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Problems in the Code

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A Modest Proposal on Exculpatory Clauses: Add a Pinch of Certainty to Incentivize Plan Proponents

Editor's Note: For more about the ABI Commission and to obtain a digital copy of its Final Report, visit commission.abi.org.

On Dec. 8, 2014, the ABI Commission to Study the Reform of Chapter 11 proposed changes to the Bankruptcy Code in response to recent developments in case law and evolving standards in the marketplace. While the Commission's proposal addressed many features of the Code, this article focuses on its recommendations regarding the inclusion of exculpatory clauses in chapter 11 reorganization plans. This article also summarizes the ABI Commission's proposals on the subject, including why it thought changes are necessary, and highlights where additional work is needed.

Commission noted, the Bankruptcy Code does not directly address the inclusion of exculpatory clauses in chapter 11 reorganization plans.⁴ Nevertheless, practice teaches us that most chapter 11 plans do contain this type of provision and that many courts approve of them — in one form or another.⁵

The value and importance of clear, easily enforceable exculpatory provisions can hardly be doubted. As the ABI Commission noted, exculpatory clauses provide valuable and justifiable protection to the debtor's directors, officers, employees, advisors and other associated professionals in connection with liabilities that may be incurred in connection with the preparation, solicitation and implementation of chapter 11 plans.⁶ These exculpatory provisions may provide for exculpation with respect to acts or omissions during the case and prior to the plan's effective date.

Since § 1125(e) is not a model of clarity and since the Bankruptcy Code lacks a specific provision authorizing exculpation, case law regarding the propriety of such provisions, the standards for approving them, and their scope is far from consistent. While some courts have approved exculpatory clauses,⁷ others have rejected such clauses, predominantly as they relate to estate professionals.⁸ In reviewing the issue of exculpatory clauses, the ABI Commission determined that such provisions are useful and appropriate when they consist of targeted provisions intended to protect good-faith conduct during a chapter 11 case. Accordingly, the

Exculpatory Clauses: Status Quo, and Why Change Is Needed

Section 1125(e)² of the Bankruptcy Code protects those who solicit acceptances or participate in plan confirmation in good faith from violations of any applicable law, rule or regulation governing solicitation of acceptances, or rejection of a plan or the offer, issuance, sale or purchase of securities (such as the registration requirements of the Securities Act of 1933).³ However, as the ABI

1 The views expressed herein are those of the authors and not necessarily their firm.

2 Section 1125(e) provides:

A person that solicits acceptance or rejection of a plan, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the applicable provisions of this title, in the offer, issuance, sale, or purchase of a security, offered or sold under the plan, of the debtor, or of an affiliate participating in a joint plan with the debtor, or of a newly organized successor to the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule, or regulation governing solicitation of acceptance or rejection of a plan or the offer, issuance, sale, or purchase of securities.

3 These provisions should be distinguished from third-party releases and the discharge afforded to the debtor, which are not addressed herein.

4 ABI Comm'n. to Study Reform of Chapter 11 Final Report and Recommendations (2014) (hereinafter, the "Final Report") at 250.

5 Final Report at 250, n.900.

6 Final Report at 251 (citing *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000), and *In re DBSD N. Am. Inc.*, 419 B.R. 179, 217 (Bankr. S.D.N.Y. 2009)).

7 Final Report at 250, n.900.

8 Final Report at 250, n.903.

Commission proposed that the Bankruptcy Code be amended to explicitly allow the inclusion of exculpatory provisions in chapter 11 plans, provided that they cover parties participating in the chapter 11 case (including estate representatives) and identified in the plan, subject to customary exclusions (e.g., bad acts). As a result, the Commission proposed that §§ 1125(e) and 1129⁹ of the Bankruptcy Code — which set forth fundamental general principles and procedures for plan confirmation — be amended to implement a predictable and uniform standard.¹⁰

A uniform standard would help reduce the need for case-by-case judicial determinations and wasteful litigation regarding the appropriateness and scope of such provisions. By making it easier for parties to predict the degree to which certain actions in support of a plan (e.g., solicitation, issuance of securities, etc.) would — and would not — give rise to liability for breaches of applicable law, such a uniform standard would incentivize third parties such as financial advisors to more vigorously and comprehensively contribute to plan implementation. This, in turn, would make the chapter 11 reorganization process less litigious and more efficient.¹¹

The need for a uniform standard for the treatment of exculpatory clauses in a chapter 11 is highlighted by the variety of approaches that courts follow when considering the approval of exculpatory clauses. Some courts take guidance from cases dealing with the retention of professionals. For example, in *DJS Properties LP v. Don J. Simplot*, the district court explained that “[a]lthough § 328 may not be directly applicable, cases examining exculpatory clauses under § 328 cannot be ignored.”¹² However, other courts analyze exculpatory clauses without reference to principles followed in connection with the retention of professionals.¹³

Several courts, looking to § 328, have held that the Bankruptcy Code does not contain a *per se* rule that makes exculpatory clauses unreasonable as a matter of law.¹⁴ These courts have offered reasoned analyses that can guide the development of a uniform standard. In *In re Comdisco Inc.*, the court stated that the reasonableness of an indemnity clause under § 328¹⁵ of the Bankruptcy Code “can be determined only on an individual basis,” and argued for the following factors in determining whether an indemnity provision — in this case, with respect to a financial advisor — is reasonable under § 328:

- the extent of the debtor’s need for a financial advisor;
- the financial advisor’s experience and level of expertise;

⁹ The ABI Commission was not clear on how it envisions amending § 1129. It simply noted that “[c]onfirmation of the chapter 11 plan under section 1129 should also include the approval and authorization of such permissible exculpatory clauses, provided that adequate disclosure of the scope of, and parties covered by, the exculpatory clause is included in the disclosure statement and the plan.” Final Report at 250 (Recommended Principles).

¹⁰ Final Report at 250 (Recommended Principles).

¹¹ Final Report at 251 (noting that these provisions “encourage[e] the parties to engage in the process and assist the debtor in achieving a confirmable plan”).

¹² *DJS Properties LP v. Don J. Simplot*, 397 B.R. 493, 506 (D. Idaho 2008).

¹³ *Upstream Energy Servs. v. Enron Corp. (In re Enron Corp.)*, 326 B.R. 497, 503-04 (S.D.N.Y. 2005) (analyzing relevant exculpation provision without reference to § 328).

¹⁴ See *Unsecured Creditors’ Comm. v. Pelotsky (In re Thermadyne Holdings Corp.)*, 283 B.R. 749, 755-56 (B.A.P. 8th Cir. 2002) (holding that (1) 11 U.S.C. § 328(a) does not contain a *per se* rule that makes exculpation and indemnification provisions unreasonable as matter of law and (2) exculpation provisions in question were unreasonable based on “factors such as market conditions, current economic conditions, and the potential economic costs to the estate”); *In re Metricom Inc.*, 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (holding that indemnification is not *per se* unreasonable); *In re Comdisco Inc.*, 2002 U.S. Dist. LEXIS 17994, *8-9 (N.D. Ill. 2002) (same).

¹⁵ Section 328(a) of the Bankruptcy Code provides that “[t]he trustee, or a committee appointed under section 1102 of this title, with the court’s approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment.”

- whether and on what terms the financial advisor would agree to remove the indemnity clause;
- whether comparable services are available from another financial advisor without an indemnity clause;
- whether the terms of the agreement were negotiated at arms’ length by all interested parties; and
- whether the creditors support the retention notwithstanding the indemnity clause.¹⁶

However, not all courts grappling with § 328 come to the same conclusion. In *In re Drexel Burnham Lambert Grp. Inc.*,¹⁷ the court rejected the exculpatory clause, instead adopting a *per se* rule because, “[s]imply stated, indemnification agreements are inappropriate.”¹⁸ Citing to a California bankruptcy case, the *Drexel* court stated that professionals, such as investment bankers, are hired based on their professional expertise, and “[i]ndemnification is not consistent with professionalism.”¹⁹

Courts specifically dealing with exculpatory clauses in a chapter 11 plan also provide helpful guidance. Many of these courts maintain that exculpatory clauses might be approved when they are reasonable under the circumstances of the case. In determining reasonableness, such courts generally consider factors such as whether exculpation relates to pre- or post-confirmation conduct, whether the parties’ conduct has been subject to notice and opportunity for filing of objections, and whether the plan has been approved by the classes entitled to vote.²⁰ Such courts also generally consider whether the exculpatory clause under consideration is “reasonable and customary and in the best interests of the estate, in conformity with applicable law and necessary for the negotiation of the [plan in question].”²¹

ABI Commission’s Proposal: What It Says (and Doesn’t Say)

As previously noted, the lack of a uniform standard can lead to unpredictable results that may chill zealous advocacy among architects and supporters of proposed plans. While many courts approve exculpatory clauses, some do not, and — as the foregoing cases demonstrate — it is difficult to predict whether a court will approve the exculpatory clauses contained in a proposed plan. The ABI Commission helped highlight this issue by identifying the gap in the relevant provisions of the Bankruptcy Code. As the Commission noted, the Code’s failure to adopt a more uniform standard leads to varying results depending on the facts at hand at the tribunal in question.²² The ABI Commission also recognizes that the question of whether an exculpatory clause should be enforceable requires a fact-intensive analysis. Largely for this reason, the Commission did not propose specific language or adoption of a particular approach in revising the Bankruptcy Code, but rather set

¹⁶ *In re Comdisco Inc.*, 2002 U.S. Dist. LEXIS 17994, at *15.

¹⁷ *In re Drexel Burnham Lambert Grp. Inc.*, 133 B.R. 13 (Bankr. S.D.N.Y. 1991).

¹⁸ See also *In re Glessner Bros. Inc.*, 102 B.R. 38, 42-43 (Bankr. W.D. Pa. 1989) (rejecting indemnification clause in retention agreement with debtor’s proposed investment bankers).

¹⁹ *Drexel*, 133 B.R. at 27 (citing *In re Mortg. & Realty Trust*, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991)).

²⁰ See *In re Friedman’s Inc.*, 356 B.R. 758, 761-63 (Bankr. S.D. Ga. 2005) (permitting exculpation provisions for professionals whose conduct was found to be transparent and where plan had already been approved by those entitled to vote, but finding portions of exculpation that related to post-confirmation conduct to be unreasonable).

²¹ *In re Enron Corp.*, 326 B.R. at 504; see also *In re PWS Holding Corp.*, 228 F.3d at 246 (finding exculpatory clause to be reasonable where exculpated parties remained liable for gross negligence and willful misconduct).

²² Final Report at 250-51.

forth guiding principles to be used for developing a modernized approach to exculpatory clauses. In short, the ABI Commission proposed the following:

- Exculpatory clauses should include estate representatives (*e.g.*, the debtor in possession, a trustee, an estate neutral, unsecured creditors' committees or committee members) and their respective professionals.
- Exculpatory clauses may include other parties who actively engage and sufficiently contribute to the reorganization or the plan process and, as a result, could be the target of litigation. The sufficiency of a party's contribution is to be determined pursuant to a fact-intensive analysis, instead of objective factors.
- Exculpatory clauses must protect only those who have acted in good faith — not bad actors.
- Exculpatory clauses should indemnify parties for conduct arguably constituting simple negligence; conduct that could constitute gross negligence or "something more" may be subject to exculpation based on the facts of the case and public policy considerations.
- Exculpatory clauses should be properly disclosed in the disclosure statement and the plan.

While helpful in identifying room for improvement in the explicit language of the Bankruptcy Code, the ABI Commission's proposal still leaves open some crucial questions with which courts grapple when determining whether exculpatory clauses are permissible. For example, the Commission did not provide any guidance on the potential inclusion of parties who "sufficiently contributed" to the chapter 11 case in the scope of exculpatory clauses. Instead, it argued that such analysis is best determined on a case-by-case basis. Given the large number of chapter 11 cases filed each year, sufficient data should exist to enable the drafters to provide courts with at least some guidance with respect to categories of parties who would *presumptively* be entitled to the protection of an exculpatory clause. This would strike a balance between predictability and flexibility.

Similarly, the ABI Commission failed to reach a consensus on the allowance of exculpation for standards of conduct other than simple negligence. While the Commission left open the possibility that certain circumstances might warrant the grant of immunity for conduct constituting gross negligence or "something more," it also left such determination to the parties and the court, to be made under the facts of the case and public policy considerations. The recommendation's vagueness does not alleviate the risk of litigation among parties assisting the debtor in the reorganization process, and ultimately does little to incentivize plan participation and management.

Conclusion

The ABI Commission's proposals regarding exculpatory clauses are valuable in highlighting an area of the Bankruptcy Code that is in need of improvement. Ultimately, as the divided case law demonstrates, this improvement should take the form of a more objective, uniform standard. As the Commission stresses, the question of whether exculpatory clauses are enforceable in the context of a given plan must be answered with consideration of the full scope of

relevant factors. Accordingly, a rigid standard would be a poor fix. Rather, the standard should adopt certain guiding principles (with potentially, a few "easy answers" such as the inclusion of categories of actors that can presumptively benefit from the protection of an exculpatory clause) that will remain open to judicial interpretation but promote more uniform judicial determinations. **abi**

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