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Ninth Circuit Opens the Door to Limited Nonconsensual Third Party Releases in Chapter 11 Plans

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On June 11, 2020, the U.S. Court of Appeals for the 9th Circuit in *Blixseth v. Credit Suisse*, 961 F.3d 1074 (2020), held that a chapter 11 plan may contain a "narrow exculpation clause" that releases claims against non-debtor parties for actions relating to the plan approval process. Although the opinion does not endorse broad nonconsensual third party releases that are available in certain other circuits under limited circumstances, it nevertheless opens the door to additional protections for creditors that typically take an active role in chapter 11 cases.

Exculpation Clauses vs. Third Party Releases

Exculpation clauses and third party releases are distinct forms of protection for non-debtor parties that are often incorporated into a chapter 11 plan. On the one hand, exculpation clauses are generally intended to insulate professionals and bankruptcy estate fiduciaries (*e.g.*, the unsecured creditors committee) from claims relating to the chapter 11 proceeding and the plan. The purpose of exculpation is to encourage robust participation in the chapter 11 process and to prevent an aggrieved party from later bringing a lawsuit or claim relating to that participation. Exculpation clauses are, by and large, focused on postpetition conduct, not particularly controversial, and frequently seen in chapter 11 plans.

On the other hand, third party releases are generally intended to protect non-debtor parties from a broad range of pre-confirmation (and often prepetition) actions. Although every circuit permits "consensual" third party releases, nonconsensual third party releases (*i.e.*, those imposed upon a creditor voting to reject the plan) are more controversial. The purpose of third party releases is to either encourage substantial contributions to a chapter 11 reorganization (*e.g.*, funding a recovery pool for

unsecured creditors) or to protect the debtor when a claim brought against the third party would significantly burden the debtor or stymie reorganization efforts. As a general matter, nonconsensual third party releases are permissible, though generally rare and tough to obtain, in the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits, but are universally prohibited in the Fifth, Ninth (at least, pre-*Blixseth*) and Tenth Circuits.

Although the *Blixseth* court referred to the provision at issue as an "exculpation clause," the provision was actually a hybrid of an exculpation clause (its scope was limited to conduct relating to the plan process) and a third party release (it covered Credit Suisse and other non-estate fiduciaries). For ease of reference, and to stay consistent with the Ninth Circuit's language, we will refer herein to the provision at issue in *Blixseth* as an "exculpation clause."

Blixseth Background

Timothy Blixseth founded the Yellowstone Club in 2000 as an "exclusive ski and golf community" in Big Sky, Montana. Following years of purported mismanagement, the companies forming the Yellowstone Club filed for chapter 11 protection in 2008. A year later, the debtors filed an amended plan containing an exculpation clause protecting Credit Suisse and others (though not Blixseth himself) from, in pertinent part:

[A]ny liability . . . for any act or omission in connection with, relating to or arising out of the Chapter 11 Cases, the formulation, negotiation, implementation, confirmation or consummation of this Plan, the Disclosure Statement, or any contract, instrument, release or other agreement or document entered into during the Chapter 11 Cases or otherwise created in connection with this Plan; provided, however, that [this exculpation clause] shall be construed to [cover] willful misconduct or gross negligence . . . .

(Yellowstone Plan § 8.4.) Blixseth objected to the scope of the exculpation clause under the Ninth Circuit's prior ruling that "without exception . . . § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors." *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995). After years of negotiations and up-and-down appeals regarding the plan, the Ninth Circuit finally ruled on the merits of the exculpation clause.

Ninth Circuit Ruling

The court observed that "[t]he question before us is whether the bankruptcy court could release Credit Suisse, a creditor, from liability for certain potential claims against it . . . ." *Blixseth*, 961 F.3d at 1081. *Blixseth* argued that the exculpation clause violated section 524(e) of the Bankruptcy Code, which provides, in pertinent part, that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." *Blixseth* cited three prior Ninth Circuit opinions, including *Lowenschuss*, which generally barred non-debtor releases pursuant to section 524(e).

The court distinguished these cases, however, noting that all involved "sweeping nondebtor releases from creditors' claims on the debts discharged in the bankruptcy, not releases of participants in the plan development and approval process for actions taken during those processes." *Blixseth*, 961 F.3d at 1083-84. Thus, in the *Blixseth* court's view, the Ninth Circuit's prior decisions did nothing more than codify the rule of section 524(e) that the Bankruptcy Code does not circumscribe claims against a debtor's "co-debtor[s] or guarantors over the discharged debt . . . ." Id. at 1083.

By contrast, the Ninth Circuit described the exculpation clause in the Yellowstone Plan as doing "nothing more than allow[ing] the settling parties—including Credit Suisse, 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." In view of that limited scope, the *Blixseth* court held that the exculpation clause did not run afoul of section 524(e) and was authorized by sections 105(a) and 1123.

Although that holding is clear, the rest of the opinion unfortunately is less clear. As an initial matter, the Ninth Circuit noted in a footnote that "Blixseth does not challenge the Exculpation Clause on the grounds that it violates the 'hallmarks of permissible non-consensual releases—fairness, necessity to the reorganization, and specific factual findings to support these conclusions.'" Id. at 1084, n.6 (citing *In re Continental Airlines*, 203 F.3d 203, 214 (3d Cir. 2000)). It is unclear whether the Ninth Circuit expects proponents of the exculpation clause to meet this difficult standard, which is typically used by courts to in other circuits to evaluate the propriety of nonconsensual third party releases (not exculpations).

To add more confusion to the mix, the *Blixseth* court cited a case in which the U.S. Court of Appeals for the 3rd Circuit remarked that exculpation clauses are "apparently a commonplace provision in Chapter 11 plans" that simply "state[] the standard of liability under the Code . . . ." *In re PWS Holdings Corp.*, 228 F.3d 224 (3d Cir. 2000). The exculpation clause in *PWS*, however, does not appear to have covered non-estate fiduciaries, and bankruptcy courts in Delaware frequently refuse to extend such exculpation clauses to non-estate fiduciaries (at least, when such clauses are challenged). *See, e.g., In re PTL Holdings LLC*, 2011 WL 5509031, at *12 (Bankr. D. Del. Nov. 10, 2011) (exculpation clause "must be reeled in to include only those parties who have acted as estate fiduciaries and their professionals").

Implications for Creditors

Large creditors, and particularly secured, funded debt creditors, often play an important role in a chapter 11 restructuring. Among other things, such creditors may have a lien on cash collateral or be the only viable option for DIP financing. Large creditors also frequently "change sides" during a chapter 11 case, often contesting a chapter 11 plan before settling with the debtor and defending the plan from attack by other constituencies.

Creditors in chapter 11 cases should therefore pay attention to the Ninth Circuit's holding in *Blixseth*. Although the ruling does not endorse broad, nonconsensual releases, the Ninth Circuit has now enabled bankruptcy courts to approve the extension of exculpation clauses typically reserved for estate fiduciaries to creditors participating in the plan process. Creditors that are substantially involved in chapter 11 cases in the Ninth Circuit may request, as part of any deal to support a chapter 11 plan, that the debtor extend such protections to them.

Conclusion

In *Blixseth*, the Ninth Circuit opened the door—at least partway—to additional creditor protections in a chapter 11 plan. In doing so, however, the court left a number of questions unresolved. What is the standard, if any, by which such exculpation clauses may extend to non-estate fiduciaries? Can non-creditor third parties, such as directors, officers, and equity sponsors, also seek such protection? Does the court's recitation of the Third Circuit's standard for nonconsensual third party releases—fairness and necessity to the reorganization—allow for the possibility of broad nonconsensual releases under the right circumstances? The only published opinion to cite *Blixseth* to date is *In re PG&E Corp.*, 2020 WL 3273475, at *11 (Bankr. N.D. Cal. June 17, 2020), in which the bankruptcy court approved, without substantial additional analysis, an exculpation provision that "comports with the contours . . . recognized in Blixseth." Accordingly, answers to these questions will require future developments in the case law.

If you have any questions about third party releases, exculpation clauses or any of the issues raised in this alert, please contact any member of the Creditors' Rights & Bankruptcy team.