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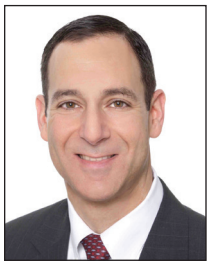
Feature

By Russell C. Silberglied[1]

Creditors' Committee Cannot Obtain Derivative Standing to Sue Fiduciaries of an LLC



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In 2011, the Delaware Court of Chancery surprised many in *CML v. Bax*[2] by holding that creditors of a limited liability company (LLC) cannot be granted derivative standing to sue members, managers or controllers for breach of fiduciary duty — even if the LLC is insolvent. This created a different regime for LLCs than what exists for corporations: The Delaware Supreme Court has made it clear that creditors of an insolvent corporation might be vested with derivative standing to sue officers, directors or controlling stockholders for breach of fiduciary duty.[3]

Shortly after *CML v. Bax*, this author asked the following questions in two separate articles, including one in the *ABI Journal*:[4] What about a creditors' committee? Does *Bax* also preclude a creditors' committee in a chapter 11 case from obtaining standing to sue the fiduciaries of an LLC derivatively? The author noted that if the answer is "yes," the effect on ensuing bankruptcy cases of LLC debtors could be significant.

Somewhat surprisingly, it appears that no reported opinion in the ensuing seven years has addressed the issue. That ended with the Delaware Bankruptcy Court's recent opinion in *Official Committee of Unsecured Creditors of HH Liquidation LLC v. Comvest Group Holdings LLC, et al. (In re HH Liquidation LLC)*.[5] The *HH Liquidation* opinion holds, just as this author predicted in 2011, that creditors' committees of an LLC debtor *cannot* be granted such standing.

Background: *HH Liquidation*

The *HH Liquidation* opinion is a post-trial tome (162 pages in the original slip opinion) addressing a panoply of issues. It will perhaps be most well-known for its analysis of substantive-consolidation claims, but it also treats, at length, claims of fraudulent transfer, breach of fiduciary duty, unjust enrichment and other theories. While the facts of the case are, in a sense, irrelevant to the standing issue described in this article, the background is unusual and quite interesting.

The debtors filed chapter 11 cases a mere few months after closing on a sale whereby Haggen, then a grocery store chain with only 18 stores, purchased 146 grocery stores from Safeway and Albertsons. The court candidly acknowledged that "[i]t is unnerving that the Project failed in a matter of months and certainly the Court had questions about how it happened."[6] It ultimately found that the committee "failed to establish gross negligence or self-dealing or the existence of any fraudulent transfers."[7] It also rejected the notion that structuring the "project" (*i.e.*, the purchased stores) into two sets of companies (an operating company group and a group that owned the real estate) was "inherently wrong," nor were the fiduciaries "so cavalier in planning and effectuating" that structure as to render them grossly negligent.[8]

However, these are post-trial findings. Procedurally, what is noteworthy is that approximately

1 The views set forth herein are those of the author and not necessarily of Richards, Layton & Finger, PA or its clients.
2 *CML V LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010).
3 *See N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).
4 Russell C. Silberglied, "Can a Creditors' Committee Be Granted Standing to Sue for Breach of Fiduciary Duty?," XXX *ABI Journal* 2, 16, 68-69, March 2011, *available at* abi.org/abi-journal; Russell C. Silberglied, "LLCs Are Different: Creditors of Insolvent LLCs Do Not Have Standing to Sue for Breach of Fiduciary Duty, But Can a Creditors' Committee Be Granted Standing?," 20 *J. Bankr. L. Prac.* 2, Art. 3 (April 2011) ("Norton Article"; collectively, the "Articles").
5 Del. Bankr. Jan. 22, 2018 (currently on appeal) (the "Opinion").
6 Opinion, *slip op.* at 4.
7 *Id.*
8 *Id.* at 3.

four months post-petition, the court approved a stipulation between and among the creditors' committee, the debtors and what ultimately became certain corporate defendants, "Granting Derivative Standing to the Official Committee of Unsecured Creditors to Commence Litigation" against certain parties to the stipulation.[9] Three months later, the committee and debtors entered into a separate, second stipulation, "Granting Derivative Standing to the Official Committee of Unsecured Creditors to Commence Litigation Against Haggen SLB, and/or its Past and/or Present Directors and Officers."[10]

Given that the parties *stipulated* to committee standing, one might ask why standing was an issue at the post-trial stage. The court held that as a general proposition, "a standing order does not act as a bar to raising standing issues."[11] For example, in *Adelphia* (the case cited by the court with approval), the court held that a prior standing order only addressed "the question of which party — the Debtors or the Creditors' Committee — would be authorized to prosecute any claims on behalf of the Debtors' estates.… [It] did not reach the question of whether the Creditors' Committee had standing to prosecute specific claims."[12]

The *HH Liquidation* opinion also noted that the stipulations reserved "all defenses," and that the defendants raised standing as an affirmative defense. Moreover, while standing is often something that would be determined in a pre-trial motion to dismiss, the court held that standing "implicates subject-matter jurisdiction," which might be raised at any time by a party or *sua sponte*.[13] Thus, the court considered the *CML v. Bax* issue post-trial.

The Holding

The court rendered its opinion on the derivative standing issue as an alternative holding "separately and independently from the merits of the fiduciary duty claims."[14] In other words, while it had already analyzed in detail why the evidence presented at trial did not support any claim on the merits, the court held that in any event the creditors' committee lacked standing.

The court's holding was a simple application of *CML v. Bax*. It noted the opinion's literal interpretation of the first few phrases of 6 Del. C. § 18-1002, entitled "Proper Plaintiff": "In a derivative action, the plaintiff must be a member or an assignee of [an LLC] interest."[15] The court simply said, "The Committee is neither a member nor an assignee. Under the plain language of the statute, the Committee has no standing to bring a breach of fiduciary duty claim."[16] The court distinguished an opinion that allowed a chapter 7 trustee to sue fiduciaries of an LLC debtor for breach of fiduciary duty.[17] It held:

> Unlike a Chapter 7 trustee, which is empowered by statute to act as "the sole representative of the estate with the authority to sue and be sued," a creditors' committee is a collection of unsecured creditors. *Id*. Its rights to assert derivative claims are limited to the derivative standing of its members, none of whom have standing as creditors of a Delaware LLC to assert derivative claims for breach of fiduciary duty on behalf of the company.[18]

This, too, was what this author had predicted in the 2011 Articles:

> [W]here a chapter 7 or 11 trustee is asserting the claim, it is exercising the power granted to it by the Bankruptcy Code to operate the company's assets, including litigation, in the same manner as a board of directors usually acts on a company's behalf under Delaware corporate law. It is not a "derivative" claim, so *Bax* does not affect such suits.[19]

The court did not address two arguments previously considered, but that the author believed lacked merit. First, it did not consider whether the Constitution's supremacy clause overrides *Bax* within a bankruptcy case. The author continues to believe that it should not: "Since there is no [Bankruptcy] Code section directly addressing and negating 6 Del. C. § 18-1002, it is difficult to see how the Code could be held to override applicable state law."[20] Second, it did not address whether the type of derivative standing that a bankruptcy court might grant a creditors' committee is somehow different than derivative standing that might be granted, for example, in the Delaware Court of Chancery. For reasons described at length in prior articles, the author continues to believe there is no such distinction.[21]

Implications on Future Cases

It is surprising that no reported opinion has addressed this issue in the seven years since *Bax* was decided. The author personally has been involved in certain cases where the issue simply was not raised, and that has likely occurred in many cases. However, now that a written opinion has been issued on the subject, the issue is likely to recur in future cases.

Thus, if a creditors' committee believes that the estate has valuable claims against insiders for breach of fiduciary duty, the committee should consider the options originally outlined in one article.[22] These include ones described in the Third Circuit's *Cybergenics* opinion, which, in holding that bankruptcy courts have the power to grant derivative standing to a creditors' committee to assert fraudulent-transfer claims, noted that other options included the appointment of a chapter 11 trustee or examiner, conversion to chapter 7 or requiring the debtor in possession to file suit. Unfortunately, while those options exist, the *Cybergenics* court aptly described that most of those options "amount to replacing the scalpel of a derivative suit with a chainsaw."[23]

A more promising alternative is to have the debtor assign its direct claims to a litigation trust controlled by either an

9 *Id.* at 12.
10 *Id.*
11 *Id.* at 125 (citing *In re Adephia*, 390 B.R. 80 (Bankr. S.D.N.Y. 2008)).
12 *Adelphia*, 390 B.R. at 88-89.
13 Opinion, *slip op.* at 125 (internal citations omitted).
14 *Id.*
15 6 Del. C. § 18-1002. While the quoted excerpt would appear to have made the *Bax* opinion obvious, it should be noted that the rest of the statute reads "at the time of bringing the action and ... at the time of the transaction of which the plaintiff complains [or other alternatives]." Thus, until *Bax*, most had simply thought of this statute as the LLC Act's incorporation of the so-called "contemporaneous ownership requirement," governing when a member must hold its equity interest in order to qualify as a derivative plaintiff, rather than a requirement that creditors could not become derivative plaintiffs. *See ABI Journal* March 2011 article at 16, 68.
16 Opinion, *slip op.* at 126.
17 *Id.* (distinguishing *In re Golden Guernsey Dairy LLC*, 548 B.R. 410, 413 (Bankr. D. Del. 2015)).
18 *Id.* (quoting *Golden Guernsey*, 548 B.R. at 413).
19 *ABI Journal* March 2011 article at 68 (internal citations omitted).
20 *Id.* at 69.
21 *Id.*
22 Norton Article at 259-60.
23 *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 577 (3d Cir. 2003) (internal quotation omitted).

independent trustee or someone the creditors' committee has appointed.[24] The trust would not be suing derivatively (*i.e.*, on the estate's behalf); rather, it would be asserting claims that it owns by way of assignment. Thus, while there does not appear to be an opinion confirming the point, *Bax* and *HH Liquidation* should not affect such a suit. Such an assignment often is made pursuant to a plan, but conceptually it need not be; there is no apparent reason why a debtor could not assign a claim during the course of a chapter 11 case if it obtains court approval (such an assignment would certainly be outside of the ordinary course of business)[25] and does not dictate class-skipping of distributions or similar terms.[26]

The bigger issue would be convincing a debtor to make such an assignment outside of a plan. After all, if the debtor believed that such claims should be brought, it could just file them itself directly. Moreover, a debtor might be more willing to assign claims in the context of a plan because it brings finality to a case and because the debtor receives something in return — the committee's support for a plan — than the debtor would during the course of the chapter 11 case.

A bankruptcy judge could put the debtor to a Hobson's choice in an appropriate circumstance: Agree to assign the claims, or have a trustee appointed.[27] Unless a statute of limitations is approaching or some other unusual factor is present, a bankruptcy judge would likely leave such an issue to the plan process rather than prematurely alter the playing field.

Finally, as previously suggested in one article on the topic, if the chapter 11 is of multiple affiliated debtors, only some of which are LLCs, it might be possible to avoid the result in *Bax* and *HH Liquidation* by having the committee sue at the corporate level.[28] For example, if a corporate debtor is the sole manager of its subsidiary LLC debtor, the committee of the parent could seek derivative standing to act on behalf of the corporate debtor, which then would sue other fiduciaries (such as officers) of the LLC subsidiary debtor directly. No case has addressed whether this structure would provide a workaround to the *Bax* issue.

Conclusion

HH Liquidation confirms that at least the Delaware Bankruptcy Court has interpreted *Bax* in the manner anticipated in the 2011 articles. The opinion is currently on appeal, so there is the possibility that it could be reversed and other courts could reach a different conclusion. Until then, when a creditors' committee of an LLC debtor believes that there are valuable causes of action against fiduciaries that the debtor refuses to pursue, it would be well advised to consider the alternatives described herein or others. abi

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24 Norton Article at 259-60.
25 *See* 11 U.S.C. § 363.
26 *See Czyzewski, et al. v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017).
27 Norton Article at 262, n.43.
28 *Id.* at 260.