NINTH CIRCUIT ALLOWS BROADER EXCULPATION CLAUSES

Ruling Signals More Permissive Attitude Toward Third-Party Releases

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The Ninth Circuit has generally prohibited nonconsensual third-party releases in bankruptcy reorganization plans for a long time.[1] *See In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995) (citing *Commercial Wholesalers, Inc. v. Investors Commercial Corp*, 172 F.2d 800, 801 (9th Cir. 1949); *see also American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985). Section 524(e) provides 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." 11 U.S.C. § 524(e). As the *Deocampo* court stated in 2016, the Ninth Circuit has "repeatedly held, without exception, that [11 U.S.C.] § 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors." *Deocampo v. Potts*, 836 F.3d 1134, 1143 (9th Cir. 2016) (collecting cases). Many lower courts have taken that repeated refrain as a categorical ban on releasing or discharging nondebtors, even where Section 524(e) plays no direct role. *See, e.g.*, *In re Fraser's Boiler Serv., Inc.*, 2019 WL 1099713 (D. Wash. Mar. 18, 2019) (disallowing third-party releases in Section 363 sale).

However, the Ninth Circuit's position is the minority view on the power of Section 524(e) over third-party releases, as most of the other circuits have held that such releases are permissible in at least some circumstances. *See In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015). It's also possible the rule from *Lowenschuss* was a result of the peculiar facts of the case—the incredibly broad third-party release there included the debtor's children, *Lowenschuss*, 67 F.3d at 1401—and was never meant to impose as vast a prohibition as later courts read.

Fortuitously, a case from this summer alters the landscape and appears to bring the Ninth Circuit into closer harmony with its sister circuits.

In *Blixseth v. Credit Suisse*, 961 F.3d 1074 (2020), the Ninth Circuit chiseled the first crack in its broad prohibition on third-party releases. The *Blixseth* court upheld the bankruptcy court's decision to confirm a Chapter 11 plan including what the Ninth Circuit described as a "narrow exculpation clause" negotiated by the debtor and various creditors that shielded listed parties from liability relating to or arising out of the bankruptcy cases, including for compromises reached between the petition and effective date such as those memorialized in the plan itself. *Id.* at 1082 (citing *In re PWS Holding Corp.*, 228 F.3d 224, 245–46 (3d Cir. 2000)).[2] This article will discuss the details and holding of *Blixseth*, and suggest what changes it may bring for bankruptcy practitioners in Oregon.

Blixseth: The Facts

Timothy Blixseth co-founded the Yellowstone Mountain Club ("Yellowstone"), a ski and golf destination business in Big Sky, Mont. The company was initially successful and sought to expand, borrowing $375 million from Credit Suisse in 2005, secured by assets of the company and its affiliates. Blixseth and his wife divorced in 2008, and in her new role as a Yellowstone owner, she filed Yellowstone's Chapter 11 bankruptcy case in the District of Montana in 2008. *Blixseth*, 961 F.3d at 1078.

The bankruptcy case was contentious, with allegations that Mr. Blixseth had sent Yellowstone into "a downward spiral" when he "mismanaged and misused the money from the 2005 loan" from Credit Suisse. *Id.* Litigation and the threat of litigation between Yellowstone, Mr. Blixseth, Credit Suisse, the potential buyer, and the unsecure creditors' committee "was plentiful." *Id.* The parties ultimately negotiated a settlement that resulted in a May 2009 plan of reorganization that included a "narrow exculpation clause" releasing nondebtors involved in the litigation and negotiation of the plan from liability on acts related to or arising from the Yellowstone bankruptcy proceedings. Credit Suisse objected to the plan, resulting in overnight negotiations that led to Credit Suisse

1 This article will refer to nonconsensual third-party releases simply as "third-party releases," as the propriety of consensual third-party releases (i.e., those where interested parties vote to approve a plan and affirmatively release third parties) is not controversial and, in any event, irrelevant to the discussion. See *In re CJ Holding Co.*, 2019 WL 497728 (S.D. Tex. Feb. 8, 2019) (holding that even in the Fifth Circuit, one of the circuits like the Ninth that categorically bans third-party releases under Section 524(e), consensual third-party plan releases are permissible).

2 Six days after *Blixseth*, on June 17, 2020, the Bankruptcy Court in the Northern District of California seized on the decision, permitting a similar exculpation clause in the largest bankruptcy case in the Circuit in some time. *In re PG & E Corp.*, 617 B.R. 671 (Bankr. N.D. Cal. 2020).

being added to the exculpated parties. In the end, the exculpation provision stated in full:

> None of [the Exculpated Parties, including Credit Suisse, CrossHarbor, and Edra Blixseth], shall have or incur any liability to any Person 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 nothing in this Section 8.4 shall be construed to release or exculpate any Exculpated Party from willful misconduct or gross negligence as determined by a Final Order or any breach of the Definitive Agreement or any documents entered into in connection therewith

Mr. Blixseth was not included in the exculpation provision and objected to the plan. The bankruptcy court approved the plan with the exculpation provision in it, and Mr. Blixseth appealed. The District Court affirmed based on equitable mootness, and Mr. Blixseth pressed the issue to the Ninth Circuit.

Blixseth: Reasoning and Holding

After first finding that the appeal was not equitably moot, the Ninth Circuit analyzed the exculpation clause and Section 524(e). Parsing the statutory language, the court stated that Section 524(e) establishes that "discharge of a *debt* of the debtor does not affect the liability of any other entity on … *such debt*." *Id.* at 1082 (quoting Section 524(e)) (emphasis in original). However, the court stated, "the discharge in no way affects the liability of any other entity … for the *discharged* debt." *Id.* (citing 4 Collier on Bankruptcy ¶ 524.05); *see also id.* (agreeing with *In re PWS Holding Corp.*, 228 F.3d 224, 245–46 (3d Cir. 2000) by reasoning that Section 524(e) "prevents a bankruptcy court from extinguishing claims of creditors against nondebtors over the very debt discharged through the bankruptcy proceedings"). The court continued that a "discharge thus protects the debtor from efforts to collect the debtor's discharged debt indirectly and outside of the bankruptcy proceedings; it does not, however, absolve a nondebtor's liabilities for that *same* 'such' debt." *Id.* at 1083.

As for the legislative history of Section 524(e), the court prescribed just how narrow Section 524(e) actually is: Section 524(e) "prevents a reorganization plan from inappropriately circumscribing a creditor's claims against a debtor's co-debtor or guarantors over the discharged debt, and so does not apply to the Clause before us." *Id.* at 1082. Eventually, the court concluded that "Section 524(e) does not bar a narrow exculpation clause of the kind here at issue—that is, one focused on actions of various participants in the Plan approval process and relating only to that process." *Id.*

Moreover, the court distinguished impermissible release provisions in previous Ninth Circuit cases, including *Lowenschuss*, as involving "sweeping nondebtor releases from creditors' claims on debts discharged in bankruptcy." *Id.* at 1083–84. However, the court noted that the *Blixseth* exculpation clause is "narrow in both scope and time" and "does not affect obligations relating to the claims filed by creditors and discharged through the bankruptcy proceedings, as it exclusively exculpates actions that occurred during the bankruptcy proceeding, not before." *Id.* at 1080.

The court also provided a policy-based justification for its conclusion, reasoning that exculpation provisions with third-party releases are permissible because Chapter 11 cases are often "highly litigious" where "oxes [sic] are gored" and such releases limited in time and scope "allow the settling parties … to engage in the give-and-take of the bankruptcy proceeding without fear of subsequent litigation over any potentially negligent actions in those proceedings." *Id.* at 1084. Finally, the court held, as many of its sister circuits have before, that under 11 U.S.C. § 105(a) and 11 U.S.C. § 1123, "the bankruptcy court here had the authority to approve an exculpation clause intended to trim subsequent litigation over acts taken during the bankruptcy proceedings and so render the Plan viable." *Id.*

What _Blixseth_ Means for Practitioners and Bankruptcy Participants

Blixseth has several potential impacts for Oregon debtor-creditor practitioners and their clients. Primarily, *Blixseth* opens the door not only for copycat exculpation clauses, but it also opened the door to all forms of third-party releases in Chapter 11 cases, including in Oregon, despite the court consistently referring to the clause at issue as an "exculpation" provision.[3] *Blixseth* plainly limits the sweeping dicta from previous Ninth Circuit cases and clarifies that Section 524(e) does not categorically prohibit

3 Exculpation clauses and third-party releases are separate protections for third parties that are often included in Chapter 11 plans outside the Ninth Circuit. Generally, exculpation clauses insulate professionals and debtor-fiduciaries from claims relating to the Chapter 11 case. Similarly, but distinctly, third-party releases provide nondebtor parties freedom from liability for preconfirmation actions, including prepetition actions. Although the *Blixseth* court referred to the provision at issue as an "exculpation clause," the *Blixseth* provision was a cross between a third-party release and an exculpation clause because it released liability for both debtor and nondebtor representatives, but only for the period between the petition date and confirmation.

nonconsensual third-party releases, bringing the circuit more in line with its sister circuits and providing more consistency on this issue across the country. Creditors in the Ninth Circuit that are actively involved in Chapter 11 cases may now demand that the debtor extend at least postpetition releases to them, or debtors may outright offer such protection during negotiations, just as they might in most other jurisdictions.

Importantly, too, *Blixseth*'s reasoning is not limited to postpetition releases; indeed, the court explicitly narrowed *Lowenschuss* and Section 524(e) to only third-party releases for the same debts from which the debtor is being discharged (i.e., where the third party is looking to be released from a debt that it is a codebtor or guarantor of the debtor). The next logical step from *Blixseth* is mutual prepetition releases for third parties; practitioners, debtors, and creditors may soon seek to push that envelope.

Moreover, in a footnote, the Ninth Circuit appeared to open the door for even broader third-party releases by citing the Third Circuit's standard from *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 214 (3d Cir. 2000), that nonconsensual third-party releases need only be fair and necessary. *Blixseth*, 961 F.3d at 1084 n.6. In doing so, the court created a road map for practitioners wishing to challenge such releases, suggesting lawyers request specific factual findings on fairness and necessity. If the proponents fail to meet those criteria or are unable to present sufficient evidence to support them, the releases should be stricken from any plan.

Plan objections to releases may be made on an entity-by-entity basis, meaning that if a creditor is concerned about the inclusion of a certain party (e.g., a director or officer) but not others (e.g., a creditor's committee), that creditor could object to the necessity or fairness of including the director or officer, and may prevail in removing that party from the release unless the preponderance of the evidence suggests that party should remain. The fact that bankruptcy courts in the Ninth Circuit have for so long broadly prohibited third-party releases lends itself to the idea that those same courts will not just freely grant third-party releases now; it is worth keeping an eye on how they proceed.

At least one court immediately seized upon *Blixseth* to approve a similar exculpation/third-party release hybrid. *See In re PG & E Corp.*, 617 B.R. 671 (Bankr. N.D. Cal. 2020). Will courts use *Blixseth* and its citation to *Gillman* to approve releases for noncreditor third parties like directors and officers? The *Blixseth* court drew no distinctions and approved the exculpation clause that included the debtor's buyer without regard to whether the buyer was a prepetition creditor. Only time will tell.

Is the *Blixseth* decision a signal that the Ninth Circuit has seen the criticism of some of its splits from other circuits that may result in debtors filing fewer large cases throughout the circuit, including Oregon? National practitioners will have noticed *Blixseth* because the rule was applied immediately in *PG&E*, where so many were involved.

Interestingly, the unanimous *Blixseth* panelists—Judge Berzon (author), Judge Paez, and Judge Bybee—are not new to the Ninth Circuit. While some court observers have wondered what the influx of Trump appointees might have on the Ninth Circuit's bankruptcy jurisprudence, *Blixseth* comes from three pre-Obama appointees. Thus, it is more likely that a decision like *Blixseth* was always available and that the more lax approach to third-party releases has deeper support at the Ninth Circuit than a decision from new appointees might have signaled; *Blixseth* cannot be taken as a policy-driven shift sparked by new appointees. Still, if it is a signal that the Ninth Circuit wants to bring itself in line with its sister circuits, what other types of releases will it approve of? Also, what other split-circuit, minority bankruptcy decisions might the Court seek to walk back?

Staying abreast of developments in the case law on third-party releases and other hot-button issues both at the bankruptcy courts and the Ninth Circuit will benefit both practitioners and their clients.

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