5th Circ. Ruling Highlights Split On Ch. 11 Exculpation

By **Evan Hollander, Daniel Rubens and David Litterine-Kaufman** (August 31, 2022)

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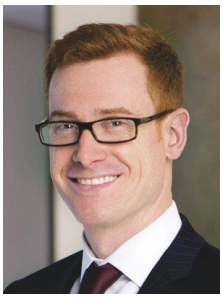

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In the latest development in the extensive litigation arising from the bankruptcy of Highland Capital Management LP, the U.S. Court of Appeals for the Fifth Circuit recently imposed strict limitations on bankruptcy courts' statutory authority to exculpate third parties from claims relating to their roles in the bankruptcy proceedings.[1]

The court's precedential opinion, authored by U.S. Circuit Judge Stuart Kyle Duncan, expressly notes a split of authority among the federal courts of appeals as to the meaning of Title 11 of the U.S. Code, Section 524(e), leaving an uncertain landscape for parties that wish to include exculpatory provisions or nonconsensual releases in Chapter 11 plans.

Background

The Highland Capital restructuring has been particularly litigious, and one co-founder's, James Dondero, litigation conduct led the U.S. Bankruptcy Court for the Northern District of Texas to conclude it was appropriate to exculpate a broad range of actors from suits arising from their involvement in the bankruptcy. Exculpation provisions are common features of Chapter 11 plans.

They generally protect exculpated parties from legal claims related to their involvement in the bankruptcy proceedings, except to the extent those claims allege bad faith, fraud, gross negligence, or similar misconduct.[2]

The plan confirmed by the bankruptcy court in Highland Capital included an exculpation provision that applied to nearly all bankruptcy participants, including the debtor, its officers and employees, a general partner of the debtor, the creditors' committee and its members, the successor entities under the plan, an oversight board comprised of four creditors and a restructuring advisor, and a catchall class of all parties related to any of the enumerated exculpated parties.[3]

The provision also covered three independent directors whom the creditors' committee had selected and, with the bankruptcy court's approval, authorized to exercise the powers of a bankruptcy trustee on behalf of the debtor.[4]

The confirmed plan also included a so-called gatekeeping provision, requiring that bankruptcy participants bring all claims against the exculpated parties first to the bankruptcy court to determine whether they are colorable and can proceed.[5]

Several creditors, including Dondero, objected to the plan's exculpatory and gatekeeping provisions. The bankruptcy court overruled those objections and confirmed the plan.

The objectors then obtained permission to appeal directly to the Fifth Circuit to challenge these provisions and other aspects of the confirmed plan.

The Fifth Circuit's Decision

After concluding that the appeal was not equitably moot, the Fifth Circuit affirmed in part and reversed in part the bankruptcy court's order confirming the plan, holding that the bankruptcy court lacked the authority to exculpate several of the nondebtor parties covered by the plan's exculpation provision.

In so concluding, the Fifth Circuit looked to Section 524, which governs the effect of discharge. Subsection (e) states that, except as otherwise provided, "discharge of a debt … does not affect the liability of any other entity on, or the property of any other entity for, such debt."

Relying on existing circuit precedent interpreting Section 524(e), the Fifth Circuit concluded that this provision "categorically bars third-party exculpations absent express authority in another provision of the Bankruptcy Code."[6]

The Fifth Circuit concluded that in light of Section 524(e)'s bar and the lack of support elsewhere in the code, the exculpation provision was unlawful as it applied to certain of the nondebtor parties covered by the plan provision.

Surveying the rest of the code, the Fifth Circuit found no alternative statutory basis for providing exculpation under a plan to parties other than the debtor, the creditors' committee and its members, and the Chapter 11 trustee.

While the debtor had suggested that such alternative basis could be found in Title 11 of the U.S. Code, Section 105[7] and 1123(b)(6),[8] the Fifth Circuit concluded that neither provision provided a statutory basis for extending nondebtor exculpation.[9]

Based on a review of circuit precedent, the Fifth Circuit recognized only three potential sources of statutory authority:

1. "A limited qualified immunity to creditors' committee members for actions within the scope of their statutory duties";

2. "A limited qualified immunity to bankruptcy trustees unless they act with gross negligence"; and

3. The authority under Section 524(g) to channel asbestos-related claims, not relevant to the Highland Capital plan.[10]

Applying those principles, the Fifth Circuit concluded that the exculpatory provision could extend only to Highland Capital, as debtor, the creditors' committee and its members, and the independent directors for conduct in the scope of their duties.

The Fifth Circuit concluded that exculpation was permissible for the independent directors only because earlier orders in the bankruptcy proceedings had given those directors the power to act as the debtor's quasi-trustee, but the court took pains to limit its holding to that "unique governance structure," disclaiming any broader authority to exculpate nondebtors.[11]

Discussion

The Fifth Circuit's decision highlights a split of authority on bankruptcy courts' powers to

exculpate nondebtors and raises questions about other protections like gatekeeping that may apply to such parties.

These concerns may well reach beyond exculpation provisions and extend to nonconsensual third-party releases,[12] like those approved by the bankruptcy court in the In re: Purdue Pharma LP bankruptcy case now on appeal to the U.S. Court of Appeals for the Second Circuit.[13]

The circuit courts are divided on the meaning of Section 524(e).

The Fifth Circuit acknowledged that its decision in Highland Capital — along with its earlier decision in In re: Pacific Lumber Co. — represents a contested view of the bankruptcy court's powers: "The simple fact of the matter is that there is a circuit split concerning the effect and reach of [Section] 524(e)."[14]

Cataloging the cases, the Fifth Circuit explained that the Second, Third, Fourth, Sixth, Seventh, Ninth and Eleventh Circuits "allow varying degrees of limited third-party exculpations."[15]

Only the U.S. Court of Appeals for the Tenth Circuit agrees with the Fifth that Section 524(e) is a categorical bar to such exculpation.[16]

Other circuits considering this issue have read the text of Section 524(e) to be more permissive of nondebtor exculpation. As the Ninth Circuit has explained, because Section 524(e) speaks only about "affect[ing] the liability ... on ... such debt," it could be read not to reach the claims covered by exculpation provisions, which represent liability for conduct in the bankruptcy process, rather than liability for the underlying debt.[17]

Moreover, Section 524(e) could be read as a floor rather than a ceiling, i.e., as providing that a plan does not automatically affect third-party liability, without constraining the bankruptcy court's power to eliminate third-party liability when it deems a third-party release appropriate.[18]

That would be consistent with other courts' conclusions that Section 524(e) should not "be literally applied in every case as a prohibition" on "the equitable power of the bankruptcy court."[19] But as U.S. District Judge Colleen McMahon detailed in the ongoing Purdue Pharma litigation, the legislative history of Section 524 may cut both ways.[20]

Notably, the Fifth Circuit rejected Title 11 of the U.S. Code, Section 1123(b)(6) as a residual source of authority to exculpate third parties. That provision authorizes bankruptcy plans to include "any other appropriate provision not inconsistent with the applicable provisions" of the code.

Other courts have concluded that an exculpation provision may be an appropriate provision to include in a plan pursuant to these powers, at least where unusual circumstances warrant.[21] But the Fifth Circuit did not address those holdings.

Instead, it disposed of Section 1123(b)(6) in a single sentence, concluding that it does not provide the independent statutory authorization that the court viewed as required by Section 524(e).[22]

The Fifth Circuit's approval of gatekeeping provisions and existing powers to combat vexatious litigation may provide a limited workaround to the prohibition

on third-party exculpation.

Although the Fifth Circuit significantly curtailed the bankruptcy court's ability to approve exculpation provisions protecting nondebtor participants in a bankruptcy case, the court nonetheless approved the bankruptcy plan's gatekeeping provisions as lawful under governing U.S. Supreme Court precedent.[23]

The gatekeeping provisions approved in Highland Capital require that parties asserting claims against the exculpated parties first establish to the satisfaction of the bankruptcy court that such claims are colorable before asserting them in another forum.

While the gatekeeping provisions of the Highland Capital plan apply by their terms only to the exculpated parties, the Fifth Circuit expressly noted that nothing in the opinion should be construed to hinder the distinct power of a bankruptcy court to enjoin or impose sanctions against vexatious litigants.[24]

Moreover, the opinion does not address the availability of a gatekeeping provision with broader application to protect parties not entitled to exculpation from the threat of vexatious litigation, although such a provision could not restrict plaintiffs to asserting only claims for bad faith, fraud, gross negligence or similar misconduct against nonexculpated parties.

The appellants in Highland Capital warned that the gatekeeping provision would extend to claims over which the bankruptcy court lacks subject-matter jurisdiction.[25]

While acknowledging this might be the case, the Fifth Circuit noted that precedent required that it leave this question to the bankruptcy court to consider in the first instance.[26]

This lingering jurisdictional question may reduce confidence in the protections afforded by gatekeeping until the issue is further developed in the courts.

Conclusion

The immediate impact of the Fifth Circuit's opinion is uncertainty about post-petition legal exposure for officers and directors of Chapter 11 debtors — and insurers providing insurance coverage for such parties — who might otherwise expect such parties to be protected by a plan's exculpation and general release provisions.

By excluding a debtor's officers and directors from the protection of exculpation provisions, the Fifth Circuit's approach may increase the costs of insurance coverage and deter important stakeholders from participating in the reorganization process.

The unavailability of exculpation to protect officers and directors may also add a level of complexity and reduce creditor recoveries in particularly litigious cases by encouraging parties who can no longer obtain exculpation to seek reserves for potential administrative claims for indemnification that would otherwise be discharged in accordance with Section 1141(d)(1)(A).[27]

The opinion may also encourage the use of other tools, like gatekeeping, to provide some level of protection short of exculpation, although the uncertainty surrounding the scope of the protections provided by gatekeeping make them, at most, only a partial substitute for exculpation.

Given the division in authority surrounding these issues and potential consequences of the Fifth Circuit's approach, the Highland Capital decision is unlikely to be the last word on the permissible scope of exculpation and gatekeeping under Chapter 11 plans.

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[1] In re Highland Cap. Mgmt., L.P., No. 21-10449 (5th Cir. Aug. 19, 2022) ("Op.").

[2] Op. 7.

[3] Id.

[4] Id. at 4, 7, 26.

[5] Id. at 7-8.

[6] Op. 24 (citing In re Pac. Lumber, 584 F.3d 229, 252-53 (5th Cir. 2009)).

[7] 11 U.S.C. § 105(a) enables the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

[8] 11 U.S.C. § 1123(b)(6) allows a plan to "include any other appropriate provision not inconsistent with the applicable provisions of this title."

[9] Op. 25 (citing In re Oxford Mgmt., Inc., 4 F.3d 1329, 1334 (5th Cir. 1993); In re Zale Corp., 62 F.3d 746, 760 (5th Cir. 1995)).

[10] Id.

[11] Id. at 4, 26.

[12] See id. at 15 (analogizing between the two).

[13] See In re Purdue Pharma, L.P., 635 B.R. 26, 104 (S.D.N.Y. 2021), appeal pending, No. 22-110 (2d Cir. argued Apr. 29, 2022).

[14] Op. 23.

[15] Id. at 24.

[16] Id. at 23-24.

[17] Blixseth v. Credit Suisse, 961 F.3d 1074, 1082-83 (9th Cir. 2020), cert. denied, 141 S.

Ct. 1394 (2021).

[18] In re Airadigm Commc'ns, Inc., 519 F.3d 640, 656 (7th Cir. 2008); In re Dow Corning Corp., 280 F.3d 648, 657 (6th Cir. 2002) ("However, this [§ 524(e)] language explains the effect of a debtor's discharge. It does not prohibit the release of a non-debtor.").

[19] In re A.H. Robins Co., 880 F.2d 694, 702 (4th Cir. 1989).

[20] See Purdue, 635 B.R. at 92-94, 107-11 (suggesting that the enactment of § 524(g), concerning asbestos claims, weighs against non-consensual releases of non-debtors for other kinds of claims).

[21] Airadigm, 519 F.3d at 657; Dow, 280 F.3d at 658.

[22] Op. 25.

[23] Id. at 28-29 (citing Barton v. Barbour, 104 U.S. 126 (1881)).

[24] Id. at 30 n.19.

[25] Id. at 29 (citing In re Craig's Stores of Tex., Inc., 266 F. 3d 388, 390 (5th Cir. 2001) (explaining that the bankruptcy court's post-confirmation jurisdiction is limited to "matters pertaining to the implementation or execution of the plan")).

[26] Id.

[27] Courts have held that indemnification claims of officers and director arising exclusively from their post-petition conduct are entitled to administrative expense priority. In re Keene Corp., 208 B.R. 112, 116 (Bankr. S.D.N.Y. 1997); In re Heck's Props., Inc., 151 B.R. 739, 768 (S.D. W. Va. 1992). 11 U.S.C. § 1141(d)(1)(A) provides that confirmation of a plan discharges a debtor from any debt that arose prior to confirmation. Thus, absent the establishment of a reserve to satisfy potential administrative claims for officer and director indemnification, such claims would be discharged upon confirmation of a plan.