Proskauer

Suing Directors of a Troubled Business: When Form Trumps Substance

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Creditors of distressed businesses are often frustrated by shareholder-controlled boards when directors pursue strategies that appear to be designed to benefit shareholders at the creditors' expense. In these circumstances, creditors might consider sending a letter to the board to convince the directors to pivot and adopt alternative strategies or face risk of liability for breaching fiduciary duties. The efficacy of this approach depends on many factors, including the company's financial condition, the board's composition and the underlying transactions at issue. But, to the surprise of many, the approach is also ***dependent*** on the corporate form of the borrower. A creditor's right to sue the company's directors depends on whether a borrower is formed as a corporation or a limited liability company ("LLC"). As explained below, creditors of an LLC (even an insolvent one) cannot sue directors (known as "managers") for breaching fiduciary obligations or otherwise pursue derivative claims on the LLC's behalf.

A. State Law

First, we provide a quick refresher on basic principles before we unpack the different rules for corporations versus LLCs. Fiduciary duties are governed by the state of formation. We focus on Delaware law because of the prevalence of companies formed in Delaware.

Here are three critical takeaways from the Delaware Supreme Court's landmark decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) ("*Gheewalla*"):

1. Directors owe fiduciary obligations ***to the corporation***.

2. When a corporation is ***solvent***, those obligations may be enforced by the corporation’s shareholders by bringing a so-called “derivative action” (as distinct from a direct action) where the shareholders sue on the corporation’s behalf because they are the ultimate beneficiaries of the corporation's growth and increased value. Derivative claims do not arise from a particularized harm that is personal to the plaintiff, but instead arise secondarily from the harm caused directly to the company. Creditors of a ***solvent*** corporation cannot enforce the directors’ duties. Instead, creditors are protected by contracts, fraudulent transfer law, bankruptcy law, general commercial law and other sources of creditor rights, and these rights do not change when a company enters the “zone of insolvency”.

3. But, when a corporation is ***insolvent***, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an ***insolvent*** corporation ***also*** have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value.

But the form of corporate entity matters! While the *Gheewalla* court's analysis is straightforward in the corporate context, applying it in the LLC context is more complicated. The distinction turns on the Delaware Limited Liability Company Act ("LLC Act"). Section 18-1001 creates a statutory right for LLC members and their assignees to bring a derivative action on behalf of an LLC. Section 18-1002 provides further that no party ***other than*** a member or assignee is permitted to bring a derivative action on behalf of the LLC. In *CML V, LLC v. Bax,* 28 A. 3d 1037 (Del. 2011) ("Bax"), the Delaware Supreme Court squarely addressed the differences between corporations and LLCs when a creditor of an insolvent LLC brought derivative action against the LLC's directors and argued that denying an LLC creditor standing to sue derivatively created an "absurd distinction between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot." The Delaware Supreme Court squarely rejected the creditors' claim and held that the language of the LLC Act is unambiguous. Applying the statute, the Delaware Supreme Court held that "only LLC members or assignees of LLC interest have derivative standing to sue on behalf of an LLC – creditors do not." The court rejected the argument that Delaware's legislature merely intended to rephrase the language of section 327 of the Delaware General Corporate Law, which the court had determined does not bar creditors of insolvent corporations from derivative standing. It concluded that the legislature intended to limit derivative standing to LLC members and assignees. As a result, creditors of an LLC lack standing to sue directors (managers) for any breach of any fiduciary duties even where the LLC is insolvent.

B. **Bankruptcy Context**

The *Bax* decision and the LLC Act have been applied in chapter 11 contexts where Delaware bankruptcy courts have repeatedly held that individual creditors and unsecured creditors' committees (as distinct from a chapter 7 trustee) cannot assert derivative claims to prosecute claims on behalf of LLC debtors. For example, in the chapter 11 case of *In re Dura Automotive Systems, LLC*, No. 19-12378 (KBO) (Bankr. D. Del. June 9, 2020) the bankruptcy court held that "the committee is not a member of the LLC debtors or an assignee of an LLC interest and, thus, lacks standing under the [LLC Act] to bring a derivative suit [for state law claims, preference under section 547, equitable subordination and recharacterization claims] on behalf of the LLC debtors."). This limitation on standing does not apply to a chapter 7 trustee, who, unlike an individual creditor or creditors' committee, is the sole representative of the estate with the authority to sue and be sued.

C. **Recent Case**

Creditors in a recent bankruptcy case tried a different tactic to skirt the state law limitation on creditor derivative standing to sue on behalf of a Delaware LLC. In *Ector County Energy Center, LLC's* chapter 11 case pending in Delaware, the debtor's largest unsecured creditor sought standing to pursue derivative claims on behalf of the LLC debtor's estate to (a) avoid $75 million in debt allegedly incurred for little value on the eve of bankruptcy while the debtor was insolvent, (b) recover damages for insider breaches of fiduciary obligations and (c) avoid insider preferences. (Their real aim appeared to be an attempt to derail the debtor's proposed plan of reorganization as it proposed to grant releases to these parties).

The plaintiff creditor argued that its standing to prosecute derivative claims is governed by the Bankruptcy Code and federal common law, ***not*** Delaware state LLC law. It argued that the LLC statute addressed "derivative actions" in the "Delaware court" on "behalf of an LLC." Here, the creditor argued it was seeking authority under the Bankruptcy Court's ***equitable powers*** to act on behalf of the bankruptcy estate and to stand in the shoes of the trustee under the Bankruptcy Code and in the Bankruptcy Court.

But to no avail. In an unwritten bench decision denying the motion, the Bankruptcy Court held that creditors are prohibited from asserting derivative claims on behalf of a Delaware LLC under the LLC Act, which only allows such claims to be pursued by LLC members or their assignees. The Bankruptcy Court also rejected the argument that the Bankruptcy Code and the applicable Third Circuit case overrode the Delaware statute. Finally, the Bankruptcy Court, like the court in *Gheewalla*, determined that the creditors had other adequate means of seeking legal redress, including seeking the appointment of a chapter 11 trustee or having the case converted to chapter 7.

Practical Takeaway: Form can trump substance. Creditors of a Delaware LLC cannot assert derivative claims on behalf of an LLC, including claims against managers for breach of fiduciary obligations and, after a bankruptcy filing, fraudulent transfer claims. There may yet be other ways for creditors to assert these claims on the LLC's behalf, but doing it derivatively is not one of them! Of course, blunting this sword in many cases may work to the benefit of secured lenders.

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