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Delaware Bankruptcy Court Grants Derivative Standing to Creditors' Committee of Debtor LLC

*By Heather Cantu Montoya, Lisa Kim and Barbra R. Parlin**

In this article, the authors review a decision by the U.S. Bankruptcy Court for the District of Delaware holding that bankruptcy courts have authority to grant creditors' committees derivative standing to assert claims belonging to the estate in cases involving debtors that are limited liability companies.

In a recent opinion, *In re Pack Liquidating, LLC (Pack Liquidating)*,¹ the U.S. Bankruptcy Court for the District of Delaware (the Delaware Bankruptcy Court) held that under *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (Cybergenics)*,² bankruptcy courts have authority to grant creditors' committees derivative standing to assert claims belonging to the estate in cases involving debtors that are limited liability companies (LLCs).³

According to the *Pack Liquidating* decision, bankruptcy courts' authority to grant a creditors' committee derivative standing is derived from federal law.⁴ As such, even if the Delaware Limited Liability Company Act (DLLCA) intended to preclude the bankruptcy court from authorizing committee standing, the U.S. Bankruptcy Code (Code) preempts the DLLCA.⁵

IMPLICATIONS OF *PACK LIQUIDATING*

In its recent decision in *Pack Liquidating*, the Delaware Bankruptcy Court concluded that the DLLCA does not bar the bankruptcy court from authorizing a creditors' committee to assert what would otherwise be derivative claims on behalf of the bankruptcy estate. Prior to *Pack Liquidating*, Delaware case law precluded the bankruptcy court from granting creditors' committees standing to sue managers and officers of insolvent LLCs on behalf of the bankruptcy estate.

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¹ *In re Pack Liquidating, LLC*, No. 22-10797 (Bankr. Del. Feb. 2, 2024).

² *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (Cybergenics)*, 330 F.3d 548 (3d Cir. 2003) (en banc).

³ *Pack Liquidating*, supra n.2.

⁴ *Id.*

⁵ *Id.*

Judge Craig Goldblatt's decision in *Pack Liquidating* found that the creditors' committee standing to assert derivative LLC claims is governed by federal law, rather than state law.

If followed, the *Pack Liquidating* decision will change the playing field for committees in LLC cases, potentially leaving LLC managers and other parties involved in operating a debtor LLC prepetition open to liability for their actions.

The *Pack Liquidating* decision may encourage out-of-court restructurings and discourage filings under Chapter 11 of the Code in the U.S. District Court for the District of Delaware for LLCs to limit actions against managers and officers.

DERIVATIVE ACTIONS UNDER DELAWARE LAW

Derivative actions are claims that shareholders pursue “on behalf of the corporation, that the corporation itself could have enforced in court.”⁶ Shareholders may bring various derivative actions on behalf of a corporation, including actions related to breach of fiduciary duties, breach of the duty of care, breach of the duty of loyalty, bad faith actions, unjust enrichment, and aiding and abetting the breach of fiduciary duties, and other claims.⁷ The purpose of derivative standing is to prevent injustice when a corporation's rights and interests would not be protected because the board of directors does not act.⁸

Derivative actions are creatures of state law.⁹ Under Delaware law, creditors “replace shareholders as residual beneficiaries of an increase in corporate value” when a corporation becomes insolvent.¹⁰ As such, Delaware state courts routinely authorize creditors of an insolvent corporation to bring derivative claims on behalf of the company.

Under the DLLCA, the law governing LLCs, derivative actions likewise are permitted. The DLLCA specifies that “[a] member or an assignee of a limited liability company interest may bring an action in the Court of Chancery in the

⁶ *Pack Liquidating*, supra n.2 (citing *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984)).

⁷ *CML V, LLC v. Bax*, 28 A.3d 1037, 1040 (Del. 2011); *In re HH Liquidation, LLC*, 590 B.R. 211, 219 (Bankr. D. Del. 2018).

⁸ *Schoon v. Smith*, 953 A.2d 196, 202 (Del. 2008) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981)).

⁹ *Pack Liquidating*, supra n.2.

¹⁰ *Id.* (citing *North Am. Catholic Ed. Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)).

right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.”¹¹

In *CML V, LLC v. Bax (CML)*,¹² a 2011 decision, the Delaware Supreme Court held that Section 18-1002 of the DLLCA precluded a creditor from asserting claims belonging to an LLC against the company’s managers on a derivative basis.¹³ The *CML* court’s decision was premised upon the fact that the entity at issue was an LLC, and the creditor was neither a member nor an assignee of a member of that LLC.

The DLLCA does not specifically state that a creditor of an insolvent LLC is not permitted to bring a derivative action in the name of the LLC. As such, in *CML, CML V LLC (CML)*, a creditor of the insolvent LLC debtor, asserted claims against the debtor’s managers derivatively on behalf of the debtor in the Delaware Chancery Court. CML’s claims included breach of the duty of care claims and bad faith claims. CML also asserted breach of the duty of loyalty claims against some of the individual defendants in the case. The defendants moved to dismiss, arguing that CML did not have standing to pursue a derivative action under Section 18-1002 of the DLLCA because CML was not a member or assignee of a member of the debtor.

The Delaware Supreme Court agreed with the defendants, relying on Section 18-1002 of the DLLCA, which states that when claims belonging to an LLC are asserted on a derivative basis, the “plaintiff must be a member or assignee” of the LLC. Since CML was a creditor and not a member or assignee of a member, the court held that CML did not have standing and that Section 18-1002 of the DLLCA precludes creditors of the insolvent LLC debtor from having derivative standing.

The *CML* court arrived at its conclusion through discussion of “the plain meaning” of the statute and supposed lack of ambiguity in the language of Section 18-1002 of the DLLCA. The court further analyzed whether its interpretation of the DLLCA provision was constitutional. The court found that it had no equitable power to extend derivative standing outside the context of corporations. In fact, the court noted that CML could have negotiated its remedies through contract, such as negotiating for provisions that creditors’ interests would convert to that of an assignee if the LLC became insolvent.

¹¹ DLLCA § 18-1001.

¹² *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011).

¹³ *Id.*

Since *CML*, lower state courts in Delaware have followed that decision and held that LLC creditors lack standing to bring derivative claims against an insolvent LLC.¹⁴ Bankruptcy courts sitting in the district of Delaware also followed *CML*, finding that derivative claims can be brought only by members or assignees of LLCs.¹⁵ These holdings effectively prevented creditors' committees in LLC cases from using the threat of litigation to negotiate better terms on behalf of their constituents.

DERIVATIVE ACTIONS UNDER BANKRUPTCY LAW

Once a company files for relief under the Bankruptcy Code, all of its assets, including causes of action arising before the filing, become assets of the estate. The Bankruptcy Code provides that the trustee appointed to oversee the debtor's estate (or the debtor-in-possession in a Chapter 11 case) is authorized in the first instance to pursue such claims, as well as any avoidance actions that may arise under the Bankruptcy Code on behalf of the estate.

In cases involving corporations as debtors, bankruptcy courts routinely grant standing to other parties, including official committees appointed in cases, to pursue prepetition claims belonging to the debtor, as well as avoidance actions for the benefit of the estate.¹⁶

THE *PACK LIQUIDATING* DECISION

In *Pack Liquidating*, the Delaware Bankruptcy Court came to a very different conclusion than the Delaware Supreme Court's decision in *CML* when it was faced with determining whether the DLLCA bars the bankruptcy court from

¹⁴ See *Quadrant Structured Prod. Co., Ltd. v. Vertin*, 102 A.3d 155, 178 (Del. Ch. 2015) (holding Section 327 of the Delaware General Corporation Law "limits derivative standing to a subset of those stockholders who otherwise would have standing to sue at common law" (citing *CML*, 28 A.3d at 1044)); *Trusa v. Nepo*, No. CV 12071-VCMR (Del. Ch. Apr. 13, 2017) (holding a creditor lacked standing to bring derivative claims (citing *CML*, 28 A.3d at 1043)).

¹⁵ See *In re PennySaver USA Publ'g, LLC*, 587 B.R. 445, 466-67 (Bankr. D. Del. 2018) ("The Trustee must allege that the creditors are members or assignees of the Debtors' LLCs to have standing to bring derivative claims."); *In re HH Liquidation, LLC*, 590 B.R. 211, 285 (Bankr. D. Del. 2018) (holding that a creditors' committee does not have standing to assert derivative claims of breach of fiduciary duty on behalf of the company).

¹⁶ See *In re Draw Another Circle.*, 602 B.R. 878, 901 (Bankr. D. Del. 2019) ("The creditors of an insolvent corporation have standing to bring derivative actions against directors for breach of fiduciary duty."); *In re TOCFHBI, Inc.*, 413 B.R. 523, 539 (Bankr. N.D. Tex. 2009) ("[C]reditors [] have standing to prosecute [a breach of fiduciary duty] cause of action on behalf of a corporation if a court gives them derivative standing.").

authorizing a creditors' committee to assert what would otherwise be derivative claims on behalf of the bankruptcy estate.¹⁷

The lead debtor in *Pack Liquidating* was Packable Holdings LLC (Packable), a Delaware LLC that filed for relief under Chapter 11 on August 8, 2022.¹⁸ Packable and its affiliates ran an e-commerce business for health and beauty products at online marketplaces in North America. Some of Packable's managers also held positions as officers of the LLC.¹⁹

Postpetition, the Official Committee of Unsecured Creditors filed a motion requesting authority from the bankruptcy court to bring breach of fiduciary duty claims on behalf of the estate.²⁰

Departing from prior decisions, the *Pack Liquidating* court held that the bankruptcy court's authorization of a creditor's committee to bring a claim on behalf of the estate is not subject to the DLLCA.²¹ Instead, the court found that it was bound by the *Cybergenics* decision, in which the U.S. Court of Appeals for the Third Circuit held that "Congress approved of creditors' committees suing derivatively to recover property for the benefit of the estate."²²

Judge Goldblatt differentiated between "*Cybergenics* actions" and state law derivative actions.²³ Judge Goldblatt described a *Cybergenics* action as "a decision authorizing a committee to assert an estate cause of action."²⁴ According to Judge Goldblatt, a derivative action is a state law procedural tool.²⁵

Judge Goldblatt acknowledged the *CML* decision and the relevant provisions of the DLLCA, but he emphasized that those provisions govern state law derivative actions and do not affect *Cybergenics* actions.²⁶

¹⁷ *Pack Liquidating*, supra n.2.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Motion of the Official Committee of Unsecured Creditors for an Order Confirming the Committee's Leave, Standing and Authority to Commence, Prosecute and Settle Certain Claims on behalf of the Debtors' Estates at 2, *In re Pack Liquidating, LLC*, No. 22-10797 (Bankr. Del. Feb. 2, 2024).

²¹ *Pack Liquidating*, supra n.2.

²² *Cybergenics*, 330 F.3d at 566.

²³ *Pack Liquidating*, supra n.2.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

Judge Goldblatt discussed the three main reasons for the Third Circuit's conclusion in *Cybergenics*:

- (1) “[T]he bankruptcy court’s authority to authorize a committee to pursue an estate cause of action [is] an implicit part of this overall congressional design”;²⁷
- (2) The bankruptcy court’s authority to grant derivative standing is implied in the Bankruptcy Code;²⁸ and
- (3) The Bankruptcy Code retains the courts’ equitable principles that courts relied on prior to the Bankruptcy Code’s enactment.²⁹

Judge Goldblatt found *Cybergenics* to be binding on the Delaware Bankruptcy Court and determined that the Third Circuit’s three reasons “point[] unmistakably to the Bankruptcy Code rather than state law as the source of authority for granting committee standing.”³⁰

Even though *Cybergenics* involved committee standing for avoidance actions under Section 544 of the Bankruptcy Code, Judge Goldblatt found the Third Circuit’s ruling extends to other causes of action.

Further, Judge Goldblatt determined that the court had an obligation to adhere to the Third Circuit precedent even if it countered other judicial opinions issued in the same court.³¹ Judge Goldblatt issued the *Pack Liquidating* decision acknowledging its divergence from other decisions of the court.³²

Thus, the *Pack Liquidating* decision allows creditor committees to bring derivative actions against LLC members in the Delaware Bankruptcy Court, unhindered by Section 18-1002 of the DLLCA.³³

²⁷ Id.

²⁸ Id. (quoting *Cybergenics*, 330 F.3d at 566).

²⁹ Id.

³⁰ Id.

³¹ Id.

³² Id.

³³ Bankruptcy courts in other jurisdictions have reached similar conclusions without distinguishing between LLCs and corporations. In *re Bear Communications, LLC*, No. 21-10495-11 (2021) (mem. op.) (granting a creditors’ committee derivative standing to bring claims on behalf of the LLC debtor); In *re Palm Ave. Partners, LLC*, 611 B.R. 457, 471 (Bankr. M.D. Fla. 2019) (granting the investors of a debtor LLC standing to pursue derivative claims as creditors on behalf of the estate); In *re Know Weigh, L.L.C.*, 576 B.R. 189, 206 (Bankr. C.D. Cal. 2017) (holding that the bankruptcy court could permit parties other than trustees or debtors in possession to bring claims on behalf of the estate in a case in which the debtor was an LLC); In *re SGK Ventures, LLC*, 521 B.R. 842, 846 (Bankr. N.D. Ill. 2014) (mem. op.) (holding the creditors’ committee had standing to bring an adversary proceeding on behalf of an LLC’s estate).