Highland Ch. 11 Remand Reinforces Gatekeeping Availability

By **Evan Hollander, Daniel Rubens and David Litterine-Kaufman** (March 10, 2023)

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In an Aug. 31, 2022, article, we described a notable decision by the U.S. Court of Appeals for the Fifth Circuit concerning the bankruptcy of Highland Capital Management LP, which limited the permissible scope of plan provisions that shield third parties from liability for alleged misconduct during the bankruptcy proceedings.[1]

Now, the U.S. Bankruptcy Court for the Northern District of Texas has weighed in on remand, limiting the exculpation provisions of the plan as directed by the Fifth Circuit and reinforcing the broad scope of the plan's original gatekeeping provisions.

Background

As we previously described, the Fifth Circuit's 2022 decision partially affirmed the bankruptcy court's order confirming Highland's Chapter 11 plan of reorganization, reversing only the limited portion of the plan that exculpated several nondebtor parties from claims relating to their roles in the bankruptcy proceedings.[2]

Such exculpation provisions — common to Chapter 11 plans — protect the exculpated parties from legal claims related to their involvement in the proceedings, except to the extent those claims allege bad faith, fraud, gross negligence or similar misconduct.

The Fifth Circuit's decision highlighted a split of authority among the federal courts of appeals about bankruptcy courts' authority under Title 11 of the U.S. Code, Section 524(e), to approve plans exculpating third parties.

The exculpation provision, however, was not the only plan provision that purported to protect third parties. The plan also included a gatekeeping provision and an injunction provision.

The gatekeeping provision required that, before claimants could proceed with claims asserted against nondebtor protected parties arising from the bankruptcy proceedings, such claimants must seek a determination from the bankruptcy court that those claims are colorable.

The gatekeeping provision further authorized the bankruptcy court, to the extent legally permissible, to adjudicate those claims, if found colorable. The injunction provision prohibited conduct "in violation[] of the discharge or otherwise inconsistent with the Plan."[3]

The Fifth Circuit's decision narrowed the bankruptcy court's exculpatory authority, but it did not disturb these latter two provisions, potentially leaving gatekeeping as an alternative, albeit weaker, protection for bankruptcy participants in the absence of broad exculpation authority.

However, the Fifth Circuit's opinion raised some uncertainty regarding the availability of gatekeeping and injunction protections for nonexculpated third parties.

In response to a petition for rehearing, the Fifth Circuit struck a sentence from the opinion that originally described the gatekeeping and injunction provisions as perfectly lawful, in contrast to the exculpation provision.[4]

Notwithstanding the Fifth Circuit's remand to the bankruptcy court, two petitions for certiorari to review the Fifth Circuit's decision are pending in the U.S. Supreme Court.[5]

Both ask the court to weigh in on the scope of a bankruptcy court's power to confirm a plan with third-party exculpation provisions in light of Section 524(e). A decision on those petitions is likely this spring.

Discussion

On remand to the bankruptcy court, the parties proceeded to litigate the vitality of the Highland Capital plan's gatekeeping and injunction provisions in the face of the Fifth Circuit's holding on exculpation.

Several funds associated with the debtor's co-founder and former CEO James Dondero argued that the Fifth Circuit's narrowing of the exculpation provisions should apply to those other provisions, too — i.e., that the same nondebtor parties excluded from the exculpation provisions by the Fifth Circuit should also be excluded from the gatekeeping and injunction provisions.

The bankruptcy court disagreed, affirming the continuing, independent protections for third parties by such provisions. The bankruptcy court maintains the scope of the gatekeeping and injunction provisions.

In an opinion issued on Feb. 27, the bankruptcy court rejected the arguments advanced by the funds associated with Dondero that the gatekeeping and injunction provisions must be narrowed in tandem with the exculpation provision.[6] The court relied on several key considerations:

- The three relevant provisions "all had distinct functions; they were not in any way redundant";[7]
- The list of parties protected by the gatekeeping provision was "not identical" to the list of parties exculpated by the exculpation provision even prior to the Fifth Circuit's restriction of the exculpation provisions of the plan;[8]
- Nothing in the Fifth Circuit's opinion purported to disturb the gatekeeping and injunction provisions — those provisions, the court of appeals explained, "are sound."[9]

In granting the debtor's motion to conform the plan to the Fifth Circuit's decision — and rejecting the proposed narrowing of the gatekeeper and injunction provisions — the bankruptcy court highlighted numerous statements in the Fifth Circuit's opinion indicating that those provisions remained unaffected.

The bankruptcy court also explained that the gatekeeping provision "is mostly a tool to deal with any future, potential lawsuits," but narrowing it in the proposed manner "would mean that the Gatekeeper Provision would have no effect on any conduct that occurs after the Plan Effective Date."[10]

Appellate Practitioners Beware: Rehearing May Not Mean Relief

The bankruptcy court's opinion was a particularly interesting exercise in interpreting appellate decisions — or perhaps acknowledging the inherent limitations on interpreting them.

It also demonstrates that requests for panel hearing aimed at clarification, even if granted, may not always yield meaningful relief, and could instead further entrench the holding the movant seeks to avoid.

Here, the Fifth Circuit's opinion originally described the gatekeeping and injunction provisions as "perfectly lawful," in contrast to the exculpation provision.[11] After commentators raised questions about the decision's effect on the gatekeeping and injunction provisions, the appellants sought rehearing, hoping to cast doubt on those provisions' status.

The Fifth Circuit panel promptly granted that request and struck the "perfectly lawful" language, without further comment.[12]

But on remand, the bankruptcy court concluded that that change had no relevant legal effect, and the gatekeeping and injunction provisions remain, indeed, perfectly lawful.[13]

As the bankruptcy court conceded, it was "awkward ... to attempt to be a mind-reader regarding editorial or wordsmithing decisions undertaken by the Fifth Circuit," but it did not "know how it could be clearer" that the scope of the gatekeeping and injunction provisions survived the appeal wholly intact.[14]

Therefore, what might have initially seemed like a rehearing success story turned out to be illusory.

Conclusion

As we previously predicted, the Fifth Circuit's Highland Capital decision has increased the importance of tools like gatekeeping in lieu of exculpation.

The bankruptcy court's recent decision confirms the viability of gatekeeping provisions and their broad potential scope even in those circuits that have limited the availability of exculpation for third parties.

Meanwhile, a two-tiered system remains in the Fifth Circuit.

Parties entitled to the benefits of exculpation may be shielded from suits over merely negligent conduct in connection with their participation in a bankruptcy case, while parties not entitled to exculpation may receive a lesser degree of protection — i.e., review for a determination whether any colorable claim has been asserted against such parties resulting from their participation in the case.

That gatekeeping function has at least two potential protective values.

First, it channels claims related to conduct in respect of bankruptcy proceedings to the bankruptcy court for adjudication. This channeling could lead to more efficient motion practice on the viability of the asserted claims because the bankruptcy court likely would already be familiar with the background of the case.

Second, it will remain for the bankruptcy courts to determine how much scrutiny to apply under the colorable claim standard, which goes undefined in the Highland Capital plan.

In the context of derivative standing, courts have construed "colorable" to mirror the plausibility standard applied under Federal Rule of Civil Procedure 12(b)(6)[15] — although some courts will undertake a limited evidentiary review for proper factual support.[16]

If courts equate colorable with the Rule 12(b)(6) plausibility standard, gatekeeping provisions would not provide any substantive protection against such claims not already available under the Federal Rules of Civil Procedure, or state law analogs, and the main benefit to those defending against such claims would be the presumed efficiencies from channeling to the bankruptcy court referenced above.

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[1] In re Highland Cap. Mgmt., L.P. (Highland II), 48 F.4th 419 (5th Cir. 2022).

[2] Id. at 435.

[3] In re Highland Cap. Mgmt., L.P. (Highland III), No. 19-34054, 2023 WL 2250145, at *5 (Bankr. N.D. Tex. Feb. 27, 2023).

[4] In re Highland Cap. Mgmt., L.P. (Highland I), No. 21-10449, 2022 WL 3571094, at *13 (5th Cir. Aug. 19, 2022) (vacated on rehearing by Highland II).

[5] Highland Cap. Mgmt., L.P. v. NexPoint Advisors, L.P., No. 22-631 (U.S. docketed Jan. 5, 2023); NexPoint Advisors, L.P. v. Highland Cap. Mgmt., L.P., No. 22-669 (U.S. docketed Jan. 16, 2023).

[6] Highland III, 2023 WL 2250145.

[7] Id. at *3.

[8] Id. at *6.

[9] Highland II, 48 F.4th at 435.

[10] Highland III, 2023 WL 2250145, at *9.

[11] Highland I, 2022 WL 3571094, at *13.

[12] Highland II, 48 F.4th at 424.

[13] Highland III, 2023 WL 2250145, at *9.

[14] Id.

[15] E.g., NetJets Sales, Inc. v. RS Air, LLC (In re RS Air, LLC), No. NC-21-1102-GTB, 2022 WL 1284012, at *4 (B.A.P. 9th Cir. Apr. 26, 2022); In re On-Site Fuel Serv., Inc., No. 18-04196-NPO, 2020 WL 3707004, at *12 (Bankr. S.D. Miss. May 8, 2020).

[16] In re Sabine Oil & Gas Corp., 562 B.R. 211, 222 (S.D.N.Y. 2016).