

Bax Limits Standing to Pursue Derivative Claims in Bankruptcy

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Carl T. Tullson

Counsel / Wilmington
302.651.3142
carl.tullson@skadden.com

Christopher M. Dressel

Associate / Chicago
312.407.0968
christopher.dressel@skadden.com

Robert E. Fitzgerald

Associate / Chicago
312.407.0806
robert.fitzgerald@skadden.com

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Four Times Square
New York, NY 10036
212.735.3000

Since the Delaware Supreme Court held in *CML V, LLC v. Bax* that creditors of a Delaware LLC lack standing to pursue derivative breach-of-fiduciary-duty claims, even if the LLC is insolvent or near insolvent, bankruptcy courts have decided a number of *Bax*-related issues in cases involving Delaware LLCs.

The 2011 holding in *Bax* was based on the Delaware LLC Act, which limits derivative standing in cases involving Delaware LLCs to members of the LLC or assignees of an LLC interest. In the wake of *Bax*, the uncertainty surrounding its application in the bankruptcy context has been exacerbated by the existence of an independent federal bankruptcy test for derivative standing. This test provides that a bankruptcy court, as a court of equity, may authorize creditors to sue derivatively if the debtor in possession or trustee unjustifiably refuses to pursue a colorable claim.

But recent developments promise to alter the landscape of committee-driven bankruptcy litigation in cases involving Delaware LLCs by significantly curtailing the ability of an official committee to assert derivative claims. For instance, in July 2018, in *PennySaver USA Publishing, LLC v. OpenGate Capital Group*, Judge Christopher S. Sontchi of the U.S. Bankruptcy Court for the District of Delaware cited *Bax* to dismiss a Chapter 7 trustee's derivative claims for breaches of fiduciary duties allegedly owed to a Delaware LLC. Other bankruptcy judges have similarly applied *Bax* to deny derivative standing in fiduciary duty and fraudulent transfer claims against Delaware LLCs, in one case even where the debtors had previously stipulated that the committees had standing.

Derivative Standing

In many bankruptcy cases, official committees aggressively litigate to obtain derivative standing to pursue estate causes of action and seek related discovery. The desire by other parties to avoid lengthy and expensive litigation in Chapter 11 often creates favorable settlement conditions for official committees in the early stages of bankruptcy cases. Committees, particularly in cases where secured creditors have liens on substantially all assets and appear to be meaningfully undersecured, often seek higher recoveries for the creditors or interest holders they represent by extracting settlements following a grant of derivative standing. In such cases, derivative claims — including fraudulent transfer and fiduciary duty lawsuits against third parties (including secured creditors), and the settlements related to those suits — may be the only valuable unencumbered property of the estate and thus form the only pool of assets from which junior stakeholders will recover.

Recently, parties in interest have built on the *Bax* line of cases and responded to committees' litigation tactics by disputing whether an official committee has standing to bring derivative causes of action. In the May 2018 case *In re VER Technologies HoldCo LLC*, for example, a creditors' committee filed a motion under Bankruptcy Rule 2004 to compel examination and discovery related to, among other topics, claims arising from alleged breaches of fiduciary duties associated with a leveraged buyout. One of the parties subject to the request objected, citing *Bax* and asserting that the committee did not have standing to pursue derivative claims because the relevant debtors were Delaware LLCs. The committee responded by arguing that even if it lacked standing, should discovery "uncover colorable derivative claims," that investigation could support either (1) the appointment of a fiduciary who could pursue such claims or (2) assignment of such claims.

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As to the first contention, appointment of a trustee would typically solve the derivative-standing issue stemming from *Bax*. As the *PennySaver Publishing* case explains, a trustee could pursue the direct claims on behalf of the debtor's estate, as if it were the debtor itself suing. However, requests to appoint a trustee simply to pursue claims that the debtor in possession does not wish to pursue should be met with skepticism by bankruptcy courts. Appointment of a trustee is an "exceptional" remedy that requires a showing that there is either "cause" to appoint a trustee, including fraud or gross mismanagement of the debtor by current management, or that the appointment is "in the interests of creditors, any equity security holders, and other interests of the estate."

Second, the potential assignment of direct claims to a committee or litigation trust is a potential solution that must be evaluated on a case-by-case basis, as such claims could either be released or voluntarily assigned to a litigation trust as part of a Chapter 11 plan.

Implications

The development of *Bax*-related case law in bankruptcy courts provides a road map for debtors, secured creditors and other parties in interest to contest the ability of an official committee to pursue derivative claims. In cases in which secured creditors are the fulcrum class, the extent to which official committees are barred under *Bax* from pursuing derivative claims against a Delaware LLC may significantly limit the committees' ability to use litigation tactics as leverage tools to extract concessions from debtors and third parties.

The impact of *Bax* and its bankruptcy progeny is both significant and continuing to develop, but these cases should not be seen as a panacea by parties that are subject to potential derivative claims and are not a substitute for seriously evaluating whether direct claims should be pursued by the debtor. Importantly, *Bax*'s impact is limited to Delaware LLCs. In multidebtor cases involving various debtor entities across different jurisdictions, the implications of *Bax* will need to be closely analyzed on a case-by-case basis.