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## Feature

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### Courts Should Approve Exculpation for the Pre-Petition Conduct of RSA Parties



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Exculpation is a standard — but often overlooked — component of chapter 11 plans. Exculpation clauses typically appear alongside a plan's more talked-about release provisions, such as debtor releases and third-party releases, but they offer a distinct form of protection. Whereas releases protect debtors or third parties from liability for certain pre-petition conduct, exculpation clauses protect estate fiduciaries, including the debtor, the official committee of unsecured creditors and their advisors, from liability for conduct related to the reorganization process.<sup>1</sup>

The rationale for exculpation is straightforward: If you contribute to or participate in the debtor's reorganization efforts, you should not face liability for your good-faith efforts. This protection fosters a fair, transparent restructuring process by reducing barriers to entry and incentivizes stakeholders to play a part in the development of a confirmable plan. Without exculpation, key creditors and competent professionals may shy away from the bankruptcy process, which would undermine chapter 11's main purpose: achieving a successful restructuring.

#### Narrow Exculpation Is the Norm

The standard exculpation provision in many chapter 11 cases today features two limitations.<sup>2</sup> First, exculpation only covers estate fiduciaries and their employees or agents.<sup>3</sup> As the Third Circuit

Court of Appeals has explained, because an official committee has a fiduciary duty to the estate, it has immunity under 11 U.S.C. § 1103(c) "for actions within the scope of [its] duties" and are liable for its own "willful misconduct or *ultra vires* acts."<sup>4</sup> The group of fiduciaries extends to "estate professionals, the [c]ommittees and their members, and the [d]ebtors' directors and officers."<sup>5</sup>

Second, the exculpation clause is temporally limited, extending only to the estate fiduciaries' post-petition conduct in connection with the chapter 11 case.<sup>6</sup> The temporal guardrail functions as a bracket. Exculpated parties receive protection for their actions beginning on the petition date and continuing through the plan's effective date.<sup>7</sup> This limitation dovetails with the exculpated parties' status as estate fiduciaries, with the rationale being that the party can only be protected for conduct that occurs while the bankruptcy estate exists. As explained in *In re Mallinckrodt PLC*,

[t]he exculpation of estate fiduciaries is afforded by Section 1103(c) of the [Bankruptcy] Code, which relates to the powers and duties of committees appointed pursuant to Section 1102, which occurs only once the bankruptcy estate has been created by the filing of a bankruptcy petition. It therefore only extends to conduct

1 Exculpation clauses generally include a carve-out for gross negligence, fraud and willful conduct.  
2 Exculpation has its roots in two distinct Bankruptcy Code provisions — 11 U.S.C. §§ 1103(c) (applying to official committees) and 1125(e) (protecting parties involved in the plan-confirmation process) — which courts often use to justify these restrictions. See *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) (approving exculpation under § 1103); see also *In re Davis Offshore LP*, 644 F.3d 259, 266 (5th Cir. 2011) (analyzing exculpation under § 1125).  
3 See, e.g., *In re Indianapolis Downs LLC*, 486 B.R. 286, 306 (Bankr. D. Del. 2013) (approving exculpation that was "limited so as to apply only to estate fiduciaries").

4 *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000).  
5 *In re Wash. Mutual Inc.*, 442 B.R. 314, 351 (Bankr. D. Del. 2011) (disapproving exculpation that extended to all released parties and related persons under plan).  
6 See, e.g., *In re Neogenix Oncology Inc.*, 508 B.R. 345, 362 (Bankr. D. Md. 2014) (approving exculpation that is "narrow in scope," such that it is "limited to post-petition actions and does not include any pre-petition claims").  
7 See *In re Midway Gold US Inc.*, 575 B.R. 475, 511-12 (Bankr. D. Colo. 2017) (disapproving exculpation that extended to "conduct and omissions arising after the confirmation date and after the Chapter 11 Cases have concluded, including, but not limited to, administration and implementation of the Plan itself").

that occurs between the Petition Date and the effective date.<sup>8</sup>

As a result, bankruptcy courts regularly strike or narrow exculpation provisions included in chapter 11 plans that go beyond estate fiduciaries and their good-faith conduct occurring between the petition date and plan effective date.<sup>9</sup> Generally speaking, these two limitations make sense because most, if not all, of the negotiation and plan formation occurs between the debtors and unsecured creditors' committee after the petition date. However, in many larger cases, the debtors have a complex capital structure that necessitates including the secured lender and *ad hoc* creditor groups in the restructuring process well before any bankruptcy case has been filed. This often results in a pre-packaged chapter 11 case or a chapter 11 plan that involves significant support from key constituencies who have executed a restructuring support agreement (RSA) with pre-negotiated plan terms. In these situations, courts should approve exculpation for non-estate fiduciaries, which includes protection for their good-faith, pre-petition conduct that is related to the plan formation and approval process.

## The Case for Pre-Petition Exculpation for Non-Estate Fiduciaries

Some courts have already been flexible in granting exculpation to non-fiduciary parties for their pre-petition conduct.<sup>10</sup> In such cases, bankruptcy courts have recognized that broader exculpation is appropriate where the protected conduct relates to the chapter 11 case and contributes to a confirmable plan.<sup>11</sup>

For example, in *Aegean Marine Petroleum Network Inc.*, the debtors proposed a plan that included exculpation for certain non-estate fiduciaries, including pre-petition secured lenders, pre-petition unsecured notes indenture trustees, and debtor-in-possession (DIP) lenders and agents, based on their participation in the RSA and certain restructuring transactions.<sup>12</sup> The U.S. Trustee objected, arguing that exculpation should be limited to the debtors, committee members and their respective advisors, and should not extend to the pre-petition lenders, who were not estate fiduciaries.<sup>13</sup> The bankruptcy court overruled the objection and approved the expanded exculpation protection. The bankruptcy court reasoned:

[A] proper exculpation provision is a protection not only of court-supervised fiduciaries, but also of court-supervised and court-approved transactions. If this Court has approved a transaction as being in the best interests of the estate and has authorized the transaction to proceed, then the parties to those transactions should not be subject to claims that

effectively seek to undermine or second-guess this Court's determinations.<sup>14</sup>

Likewise, in *In re Station Casinos Inc.*, the U.S. Bankruptcy Court for the District of Nevada approved a similar exculpation provision:

It would be inequitable, and would not comport with the plain intent of Section 1125(e) if, after confirmation of the Plan and implementation of the Restructuring Transactions, the Exculpated Parties — the Persons and Entities on the Debtor and creditor sides that actively participated in the process of reaching a consensual chapter 11 plan — could then be sued for their good-faith pre-petition and post-petition restructuring efforts.<sup>15</sup>

The broad exculpation provision was an “additional incentive for the various major parties to the Chapter 11 Cases to commit to and support the Plan,” which was ultimately confirmed without objection.<sup>16</sup> As these cases demonstrate, the proper circumstances for expanded exculpation typically arise in pre-negotiated or pre-packaged bankruptcy cases. In such cases, debtors and their creditors engage in pre-petition restructuring negotiations that may address a variety of issues, including the timing and venue of a bankruptcy filing, the terms and amount of DIP financing, the classification and treatment of claims, and the sale of any of the debtor's claims or assets, and the source and nature of funding for the reorganized debtors.<sup>17</sup>

These are precisely the type of negotiations that traditionally happen after a bankruptcy filing in the formation of a confirmable plan and for which estate fiduciaries can expect to be exculpated under §§ 1103 and 1125. It follows naturally that exculpation should then be extended to parties that participate in good faith in pre-petition negotiations that lead to a confirmed reorganization plan.

*Murray Metallurgical Coal Holdings LLC* is an apt example.<sup>18</sup> In this case, on the day before the petition date, the debtors finalized and executed an RSA with pre-petition term lenders holding approximately \$169 million of the debtors' \$270 million in outstanding debt obligations, certain additional creditors and customers, and certain affiliates of the debtors.<sup>19</sup> The signing of the RSA was the culmination of negotiations by the various parties that extended back many months and ultimately paved the way for an effective reorganization.<sup>20</sup>

The RSA contemplated a multi-step restructuring that included various asset sales and the transfer of reclamation obligations.<sup>21</sup> It also contemplated certain post-petition financing arrangements to fund the reorganization of the

<sup>14</sup> *Id.*

<sup>15</sup> *In re Station Casinos Inc.*, Case No. BK-09-52477, 2010 Bankr. LEXIS 5380, at \*98 (Bankr. D. Nev. Aug. 27, 2010).

<sup>16</sup> *Id.* at \*59.

<sup>17</sup> See generally Restructuring Support Agreement, Disclosure Statement for Joint Pre-Packaged Chapter 11 Plan of Reorganization of Guitar Center Inc., *et al.*, Ex. B, *In re Guitar Center Inc.*, Case No. 20-34656-KRH (Bankr. E.D. Va. Nov. 22, 2020), ECF No. 15 at 170-347 (covering such topics as bankruptcy filing, first-day pleadings, DIP financing, treatment of claims and interests, payment of professional fees, exit financing, transfer of claims, releases and exculpation, assumption of executory contracts, and post-emergence corporate governance).

<sup>18</sup> *In re Murray Metallurgical Coal Holdings LLC*, Case No. 20-10390, 623 B.R. 444 (Bankr. S.D. Ohio 2021). <sup>19</sup> *Id.* at 455.

<sup>20</sup> *Id.* at 504 (“[P]re-petition negotiations between multiple stakeholders led to the execution of the RSA, the agreement that enabled the Debtors to obtain the DIP Financing required to fund their post-petition operations. The RSA also formed the basis of the marketing process approved by the Court and the eventual filing of the Plan.”).

<sup>21</sup> *Id.*

<sup>8</sup> See *In re Mallinckrodt PLC*, Case No. 20-12522 (JTD), \_\_\_ B.R. \_\_\_, 2022 WL 404323, at \*27 (Bankr. D. Del. Feb. 8, 2022).

<sup>9</sup> See *id.* (striking language from exculpation provision that extended to pre-petition actions).

<sup>10</sup> See, e.g., *In re Health Diagnostic Lab'y Inc.*, 551 B.R. 218, 231-34 (Bankr. E.D. Va. 2016) (approving exculpation provision “captur[ing] pre-petition conduct to the limited extent that such conduct is related to the filing of the Debtors' bankruptcy cases”); *In re Cici's Holdings Inc.*, Case No. 21-30146 (SGJ), 2021 WL 819330, at \*10 (Bankr. N.D. Tex. March 3, 2021) (approving exculpation for conduct related to, in pertinent part, pre-petition credit agreement, RSA and “related pre-petition transactions”).

<sup>11</sup> See *In re PG&E Corp.*, Case No. 19-30088-DM, 2020 WL 9211213, at \*3 (Bankr. N.D. Cal. Oct. 22, 2020) (“[I]t is appropriate ... to extend exculpation to parties who participated, negotiated, and even ‘pursued’ the Noteholder RSA and countless other documents.”).

<sup>12</sup> *In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717, 721 (Bankr. S.D.N.Y. 2019).

<sup>13</sup> *Id.*

debtors and their emergence from chapter 11.<sup>22</sup> In part based on the RSA, the debtors were able to file their proposed reorganization plan and disclosure statement less than two months after the petition date.<sup>23</sup>

The plan included an exculpation clause that covered the debtors, the unsecured creditors' committee and its members, the DIP lenders and the RSA parties, as well as each exculpated party's employees, directors, agents, professionals and affiliates.<sup>24</sup> The exculpation clause protected these parties from liability for any conduct, in pertinent part, "based on the negotiation, execution, and implementation of any transactions approved by the Bankruptcy Court in the Chapter 11 Cases, including the RSA."<sup>25</sup> The U.S. Trustee objected to the exculpation clause on the grounds that it was overly broad based on the parties covered and the temporal scope.<sup>26</sup> The debtors contended that the exculpation provision was an integral component of the plan that was supported by virtually all creditors.<sup>27</sup>

The bankruptcy court acknowledged that the pre-petition negotiations leading to the RSA ultimately enabled the debtors to obtain DIP financing, fund their post-petition operations and develop the proposed plan.<sup>28</sup> Siding with the debtors, the bankruptcy court held:

[E]xculpation need not be limited to post-petition conduct. A properly crafted exculpation provision (like the Plan's Exculpation Clause) may properly encompass all acts or omissions of the Exculpated Parties — whether occurring pre-petition or post-petition — that relate to or otherwise involve the negotiation of and entry into transactions approved by the Court.... To hold otherwise would penalize, rather than encourage, good-faith efforts to negotiate and resolve restructuring issues consensually in advance of a chapter 11 filing.<sup>29</sup>

## Conclusion

Exculpation should extend to pre-petition conduct in appropriate circumstances. Pre-negotiated and pre-packaged cases involve important pre-petition negotiations that help the debtor fare better once in and upon exiting chapter 11. In such cases, exculpation for RSA parties and their pre-petition conduct incentivizes a fair, transparent, and efficient chapter 11 process. **abi**

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<sup>22</sup> See *id.* at 456.

<sup>23</sup> See *id.* at 462.

<sup>24</sup> *Id.* at 468, n.17.

<sup>25</sup> *Id.* at 467.

<sup>26</sup> *Id.* at 500.

<sup>27</sup> *Id.* at 502.

<sup>28</sup> *Id.* at 504.

<sup>29</sup> *Id.*