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Bankruptcy Court Grants Creditors Standing to Pursue Claims Against Delaware LLC Directors and Officers

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Recently, in *In re Pack Liquidating LLC*,[1] Hon. Craig T. Goldblatt of the U.S. Bankruptcy Court for the District of Delaware granted derivative standing to the official committee of unsecured creditors to pursue breach-of-fiduciary-duty claims against the company's founders on behalf of the debtors' estates. This holding is notable because Judge Goldblatt departed from the prior decisions of other judges in the Delaware Bankruptcy Court, which had previously held that the Delaware Limited Liability Company Act (DLLCA) precludes bankruptcy courts from granting standing to committees to pursue such causes of action on behalf of limited liability

companies.

In this case, the committee filed an adversary proceeding against the company's founders asserting, among other things, breach-of-fiduciary-duty claims due to mismanagement and self-dealing. The defendants argued that under the DLLCA and related case law, the committee could not bring these causes of action because only members of a Delaware limited liability company or the company's assignees may be given derivative standing to act on behalf of the company.

Section 18-1002 of the DLLCA describes who can be a plaintiff in a state law derivative action, and it identifies only members or assignees of limited liability company interests at the time of bringing the action.[2] The Delaware Supreme Court in *CML V LLC v. Bax* (a case not involving a bankruptcy) held that the DLLCA means what it says — that creditors of a limited liability company cannot bring derivative actions on behalf of the company; their sole recourse is to negotiate a contractual protection that may be enforced directly against such potential defendants, without derivative standing.[3] Subsequently, three other judges of the Delaware Bankruptcy Court issued decisions denying official creditors' committees derivative standing in reliance on this case and its reasoning.[4]

However, the court in *In re Pack Liquidating* disagreed with these prior bankruptcy court decisions, noting that they cannot be "squared with the Third Circuit's *en banc* opinion in *In re Cybergenics*, which treats the authority to grant a committee derivative standing to pursue an estate claim as one that stems from the Bankruptcy Code rather than state law."[5]

The court determined that under *Cybergenics*, an order granting a committee standing to pursue estate claims is a tool that is provided by federal bankruptcy law that does not depend on state law at all and found it notable that the *Cybergenics* court did not refer to any state law in authorizing derivative standing in that case. Instead, the *Cybergenics* court found derivative standing implicit in the Bankruptcy Code.

Specifically, the *Cybergenics* court gave three reasons for its conclusion. *First*, the power to grant derivative standing is a "lesser power" that can be implied from the court's greater powers to displace management by appointing a chapter 11 trustee or examiner or to convert chapter 11 cases to cases under chapter 7. Where the debtor-in-possession is unable or unwilling to meet its statutory obligation to serve as a faithful trustee, it is appropriate to

grant standing to an official committee that is willing to ensure that claims are pursued for the benefit of creditors and other stakeholders.

Second, the *Cybergenics* court found that the power to grant derivative standing is implied from (1) § 1109(b) of the Bankruptcy Code, which expressly authorizes a creditors' committee to appear and be heard on any issue in the chapter 11 case; (2) § 1103(c)(5), which permits an official committee to perform such other services as are in the interest of those represented; and (3) § 503(b)(3)(B), which contemplates the allowance of an administrative claim for a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor.

Third, the *Cybergenics* court found that the Bankruptcy Code preserved the court's residual equitable authority (commonly exercised pre-Code) to grant derivative standing — not only to a "trustee" as identified in §§ 544 and 506(c), but also to a committee when a trustee declines to assert a valuable claim.

Essentially, the court found that "*Cybergenics*[']s actions and state-law derivative actions are simply two different kinds of creatures"**[6]** and that any restrictions on state law derivative actions imposed by the DLLCA have no bearing on the bankruptcy court's ability to grant standing in a bankruptcy case. In the alternative, the court held that even if the DLLCA had purported to prevent a bankruptcy court from granting standing to the committee, it would be preempted by the Bankruptcy Code.**[7]**

The court acknowledged that judges in a multi-judge trial court generally seek to pursue uniformity to provide clarity, predictability and consensus. But the court here found that its obligation to adhere to binding Third Circuit precedent — *Cybergenics* — must come ahead of its desire to achieve consensus. The court noted that the three prior bankruptcy court decisions did not address the application of *Cybergenics* at all, and in two of those cases, *PennySaver* and *Citadel Watford*, the plaintiffs had direct claims for breach of fiduciary duty, so it was unclear why the court analyzed those as derivative claims.**[8]** For these reasons, the court disagreed with the prior bankruptcy court decisions and granted standing to the committee to pursue breach-of-fiduciary-duty claims, notwithstanding the DLLCA and *Bax*.

This decision appears to be a great victory for official creditors' committees and unsecured creditors of Delaware limited liability companies. However, this decision is not binding on other courts, and for now, there may be uncertainty in Delaware as to whether standing will be

granted to committees seeking to bring breach-of-fiduciary-duty claims involving limited liability companies. The result may depend on the judge appointed in an individual case until the decisions are further reconciled.

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[1] *In re Pack Liquidating LLC*, 2024 Bankr. LEXIS 241, 2024 WL 409830 (Bankr. D. Del. Feb. 2, 2024).

[2] 6 Del. C. § 18-1002.

[3] 28 A.3d 1037.

[4] *See In re HH Liquidation LLC*, 590 B.R. 211 (Bankr. D. Del. 2018) (KG); *In re PennySaver USA Publishing LLC*, 587 B.R. 445 (Bankr. D. Del. 2018) (CSS); and *In re Citadel Watford City Disposal Partners L.P.*, 603 B.R. 897 (Bankr. D. Del. 2019) (KJC).

[5] *Pack* at 3.

[6] *Pack* at 4.

[7] *Pack* at 27. Separately, the court made a distinction between the substantive provisions that allow companies to expand, restrict or eliminate fiduciary duties in their operating agreements, and the procedural provisions that dictate who may sue derivatively under state law. With respect to the former, the state law provisions would control; with respect to the latter, federal bankruptcy law would govern. *Pack* at 10-17.

[8] In *PennySaver,* the plaintiff was chapter 7 trustee, and in *Citadel Watford*, the plaintiff was a post-confirmation trust, which was a successor to the debtor.