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On the Edge

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Gatekeeping Provisions May Provide an Alternative to Nonconsensual Releases

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Where broad nonconsensual nondebtor releases are unavailable, the Fifth Circuit has endorsed gatekeeping provisions and injunctions to protect certain nondebtor plan participants from post-confirmation litigation that could undermine a reorganization. "Gatekeeping" is not a release; it is an injunction preventing lawsuits against critical plan participants before the bankruptcy court that determines that there is a "colorable claim" that it or some other court will adjudicate. This alternative may be utilized more often if the U.S. Supreme Court rules that nonconsensual nondebtor releases are unavailable under the Bankruptcy Code in *Purdue*, which likely will be decided this term.

Background

Courts regularly find nonconsensual nondebtor releases controversial because they purport to release the claims of a nondebtor party against another nondebtor party, potentially for both pre- and post-petition conduct. A nondebtor exculpation, similar to a release, is the phrase used to describe a limited release of claims against nondebtor parties participating in a bankruptcy case (*i.e.*, trustees and creditor committee members). Exculpation typically concerns conduct during the case. A nondebtor release or exculpation is "nonconsensual" if imposed on a releasing party without its explicit or, in some cases, implicit consent.

Nonconsensual nondebtor releases have been a key reason that businesses facing mass tort claims have filed for bankruptcy. The business hopes that chapter 11 will result in a faster, less-expensive resolution of mass tort claims than class actions or multidistrict litigation. This relief emerged from the landmark asbestos case of *Johns-Manville*,[1] after which Congress enacted 11 U.S.C. § 524(g), a case that provided for nonconsensual nondebtor releases within a framework that channels asbestos-liability claims away from a debtor to a trust designed to evaluate and pay those claims.

Congress never expanded the application of § 524(g) to include mass torts beyond those arising from asbestos-related injuries. Circuits have split on the authority of bankruptcy courts to grant nonconsensual nondebtor releases in non-asbestos cases. The Second, Third, Fourth, Sixth, Seventh, Ninth and Eleventh Circuits allow varying degrees of nonconsensual nondebtor releases in non-asbestos cases, whereas the Fifth and Tenth Circuits categorically bar nonconsensual nondebtor releases outside of asbestos cases.[2]

In 2021, several members of Congress introduced the Nondebtor Release Prohibition Act, a bill to amend the Bankruptcy Code to prohibit nonconsensual nondebtor releases other than as already provided in § 524(g) for asbestos cases. However, the bill never made it to the floor for a vote.[3]

The Supreme Court recently recalled and stayed the mandate of the Second Circuit approving non-

1 *In re Johns-Manville Corp.*, 68 B.R. 618, 626 (Bankr. S.D.N.Y. 1986), *aff'd in part, rev'd in part*, 78 B.R. 406 (S.D.N.Y. 1987), *aff'd sub nom.*, *Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988).

2 *Compare Deutsche Bank AG, London Branch v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*, 416 F.3d 136, 143 (2d Cir. 2005); *In re Millennium Lab Holdings II LLC*, 945 F.3d 126, 139 (3d Cir. 2019); *Behrmann v. Nat'l Heritage Found. Inc.*, 663 F.3d 704, 712 (4th Cir. 2011); *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002); *Blixseth v. Credit Suisse*, 961 F.3d 1074, 1084 (9th Cir. 2020); *SE Prop. Holdings LLC v. Seaside Eng'g & Surveying (In re Seaside Eng'g & Surveying)*, 780 F.3d 1070, 1078 (11th Cir. 2015); *with Bank of N.Y. Tr. Co., NA v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 251-53 (5th Cir. 2009); *In re W. Real Estate Fund Inc.*, 922 F.2d 592, 600-02 (10th Cir. 1990).

3 *See* H.R. 4777: Nondebtor Release Prohibition Act of 2021, *available at* congress.gov/bill/117th-congress/house-bill/4777 (last visited Oct. 17, 2023).

consensual nondebtor releases in *Purdue* and will hear argument in December 2023 on "whether the Bankruptcy Code authorizes a court to approve, as part of a plan of reorganization under Chapter 11 of the Bankruptcy Code, a release that extinguishes claims held by nondebtors against nondebtor third parties, without the claimants' consent."[4] A decision is expected by June 30, 2024.

The press has become more attentive to nonconsensual nondebtor releases based solely on a monetary contribution to a debtor's reorganization plan (such as the releases being provided to members of the Sackler family in *Purdue*). However, narrower releases for essential nondebtor plan participants who contribute more than, or something other than, money to a debtor's ability to successfully reorganize have enjoyed more success, even under a less-expansive view of bankruptcy courts' authority to grant such releases.[5]

Highland Capital: Fifth Circuit's Decision

Mass tort scenarios run the risk of overwhelming a potential debtor who lacks the resources to litigate (much less satisfy) claims. Although *Highland Capital* was not a mass tort case, the debtor was under threat of "vexatious litigation" from James Dondero, the investment firm's founder and former CEO, who allegedly wanted to "burn the place down."[6]

Instead of appointing a chapter 11 trustee, the creditors' committee selected three independent directors to act as a "quasi-trustee" whose cramdown plan was ultimately confirmed by the bankruptcy court. Because of Dondero's litigation posture, the plan proposed to protect nearly all of the bankruptcy participants from further litigation outside of bankruptcy court. There was a risk that the debtor's officers, employees, trustees and oversight board members would resign rather than be the target of more litigation brought by Dondero, and that the departure of professionals could result in significant deterioration of asset value.[7]

To minimize these risks, the *Highland Capital* plan proposed an exculpation provision enforced by an injunction and "gatekeeper" provision. The plan's exculpated parties were numerous and included the debtor, its employees, its general partner, the independent directors, the creditors' committee members, successor entities, the oversight board created to monitor plan implementation, retained professionals and "Related Persons."[8] As gatekeeper, the bankruptcy court would (1) determine whether any party seeking to bring a claim against an exculpated party had a "colorable claim," (2) authorize the party to bring the claim and (3) adjudicate the claim if the bankruptcy court had jurisdiction over the merits.[9]

This gatekeeping construct is based on the *Barton* doctrine, a judicial doctrine based on the bankruptcy court's power to supervise trustees such that alleged misdeeds of trustees (or debtors in possession (DIPs)) should be brought in bankruptcy court.[10] Under the *Barton* doctrine, bankruptcy courts can prevent suits against trustees in non-bankruptcy courts.

The Fifth Circuit accepted the gatekeeping provisions as a function that bankruptcy courts traditionally perform. To prevent the pursuit of bankruptcy-specific claims against certain insiders outside of the bankruptcy courts, the Fifth Circuit permits bankruptcy courts to issue injunctions and channeling orders requiring that suits against certain people involved in a case must first be brought to the bankruptcy court for review. While not a release, the gatekeeping injunction could limit improper, highly speculative or vexatious suits against chapter 11 insiders while still preserving the plaintiff's right to assert claims.

However, the Fifth Circuit also rejected the breadth of parties protected by the plan's nonconsensual exculpations as being beyond the bankruptcy court's authority under 11 U.S.C. § 524(e). The bankruptcy court viewed prior Fifth Circuit precedent in *Pacific Lumber* as allowing nondebtor exculpations if the bankruptcy court finds litigation likely "to swamp either [released] parties or the consummated reorganization."[11] The Fifth Circuit disagreed on appeal, stating, "We do not read the decision that way. The bankruptcy court's underlying factual findings do not alter whether it has statutory authority to exculpate a nondebtor."[12] The Fifth Circuit then held that a bankruptcy court's authority to exculpate nondebtors is limited to the creditors' committee members under *Hilal v. Williams*[13] and the independent directors (acting as quasi-trustee of the DIP) under 11 U.S.C. § 1107(a).

Highland Capital: The Bankruptcy Court Exercising Its Gatekeeping Function

The U.S. Bankruptcy Court for the Northern District of Texas recently exercised the gatekeeping provisions in the *Highland Capital* plan by denying Hunter Mountain Investment Trust (HMIT) leave to file a complaint against the debtor's CEO, James Seery, and others. Although Dondero denies that he controls HMIT, he and his family are its beneficiaries.

The proposed complaint alleged that Seery breached fiduciary duties and conspired to induce unsecured creditors to sell their claims at a discount to purchasers, those allegedly friendly with Seery who would approve of his allegedly excessive compensation demands. Thus, the discounted sale resulted in less money to pay off the creditor body in full and diminished the likelihood that HMIT will realize any recovery on its contingent class 10 former equity interest.[14]

4 *In re Purdue Pharma LP*, 69 F.4th 45 (2d Cir. 2023), *cert. granted sub nom.*, *Harrington v. Purdue Pharma LP*, No. 23-124, 2023 WL 5116031 (U.S. Aug. 10, 2023)

5 *See, e.g., Blixseth v. Credit Suisse*, 961 F.3d 1074, 1081-85 (9th Cir. 2020) (approving provisions exculpating nondebtors after finding that they were "narrow in both scope and time," limited to acts and omissions "in connection with, relating to or arising out of the Chapter 11 cases," and only covered those parties who were "closely involved" in drafting plan); *SE Property Holdings LLC v. Seaside Eng'g & Surveying Inc. (In re Seaside Eng'g & Surveying Inc.)*, 780 F.3d 1070, 1075-81 (11th Cir. 2015) (approving releases "narrowly limited in scope to claims arising out of the Chapter 11 case" where nondebtors' only contribution was "their labor ... the very life blood of the reorganized debtor").

6 *Nexpoint Advisors LP v. Highland Capital Mgmt. LP (In re Highland Capital Mgmt. LP)*, 48 F.4th 419, 426 (5th Cir. 2022).

7 *Id.* at 431.

8 *Id.* at 427.

9 *Id.*

10 *Barton v. Barbour*, 104 U.S. 126, 128 (1881).

11 *In re Pac. Lumber Co.*, 584 F.3d at 252.

12 *In re Highland Capital*, 48 F.4th 419 at 437.

13 *Hilal v. Williams (In re Hilal)*, 534 F.3d 498 (5th Cir. 2008).

14 *In re Highland Capital Mgmt. LP*, No. 19-34054-sgj-11, 2023 Bankr. LEXIS 2104, at *58 (Bankr. N.D. Tex. Aug. 25, 2023).

The bankruptcy court held a full-day evidentiary hearing, admitting more than 80 exhibits and receiving testimony from Seery, Dondero and HMIT's administrator.[15] The court concluded that HMIT lacked standing to bring the proposed claims, and that even if HMIT had standing, it "has not met its burden under the Gatekeeper Colorability Test of showing that ... the Proposed Claims are not without foundation, not without merit and not being pursued for an improper purpose."[16]

Conclusion

Debtors may consider adding gatekeeper provisions to their plans to protect people from suit for participating in a chapter 11 case, especially with uncertainty over releases stemming from the Supreme Court's pending decision in *Purdue*. Adding a gatekeeper provision is a form of protection that, if a release of an essential chapter 11 participant is unenforceable, can limit litigation against plan participants while still providing a remedy if there was wrongdoing. abi

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15 *Id.* at 72.
16 *Id.* at 155.