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# United States Trustee Challenges Exculpation Provisions in Chapter 11 Plans

Chapter 11 plans commonly protect a debtor's key stakeholders that participate in the chapter 11 process from claims arising in connection with the bankruptcy case. The Office of the United States Trustee (the "US Trustee"), the branch of the Department of Justice tasked with monitoring bankruptcy cases, has recently taken aim at limiting the use and scope of these "exculpation" provisions in large restructuring cases across the country.

## Background and Standards

In chapter 11 cases, exculpation clauses are often approved in the ordinary course as an exercise of the Debtor's business judgment. These provisions are customarily limited to specific claims that could arise in connection with the chapter 11 case, including plan negotiation and implementation. Liabilities arising from gross negligence, fraud and willful misconduct are typically carved-out of plan exculpation provisions.[1] Exculpation provisions are also typically limited to key parties in the plan formulation process, such as the debtors, any official committee, certain lenders or security holders, and their related parties. In practice, exculpation provisions create a higher standard of liability for any claims against exculpated parties that relate to their participation in the chapter 11 case. These provisions are intended to induce important stakeholders to take an active role in the plan formulation process in order to maximize value and efficiencies in a debtor's chapter 11 case.

However, in *Pacific Lumber*, the Fifth Circuit Court of Appeals held that section 524(e) of the Bankruptcy Code precluded the exculpation and third party releases in that case.[2] Section 524(e) of the Bankruptcy Code provides that, except for certain inapplicable exceptions, the "discharge of a debt . . . [in a chapter 11 proceeding] does not affect the liability of any other entity on . . . such debt." The Fifth Circuit interpreted this section as prohibiting the effective release of claims against non-debtor exculpated parties. It therefore struck the exculpation provision at issue, retaining only a narrow exculpation for the official unsecured creditors' committee and its members which the Court regarded as statutorily empowered to act for the

1 *See In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) (explaining the universal formulation of exculpation provisions carving out willful misconduct and gross negligence).

2 *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

benefit of the debtors and their estates, and thus, as warranting qualified immunity for actions taken within the scope of such duties.[3]

Following *Pacific Lumber*, the Ninth Circuit in *Blixseth*[4] distinguished the Fifth Circuit's rationale. Referencing *Pacific Lumber*, the Ninth Circuit noted that section 524(e) of the Bankruptcy Code does not bar a customary exculpation (*i.e.*, one limited to separate claims arising for acts or omissions in connection with the chapter 11 cases and the filing and solicitation of the plan). The court further held that a typical exculpation provision does not implicate section 524(e) of the Bankruptcy Code at all, because it only applies to claims arising from the bankruptcy proceeding itself and does not impermissibly absolve a co-debtor or guarantor's liability on a discharged debt.[5]

## US Trustee Objections to Exculpation Provisions

Recently, the US Trustee has been objecting in jurisdictions across the country to plan exculpation provisions, arguing, among other things,[6] that only a statutory committee and its members may be exculpated under *Pacific Lumber*.

In response, many debtors[7] have argued that standard exculpation provisions are properly included in chapter 11 plans as a matter of the debtor's business judgment to ensure that necessary parties, including parties other than the committee and its members, participate in the formulation of a debtor's chapter 11

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3 The *Pacific Lumber* plan included exculpation and release provisions that released claims against certain of the debtors' prepetition creditors (and their related parties) that were plan proponents and which ultimately became the owners of the reorganized debtors under the plan, as well as the statutory committee of unsecured creditors and its members. *See id*. at 251.

4 *See Blixseth* v. *Credit Suisse*, 961 F.3d 1074 (9th Cir. 2020), *cert. denied*, 141 S.Ct. 1394 (2021).

5 *See id*. at 1082-84.

6 In certain cases, the US Trustee argued that an exculpation provision is impermissible because it lacks consent from third-parties. While this argument can be rebuffed by a debtor demonstrating that third-parties have provided consent, the outcomes of these objections are mixed. *Compare In re Stein Mart, Inc.*, 2021 WL 1216557 (Bankr. M.D. Fla. Mar. 29, 2021) (denying plan confirmation on the grounds the exculpation provision was an impermissible nonconsensual release) *with In re Ascena Retail Grp., et. al*, No. 20-33113 (KRH) (Bankr. E.D. Va.) (overruling US Trustee's objection and finding that the exculpation provision was consensual).

7 *See, e.g.*, *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444 (Bankr. S.D. Ohio 2021); *In re Astria Health*, 623 B.R. 793 (Bankr. E.D. Wash. 2021); *In re Highland Capital Mgmt., L.P.*, No. 19-34054 (SGJ) (Bankr. N.D. Tex. Feb. 22, 2021) [Docket No. 1943]; *In re Southern Foods Grp., LLC*, No. 19-36313 (DRJ) (Bankr. S.D. Tex.); *In re Ascena Retail Grp., et. al*, No. 20-33113 (KRH) (Bankr. E.D. Va.).

plan.[8] Bankruptcy courts have generally agreed with these debtors and have overruled the US Trustee objections, noting that exculpation clauses appropriately cover prepetition and postpetition acts by key stakeholders that directly relate to the bankruptcy case.[9] Many of these courts acknowledge that exculpated parties, including non-estate fiduciaries, add value to the restructuring process and that plan exculpation provisions properly encourage them to do so.[10]

## Conclusion

Given the US Trustee's recent concerted nationwide policy drive against plan exculpation clauses, we expect more decisions on this issue soon. The continued evolution of exculpation provisions is an important trend worth following given their critical, customary and common-sense use in plans, coupled with their effectiveness in encouraging stakeholder participation in the chapter 11 process.

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8 Some debtors also choose to not litigate the issue at all, instead agreeing to language that resolves the US Trustee's objections, but which leaves open the final determination of which parties are covered by a plan's exculpation provision. *See, e.g.*, *In re Valaris, plc*, No. 20-34114 (MI) (Bankr. S.D. Tex. Mar. 3, 2021), Hr'g Tr. at 21-22.

9 *See, e.g.*, *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444 (Bankr. S.D. Ohio 2021) (noting it was appropriate for an exculpation to cover prepetition acts such as the negotiation of DIP financing or a restructuring support agreement among a debtor and its stakeholders); *In re Astria Health*, 623 B.R. 793 (Bankr. E.D. Wash. 2021) (holding that an exculpation may properly be applied to non-estate fiduciaries and to postpetition acts or omissions taken in connection with the bankruptcy case); *In re Southern Foods Grp., LLC*, No. 19-36313 (DRJ) (Bankr. S.D. Tex. Mar. 17, 2021) (explaining that exculpation provisions could be construed as postpetition releases for conduct taken by certain parties in connection with a bankruptcy case).

10 *See, e.g.*, *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444 (Bankr. S.D. Ohio 2021) (holding that it was appropriate to apply the exculpation to non-estate fiduciaries to ensure that skilled parties participated in the formulation of a debtor's chapter 11 plan); *In re Ascena Retail Grp., et. al*, No. 20-33113 (KRH) (Bankr. E.D. Va.) (holding that each of the exculpated parties had provided valuable services to the debtors' estates, even going so far as to close a bankruptcy asset sale of *Ascena*'s retail businesses during the ongoing COVID-19 pandemic); *In re Highland Capital Mgmt., L.P.*, No. 19-34054 (SGJ) (Bankr. N.D. Tex. Feb. 22, 2021) [Docket No. 1943] (holding that it was appropriate to have an exculpation apply to parties who perform roles similar to a creditors' committee and its members, such as independent directors, executive officers of the debtor and the general partner of the debtor, which each provided services that are fiduciary or beneficial in nature to the debtor during the course of the debtor's bankruptcy); *see also Blixseth* v. *Credit Suisse*, 961 F.3d 1074, 1084 (9th Cir. 2020) ("[The Exculpation] Clause does nothing more than allow the settling parties—including . . . the Debtors' largest creditor—to engage in the give-and-take of the bankruptcy proceeding without fear of subsequent litigation over any potentially negligent actions in those proceedings.").

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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