



LOWENSTEIN BANKRUPTCY LOWDOWN

Lowenstein Bankruptcy Lowdown Video 16 – Circuits Split on How Far to Extend Third-Party Exculpation Provisions

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Nicole Fulfree: Hi, everybody. I'm Nicole Fulfree, a partner in Lowenstein's [Bankruptcy & Restructuring Department](#).

In *Highland Capital*, in a departure from relevant Fifth Circuit precedent, the Northern District of Texas Bankruptcy Court approved a broader-than-typical third-party exculpation provision, along with gatekeeping protections.

The confirmation order approved by the Bankruptcy Court shielded a laundry list of third parties, including all former, present, and future officers, directors, employees, principals, and professionals from litigation through a third-party exculpation provision. These protections covered a broad range of claims, including breach of contract and negligence claims, but excluding intentional misconduct. The gatekeeping provision required a party seeking to bring a claim against any of the protected parties to actually get a determination from the bankruptcy court that its claim was colorable before it could pursue such claim. The Debtor's co-founder and others appealed the confirmation order directly to the Fifth Circuit.

The Court of Appeals, somewhat predictably, cited to *Pacific Lumber*, the seminal Fifth Circuit case on the issue, for the proposition that, absent another source of authority, Section 524(e) of the Bankruptcy Code does not permit third-party exculpation.

Applying that precedent and notwithstanding the particular facts of the case, the Fifth Circuit partially rejected the exculpation clause, ruling that the exculpation of most of the protected parties was beyond the bankruptcy court's jurisdiction. Typically, third-party exculpation in the Fifth Circuit is limited to the asbestos context, and to creditors' committee members for actions that are within the scope of their duties. Here, however, the court expanded *Pacific Lumber's* limited allowance of exculpation of certain third parties to include the Independent Directors who, in this case, acted as a quasi-chapter 11 trustee. The Court also affirmed the approval of the gatekeeping provision, which is relatively uncommon, but unsurprising here given the extensive findings regarding the disruptive behavior of the debtor's co-founder throughout the chapter 11 cases.

Although the Fifth Circuit's decision in *Highland Capital* represents a slight broadening of the applicable precedent on third-party exculpation provisions, it nevertheless reaffirms the existence of a long-standing circuit split concerning the effect of Section 524(e), a split on which the Fifth Circuit continues to find itself in the minority.

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