



AMERICAN
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2020 Mid-Atlantic Virtual Bankruptcy Workshop

Bax Decision

Amanda R. Steele, Moderator

Richards, Layton & Finger, PA | Wilmington, Del.

Hon. Michael B. Kaplan

U.S. Bankruptcy Court (D. N.J.) | Trenton

Stacy A. Lutkus

McDermott Will & Emery | New York

Curtis S. Miller

Morris, Nichols, Arsht & Tunnell LLP | Wilmington, Del.

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August 6, 2020

Amanda R. Steele – *Richards, Layton & Finger, PA*

The Honorable Michael B. Kaplan – *U.S. Bankruptcy Court (D. N.J.)*

Stacy A. Lutkus – *McDermott Will & Emery*

Curtis S. Miller – *Morris, Nichols, Arsht & Tunnell LLP*

Today's Panel



Amanda R. Steele, Moderator
Richards, Layton & Finger
Director



Hon. Michael B. Kaplan, Panelist
U.S. Bankruptcy Court (D. N.J.)
Chief Judge



Stacy A. Lutkus, Panelist
McDermott Will & Emery
Counsel



Curtis S. Miller, Panelist
Morris, Nichols, Arsht & Tunnell
Partner

Overview of *Bax* Decision

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CML V LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010): JetDirect Chancery Court Action

- CML – junior secured creditor of JetDirect Aviation Holdings, LLC
- CML brought derivative claims in Delaware Court of Chancery against JetDirect’s present and former managers for:
 1. Breach of standard of care in approving four major acquisitions despite lacking sufficient information regarding JetDirect’s financial condition
 2. Acting in bad faith by failing to maintain and monitor adequate internal controls
 3. Breach of duty of loyalty against certain managers for negotiating self-interested sales of assets to entities they controlled during JetDirect’s liquidation process
- Chancery Court granted defendants’ motion to dismiss
- Ruling: CML, as a creditor, lacked standing under Section 18–1002 of Delaware’s LLC Act to pursue derivative claims
 - The plain meaning of the statute is unambiguous
 - Comparable derivative standing provisions in Delaware’s LP Act and the statutory origins of Delaware’s alternative entity standing provisions support the Court’s ruling

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CML V LLC v. Bax, 28 A.3d 1037 (Del. 2011):
Delaware Supreme Court Decision

- CML Affirmed Chancery Court’s decision
The plain language of 6 Del. C. §18–1002 is unambiguous and limits derivative standing in LLCs *exclusively* to “member[s]” or “assignee[s].” *Id.* at 1041.
- Plain reading of the statute does not produce an absurd result
 - LLCs and corporations are different legal entities that offer different bundles of rights
 - LLCs afford creditors flexibility in negotiating their rights through the LLC agreement
 - Logical for Delaware General Assembly to limit derivative standing in the LLC context
- Section 18–1002 is constitutional
 - Delaware Constitution only prohibits the Delaware General Assembly from limiting the Chancery Court’s equity jurisdiction to prevent failures of justice in the corporate context
 - Even if Chancery Court had jurisdiction to extend derivative standing for LLCs, this jurisdiction should be exercised only absent an adequate remedy at law
 - Creditors of LLCs have the opportunity to negotiate their remedies by contract
 - A creditor’s failure to adequately protect its remedies does not “threaten the interests of justice” to justify extending the Chancery Court’s equity jurisdiction (*Id.* at 1046)

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Cases Addressing
CML V, LLC v. Bax and the Ability of Bankruptcy
Estate Representatives to Pursue Derivative Claims

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Tow v. Amegy Bank N.A., 976 F. Supp. 2d 889, 904 (S.D. Tex. 2013)

- Partnership's bankruptcy trustee brought action against former limited partner and his affiliated companies, alleging that defendants conspired with general partner to breach fiduciary duties owed to partnership. District court granted SJ in favor of Defendants finding, in part, that the bankruptcy trustee lacked derivative standing to sue limited partner for breach of fiduciary duties allegedly owed to partnership ("Read literally, the provisions prevent creditors from suing on behalf of the partnership, and Delaware courts historically have interpreted" the provisions as giving the partners exclusive rights to sue for breach of another party's fiduciary duties to them. *CML V, LLC v. Bax*, 6 A.3d 238, 245 (Del.Ch.2010), *aff'd* 28 A.3d 1037 (Del.2011)).

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Bank of Am., N.A. v. Knight, 875 F. Supp. 2d 837 (N.D. Ill. 2012), *aff'd*, 725 F.3d 815 (7th Cir. 2013).

- Lender brought action against borrower limited liability companies (LLCs) and their directors, officers, controlling members, and auditors, alleging that individual defendants abused their positions of authority and control to loot the LLCs by diverting assets and opportunities to other companies they owned or controlled. Lender had been assigned claims by the bankruptcy trustee for the holding company. Defendants argued that under *Bax*, lender had no standing to pursue claims. The Court noted that debtor, as a member, held a right under Delaware law to bring derivative suits, but that the lender had not brought the claims derivatively on behalf of all creditors, but, rather, sought to recover its specific damages only for itself, and, thus, the claims were direct actions unavailable under Delaware law.

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Refco Grp. Ltd., LLC v. Cantor Fitzgerald, L.P., No. 13 CIV. 1654 RA, 2014 WL 2610608 (S.D.N.Y. June 10, 2014)

- Reorganized Debtor (“RGL”) brought a variety of claims under Delaware and N.Y. law on behalf of nominal defendants, as well as its own behalf, alleging that defendants orchestrated self-interested transactions to siphon assets away from the subsidiaries of a limited partnership in which RGL held a 10% interest. Defendants move to dismiss for lack of standing. Defendants argued that RGL did not have standing to maintain action because the Plan governing RGL's bankruptcy had assigned all of RGL's claims to a Litigation Trust. RGL contends that, while the Plan could be read as assigning RGL's direct claims to the Litigation Trust, it could not have assigned RGL's derivative claims. Citing to *Bax*, the Court concluded that the Delaware Revised Uniform Limited Partnership Act (“DRULPA”) imposes strict limits on derivative standing. The Litigation Trust was neither a partner nor an assignee of any partnership interest and therefore would lack standing to bring RGL's derivative claims. The Court found it implausible that the Plan would have transfer RGL's derivative claims separately from the underlying partnership interest and thereby extinguish them entirely.

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In re Golden Guernsey Dairy, LLC, 548 B.R. 410 (Bankr. D. Del. 2015)

- In this case, Judge Gross determined that a trustee could pursue fiduciary duty claims held by the debtor LLC as the “sole representative of the estate, with the authority to sue and be sued. Judge Gross ruled that the Trustee has a statutory mandate to pursue the estate's interests, including all direct and derivative claims. Thus, the trustee has standing when he is stepping into the debtor's shoes, asserting a fiduciary duty claim that belonged to the debtor. Likewise, a debtor in possession should have the same ability to pursue a claim held by the debtor for breach of fiduciary duty.

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In re HH Liquidation, LLC, 590 B.R. 211, 284 (Bankr. D. Del. 2018)

- In *HH Liquidation, LLC*, the Delaware bankruptcy court (Judge Gross) considered whether an official committee of unsecured creditors had standing to pursue derivative claims on behalf of a Delaware LLC. In that case, the committee asserted a seventy-eight count complaint, which included claims for fraudulent transfer, breach of fiduciary duty and unjust enrichment. The bankruptcy court ruled that the LLC Act is “clear and unambiguous about who can bring a derivative action: the plaintiff ‘must be a member or an assignee.’” citing 6 Del. C. § 18-1002. The court reasoned that because the committee was neither a member nor an assignee, it did not have standing to bring a breach of fiduciary duty claim. Judge Gross distinguished his earlier ruling in *In re Golden Guernsey* by noting that unlike a Chapter 7 trustee, which is empowered by statute to act as “the sole representative of the estate”, a creditors committee is a collection of unsecured creditors whose rights to assert derivative claims are limited to the derivative standing of its members, none of whom have to assert derivative claims of breach of fiduciary duty on behalf of the company.

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In re PennySaver USA Publ'g, LLC, 587 B.R. 445 (Bankr. D. Del. 2018)

- Judge Sontchi in *In re Pennysaver* held that a trustee could not seek to assert claims on behalf of the creditors of the LLC under Delaware law. Although it was not clear whether the trustee was seeking to assert direct or derivative fiduciary duty claims, the court held that the trustee did not have standing in either scenario. It held that creditors of an LLC are prohibited from pursuing direct claims against LLCs, their members, managers and officers under *Bax*. If the claims were derivative in nature, those claims were also barred because such claims “can only be brought by members or assignees of LLCs.” Thus, unless the creditors were also members or assignees, the trustee was prohibited from asserting breach of fiduciary duty claims because “[t]he Trustee does not have standing to sue on behalf of the creditors who themselves have no standing.”

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In re Citadel Watford City Disposal Partners, 2019 Bankr. LEXIS 1375

- In *Citadel*, Judge Carey extended the rationale of *In re Pennysaver* and *In re HH Liquidation* in recognizing the similarities between the LLC Act and the Delaware Revised Uniform Limited Partnership Act and concluded that the creditors' committee was not permitted to pursue claims against a Delaware limited partnership. He also threw out the committee's claims against a Wyoming LLC under the Wyoming Limited Liability Company Act because the Wyoming Supreme Court had followed *Bax* in holding that creditors of a Wyoming LLC were not permitted to bring fiduciary duty claims, limiting derivative actions to members at the time an action is commenced. Finally, he also dismissed the committee's claims against a North Dakota LLC determining that the language of the North Dakota statute was "sufficiently similar to the Delaware LLC Act" and applied Delaware cases in interpreting North Dakota law. While the claims at issue were ultimately assigned to the liquidation trustee under the debtor's plan, the trustee was not permitted to pursue any of these claims because they were originally commenced by the committee, who lacked standing to bring them in the first place.

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Questions Raised by the *Bax* Decision

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In re Furie Operating Alaska, LLC

- First-day motion seeking approval of DIP financing to be provided by affiliates of certain prepetition secured parties
- No committee appointed in the cases (“[i]nsufficient response to the United States Trustee communication/contact for service on the committee”)
- Contested final DIP hearing
 - Objecting parties included royalty interest holder
 - “Not having a committee who could take a look at this financing is quite frankly unhelpful”
 - DIP approved on final basis, including customary debtor stipulations and releases

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In re Furie Operating Alaska, LLC

- Standing motions filed by two royalty interest holders prior to expiration of challenge period
- Two-day evidentiary hearing on merits of claims
- Court letter to parties prior to closing arguments
 - Is *Bax* being imported correctly into the bankruptcy context?
 - If *Bax* does not prevent a Committee or a creditor from bringing the debtor/LLC estate causes of action, do creditors get more rights in bankruptcy than outside of bankruptcy?
 - Is the Court empowered to approve another estate representative to bring causes of action when the debtor is a debtor-in-possession?
 - How does *Bax* impact first day DIP hearings?

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Bax in Bankruptcy

- *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 566 (3d Cir. 2003)
 - Official creditors’ committee could be granted standing to bring fraudulent transfer claims on behalf of the estate
 - Holding did not extend to individual creditors
 - Facts and circumstances did not involve unambiguous statute and definitive ruling from state’s highest court
 - 6 Del. Code § 18-1002: plaintiff in a derivative action must be a “member or an assignee” of the LLC
 - Delaware Supreme Court: Delaware LLC Act “denies derivative standing to LLC creditors” *CML V, LLC v. Bax*, 28 A.3d 1037, 1046 (Del. 2011)

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Creditor Rights In/Outside of Bankruptcy

- *In re Timberline Prop. Dev., Inc.*, 136 B.R. 382, 385 (Bankr. D.N.J. 1992) (“[T]he Supreme Court has determined that a bankruptcy court is not empowered to give a creditor rights that state law withholds.”) (citing *Butner v. United States*, 440 U.S. 48 (1979))
 - Individual creditor’s rights limited to what state law allows and what the creditor negotiated for outside bankruptcy

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Estate Representatives

- Appointment of a chapter 11 trustee for the sole purpose of bringing estate causes of action overly “drastic”; would amount to “replacing the scalpel of derivative suit with a chainsaw” *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003)
 - disruption and “immense costs” of “replacing current management with a team that is less familiar with the debtor specifically and its market generally”
- Conversion “would amount to instructing management: ‘Pursue this action, or we will move to dissolve your company.’” 330 F.3d at 579
- Examiner with expanded powers: “§ 1106(b)’s broad grant is most naturally interpreted to authorize only acts relating directly to investigation.” 330 F.3d at 578

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Impact on First-Day Hearings

- Parties in interest entitled exercise their rights under 11 U.S.C. §1109(b) to object to proposed DIP financing
- Creditors presumed “capable of protecting themselves through the contractual agreements that govern their relationships with” their contract counterparties *Bax*, 6 A.3d 238, 250 (Del. Ch. 2010)

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How are creditors (and Courts) are drafting to protect against the *Bax* decision?

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In re Payless Holdings LLC
Case No. 19-40883

- Final DIP Order “punted” the issue until a later date
- Parties were authorized to file either (a) standing motion or (b) fiduciary motion (examiner, chapter 11 trustee, etc.)
- If filed a fiduciary motion and the Court granted the motion, the challenge period was tolled until 45 days after appointment of fiduciary.
- If filed both a standing motion and a fiduciary motion, then challenge period was extended until 45 days after Court granted fiduciary motion.
- If the Court confirmed a plan prior to challenge deadline then causes of action were transferred to a trust, the challenge period was extended to the later of (i) challenge deadline or (ii) 45 days after effective date.

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In re Rudy's Barbershop Holdings, LLC

Case No. 20-10746

- Judge Silverstein raised the *Bax* issue at the First Day Hearing. DIP Lenders agreed to the following language to be included in the Final DIP Order:
 - Court Condition to Approving Motion.
 - “As a condition to granting the Motion, the Court insisted that the Challenge Period and any lawsuit or contested matter stemming therefrom or in connection therewith not be illusory.”
 - “Prepetition Secured Parties will not raise as a defense in any Challenge Proceeding or any adversary proceeding or contested matter brought in connection with matters related to (as delineated in Paragraph 5.10 of this Order) the Prepetition Loan Documents, the Prepetition Secured Obligations, the Prepetition Liens and the Prepetition Collateral the ability of creditors to file derivative suits on behalf of limited liability companies.”
 - “. . . agree that the Amended and Restated Limited Liability Company Agreement of Rudy's Barbershop Holdings, LLC is hereby amended to permit a Challenge Proceeding or any adversary proceeding or contested matter against a Prepetition Secured Party to be commenced by a creditor or an official committee appointed in these bankruptcy cases.”

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In re Techniplas, LLC

Case No. 20-11049

- To address Judge Silverstein's concerns in *Rudy's* the lenders agreed to the following language in the DIP Order:
 - The Prepetition Secured Parties stipulate and agree that each of the Prepetition Secured Parties **will not raise as a defense in connection with any Challenge the ability of creditors to file derivative suits on behalf of limited liability companies.** If the Committee pursues or brings forth a Challenge, the defendant of such Challenge shall not object on the grounds that the Committee lacks standing. (emphasis added).

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Questions?