

Court Finds That Delaware Law Does Not Preclude Derivative Standing in Bankruptcy but Reaffirms Validity of Exculpation Provisions

March 6, 2024

In a recent decision, Judge Craig T. Goldblatt of the U.S. Bankruptcy Court for the District of Delaware found that in bankruptcy, a creditors' committee of a Delaware limited liability company can obtain derivative standing to pursue claims against the LLC's managers and officers. Previously, Delaware bankruptcy courts held that the Delaware Limited Liability Company Act (the "DLLCA"), which limits derivative standing to the members and assignees of the Delaware LLC, prohibits creditors of an LLC from pursuing such derivative claims in bankruptcy.

In *In re Pack Liquidating LLC* ("Pack"), Case No. 22-10797 (CTG), Judge Goldblatt found that federal law, not state law, governs the analysis of whether creditors may pursue derivative claims in bankruptcy, and that the Bankruptcy Code creates an independent federal right for creditors to bring derivative lawsuits "to ensure that a debtor-in-possession is performing its role in the best interests of the estate." Perhaps equally noteworthy is that Judge Goldblatt confirmed that state law exculpation provisions in formation documents are "fully respected and controlling in bankruptcy," although such protections may be interpreted narrowly. Thus, while *Pack* is a cautionary warning for managers and officers of a Delaware LLC (and other potential defendants) that they may be subject to litigation in bankruptcy notwithstanding the DLLCA, it is a valuable confirmation that exculpations will be respected during a bankruptcy.

Background. The *Pack* debtors, organized as a series of Delaware LLCs, operated an e-commerce business. After a failed merger and several rounds of debt and equity financing, the debtors filed for bankruptcy in August 2022. During the bankruptcy cases, the Official Committee of Unsecured Creditors (the "Committee") filed a motion seeking derivative standing to pursue various claims on behalf of the debtors, including claims for breach of fiduciary duty against the debtors' members and officers. At the heart of the Committee's complaint was the allegation that the debtors' members, managers and officers had mismanaged the company and put their own interests ahead of the debtors'.

Holding in *Pack*. While the court noted that it was “loath” to break with its colleagues, the court found that bankruptcy derivative standing is a federal right granted under the Bankruptcy Code, and thus, not dependent on applicable state law. Accordingly, the DLLCA’s limitation of derivative standing to the members and assignees of the Delaware LLC does not preclude a committee’s standing to pursue derivative claims in bankruptcy.

However, the court also held that the underlying claims must be “colorable” in order to grant a committee derivative standing. In *Pack*, the debtors’ formation documents contained exculpation provisions to protect the managers from breach of fiduciary duty claims. Judge Goldblatt held that such exculpation provisions are “fully respected and controlling in bankruptcy” and thus such claims were not colorable, because “[u]nlike the provisions addressed to who may maintain a derivative lawsuit, which are procedural in nature, the disclaimer of fiduciary duties affect the *substance* of the rights that the debtor would have had as of the time of the bankruptcy filing.” Nevertheless, the court determined that the relevant exculpation provisions only protected the members in their capacity as managers, but not in their capacity as officers, and thus the breach of fiduciary duty claims against the defendants in their capacity as managers were not colorable, while claims against such defendants in their capacity as officers were.

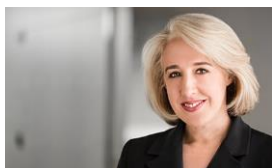
Implications of *Pack*. It remains to be seen whether other courts will follow *Pack* going forward. Nonetheless, even if creditors’ committees have derivative standing to pursue certain claims, defendants will be entitled to rely on properly drafted exculpation provisions. Most relevant, an operating agreement for a Delaware LLC that provides for exculpation of its managers and officers may provide meaningful protection. Section 18-1101(c) of the DLLCA authorizes the members of an LLC, in its formation documents, to disclaim fiduciary duties running to the entity, while section 18-1101(e) permits members to leave the default fiduciary duties, while eliminating liabilities for a breach of such duties. Thus, *Pack* reaffirms that to the extent an LLC agreement contains such protections, managers and officers may be fully insulated against most claims for breaches of fiduciary duties.

Two points should be kept in mind when drafting such provisions, however:

- **Bad faith conduct cannot be subject to exculpation:** Notwithstanding the foregoing protective provisions, under the DLLCA, an LLC agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

- **If an individual wears multiple hats, formation documents must clearly and unambiguously exculpate the individual in each capacity to be fully protective:** In *Pack*, the operating agreement only protected the defendants in their capacities as managers, not officers. The court thus barred the Committee from pursuing claims against the defendants for any breach of fiduciary duty as managers, but allowed the Committee to proceed against the same defendants in their capacities as officers.

We are happy to discuss further if you have any questions or would like more detail regarding this opinion and its implications.



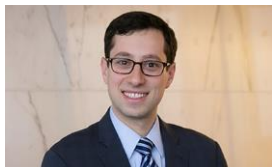
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