

US Court expands creditors' rights to assert claims against insiders

David Conaway writes on a recent ruling involving breaches of fiduciary duties



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On 2 February 2024, in the Chapter 11 case of *Packable Holdings, LLC*, the Bankruptcy Court for the District of Delaware ruled that the US Bankruptcy Code provides creditors (including creditors' committees) federal law-based derivative standing to sue LLC members, managers and officers for breaches of fiduciary duties.

The *Packable Holdings* creditors' committee filed a complaint for breaches of fiduciary duties, equitable subordination of claims, the avoidance and recovery of fraudulent conveyances, and the disallowance of claims. In so ruling, the Bankruptcy Court determined that the Bankruptcy Code-based derivative standing trumped the prohibition in Delaware Limited Liability Company Act (DLLCA) against creditor claims against LLC members and managers. The *Packable Holdings* ruling was also in direct conflict with three prior Delaware Bankruptcy Court rulings in 2018 and 2019, which held the DLLCA indeed prohibited derivative standing for creditors to file claims.

The *Packable Holdings* ruling has significant ramifications for foreign-based company groups and foreign investors. Many foreign investors create US LLCs (often in Delaware) to invest in US operating enterprises, which may be Subchapter C or S corporations, but are often registered as limited liability companies. When US investment entities file Chapter 11, foreign owners, members, managers and officers may have liability to

creditors. The creditors' committee complain in *Packable Holdings* included, as defendants, individuals, corporations and LLCs that were owners, members, managers or officers of *Packable Holdings*.

The background was, according to the court ruling:

"The debtors operated an e-commerce business, as third-party sellers of health, beauty, and other consumer products on online marketplaces. They filed for bankruptcy after raising several rounds of debt and equity financing, followed by the collapse of a potential merger with a special purpose acquisition company ("SPAC") under which the debtors would have become a public company that allegedly would have been valued at \$1.5 billion. As the first-day declaration describes, after the SPAC merger failed, the debtors shifted their efforts to pursuing a going-concern sale. Those efforts, however, were unsuccessful, leaving the debtors to wind down their affairs through an orderly liquidation in bankruptcy.

The Official Committee of Unsecured Creditors appointed in this bankruptcy case alleges that the business failure is not the result of a challenged SPAC market and generally unfavourable business conditions, but instead was caused by mismanagement and self-dealing by the company's insiders. The Committee has filed an adversary proceeding asserting those claims, as well as claims for equitable

subordination, the avoidance and recovery of alleged fraudulent conveyances, and the disallowance of claims."

The defendants have challenged only the creditors' right to assert claims for breaches of fiduciary duties, based upon the prohibition of the DLLCA, and the three prior Delaware Bankruptcy Court opinions that applied the DLLCA prohibition on creditors' derivative standing to deny claims by creditors against LLC members, managers and officers.

It should be noted that Delaware law for corporations (a Subchapter C or S corporation) is different. Under Delaware General Corporate Law, the right to assert a derivative action is limited to shareholders who held shares at the time of the challenged transaction. However, Delaware case law also recognizes that, when a corporation becomes insolvent, creditors replace shareholders as the residual beneficiaries of corporate value. The Delaware Supreme Court has ruled that creditors may assert derivative claims to enforce obligations that an insolvent company's directors owe to the corporation.

The *Packable Holdings* court noted that:

"Delaware law treats limited liability companies as "creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'" A limited liability company can be managed either by a member (which is the title for an owner of a limited liability company) or by a non-member manager. Members can therefore either serve as



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managers or can be passive investors. As a general proposition, the manager of a limited liability company (whether or not the manager is a member), much like a corporate officer, owes fiduciary duties to the entity and its members. In addition, it bears note that various of *Packable's* managers also served as officers of the limited liability company.

The Delaware Limited Liability Company Act, however, allows for the exculpation of these fiduciary duties. The Act permits the company's operating agreement to expand, restrict, or eliminate a manager's fiduciary duties.

The Delaware Limited Liability Company Act also provides that, in a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action and at the time of the transaction of which the plaintiff complains.”

The Delaware Supreme Court has enforced this limitation, as the DLLCA “means what it says”, despite the Delaware Supreme Court's 2007 *Gheewalla* ruling that creditors of an insolvent Corporation have standing to

pursue derivative claims against the corporation's officers and directors.

However, in the *Cybergenics Corp.* Chapter 11 case, the US Third Circuit Court of Appeals ruled that the Delaware Bankruptcy Court in *Cybergenics* could exercise its federal law equitable power (under the US Bankruptcy Code) to grant a creditors' committee derivative standing to assert fraudulent conveyance claims. The *Cybergenics* court made clear it did not, and did not need to, rely on any state law, such as the DLLCA, in determining the creditors' committee's derivative standing.

The Delaware Bankruptcy Court in *Packable Holdings* concluded that the *Cybergenics* ruling was controlling authority, and that neither the DLLCA nor the prior Delaware state court rulings prohibited creditors' standings to bring derivative actions for bankruptcy “estate” causes of action against the LLC's members and officers, which are federal law claims. Moreover, the court in *Packable Holdings* ruled that the Bankruptcy Court's

federal law power was not limited to fraudulent conveyances; rather, the power to grant creditors' derivative standing to assert claims included claims for breaches of fiduciary duties.

The Delaware Bankruptcy Court in *Packable Holdings* noted that, as LLCs are creatures of contract, the provisions of LLCs' operating agreements would be determinative and enforced, including waivers of liability. In the *Packable Holdings* LLC operating agreement, managers were exculpated from liabilities. However, LLC officers were not included in the exculpation provision.

While *Packable Holdings* is a dramatic expansion of creditors' rights against insiders as a source of recovery, its impact can be minimized or avoided by a well written LLC operating agreement. Foreign business enterprises who have US affiliates or investments should take note of the ruling, to avoid potential liability arising from the insolvency of its affiliates or US investment entities. ■