both sides.") (quoting H.R. REP. NO. 95-595, at 347 (1977)).

13. 11 U.S.C. § 364. The court may authorize the debtor, after notice and a hearing, to obtain unsecured credit or incur unsecured debt. *Id.*

14. 1 COLLIER ON BANKRUPTCY ¶ 1.01[1] (16th ed. 2024) ("[B]ankruptcy's absolute priority rule require[es] debt obligations to be paid before equity interests (unless creditors consent) [and] respects that

claims,[15] outlines the debtor's duty of candor and disclosure to the court,[16] and defines what constitutes property of the estate.[17] As the case progresses, the debtor and creditors file motions back and forth attempting to establish the pool of assets available to creditors and create the best reorganizational strategy. The bankruptcy judge oversees this process, attempting to discern which legal course of action is the most economically efficient and fair to interested parties. If all things go as planned, the debtor and creditors will be able to confirm a bankruptcy plan that gives the debtor a new economic life. The American bankruptcy system is also entirely federal,[18] with the Bankruptcy Clause of the Constitution providing that Congress is to establish "uniform laws on the subject of bankruptcies."[19] Interpretations of the Bankruptcy Clause suggest that its scope is exceedingly broad, with the Supreme Court recognizing that the subject of bankruptcies is incapable of a final definition and "includes nothing less than the subject of the relations between [a] debtor and his creditors."[20] Accordingly, bankruptcy scholars have attempted to better define bankruptcy's limitations.[21] Lastly, Bankruptcy is unique in that it is both adversarial and collaborative, making honesty and good communication essential to any bankruptcy case.

A. THE BANKRUPTCY CODE'S GOOD FAITH REQUIREMENT PREVENTS BANKRUPTCY FROM FUNCTIONING AS A TAKING UNDER THE FIFTH AMENDMENT

Accordingly, the Code enshrines an inherent suspicion of abusive litigation tactics in section 1112(b) of the Code by requiring every petition to be filed in good faith.[22] The good faith requirement places a burden on the debtor to demonstrate that, based on the surrounding facts and circumstances, (1) the

ranking and ordering; the rule 'protects the rights of senior creditors against dilution either by junior creditors or by equity interests.'" (citing Marine Harbor Props. v. Mfrs. Tr. Co., 317 U.S. 78, 87 (1942))); Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 457 (2017). The Code sets forth a system of priority which determines the order in which the bankruptcy court will distribute the estate's assets. *Id.* Secured creditors have the highest priority because they must receive the proceeds of the collateral that secures their debts. *Id.* Special classes of creditors, such as those who hold claims for taxes or wages come next in the order of priority. *Id.* The special classes of creditors are followed by general unsecured creditors, and lastly equity shareholders. *Id.*

15. *See* 11 U.S.C. § 502 (a)–(b).

16. 11 U.S.C. § 527(a).

17. 11 U.S.C. § 541(a)(1). Property of the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in the property as of the commencement of the case." *Id.*

18. Alicia Tuovila, *Bankruptcy Explained: Types and How It Works*, INVESTOPEDIA (Oct. 28, 2024), https://www.investopedia.com/terms/b/bankruptcy.asp ("All bankruptcy cases in the United States go through federal courts. A bankruptcy judge makes decisions, including whether a debtor is eligible to file and whether they should be discharged of their debts.").

19. U.S. CONST. art. I, § 8, cl. 4.

20. Siegel v. Fitzgerald, 596 U.S. 464, 473–74 (2022) (quoting Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513–14 (1938)).

21. Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 490–91 (1996) ("[Congress's] discretion *within* the subject of bankruptcies does not imply that Congress has complete discretion to define the *boundaries* of the 'subject of Bankruptcies.'").

22. 11 U.S.C. § 1129(b). The bankruptcy court may dismiss petitions "for cause" if there is no valid reorganizational purpose. *Id.*

petition serves a valid bankruptcy purpose (such as preserving a going concern or maximizing the debtor's estate); and (2) the petition is not being filed merely to obtain a tactical litigation advantage.[23] Without a good faith standard, the Code would cease to serve its intended purposes and instead would become a mechanism that systematically divests creditors of their rightful property interests. Put another way, the Code's application would resemble a regulatory taking.[24]

The Code restrains the property interests of creditors, which naturally leads to significant due process concerns[25] by altering the creditor's substantive rights to pursue their claims, and issues under the Fifth Amendment's Takings Clause[26] by infringing on creditor property interests. It follows that the Fifth Amendment and the Code are implicitly connected. As an illustration of the Code's Fifth Amendment limitations, secured creditors[27] are provided with remedial measures, such as the right to adequate protection.[28] Secured creditors are placed in a vulnerable economic position by the Code's automatic stay, which enjoins legal actions against the debtor, because it prevents secured creditors from foreclosing on their security interests. This may cost the creditor the time value of money,[29] opportunity cost, or lead to a dissipation of the actual collateral's value over time.[30] A debtor can stop a creditor from foreclosing on the creditor's collateral for a variety of business reasons depending on the nature of the collateral and circumstances of the case. The bottom line is that some encumbered assets, such as specialized equipment, inventory, receivables, or real property might be too vital to the operation of the debtor's business to allow a creditor to foreclose.

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23. *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 119–21 (3d Cir. 2004).

24. As discussed later in this Note, even with the good faith requirement in place, there is an argument that in practice, the Two-Step constitutes a regulatory taking despite the Code's good faith protections. *See infra* Part V.

25. *See, e.g.*, *In re* Grossman's Inc., 607 F.3d 114, 127 (3d Cir. 2011) (reasoning that the court must decide whether discharge of the appellee's claims would comport with due process); U.S. CONST. amend. V.

26. U.S. CONST. amend. V. The Fifth Amendment provides that "[n]o person shall . . . be deprived of life, liberty or property, without due process of the law; nor shall private property be taken for public use, without just compensation." *Id.*

27. Secured creditors have a right to foreclose on a specific asset (collateral) of the debtor, whereas unsecured creditors such as equity shareholders or mass tort claimants may have claims against the debtor's estate, but they are not secured in any of the debtor's assets. 4 COLLIER ON BANKRUPTCY ¶ 506.03[1] (16th ed. 2024).

28. 11 U.S.C. § 362(d)(1).

29. Shauna Croome, *Understanding the Time Value of Money*, INVESTOPEDIA (Jan. 30, 2024), https://www.investopedia.com/articles/03/082703.asp#:~:text=The%20time%20value%20of%20money%20is%20a%20financial%20concept%20that,the%20same%20amount%20of%20money ("The time value of money is a financial concept that holds that the value of a dollar today is worth more than the value of a dollar in the future.").

30. *See* ADLER ET AL., *supra* note 2, at 491.

B. THE CODE SEEKS TO PROTECT CREDITOR PROPERTY INTERESTS AND PROMOTE HONESTY BETWEEN LITIGANTS

The conflict between the interests of creditors and reorganizing debtors is recognized by Section 362(d) of the Code, which provides that on motion of a secured creditor, the court must grant relief from the stay unless the debtor is adequately protected.[31] This bankruptcy-triggered[32] burden is placed on the debtor to establish that the collateral at issue is necessary for an effective reorganization, meaning they must show a reasonable possibility of a successful reorganization within a reasonable time.[33] If the debtor cannot meet this burden[34] by demonstrating the creditor is adequately protected, the creditor is entitled to compensation for the diminution in value of the collateral.[35] A debtor's burden to provide adequate protection harkens back to the Code's theme of honesty, good faith filing, and protection of property interests.[36] Similar provisions can be found throughout the Code,[37] tacitly acknowledging that the Code's powers must be wielded responsibly and equitably.

The fluid and expansive nature of the Code that permits creativity also allows for controversial applications. Many bankruptcy scholars opine that the Code's power is akin to the theory of the universe—constantly expanding.[38] Even the very meaning of "bankruptcy" has continued to evolve and evade a clear definition.[39] Some courts even disagree over whether "financial distress"[40] is required for a good faith bankruptcy petition.[41] The inherent tensions between bankruptcy, due process, and property interests discussed in this Note provide

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31. 1 COLLIER, *supra* note 14, ¶ 1.05[1].

32. *See* 11 U.S.C. § 362(d)(1); United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 375–76 (1988).

33. *Timbers*, 484 U.S. at 375–76.

34. A substantial equity cushion—the value of collateral in excess of the secured creditor's claim—may adequately protect a secured creditor's interest in the property. *See* 11 U.S.C. § 361; *see, e.g.*, *In re* Garcia, 584 B.R. 483, 489 (Bankr. S.D.N.Y. 2018) ("Courts may find that there is adequate protection for a secured creditor when there is equity in the property, but the equity cushion must be significant.").

35. 11 U.S.C. § 361(1)–(3). Section 361 of the Code provides three non-exclusive methods for providing adequate protection to creditors including (1) cash or period cash payments; (2) an additional or replacement lien; or (3) the indubitable equivalent of the creditor's interest in the property. *Id.*

36. *See* 11 U.S.C. § 1129(b); *see, e.g.*, *In re* Muhammad, 536 B.R. 469, 473 (Bankr. M.D. Ala. 2015) ("When the Court orders a debtor to provide a creditor with adequate protection and the debtor fails to do so, a presumption that a subsequent bankruptcy filing is not in good faith arises." (citing 11 U.S.C. § 362)).

37. For example, the Code protects a tenant's right to possession and use of property for the remainder of a lease term, even if a bankrupt landlord rejects the contractual rights under the lease. 11 U.S.C. § 365(h)(1)(A)(ii).

38. Plank, *supra* note 21, at 489.

39. *Id.* at 489–90.

40. Adam Hayes, *Financial Distress: Definition, Signs, and Remedies*, INVESTOPEDIA (Apr. 18, 2021), https://www.investopedia.com/terms/f/financial_distress.asp (defining financial distress as "a condition in which a company or individual cannot generate sufficient revenues or income, making it unable to meet or pay its financial obligations.").

41. *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *18 (Bankr. W.D.N.C. Dec. 28, 2023) (holding that "financial distress" is not a constitutional prerequisite for filing a Chapter 11 bankruptcy petition).

the backdrop for new and controversial applications of the Code's powers.[42] While many entities use the Code to creatively benefit both the debtor and its creditors, the potential for misuse still exists. Thus, special provisions are included in the Code to prevent abuse.[43]

Despite these doctrinal complexities, many believe that the U.S. Bankruptcy system is the best on the planet.[44] In practice, however, the Code can be manipulated in ways that could call a filers' good faith into question. Thus, to retain the Code's integrity, it is essential that the Code's provisions continue to be utilized equitably and in compliance with the Constitution. The "Texas Two-Step's,"[45] questionable use of the Code indicates that Two-Step bankruptcies are not being filed in good faith, and further, that the Code is being used unconstitutionally.

III. WHAT IS THE "TEXAS TWO-STEP"?

The "Texas Two-Step" consists of (1) a divisional merger[46] under a state statute[47] followed by (2) a bankruptcy petition.[48] The strategy is as follows: a corporation (old corporation) facing an abundance of mass tort claims (e.g., asbestos claims[49]) divides itself into two new companies, which some

42. 7 COLLIER, *supra* note 5 ("[C]orporate reorganization must strike a balance between the need of a corporate debtor in financial hardship to be made economically sound and the desire to preserve creditors' and stakeholders' existing legal rights to the greatest extent possible.").

43. *See* 11 U.S.C. § 1112(b)(1)–(4) (granting courts the ability to dismiss or convert a bankruptcy petition to a chapter 7 *for cause*, and defining *cause* as improper acts such as gross mismanagement of the estate, failure to comply with court orders, or failure to make adequate disclosures); *In re* Little Creek Dev. Co., 779 F.2d 1068, 1072 (5th Cir. 1986) (explaining that the good faith requirement seeks to prevent "abuse of the bankruptcy process by debtors whose overriding motive is to delay creditors without benefitting them in any way or to achieve reprehensible purposes"); *see also* 7 COLLIER, *supra* note 5, ¶ 1100.09 ("The objective of a chapter 11 reorganization is to formulate a restructuring or reorganization plan that will enable the debtor to emerge from bankruptcy as a viable, profitable enterprise.").

44. *See* Stacey Vanek Smith, *The Latest American Export: Bankruptcy Laws*, NPR, (Sept. 10, 2015, 4:28 PM ET), https://www.npr.org/2015/09/10/439246992/the-latest-american-export-bankruptcy-laws (discussing how countries such as Ireland, France, and Germany have adopted the United States Chapter 11 bankruptcy regulatory scheme); *China Embraces Bankruptcy, U.S.-Style, to Cushion a Slowing Economy*, WALL ST. J. (Nov. 6, 2019, 11:42 AM ET) https://www.wsj.com/articles/china-embraces-bankruptcy-u-s-style-to-cushion-a-slowing-economy-11573058567 ("The country now has more than 90 U.S.-style specialized bankruptcy courts to help sort through a morass of corporate debt that, until recently, would have been swallowed by state banks and other creditors. . . . The bankruptcy system in China, drawing on U.S. chapter 11 provisions, aims to allow companies to restructure under court protection to keep businesses alive and pay creditors over time.").

45. Brubaker, *supra* note 3, at 10.

46. A divisional merger allows a company to split itself into two or more entities. *In re* DBMP LLC, No. 20-30080, 2021 WL 3552350, at *24 (Bankr. W.D.N.C. Aug. 11, 2021).

47. *See* TEX. BUS. ORGS. CODE ANN. § 1.002(55)(A) (West 2022); DEL. CODE ANN. tit. 6, § 18-217(b)-(c) (2024); ARIZ. REV. STAT. ANN. § 29-2206 (2015); KAN. STAT. ANN. § 17-7685a (2021); 15 PA. CONS. STAT. § 368(a) (2014).

48. Brubaker, *supra* note 3.

49. Eight out of ten people diagnosed with mesothelioma, a cancer that most commonly affects the lining of the lungs and chest report asbestos exposure, which is why asbestos is considered the largest risk factor in developing the disease, even when symptoms develop decades after the initial exposure. *Learn About Mesothelioma*, AM. LUNG ASS'N (Aug. 7, 2023), https://www.lung.org/lung-health-diseases/lung-disease-lookup/mesothelioma/learn-about-mesothelioma.

bankruptcy practitioners refer to as "GoodCo" and "BadCo."[50] As a result of the merger, BadCo takes on all of the old corporation's mass-tort liabilities.[51] Meanwhile, GoodCo takes the old corporation's assets, business operations, and other liabilities.[52] To complete the merger, GoodCo provides BadCo with a funding agreement to pay for the mass-tort obligations and fund the bankruptcy petition in the second step of the transaction.[53] In the second step, BadCo files for bankruptcy under Chapter 11 while GoodCo continues to operate its business without exposing its valuable assets or hindering its daily operations in the bankruptcy process.[54] The old corporation is then terminated.[55]

This strategy is extremely beneficial for a corporation facing an endless stream of mass-tort litigation. It is ostensibly a clever and sensible strategy because the Two-Step consolidates mass tort claims in a single forum, leading to a quicker and more conclusive settlement of all present and future claims while compensating the tort litigants via the funding agreement.[56]

The Two-Step is made possible under section 524(g) of the Code, which functions as a specialized tool for compensating mass tort claimants.[57] This provision allows a debtor to create a trust for the benefit of current *and* future tort claimants in its reorganization plan.[58] Under 524(g), the bankruptcy court issues injunctions which channel all of the mass-tort litigation against the debtor into the trust.[59] The Two-Step is effective because BadCo can take advantage of 524(g) to channel all claims into the trust, and the bankruptcy judge can use their broad powers of the court under Code section 105 to issue an injunction against third parties from suing GoodCo.[60] The Two-Step has been utilized in several

50. Brubaker, *supra* note 3.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *See id.* at 6; *In re* DBMP LLC, No. 20-30080, 2021 WL 3552350, at *24 (Bankr. W.D.N.C. Aug. 11, 2021) (explaining that under the current Texas Business Organizations Code, "upon a divisional merger in which the *dividing entity does not survive*, all liabilities and obligations of the dividing entity automatically are allocated to one or more of the … new organizations in the manner provided by the plan of the merger." (emphasis added)).

56. Brubaker, *supra* note 3, at 5.

57. 11 U.S.C. § 524(g)(1)–(2). Under this code section an injunction may be issued to enjoin entities from taking legal action for the purpose of collecting, recovering, or receiving payment or recovery with respect to any claim under a plan of reorganization which is to be paid by a trust described in paragraph (2)(B)(i). Under subsection (2)(B)(i), the injunction is implemented in connection with a trust that, pursuant to the plan of reorganization assumes the liabilities of a debtor which has been named as a defendant in personal injury, wrongful death, or property-damage actions seeking recovery for damages allegedly caused by the presence of, or exposure to, asbestos or asbestos-containing products. Put simply, the trust is a pool of money set aside by the debtor to distribute settlement payments to tort victims. *Id.*

58. *Id.*

59. *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *23 (Bankr. W.D.N.C. Dec. 28, 2023); 11 U.S.C. § 524(g) (providing that the channeling injunction can also apply to third parties affiliated with the debtor).

60. 11 U.S.C. § 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

recent cases for the purpose of isolating asbestos-related tort liabilities.[61] The arguments and judicial reasoning in bankruptcy court cases considering the Two-Step lay the foundation for scholars to question the Two-Step strategy's constitutionality.

IV. CHALLENGING THE TWO-STEP AS A DUE PROCESS VIOLATION

The Two-Step risks prejudicing mass-tort claimants by forcing them into the bankruptcy forum where their interests are fundamentally altered in a way that does not exist anywhere in the law outside of bankruptcy.[62] For instance, even if a group of asbestos claimants were certified as a class, outside of bankruptcy each individual claimant retains an absolute right to opt out of the class action proceeding and pursue their individual claim as they see fit.[63] Outside of bankruptcy, the only scenario where members of a certified class are prevented from opting out of a settlement is when the defendant possesses insufficient resources to fully satisfy their mass tort obligations.[64]

For example, the Supreme Court in *Ortiz v. Fibreboard* (a nonbankruptcy case) considered whether settling asbestos claims through a settlement trust comported with due process.[65] This strategy is substantially similar to the Two-Step. In *Ortiz*, the final settlement agreement provided that in exchange for full liability releases from class members, Fibreboard would establish a trust to process and compensate class members' asbestos claims.[66] Claimants would be required to settle with the trust, and if initial settlement negotiations failed, the claimants could proceed to mediation, arbitration, and a mandatory settlement conference.[67] Only after those actions were exhausted would the claimants be allowed to litigate against the trust, but their potential recovery was capped at $500,000 per claim with punitive damages barred.[68] The Court found the settlement fund not to be limited—meaning there was no risk of claims exceeding the defendant's assets—and therefore the settlement violated the due process principle that, with limited exceptions, people are not bound by a court's decision where they are not a party.[69] In other words, the plan impermissibly altered the substantive rights of the claimants.[70] The Court further opined that

61. *See, e.g.*, *Aldrich Pump*, 2023 WL 9016506, at *4; *In re* LTL Mgmt., LLC, 64 F.4th 84, 95 (3d Cir. 2023); *In re* Bestwall LLC, 71 F.4th 168, 169 (4th Cir. 2023).

62. *See* Brubaker, *supra* note 3, at 9.

63. FED. R. CIV. P. 23(c)(2)(B)(v) ("For any class certified under Rule 23(b)(3) . . . the court will exclude from the class any member who requests exclusion."); *see also* Brubaker, *supra* note 3, at 9.

64. Brubaker, *supra* note 3, at 9–10.

65. Ortiz v. Fibreboard Corp., 527 U.S. 815, 846 (1999).

66. *Id.* at 827.

67. *Id.*

68. *Id.*

69. *Id.* at 846 ("'[I]n certain limited circumstances, a person, although not a party, has his interests adequately represented by someone with the same interests who is a party,' or 'where a special remedial scheme exists expressly foreclosing successive litigation by nonlitigants, as for example in bankruptcy or probate.'" (quoting Martin v. Wilks, 490 U.S. 755, 762 (1989))).

70. *Id.* at 847.

"the greater the leniency in departing from the historical limited fund model, the greater the likelihood of abuse."[71] The Court expressed that it preferred to proceed with caution in the case to avoid "serious constitutional concerns raised by the mandatory class resolution of individual legal claims, especially where [the] case [sought] to resolve future liability in a settlement-only action."[72]

The Supreme Court's concerns in *Ortiz* could easily be said about the Two-Step. Given that mandatory no opt-out settlements are only permissible when the defendant has limited resources outside of bankruptcy, logically this principle should apply inside of bankruptcy to financially distressed debtors. Moreover, U.S. bankruptcy laws seek to honor non-bankruptcy rights and interests. As acknowledged by the Supreme Court in *Butner*—a landmark bankruptcy case—property rights and interests are created by state law.[73] Therefore the Bankruptcy Code respects rights which exist outside of bankruptcy unless the Bankruptcy Code requires a different rule.[74] Thus, the Two-Step's constitutionality is doubtful because there is no procedure like it which exists outside of bankruptcy, and it fundamentally alters claimant property interests and due process rights.

A. *IN RE BESTWALL*—DEFENDING THE TWO-STEP

One recent case, in particular, highlights creditors' ongoing constitutional concerns and demonstrates the inconsistency in lower court decisions. In *Bestwall*, the Fourth Circuit Court of Appeals agreed with a debtor's eligibility to file under the Code and approved of the Two-Step strategy, defending the practical implications of the Two-Step and challenging the American tort system in the process.[75] Georgia-Pacific, a major manufacturer of pulp, paper, and construction materials, acquired Bestwall Gypsum Co. in 1965.[76] Georgia-Pacific acceded to all of Bestwall's asbestos liabilities in the acquisition, and continued to manufacture Bestwall asbestos-containing products, such as drywall joint compound.[77] By 1977, the Consumer Products Safety Commission outlawed the use of asbestos in joint compounds and drywall tape in the United States,[78] and shortly thereafter Georgia-Pacific faced thousands of asbestos-

71. *Id.* at 842.

72. *Id.*

73. Butner v. United States., 440 U.S. 48, 55 (1979).

74. *See id.* ("Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" (quoting Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 609 (1961))).

75. *In re* Bestwall LLC, 71 F.4th 168, 182–84 (4th Cir. 2023).

76. Brubaker, *supra* note 3, at 2.

77. *Id.*

78. 16 C.F.R. § 1304.1(a) (2024) ("[T]he Consumer Product Safety Commission declares that consumer patching compounds containing intentionally-added respirable freeform asbestos in such a manner that the asbestos fibers can become airborne under reasonably foreseeable conditions of use, are banned hazardous products under sections 8 and 9 of the Consumer Product Safety Act (CPSA) (15 U.S.C. 2057 and 2058).").

related lawsuits.[79] Although Georgia-Pacific has spent more than $2.9 billion defending against asbestos claims since 1979, the company acknowledges that thousands of additional claims will be filed every year over the next several decades.[80] Despite this, Georgia-Pacific has remained a fully solvent, multibillion-dollar profitable business.[81]

This is because, in 2017, Old Georgia-Pacific executed a divisional merger under Texas state law.[82] The merger resulted in the termination of Old Georgia-Pacific and created two new entities: Bestwall and New Georgia-Pacific.[83] Both entities are wholly owned subsidiaries of Georgia-Pacific Holdings, LLC.[84] The purpose of the restructuring was to (1) isolate old Georgia-Pacific's assets and personnel primarily engaged in defending against asbestos claims; and (2) utilize section 524(g) of the Code to set up a trust fund for the claimants without subjecting the entirety of Old Georgia-Pacific to the Chapter 11 bankruptcy process.[85] Bestwall received about $32 million in cash, all contracts related to the asbestos litigation (including settlement agreements and insurance policies), a tract of land, and the full 100-percent equity interest in the profitable corporate subsidiary Georgia-Pacific Industrial Plasters.[86] Notably, New Georgia-Pacific and Bestwall entered into a funding agreement where New Georgia-Pacific agreed to cover Bestwall's expenses pertaining to the costs of administering the bankruptcy estate and funding the section 524(g) asbestos trust.[87]

Bestwall also filed for a preliminary injunction under section 105 of the Code to enjoin any asbestos-related claims against New Georgia-Pacific.[88] Bestwall argued that the injunction was absolutely essential to the bankruptcy because without it, asbestos claimants would continue to sue New Georgia-Pacific for its valuable assets, rendering the bankruptcy petition and trust pointless.[89] The Bankruptcy Court agreed with Bestwall's argument that the Two-Step was permissive, and the district court affirmed by reasoning that the funding agreement and the injunction created a reasonable likelihood of a successful reorganization.[90]

At the bankruptcy court level, the asbestos claimants argued that the court lacked subject matter jurisdiction over the proceeding, the preliminary injunction was improperly granted, and notably, the divisional merger deprived

79. *Bestwall*, 71 F.4th at 173.
80. *Id.* at 186–87 (King, J., dissenting).
81. *Id.* at 187.
82. *Id.* at 173–74 (majority opinion).
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at 174 n.2.
87. *Id.* at 175.
88. *Id.* at 176.
89. *Id.*
90. *Id.* at 176–77.

them of their constitutional due process rights.[91] However, by the time the case reached the Fourth Circuit Court of Appeals, the court was primarily concerned with the merits of the preliminary injunction and subject matter jurisdiction.[92] Despite this, the case illustrates the ongoing concerns that the Texas Two-Step can be used in constitutionally questionable ways.

The Fourth Circuit agreed with the bankruptcy court that jurisdiction to grant the injunction was proper because bankruptcy courts have jurisdiction over all civil proceedings "arising in or related to cases under title 11."[93] Both the bankruptcy court and the Court of Appeals applied the "related to" jurisdiction test[94] where the inquiry is whether the outcome of a proceeding could conceivably have any effect on the bankruptcy estate.[95] More specifically, "[a]n action is *related to* bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate."[96] Thus, Bankruptcy Courts have broad jurisdictional powers, which are multiplied when combined with the bankruptcy judge's authority to issue injunctions necessary to a reorganization.[97] The court's jurisdiction to enjoin Bestwall asbestos claims against New Georgia-Pacific was vital to the Two-Step's strategy.[98] If the court lacked jurisdiction this would render Old Georgia-Pacific's 524(g) trust pointless, as claimants would then proceed to hold New Georgia-Pacific liable, unrestrained by the court's channeling injunctions.[99]

In concluding that the bankruptcy court had proper jurisdiction, the Fourth Circuit criticized the asbestos claimants' jurisdictional argument that the debtor made a "back-door" attempt to challenge the appropriateness of the Chapter 11 plan before confirmation.[100] As the North Carolina bankruptcy court referenced, the bankruptcy plan confirmation voting requirements should afford claimants due process.[101] In order for a plan of reorganization to be confirmed—which is the end goal of a successful bankruptcy case—a group of claimants holding at

91. *In re* Bestwall LLC, 606 B.R. 243, 249–55 (Bankr. W.D.N.C. 2019).

92. *Id.* at 251 (holding that the claimants will be afforded due process "as a result of the requirements of the Bankruptcy Code, and in particular, section 524(g)" because a 524(g) plan must be supported by a majority vote of the claimants); *Bestwall*, 71 F.4th at 176–77.

93. *Bestwall*, 71 F.4th at 178; *see* 28 U.S.C. § 1334(b) ("[T]he district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.").

94. *Bestwall*, 71 F.4th at 178; *Bestwall*, 606 B.R. at 249.

95. Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984), *overruled on other grounds by In re* W.R. Grace & Co., 591 F.3d 164 (3d Cir. 2009).

96. *Id.* (emphasis added).

97. *See* 11 U.S.C. § 105(a).

98. *Bestwall*, 606 B.R. at 249.

99. *Id.*

100. *In re* Bestwall LLC, 71 F.4th 168, 183 (4th Cir. 2023); *see also* 11 U.S.C. § 1141(d)(1)(A) (providing that after a debtor comes up with a reorganization plan, the creditors committee may confirm the plan, which results in the discharge of claims that arose before the confirmation).

101. *Bestwall*, 606 B.R. at 251.

least two-thirds of the value of the claims, and greater than half the quantity of the allowed claims in the class, must accept the plan; however, in the asbestos context, included under section 524(g) are heightened voting requirements where seventy-five percent of the claimants must vote in favor of the plan for it to be approved.[102] In other words, the reorganization plan must be accepted by a controlling majority of the claimants, which theoretically protects the claimants' interests.

The Fourth Circuit held the claimants' capacity to vote on the confirmation plan demonstrated that the Two-Step is fair, and doubted that there was a threat of deceit lurking behind the Two-Step, instead characterizing the claimant's constitutional concerns as a "false narrative."[103] Moreover, the court validated this use of the Code by reasoning that bankruptcy offers a streamlined, equitable, and timely resolution of asbestos claims in a single forum.[104] The court lauded bankruptcy's superiority to the costly and protracted American tort system, which it characterized as a means to enrich personal injury attorneys through costly legal fees.[105]

The Fourth Circuit ultimately affirmed the preliminary injunction, channeling litigation into the Bestwall asbestos trust fund.[106] The court reasoned that it was simply too early in the case for the claimants to argue there was no likelihood of a successful reorganization.[107] The court also concluded that the injunction was essential to the prospects of a successful reorganization.[108] The Fourth Circuit did not comment on the lower bankruptcy court's constitutional holdings, but perhaps under a different set of facts, or a different due process argument, even the Fourth Circuit will eventually side with the claimants.

V. CHALLENGING THE "TWO-STEP" AS A REGULATORY TAKING

Another possible approach would be to challenge the Two-Step as a regulatory taking. Even though the Fourth Circuit Court of Appeal's opinion in *Bestwall* characterized the Two-Step as an intelligent and equitable use of the Code, as discussed above, the court did not consider the Two-Step's constitutional implications. A regulatory taking challenge to the Two-Step might be a difficult argument, but it merits exploration because it is likely instructive on the limits of Bankruptcy Code and whether a Two-Step bankruptcy petition can be filed in good faith.

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102. 11 U.S.C. § 1126(c); 4 COLLIER, *supra* note 27, ¶ 524.07[2] (explaining that at least seventy-five percent of claimants in asbestos bankruptcies must vote in favor of the 524(g) plan to be confirmed and citing 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb)).

103. *Bestwall*, 71 F.4th at 183.

104. *Id.*

105. *Id.* at 184 ("It is not clear why Claimant Representatives' counsel have relentlessly attempted to circumvent the bankruptcy proceeding, but we note that aspirational greater fees that could be awarded to the claimants' counsel in the state-court proceedings is not a valid reason to object . . . .").

106. *Id.* at 184–85.

107. *Id.* at 185.

108. *Id.*

The Takings Clause provides that private property shall not be taken for public use without just compensation.[109] Takings typically occur in the form of physical invasions of a citizen's property (per se takings)[110] and regulations which may rise to the level of a taking if they adversely affect a person's property interests.[111] As the Supreme Court of the United States reasoned in *Cedar Point Nursery v. Hassid*, takings jurisprudence has "often described use restrictions that go *too far* as regulatory takings."[112] Fundamentally, whenever a debtor invokes the powers of the Code, it is using the power of the state to restrict the claimant's property interests. Accordingly, uses of the Code can theoretically go too far.[113] Despite the possible benefits of resolving asbestos claims in the Two-Step, as articulated by the Fourth Circuit in *Bestwall*, the Supreme Court urges that the "Constitution . . . is concerned with means as well as ends[]" when it comes to takings.[114] Thus, how the Code is invoked is just as important to the taking inquiry as the ultimate end result of the reorganization.

For example, asbestos claimants could argue that the Two-Step violates their Fifth Amendment rights under the Takings Clause because it adversely affects their property interests, specifically of those bringing an as-applied challenge to section 109 of the Bankruptcy Code.[115] Section 109, which defines debtors eligible to declare bankruptcy, could be considered unconstitutional as applied because it allows completely solvent and financially healthy corporations to take advantage of the Code's provisions. They could argue that the Two-Step is an especially problematic application of the Code because the channeling injunctions, which prevent claimants from directly pursuing the going-concern corporation—GoodCo's—assets, cut off the claimants' ability to freely pursue their claims.[116] The argument would be that the power of the Bankruptcy Court under section 105 to enjoin actions that threaten a reorganization and the Bankruptcy Court's broad "related to" jurisdiction, are reserved for genuinely insolvent debtors in need of immediate relief. It would

109. U.S. CONST. amend. V.

110. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 434–35 (1982).

111. Penn. Cent. Transp. Co. v. New York City, 438 U.S. 104, 124–27 (1978) (stating that a regulation may rise to the level of a taking depending on a several factors: (1) the economic impact on the property owner, (2) the owner's investment-backed expectations, and (3) the degree to which the regulation will benefit society).

112. 594 U.S. 139, 149 (2021) (alterations in original) (emphasis added) (citing Horne v. Dep't. of Agric., 576 U.S. 351, 360 (2015)).

113. *See* New Haven Inclusion Cases, 399 U.S. 392, 489 (1970) (holding that a reorganization plan of the New York, New Haven, and Hartford Railroad, which involved a transfer of assets to Penn Central, constituted a taking in violation of the Fifth Amendment because the purchase price was too far below market value).

114. *Horne*, 576 U.S. at 362; *see also* McCulloch v. Maryland, 17 U.S. 316, 421 (1819) (reasoning that the legislature must pursue ends that "consist with the letter and spirit of the constitution").

115. 11 U.S.C. § 109(a) (providing that potential debtors under the Bankruptcy Code are limited to "person[s]" defined by §101(41) of the code as individuals, partnerships, and corporations who reside, have a place of domicile, place of business, or property in the United States).

116. *See In re* Bestwall LLC, 71 F.4th 168, 186 (4th Cir. 2023) (King, J., dissenting) ("Old [Georgia-Pacific], Bestwall, and new [Georgia Pacific] manufactured the jurisdiction of the bankruptcy court in these proceedings, in an unmistakable effort to gain leverage over future asbestos claims against New GP.").

logically follow that eligibility under the Code would revert to a regulatory taking.

A. THE TWO-STEP FUNCTIONS AS A TAKING BY DEPRIVING CREDITORS OF THEIR CAUSES OF ACTION

To further lay the groundwork for the claimants, it is important to define the property interests at stake and the scope of regulatory takings. A regulation may rise to the level of a taking if it adversely affects a person's property interest, depending on how a court weighs the *Penn Central* balancing factors.[117] Here, the adversely affected property interests of the asbestos litigants would be their claims against the debtor, because their causes of action are their property.[118] From a first principles perspective, a regulatory taking can be characterized as a restriction on property that crosses the line from reasonable regulation to unjustifiable government restriction.[119] The Two-Step's application of section 109 might have crossed that line.

The Supreme Court squarely addressed the relationship between the Takings Clause and bankruptcy law in *Louisville Joint Stock Land Bank v. Radford*.[120] There the Court addressed an unconstitutional as-applied challenge to the Frazier-Lemke Act, which amended the Bankruptcy Act of 1898 to restrict the ability of banks to repossess farms.[121] The Frazier-Lemke Act afforded bankrupt farmers the right to purchase their mortgaged property at its appraised value on a deferred payment plan.[122] If the mortgagee did not consent to the purchase plan, the debtor farmer would receive a stay of foreclosure proceedings for five years.[123] During those five years, the debtor farmer would be entitled to possession of the property subject to a reasonable annual rent, and they would be entitled to purchase the property for its appraised value at any time.[124]

In a unanimous decision, the Supreme Court held that the Frazier-Lemke Act violated the Fifth Amendment by taking the banks' property interests without compensation.[125] The Court reasoned that the mortgagee banks had property rights under state law, such as the right to retain the lien until the debt was paid in full, the right to conduct and bid in a foreclosure sale, and the right to control the property while the indebted farmer was in default.[126] Subsequent

117. Penn. Cent. Transp. Co. v. New York City, 438 U.S. 104, 124–27 (1978).

118. Tulsa Pro. Collection Servs., Inc. v. Pope, 485 U.S. 478, 485 (1988) (holding that "a cause of action is a species of property" that has been recognized as deserving due process protections).

119. *See* Cedar Point Nursery v. Hassid, 594 U.S. 139, 149 (2021).

120. 295 U.S. 555, 589 (1935).

121. *Id.* at 589–90.

122. *Id.* at 575.

123. *Id.* at 575–76.

124. *Id.* at 576.

125. *Id.* at 601–02.

126. *Id.* at 594–95.

Supreme Court cases have criticized aspects of the *Radford* holding,[127] but the Court has never questioned the principle that the bankruptcy power is subject to the Fifth Amendment.[128] Similar reasoning can be employed by judges in the Two-Step context to find that this use of the Code constitutes an unconstitutional regulatory taking when creditors are stripped of their ability to pursue their claims freely.

B. BANKRUPTCY'S CLAIM ESTIMATION PROCESS RISKS TAKING THE CLAIMANTS' PROPERTY INTERESTS

Today, the Code fits harmoniously within the Fifth Amendment's takings framework. Despite bankruptcy's impact on property interests, takings depend on the degree of the deprivation, not just whether property interests were affected in any way.[129] But complying with the Code does not automatically preclude constitutional concerns. Bankruptcy's claim estimation process,[130] which is vital to establishing the asbestos trust under section 524(g), inherently poses the risk of forcing an insufficient settlement on all current and future tort claimants.

Before allowing a claim against a debtor, the court must first estimate the claim's value.[131] The claim estimation process starts when a creditor files a "proof of claim" with the bankruptcy court pursuant to section 501 of the Code.[132] A proof of claim is a three-page form used by the creditor to indicate the amount of debt they are owed by the debtor on the date of the bankruptcy filing.[133] This document provides notice of the claim to all relevant parties involved in the bankruptcy, including the court, the debtor, and other creditors.[134] Once filed, a claim is deemed "allowed" unless a "party in interest" with respect to the claim (typically the debtor) objects to the allowance.[135] If a party in interest objects to a claim, the Bankruptcy Court must decide whether to allow the claim and how the claim should be valued.[136] If a claim is allowed

127. *See, e.g.*, Wright v. Vinton Branch of the Mountain Tr. Bank of Roanoke, 300 U.S. 440, 468–70 (1937) (holding that the amended Frazier-Lemke Act, which reduced the stay of foreclosure to three years, did not violate the banks' property rights under the Fifth Amendment).

128. Julia Patterson Forrester, *Bankruptcy Takings*, 51 FLA. L. REV. 851, 868 (1999).

129. *See* Cedar Point Nursery v. Hassid, 594 U.S. 139, 149 (2021).

130. 11 U.S.C. § 502(a)–(b) (providing that for a claim to be allowed against the debtor, the value of the claim must first be estimated).

131. 4 COLLIER, *supra* note 27, ¶ 502.04[4] ("Claim estimation takes on increased importance in the context of mass tort bankruptcy cases. . . . Claim estimation for large cases most commonly involves a trial making heavy use of expert witnesses to attach liability amounts to individual claims.").

132. 11 U.S.C. § 501(a) ("A creditor or an indenture trustee may file a *proof of claim*." (emphasis added)).

133. Daniel Kurt, *Proof of Claim: What It Means, How It Works*, INVESTOPEDIA (Jan. 12, 2023), https://www.investopedia.com/proof-of-claim-5189527.

134. *Id.*

135. 11 U.S.C. § 502(a).

136. 11 U.S.C. § 502(b) ("[I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount . . . .").

under section 502 of the Code, the creditor is recognized as having a right to share in the assets of the debtor's estate.[137] However, the Code is silent about how a court should estimate the value of an unliquidated claim.[138] Thus, bankruptcy judges have broad discretion in applying the appropriate method for estimating a claim.

The claim estimation process is important for the mass tort creditors in a Two-Step. For the 524(g) trust to be funded, all claims for the current class of litigants and classes in the foreseeable future must be estimated by a preponderance of the evidence.[139] In the case of mass tort litigation, courts often wait for a handful of cases to go to trial and reach jury verdicts.[140] After those test cases reach verdicts, the court can project a verdict for the entire class and estimate the aggregate value of pending mass future unliquidated claims.[141] Other means of estimating unliquidated claims include assessing the likelihood of prevailing on the merits and providing the creditor with a claim in the entire amount of the purported damages.[142] Utilizing the same reasoning, the judge may estimate a claim as a fraction of the purported damages amount when the judge believes the litigant is unlikely to prevail (e.g. a purported damages value of $100, with a 20 percent likelihood of success, is thus considered a claim worth only $20 against the debtor's estate).[143]

The purpose of claim estimation is to expedite the bankruptcy proceedings despite ongoing and protracted non-bankruptcy litigation.[144] However, it also provides the framework for regulatory takings. This is because the judicial estimate allows a debtor, such as Bestwall, to set up the asbestos trust fund in the exact amount allowed by the court for payment and nothing more.[145] Therefore, a fully solvent defendant can place a hard cap on the aggregate value of current and future asbestos claims.[146] In a Two-Step bankruptcy, the funding agreement between GoodCo and BadCo is capped pursuant to the exact estimated value of the claims in the trust fund.[147] Additionally, if a majority of the claimant class approves the plan, a minority of the claimants who are not satisfied with the plan are barred from opting out.[148] Although claim estimation is essential to the bankruptcy process, there is always a risk of prejudicing mass

137. *See* 11 U.S.C. § 502.

138. *See id.*; *Unliquidated Claim*, BLACK'S LAW DICTIONARY (11th ed. 2019) ("A claim in which the amount owed has not been determined.").

139. Brubaker, *supra* note 3, at 12–13.

140. NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 343 (1997).

141. *Id.* at 341.

142. *See* Bittner v. Borne Chem. Co., 691 F.2d 134, 135–37 (3d Cir. 1982).

143. *Id.*

144. NAT'L. BANKR. REV. COMM'N, *supra* note 140, at 341.

145. Brubaker, *supra* note 3, at 13.

146. *Id.*

147. *Id.*

148. *Id.*; *see also* 11 U.S.C. § 1126(c) (discussing the requirements for accepting or rejecting a Chapter 11 reorganization plan by a class of claims).

tort claimants through grossly underestimating the claims.[149] If the capped value of the trust is insufficient, the remaining claimants are simply out of luck.[150]

The risk of undervaluing claims is something bankruptcy courts are not concerned about because bankruptcy trusts are often adequately funded and typically make timely distributions to creditors.[151] However, claims have been grossly underestimated in the past, as in one of the earliest asbestos bankruptcy cases, *In Re Johns-Manville* where a 524(g) trust was created to settle mass-tort claims.[152]

In *Manville*, the Johns-Manville corporation, which manufactures insulation, commercial roofing, and building materials, also found itself confronted with mounting asbestos litigation.[153] A special committee appointed by the company's board of directors concluded that the costs of litigating asbestos suits over the next twenty to thirty years would likely exceed Johns-Manville's ability to pay and finance continuing operation costs.[154] In determining this, Johns-Manville hired the Epidemiological Research Institute, a consulting firm specializing in biostatistical analysis, to conduct a study and project the number of claims the company would likely encounter.[155] The study "estimated that a reasonable control projection of the number of lawsuits seen from 1982 on is likely to be about 45,000, with a reasonably firm lower bound of 30,000 and a very definitive upper bound on the order of 120,000."[156] Johns-Manville estimated that each asbestos case would cost about $40,000, with a projected litigation cost of $2 billion over the next 20 years.[157] The board of directors feared this would "potentially force the sale, liquidation or other disposition of Manville's assets and the dismemberment of its business."[158] In reality, these amounts were grossly underestimated. Later estimates showed there were over 200,000 future claims, exceeding the "definitive upper bound" of 120,000.[159]

To make matters worse, some claimants proceeded to litigation while Johns-Manville was negotiating group settlements.[160] This forced the Manville asbestos trust to litigate on multiple fronts simultaneously, which undercut the

149. Brubaker, *supra* note 3, at 13.

150. *Id.*

151. *See* NAT'L. BANKR. REV. COMM'N, *supra* note 140, at 344.

152. *Id.* at 343–44; *In re* Johns-Manville Corp., 36 B.R. 743, 746–47 (Bankr. S.D.N.Y. 1984); *see* MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 90 (2d Cir. 1988) (affirming the enjoinment of all suits against Johns-Manville's insurers related to asbestos settlement policies).

153. *Johns-Manville*, 36 B.R. at 745.

154. *Id.* at 745–46.

155. *Id.* at 746.

156. *Id.* (internal quotation marks omitted).

157. *Id.*

158. *Id.*

159. Sheldon S. Toll, *Bankruptcy and Mass Torts: The Commission's Proposals*, 5 AM. BANKR. INST. L. REV. 363, 370 n.23 (1997).

160. NAT'L. BANKR. REV. COMM'N, *supra* note 140, at 344.

trust's ability to compensate asbestos claimants.[161] Additionally, some of the asbestos claimant attorneys managed to accumulate massive legal fees for themselves, looting the trust's assets in the process by encouraging their clients to "jump the queue" and litigate instead of participating in group settlement negotiations.[162]

Notwithstanding these complicating factors, the goal of the Two-Step is to avoid the woes encountered by the Johns-Manville trust and consolidate all of the tort-claimants into one forum, subject to one large, no-opt-outs settlement agreement. However, even if a bankruptcy court channels all lawsuits into the trust subject to a settlement agreement with the debtor, there is still a risk that the assets may run out over time, leaving future claimants without a remedy.

In comparison to the Manville trust, where Johns-Manville itself declared bankruptcy, Bestwall is nothing more than New Georgia-Pacific's corporate shield after executing the divisional merger.[163] Bestwall has substantially no assets compared to New Georgia-Pacific, and the only value claimants have access to after the channeling injunctions are those that are deposited in the trust by the funding agreement.[164] Thus, present and future claimants cannot pursue their claims freely and are exposed to the inherent risks of mass-tort claim estimation. There is no procedure outside of bankruptcy which permits courts to enforce such binding settlements on present and future nonconsenting claimants within a class.[165] The bankruptcy court's numerous powers and abilities to channel litigation into a 524(g) trust demonstrate a supreme ability to restrain property interests. The Supreme Court has echoed this principle, holding that "one person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation [is] paid."[166] In a Two-Step, the asbestos claimants' property interests in their causes of action are restrained for the economic benefit of a completely solvent debtor. This leads to concerns over whether the Two-Step can be completed in good faith as well as whether it is even constitutional.

C. DIFFICULTIES IN PINPOINTING THE TAKING

Notwithstanding these concerns, the Code provisions that the Two-Step exploits are vital to effective reorganizations and genuinely distressed debtors attempting to settle endless streams of litigation.[167] The Code itself can be viewed as a policy-driven compromise regarding property interests, not a systematic means of taking property. In fact, many 524(g) trust settlements

161. *Id.*

162. *Id.* at 344 n.857.

163. *See In re* Bestwall LLC, 71 F.4th 168, 187 (King, J., dissenting).

164. *Id.* at 174 n.2 (majority opinion).

165. *See* Brubaker, *supra* note 3, at 13.

166. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984) (quoting Thompson v. Consol. Gas Corp., 300 U.S. 55, 80 (1937)).

167. NAT'L. BANKR. REV. COMM'N, *supra* note 140, at 346.

accompanied by channeling injunctions have been extremely successful, working to the benefit of both mass tort claimants and the reorganized debtor.[168] For instance, the asbestos trust in *In re A.H. Robins Co.* was funded in excess of the original claim estimation.[169] In that case, the reorganized corporation was even able to provide a second trust distribution to the claimants.[170] The A.H. Robins trust claims were estimated by multiple experts representing the interests of each party involved in the case.[171] The experts conducted a thorough statistical analysis of about one-third of the claims that were initially filed.[172] The experts then asked claimants for information about the nature of their injuries.[173] Additionally, the experts were instructed by the debtor not to give a low estimate, and accordingly estimated the total claims to be $2.475 billion.[174] Successful claim estimations, such as the estimation of the A.H. Robins trust, make it difficult for asbestos claimants to argue that they are certain to suffer a loss of property and violation of their constitutional rights.

To further illustrate the difficulty of pinpointing where the actual taking occurred, consider the following counterfactual: let's say Bestwall was deeply balance sheet insolvent[175] but still made use of the Texas Two-Step strategy by spinning off its liabilities into a subsidiary corporation and declaring bankruptcy without subjecting the rest of its business to the bankruptcy proceedings. Is this still an unfair and inequitable use of the Bankruptcy Code? In this hypothetical, the debtor's Two-Step would seem more harmonious with the Code's purpose. Here the GoodCo's equity shareholders, suppliers, employees, and other classes of creditors would be happy to be left unaffected by the chaotic logistical and financial complexities of a bankruptcy filing. Meanwhile, BadCo will make use of the 524(g) trust and class voting rules, and will channel injunctions to settle the claims.[176] But even if the debtor is genuinely insolvent, the Two-Step is still an expansive use of the Code because the petition is orchestrated entirely for the benefit of a non-debtor affiliate.[177]

It is doubtful whether the authors of the modern Code, or the founding fathers, envisioned this use of bankruptcy laws.[178] The Two-Step is essentially a self-imposed discharge of debts, because a debtor can separate itself from its burdens without subjecting its assets to the bankruptcy process. Although Two-

168. *See id.* at 344–45.
169. *Id.*
170. *Id.*
171. *In re* A.H. Robins, 880 F.2d 694, 699 (4th Cir. 1989).
172. *Id.*
173. *Id.*
174. *Id.* at 700.
175. Will Kenton, *Accounting Insolvency: Overview and Examples*, INVESTOPEDIA (June 30, 2021), https://www.investopedia.com/terms/a/accounting_insolvency.asp (Balance sheet insolvency or accounting insolvency "refers to a situation where the value of a company's liabilities exceeds the value of its assets.").
176. *See* Brubaker, *supra* note 3, at 6.
177. *Id.* at 7.
178. *See* Plank, *supra* note 21, at 499–500.

Step bankruptcies require funding agreements between "GoodCo" and "BadCo,"[179] which hypothetically preserve the self-dividing debtor's responsibility for ultimately resolving the claims,[180] the Two-Step's initial separation of liabilities from corporate assets is an extreme application of the Code. There is a strong argument for the claimants that the Two-Step functions as an unconstitutional regulatory taking because it takes the Code, which is intended to solve the multi-creditor problem, and repurposes it as a tool predominantly for hiding valuable corporate assets. This prejudices claimants and vitiates bankruptcy's constitutional principles.

VI. CHALLENGING THE TWO-STEP WHERE THERE IS NO FINANCIAL DISTRESS, WHICH IS ARGUABLY REQUIRED FOR A GOOD FAITH FILING

Given the difficulty surrounding constitutional claims of due process violations or regulatory takings, creditors could look to another path to invalidating the Two-Step. As discussed above, there is a good faith requirement in all bankruptcy filings.[181] Accordingly, creditors could argue that Two-Step bankruptcy petitions cannot be filed in good faith when the corporate parent is not financially distressed. A Two-Step initiated by a completely *solvent* debtor might go too far, pushing bankruptcy law beyond the bounds of its known universe and creating issues of constitutionality. That said, perhaps an *insolvent* debtor should be permitted to execute this unconventional and expansive use of the Code when the primary reason for their insolvency is mass tort litigation.

A clearer definition of financial distress and insolvency would help square the Third and Fourth circuit's financial distress circuit split.[182] Today, bankruptcy courts quibble over the subtle differences between insolvency and financial distress. Although the bankruptcy judges overseeing the Two-Step cases differentiate financial distress from insolvency,[183] the terms are oftentimes indistinguishable; it may be helpful to frame the terms as an economic spectrum. Insolvency can be understood as the inability to pay debts as they come due, or a large excess of debt over liabilities.[184] Financial distress can be defined more loosely as a holistic metric of a firm's overall financial health.[185] Additionally,

179. *See* Brubaker, *supra* note 3, at 1, 12.

180. *See In re* Bestwall LLC, 71 F.4th 168, 175 (4th Cir. 2023); *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *5 (Bankr. W.D.N.C. Dec. 28, 2023).

181. *See infra* Part II.

182. *In re* LTL Mgmt., LLC, 64 F.4th 84, 100 (3d Cir. 2023); *Aldrich Pump*, 2023 WL 9016506, at *18.

183. *See Aldrich Pump*, 2023 Bankr. W.D.N.C. WL 9016506, at *12; *LTL Mgmt.*, 64 F.4th at 102 ("To say, for example, that a debtor must be in financial distress is not to say it must necessarily be insolvent.").

184. 2 COLLIER ON BANKRUPTCY ¶ 101.32[4] (16th ed. 2024).

185. *See LTL Mgmt.*, 64 F.4th at 110; *see also In re* Integrated Telecom Express, Inc., 384 F.3d 108, 121–22 (3d Cir. 2004) ("Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition." (quoting *In re* Johns-Manville Corp., 36 B.R. 727, 736 (Bankr. S.D.N.Y. 1984))).

even solvent firms can suffer from financial distress.[186] Although there is a circuit split as to whether financial solvency is required in a good faith filing, the case law suggests that this claim could be one avenue to invalidating the Two-Step.[187]

Logically, bankruptcy should be reserved for the financially distressed debtor in need of relief from its economic struggles. However, bankruptcy law today frequently operates upstream from corporate mergers, thus calling into question where expansive uses of the Code, such as the Two-Step, fit within bankruptcy's "good-faith" framework.

A. THE STATE OF THE MODERN BIG CORPORATE BANKRUPTCY PRACTICE

A Two-Step supporter could argue that the Two-Step is simply the culmination of an ongoing process in the development of bankruptcy law. In fact, many see corporate bankruptcies as having developed into a species of mergers and acquisitions.[188] For example, in the context of bankruptcy asset sales, if we were to take a snapshot of a reorganizing corporation before and after a Chapter 11 plan confirmation, it would be difficult to tell if there had been a reorganization or a corporate control transaction such as a tender offer or merger.[189] Corporate reorganizations often result in: one business folding into another; old shareholders, managers, and board members being replaced; and business operations being streamlined or otherwise changed.[190] Moreover, bankruptcy has become a top earning practice area among the nation's largest law firms, with leading bankruptcy firms—including Kirkland & Ellis LLP, Latham & Watkins, and Weil Gotshal & Manges LLP—charging up to $1,500 an hour for their top associates, and over $2,500 for top restructuring partners.[191] In light of bankruptcy's M&A makeover, courts are conflicted over who should be able to take advantage of the Bankruptcy Code's provisions.

B. *ALDRICH PUMP*—FINANCIAL DISTRESS AS A NON-DISPOSITIVE FINDING OF FACT

In considering the question of whether financial distress is required in bankruptcy filings, the court in *Aldrich Pump* went so far as to hold that financial distress is not a constitutional requirement for filing a Chapter 11.[192] Aldrich

186. *Integrated Telecom*, 384 F.3d at 122 (citing *In re* SGL Carbon Corp., 200 F.3d 154, 163 (3d Cir. 1999)).

187. *See id.* at 121–22; *LTL Mgmt.*, 64 F.4th at 110.

188. *See, e.g.*, ADLER ET AL., *supra* note 2, at 769.

189. *Id.*

190. *Id.*

191. Evan Oschner, *Big Law Bankruptcy Fees Reach $2,500 an Hour for Top Lawyers*, BLOOMBERG L. (Feb. 5, 2024, 1:32PM PST), https://news.bloomberglaw.com/bankruptcy-law/big-law-bankruptcy-fees-reach-2-500-an-hour-for-top-lawyers ("The higher rates come as law firms are bumping associate pay and as complex bankruptcy cases are requiring lawyers to tackle novel questions about how to divvy up cryptocurrency and resolve mass tort liability.").

192. *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *18 (Bankr. W.D.N.C. Dec. 28, 2023).

Pump LLC and Murray Boiler LLC were spun off in a Two-Step from HVAC and manufacturing conglomerate Trane Technologies.[193] In June of 2020, just under two months after Aldrich Pump and Murray Boiler were born, both companies filed a Chapter 11 bankruptcy petition in the U.S. Bankruptcy Court for the Western District of North Carolina.[194] The merger allocated Aldrich Pump and Murray Boiler all of Trane's asbestos liabilities, which included over 90,000 lawsuits.[195] Aldrich Pump and Murray Boiler otherwise had no employees, no business operations, and only a small portion of Trane's assets.[196] The divisive merger also produced Trane Technologies Company LLC and Trane U.S. Inc., allocating them all of Old Trane's assets and business operations.[197] Similar to the debtor subsidiary in *Bestwall*, Aldrich Pump and Murray Boiler received funding agreements from the going-concern corporations, promising to fund an asbestos trust and pay the allowed claims of the asbestos victims.[198] As the court observed, the sole purpose of the Two-Step is to permit the completely solvent old corporation to achieve a "holistic and global resolution of those asbestos liabilities pursuant to an asbestos trust formed under Bankruptcy Code Section 524(g), without having to file bankruptcy themselves."[199]

In assessing whether the debtors in this case were financially distressed, the Bankruptcy Court opined that a finding of financial distress "depends on how one defines the term."[200] The court did not offer a rule statement for financial distress.[201] Rather, it proceeded to list the facts in the record, which indicated Trane Technologies' overall financial health.[202] Before the Two-Step, Trane Technologies managed to settle many asbestos claims without difficulty.[203] Trane also represented to the SEC and its equity shareholders that the corporation did not expect asbestos-related liabilities to have any material adverse impact on their business operations, overall financial condition, cash flows, or liquidity.[204] Trane's independent auditors analyzed these assumptions and ultimately agreed that Trane Technologies should continue to operate with a full bill of economic health, materially unaffected by the asbestos claims.[205]

193. *Id.* at *1.
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.* at *5 (alteration in original).
200. *Id.*
201. Adam Hayes, *Financial Distress: Definition, Signs, and Remedies*, INVESTOPEDIA (Apr. 18, 2021), https://www.investopedia.com/terms/f/financial_distress.asp (defining financial distress as "a condition in which a company or individual cannot generate sufficient revenues or income, making it unable to meet or pay its financial obligations.").
202. *Aldrich Pump*, 2023 WL 9016506, at *6.
203. *Id.*
204. *Id.*
205. *Id.*

Furthermore, Trane Technologies had plenty of cash reserves, and possessed substantial insurance coverage to compensate the asbestos claimants.[206]

Although the projected costs of current and future asbestos claims were projected to surpass Trane's insurance policy by about $240 million, the court still concluded that there was no financial distress.[207] The bankruptcy court reasoned that even though the debtor subsidiaries (Aldrich Pump and Murray Boiler) would owe $240 million in excess of the assets allocated to them in the divisive merger, their financial distress should be analyzed as part of Trane Technologies' overall financial health.[208] This was because the subsidiaries were designed to be reliant on Trane through the funding agreement.[209] At the time of the case, Trane reported $16 billion in annual revenues, annual excess cash flow of $1.8 billion, and a market cap of $54 billion.[210] The court had little difficulty concluding the debtors could easily fund asbestos settlements on the bankruptcy petition date.[211]

Despite finding the debtors were not financially distressed, the bankruptcy court denied movant's motion to dismiss the petition.[212] The court conceded that logically, a solvent, non-distressed corporation should rarely be permitted to declare bankruptcy,[213] because "in a capitalistic society, those who can pay their creditors, must pay. Otherwise, the economic system would collapse."[214] However, the *Aldrich Pump* court reasoned that neither bankruptcy case law nor the Code imply that Chapter 11 is exclusively and constitutionally reserved for financially distressed, insolvent debtors.[215]

In applying the Fourth Circuit's two-prong test for bad faith filings—which requires the movant to show both (1) the subjective bad faith of the filing party and (2) the objective futility of any possible reorganization—the court concluded that the claimants did not make a sufficient showing.[216] The court explained that when it comes to bad faith filings, the ultimate question is whether the bankruptcy case is consistent with the Code.[217] Applying that principle, the *Aldrich Pump* court agreed with the *Bestwall* bankruptcy judge who ruled that "attempting to resolve asbestos claims through [a 524(g) trust] is a valid reorganizational purpose, and filing for Chapter 11, especially in the context of

206. *Id.*

207. *Id.* at *7 ("While the current and future asbestos liabilities of Old Trane/Old IRNJ were projected to be at least $547 million, only $240 million (43%) of that projection would not be covered by insurance." (citations omitted)).

208. *Id.* at *8.

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.* at *8.

213. *Id.* at *17.

214. *Id.*

215. *Id.*

216. *Id.* at *28.

217. *Id.* at *24.

an asbestos or mass tort case, need not be due to insolvency."[218] Additionally, the court reasoned that the *Aldrich Pump* reorganizations seem even more promising than *Bestwall*'s because both Aldrich Pump and Murray Boiler came to an agreement with the largest claimant constituency—the future claims[219]—on terms for the plan.[220] The court also reasoned that the funding agreements will ensure the subsidiary debtors can adequately fund the trusts.[221]

Aldrich Pump's takeaways are that the Two-Step can serve a valid reorganizational purpose, and neither financial distress nor insolvency are required for a bankruptcy petition to be filed in good faith. The court seemed to believe a financial distress requirement too rigidly constrained bankruptcy eligibility.[222] In holding that a bankruptcy plan must simply serve a valid reorganizational purpose without requiring financial distress or insolvency, *Aldrich Pump* suggests that it will be difficult for creditors to invalidate the Two-Step as a bad-faith filing.

The consequences of this loose bankruptcy eligibility standard become clearer when Aldrich Pump's Two-Step is compared to the Bestwall plan. As the *Aldrich Pump* bankruptcy court noted, even though the New Trane companies resulting from the Two-Step have the capability of paying asbestos claims, "the claimants' ability to collect from them is uncertain."[223] Whereas the *Bestwall* Two-Step included a full funding agreement, the *Aldrich Pump* funding agreements were not secured, were not enforceable by creditors, and could not be assigned without written consent.[224] Additionally, the funding agreements contained automatic termination provisions where the solvent corporate parents funding obligations ceased once the 524(g) trust plan was confirmed.[225] These provisions posed significant risks to the claimants that their rights may be infringed through the claim estimation process. Together, *Aldrich Pump* and *Bestwall* create a major circuit split in today's bankruptcy courts because the Third Circuit in *LTL Management* drew the exact opposite conclusion.[226]

C. *LTL MANAGEMENT*—FINANCIAL DISTRESS AS A NECESSARY CONCLUSION OF LAW.

While *Bestwall* and *Aldrich* found no justification for invalidating the Two-Step, the Third Circuit's reasoning in *LTL Management* might propose an avenue for creditors to bring a successful bad faith argument against the Two-

218. *Id.* at *15 (citing *In re* Bestwall LLC, 605 B.R. 43, 49 (Bankr. W.D.N.C. 2019)).

219. 11 U.S.C. § 524(g)(4)(B)(i) (providing that a 524(g) trust requires a legal representative be appointed to represent future, unknown claimants).

220. *Aldrich Pump*, 2023 WL 9016506, at *28.

221. *Id.* at *3.

222. *See id.* at *18.

223. *Id.* at *8.

224. *Id*.

225. *Id.*

226. *In re* LTL Mgmt., LLC, 64 F.4th 84, 101 (3d Cir. 2023).

Step. In *LTL Management*, Johnson & Johnson executed a Two-Step that mirrored the Two-Steps in *Aldrich Pump* and *Bestwall*.[227] Johnson & Johnson stated that its goal was to isolate its asbestos liabilities associated with talc—a fine mineral powder which made up the base for Johnson & Johnson's baby powder—in a new subsidiary (LTL Management) so that the entity could file a Chapter 11 petition without subjecting the corporate parent's entire enterprise to bankruptcy proceedings.[228] The most valuable asset distributed to LTL Management in the divisional merger was a substantial funding agreement, granting LTL Management access to Johnson & Johnson[229]

The Third Circuit determined that financial distress is a necessary condition for bankruptcy eligibility and reviewed the lower bankruptcy court's financial distress finding de novo as a conclusion of law.[230] The court defined financial distress as a condition which depends on (1) underlying basic facts, such as the debtor's ability to pay current debts, and (2) inferred facts, such as projections of how much pending and future liabilities could cost in the future.[231] In its financial distress analysis the Third Circuit considered several facts, such as how Johnson & Johnson was able to boast "an exceptionally strong balance sheet" at the time of the bankruptcy filing.[232] Additionally, the court noted that prior to the Two-Step, Johnson & Johnson settled about 6,800 talc-related claims for under $1 billion dollars, dismissed about 1,300 ovarian cancer claims as well as 250 mesothelioma claims, and won a majority of the completed trial verdicts.[233]

Considering the financial health of Johnson & Johnson together with LTL Management, the court held that LTL was not financially distressed because LTL could use its parent company as "a funding backstop, not unlike an ATM disguised as a contract, that it can draw on to pay liabilities without any disruption to its business or threat to its financial viability."[234] Accordingly, the court did not think the attenuated possibility that future talc litigation may lead to a Johnson & Johnson bankruptcy constituted a good faith filing and granted the claimant's motion to dismiss.[235] In other words, the court felt the LTL Management bankruptcy petition was filed prematurely.[236]

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227. *Id.* at 93. Johnson & Johnson executed a divisive merger under Texas state law and split itself into two new entities: (1) LTL Management LLC, which held all the asbestos liabilities and a funding agreement, and (2) Johnson & Johnson Consumer Inc., which held all the productive business assets. *Id.*

228. *Id.*

229. *Id*.

230. *Id.* at 101 (citing *Integrated Telecom*, 384 F.3d at 121); *but see Aldrich Pump*, 2023 WL 9016506, at *15 (analyzing financial distress as a non-dispositive finding of fact).

231. *LTL Mgmt.*, 64 F.4th at 100.

232. *Id.* at 106 ("At the time of LTL's filing, J&J had well over $400 billion in equity value with a AAA credit rating and $31 billion in cash and marketable securities.").

233. *Id.* at 107.

234. *Id.* at 109.

235. *Id.* at 110.

236. *Id.* at 109.

The Third Circuit in *LTL Management* was highly suspicious of the Two-Step seemingly because it breaks bankruptcy's logic.[237] The court even noted that the larger the funding agreement, the less the corporate subsidiary is fit to file.[238] This meant that even if Johnson & Johnson sincerely believed the Two-Step would benefit all stakeholders, the court was reluctant to grant the powers of the bankruptcy forum to such an unusual debtor in LTL Management because the claimant's pre-bankruptcy rights to prove their claims before a jury of their peers should be "disrupted only when necessary."[239] The Third Circuit's opinion is that the Two-Step simply poses too substantial of risks to claimants, especially where a bankruptcy filing is not essential to the financial health of a debtor or its corporate family.[240] Although the case law is split, *LTL Management* presents an avenue for claimants to invalidate the Two-Step as a bad-faith filing.

VII. USING THE BANKRUPTCY CLAUSE'S BROAD SCOPE AND NARROW PREREQUISITE OF FINANCIAL DISTRESS TO CHALLENGE THE TWO-STEP

Creditors could also look to the Bankruptcy Clause and its historical roots for guidance in challenging the Two-Step. The circuit split over financial distress calls into question how the Bankruptcy Clause is "consist[ent] with the letter and spirit of the Constitution."[241] The Bankruptcy Clause provides that "Congress shall have power…[t]o establish…uniform Laws on the subject of Bankruptcies throughout the United States[.]"[242] In construing these words, the Supreme Court has looked to the English bankruptcy laws as they existed at the time the Constitution was adopted.[243] When the Constitution was born, English bankruptcy law limited its scope to merchants and only allowed for involuntary[244] bankruptcies.[245] But over time, the nation's bankruptcy laws were extended to practically all persons and corporations.[246] At the founding, English bankruptcy laws presumed that debtors were likely dishonest and deserving of punishment, but by the middle of the nineteenth century America's

237. *Id.* at 110.

238. *Id.* at 111.

239. *Id.*

240. *Id.* at 106–10.

241. McCulloch v. Maryland, 17 U.S. 316, 421 (1819).

242. U.S. CONST. art. 1, § 8, cl. 4.

243. Cont'l Ill. Nat'l Bank & Trust Co. v. Chi., Rock Island & Pac. Ry. Co., 294 U.S. 648, 668–69 (1935).

244. Will Kenton, *Involuntary Bankruptcy: What It Is, How It Works*, INVESTOPEDIA (July 18, 2024), https://www.investopedia.com/terms/i/involuntary-bankruptcy.asp#:~:text=Involuntary%20bankruptcy%20is%20a%20legal,proceedings%20don't%20take%20place ("Involuntary bankruptcy is a legal proceeding through which creditors request that a person or business go into bankruptcy. Creditors can request involuntary bankruptcy if they think that they will not be paid if bankruptcy proceedings don't take place."); *see* 11 U.S.C. § 303(b)(1). An involuntary bankruptcy petition may be commenced against a person by three or more entities, each of which is a holder of a claim that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, and if such noncontingent, undisputed claims aggregate to at least $18,600 more than the value of any lien on property of the debtor securing such claims held by holders of such claims. *Id.*

245. *Cont'l Ill. Nat'l Bank*, 294 U.S. at 668.

246. *Id.* at 670.

bankruptcy philosophy began to operate under the assumption that debtors might be honest but unfortunate and entitled to relief from their misfortunes.[247] Bankruptcy law grew to be more forgiving, as financial distress is a common occurrence in a capitalistic society.

The Supreme Court characterized the scope of the bankruptcy clause as extending to (1) all cases where the law distributes the property of the debtor among its creditors, and (2) the discharge of a debtor from its contracts.[248] "All intermediate legislation" pertaining to the subjects of asset distribution and discharge from indebtedness "are in the competency and discretion of Congress."[249] Thus, bankruptcy law has always been—and continues to be—a creature of statute without firmly delineated boundaries. However, bankruptcy law's historical origins seem to indicate that some degree of insolvency or financial distress is necessary to constitutional bankruptcy eligibility, providing an additional path to invalidating the Two-Step. Specifically, claimants can argue that the Two-Step exceeds the bankruptcy clause by reinventing what it means to be eligible to file for bankruptcy.

A. BANKRUPTCY'S HISTORICAL ORIGINS IN CURING INSOLVENCIES PLACE LIMITS ON THE CODE'S BROAD AND EVERCHANGING APPLICATION

In *Continental Illinois*, the Supreme Court provided a framework that claimants might consider using to argue the Two-Step is unconstitutional. The court considered whether the 1898 Bankruptcy Act permitted a bankruptcy court to enjoin banks from selling bonds that were held as security for collateral notes in a debtor railroad company.[250] In the process, the Court opined on the meaning of the Bankruptcy Clause and its evolution over time.[251]

If the history of bankruptcy law in the United States were distilled to a single theme, the *Continental Illinois* Court seemed to think it would be adaptability.[252] As the Court observed, bankruptcy law's "radically progressive nature" demonstrates "the capacity of the bankruptcy clause to meet new conditions as they have been disclosed as a result of the tremendous growth of business and development of human activities from 1800 to the present day."[253] Presciently, the Court noted that bankruptcy laws have not yet "gone beyond the limit of congressional power; but rather have constituted extensions into a field whose boundaries may not yet be fully revealed."[254] The Two-Step tests the limits of bankruptcy law in a novel and unforeseen way, just as the Supreme Court predicted. Despite bankruptcy's dynamism, some bankruptcy scholars

247. *Id.* at 670–71.
248. Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 186 (1902).
249. *Id.*
250. *Cont'l Ill. Nat'l Bank*, 294 U.S. at 664–67.
251. *Id.* at 668–72.
252. *See id.* at 671.
253. *Id.*
254. *Id.*

believe that the essential aspects of bankruptcy law retain their original meaning from the founding.

Professor Thomas Plank's influential article,[255] *The Constitutional Limits of Bankruptcy*, proposed the theory that "bankruptcy," as understood at the time of the constitutional convention, pertained to the narrow social dilemma posed by insolvent debtors and their creditors.[256] Plank's thesis is essentially that the Bankruptcy Clause was based on English insolvency and bankruptcy laws at the time, and thus bankruptcy eligibility requires some degree of insolvency.[257] In discerning the Framers' intent, Plank surveyed numerous sources, including Samuel Johnson's *Dictionary of the English Language*, which was first published in 1755.[258] The dictionary defined "Bankruptcy" as "[t]he state of a man broken, or bankrupt[]" and "[t]he act of declaring [oneself] bankrupt; as, he silenced the clamours of his creditors by a sudden bankruptcy." [259] "Bankrupt" was defined as being "[i]n debt beyond the power of payment.[260] Plank also notes that the 1773 and 1799 editions of Johnson's dictionary contained "substantially the same definitions."[261] Plank's research further indicated that at the time of the founding, "bankruptcy" literally meant "insolvency," meaning bankruptcies require the debtor to be insolvent in some sense.[262]

Broad adoption of Plank's insolvency theory would resolve much of the confusion caused by the Two-Step, and potentially ensure future bankruptcy petitions are filed in good faith, eliminating some of claimants' constitutional concerns. A minimum showing of financial distress, analyzed alongside other indicia of bad faith,[263] seems to not only be in line with the historical origins of bankruptcy law, but also seems to be a practical way to unify courts on how to address emerging complexities in modern bankruptcy practice. Afterall, the Bankruptcy Clause gives Congress the power to pass *uniform* bankruptcy laws, meaning major circuit splits ought to be avoided.[264] The premise of Plank's

255. *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *18 (Bankr. W.D.N.C. Dec. 28, 2023).

256. Plank, *supra* note 21, at 545.

257. *Id.* at 526 ("As the federal bankruptcy laws following the adoption of the Constitution evolved, many of the specific distinguishing features of the English bankruptcy acts, the English insolvency acts, and the American statutes disappeared. The gradual development of the federal bankruptcy laws, however, did not change the essential elements that all three bodies of legislation shared.").

258. *Id.* at 529.

259. *Id.*

260. *Id.*

261. *Id.* at 530.

262. *Id.* at 492, 532 ("Hening's 1820 volume of Virginia law indexes the shortlived Virginia discharge statute under 'Bankrupt' and describes it as 'Act for relief of *insolvent* debtors, on the principles of the bankrupt law.' Hening also indexed the law under 'Insolvents.'" (emphasis added) (citations omitted)).

263. *See In re* Duvar Apt., Inc., 205 B.R. 196, 200 (B.A.P. 9th Cir. 1996) ([An example of a bad faith filing is] "the new debtor syndrome. . . . Indicia of the new debtor syndrome include: (1) transfer of distressed property into a newly created corporation; (2) transfer occurring within a close proximity to the bankruptcy filing; (3) transfer for no consideration; (4) the debtor has no assets other than the recently transferred property; (5) the debtor has no or minimal unsecured debt; (6) the debtor has no employees and no ongoing business; and (7) the debtor has no means, other than the transferred property, to service the debt on the property." (citations omitted)).

264. *See* U.S. CONST. art. 1, § 8, cl. 4.

article and bankruptcy case law indicate that bankruptcy is not meant to help financially healthy companies.[265] As the Third Circuit expressed in *Integrated Telecom*, "[s]aying there is no insolvency requirement, however, does not mean that all solvent firms should have unfettered access to Chapter 11."[266] Citing the Bankruptcy Clause, claimants can argue that Congress's authority to pass uniform bankruptcy laws does not include the unquestioned ability to fundamentally redefine bankruptcy eligibility.

The Two-Step cases sit in tension with the Constitution by granting financially healthy corporate conglomerates access to the Code for the sole purpose of resolving only one class of liabilities. Principally, the question is whether this is fair and equitable. Looking to the Constitution, the Bankruptcy Clause and the Takings Clause intersect to create dueling overarching principles of (1) adaptability to new circumstances and (2) protecting both property interests and due process rights. From the perspective of the asbestos claimants, the Two-Step weighs too far on the side of adaptability, and neglects both due process concerns and property interests.

VIII. DEBT END: THE FATE OF THE TWO-STEP

The fate of the Two-Step remains unknown. In *Aldrich Pump*, counsel for the asbestos claimants asserted in their brief that the Two-Step bankruptcies permitted the defendants to gain leverage over the asbestos victims, "many of whom are gravely ill or dying," and delay payments to "their families, estates, and heirs for years."[267] The *Aldrich Pump* court responded by acknowledging how contested asbestos bankruptcy cases proceed at a much slower pace than other reorganization cases, sometimes taking between four and ten years.[268] But the Two-Step strategy is a new and highly controversial strategy,[269] and it is unclear if the Supreme Court will weigh in on the Two-Step cases.[270] If the Supreme Court does weigh in, they have several arguments to consider in assessing the constitutionality of the Two-Step, including whether the strategy: violates Due Process rights, constitutes a regulatory taking in violation of the

265. *See* Plank, *supra* note 21, at 548–49 (describing how courts have dismissed voluntary petitions from financially solvent companies when not filed in good faith); *see also In re* SGL Carbon Corp., 200 F.3d 154, 166 (3d Cir. 1999) ("Courts, therefore, have consistently dismissed Chapter 11 petitions filed by *financially healthy companies* with no need to reorganize under the protection of Chapter 11." (emphasis added)).

266. *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 122 (3d Cir. 2004).

267. Complaint at 5, *In re* Aldrich Pump LLC, No. 20-30608 (Bankr. W.D.N.C. June 18, 2022).

268. *In re* Aldrich Pump LLC, No. 20-30608, 2023 WL 9016506, at *31 (Bankr. W.D.N.C. Dec. 28, 2023) (explaining that, by contrast, most Chapter 11 cases are either confirmed, dismissed, or converted in less than a year).

269. *Id.*

270. *See* Evan Oschner, *Texas Two-Step Asbestos Bankruptcy Avoids Supreme Court Look*, BLOOMBERG L. (May 13, 2024, 8:04 AM PDT), https://news.bloomberglaw.com/bankruptcy-law/high-court-wont-weigh-in-on-texas-two-step-asbestos-bankruptcy ("Justices on Monday declined to hear whether manufacturing giant Georgia-Pacific can obtain a litigation shield through the bankruptcy of Bestwall LLC, an affiliate it created to handle asbestos lawsuits.").

Takings Clause, should be classified as a bad-faith filing, or violates the interpretation of the Constitution's Bankruptcy Clause that requires insolvency.

Fundamentally, corporate bankruptcy is moving in the direction of corporate control transactions, and away from the narrow purpose of solving the problem of insolvent debtors developed at the time of the founding. This has led to the invention of brilliant new strategies and creative problem solving. Even the Third Circuit in *LTL Management* acknowledged, while dismissing the Two-Step, that it did not intend to "discourage lawyers from being inventive and management from experimenting with novel solutions[,]"[271] because "[c]reative crafting in the law can at times accrue to the benefit of all, or nearly all, stakeholders."[272] But the essential question remains: who is meant to benefit from the Bankruptcy Code's powers? Despite bankruptcy's shift toward mergers and acquisitions, it cannot escape its constitutional origins. Bankruptcy law offers a series of practical and logical compromises regarding property interests, but it should never compromise when it comes to its constitutional roots.

271. *In re* LTL Mgmt. LLC, 64 F.4th 84, 111 (3d Cir. 2023).
272. *Id.*