

Recent Legislative Developments in Business Bankruptcy: The “Texas Two-Step” and the Nondebtor Release Prohibition Act of 2021

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Abstract

The Public backlash over the use of both longstanding and novel restructuring strategies in Chapter 11 cases affecting victims of the opioid crisis (Purdue Pharma), sexual abuse (USA Gymnastics and Boy Scouts of America) and talc-based products (LTL Management), among others, has led to recent proposed legislation focused on curtailing perceived abuses of the bankruptcy system. On July 28, 2021, Senators Elizabeth Warren (D-MA), Richard Blumenthal (D-NH) and Dick Durbin (D-IL) introduced S. 2497, the Nondebtor Release Prohibition Act of 2021 (the “NRPA”) in Congress.¹ If passed, the NRPA would amend the Bankruptcy Code² to significantly restrict the ability of courts to approve non-debtor third-party releases and related injunctions – an issue that courts have to date attempted to resolve by judicial decision, with divergent results.³ The NRPA would also limit use of the “Texas Two-Step,” a restructuring strategy whereby corporations separate their assets from liabilities before bankruptcy using a unique form of divisional merger available under Texas law.⁴ The recent bankruptcy court decision in LTL Management finding the cases were properly filed after utilization of the Texas Two-Step to address mass tort liability will only magnify this portion of the legislation and the pressure on Congress to limit this technique.

The following is an overview of issues surrounding the use of third-party releases and the Texas Two-Step, the provisions of the NRPA aimed at addressing these restructuring tools, and the ongoing debate surrounding this proposed legislation.

Third-Party Releases

In Chapter 11 reorganizations, debtors commonly propose a reorganization plan in which the debtor (or a new entity) makes distributions to creditors in exchange for a release from pre-bankruptcy liabilities and an injunction barring creditors from asserting any released claims outside of the bankruptcy proceedings. Unlike *debtor* releases, third-party releases prevent creditors from asserting their claims (via litigation or otherwise) against *non-debtors*, or individuals or entities that have not themselves filed for bankruptcy. The use of third-party releases and injunctions has become prevalent in Chapter 11 cases and is a valuable incentive offered to obtain funding or other financial accommodations from non-debtors concerned about their own liability relating to the debtor(s). While the inclusion of third-party releases is often contentious and heavily negotiated, they are almost always characterized as necessary to consummate a complex restructuring.

Third-party releases may be consensual or nonconsensual. Consensual releases are typically permitted by courts, although courts sometimes differ as to whether consent is required to be affirmative or can be implied from the failure to vote on a plan or “opt-out” of such releases.⁵

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