

# Claims Chat

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## Catch a Waiver: Advanced Issues in Delaware Entity Lien Challenges

The Delaware Limited Liability Company Act indirectly bars creditors from pursuing derivative claims on behalf of a Delaware limited liability company (LLC).<sup>2</sup> Recent cases have applied these restrictions in bankruptcy cases to block creditors' committees from pursuing breach-of-fiduciary-duty claims against members of Delaware LLCs.<sup>3</sup> A similar rationale has been applied to Delaware limited partnerships.<sup>4</sup> Courts have also refused to permit subsequently appointed trustees from pursuing these claims.<sup>5</sup>

Although cases addressing this issue to date have applied these limitations only with respect to fiduciary-duty claims, recent efforts to expand these limitations to other claims a creditors' committee might seek to bring in a bankruptcy case involving Delaware LLCs and limited partnerships have created significant practical issues for creditors' committees at the conclusion of their lien investigations. This article discusses some recent disputes regarding these state law statutory limitations, and proposes an approach to limit the potential pitfalls associated with them.

### The Challenge Period

In Delaware, as well as in several other jurisdictions, orders approving debtor-in-possession (DIP) financing orders typically provide the creditors' committee with a fixed period to investigate and bring challenges to the secured claims held by pre-petition lenders. This so-called "challenge period" also applies to claims against the lenders that the debtor waives in the DIP-financing or cash-collateral order. Delaware Local Rule 4001-2(a)(i)(B) requires that any DIP-financing or cash-collateral order provide parties in interest with at least 75 days from the entry of the order to challenge the "validity, perfection or amount" of the liens or "the waiver of claims against the secured creditor."<sup>6</sup> The rule

also provides that the creditors' committee shall be given at least 60 days from the "date of its formation to investigate such matters."<sup>7</sup> There are generally two purposes of the challenge period: (1) to provide the creditors' committee with sufficient time to investigate the secured lender's liens; and (2) to ensure that the debtor's stipulations and releases regarding such liens and any related claims against the secured lender are not immediately and forever binding on the debtor's estate.

The use of a challenge period also serves many practical purposes. As previously noted, it gives the creditors' committee time to properly investigate the debtors' pre-petition liens before deciding whether to bring any challenge thereto. Without the challenge period, the committee would be forced to file an adversary proceeding to challenge the liens prior to the final hearing on the DIP-financing motion in order to avoid the binding effect of the debtors' stipulations, waivers and releases regarding such challenges. Because that hearing usually takes place around one week following the formation of the creditors' committee, the committee would almost always be forced to file the adversary proceeding blind, without the benefit of any real investigation and with only preliminary information from the debtor. Such an approach is both wasteful of estate assets and discourages cooperation between the debtor and creditors' committee, likely to the detriment of all the estate's creditors.

However, in cases involving Delaware LLCs and limited partnerships, the challenge period would be a legal fiction if creditors, including the creditors' committee, are not able to assert claims on behalf of the debtor or the bankruptcy estate because the debtor's waiver of claims against its lenders in the DIP financing order will be immediately binding upon the estate, notwithstanding the challenge period.<sup>8</sup> In this situation, the creditors' committee's alternatives are to file a motion to appoint a chapter 11 trustee or move to convert the cases to chapter 7 prior to the final DIP hearing (or, depending on the terms of the DIP or cash-collateral order, prior to the expiration of the challenge period).<sup>9</sup> Either of these motions



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<sup>2</sup> 6 Del. C. § 18-1002 (2019); see also *CML V LLC v. Bax*, 28 A.3d 1037, 1039 (Del. 2011).

<sup>3</sup> See *In re HH Liquidation LLC*, 590 B.R. 211, 283-85 (Bankr. D. Del. 2018) (finding that creditors' committee had no standing to bring breach-of-fiduciary-duty claim).

<sup>4</sup> See *In re Citadel Watford City Disposal Partners LP*, 603 B.R. 897, 904-05 (Bankr. D. Del. 2019) (finding that only partners can bring derivative claims on behalf of Delaware limited partnership); see also 6 Del. C. § 17-1002 (2019) (permitting only partners and their assignees to bring derivative claims on partnership's behalf).

<sup>5</sup> See *In re Pennysaver USA Publ'g LLC*, 587 B.R. 445, 466-67 (Bankr. D. Del. 2018) ("The [chapter 7] Trustee does not have standing to sue on behalf of the creditors who themselves have no standing."); *Citadel*, 603 B.R. at 907 (holding that liquidation trustee was not permitted to pursue derivative fiduciary-duty claims at issue because they were originally filed by creditors' committee, which lacked standing to bring those claims in the first instance).

<sup>6</sup> Del. Local Rule 4001-2(a)(i)(B) (2019).

<sup>7</sup> *Id.*

<sup>8</sup> These lost claims might include breach-of-fiduciary-duty claims, avoidance actions and breach-of-contract claims by the debtor's contract counterparties, among many others.

<sup>9</sup> See *In re Avenue Stores LLC*, Case No. 19-11842 (LSS) at D.I. 448 (seeking conversion to chapter 7 prior to looming challenge deadline).

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is likely to lead to significant legal fees on both sides in litigating the motion and again would discourage cooperation between the debtor and creditors' committee.

Like the blind adversary proceeding previously discussed, these motions would likely be premature at best, as the creditors' committee would have approximately one week to communicate with the debtor and gather information. It would also place tremendous strain on the debtor's operations at a critical point in its bankruptcy case, especially if an early sale process is underway. Given the waste engendered by these motions and the potential harms to creditors from value-destructive litigation, the use of a challenge period to allow the creditors' committee time to investigate potential claims against the debtor's lenders provides an appropriate compromise between the interests of the committee in investigating the secured lenders' liens and actions and the interests of the debtor in making the concessions necessary to obtain critical financing to fund its bankruptcy case.

## Recent Efforts to Moot the Challenge Period

Despite the benefits of a challenge period, debtors in Delaware cases have begun to assert that the creditors' committee cannot have standing to bring derivative claims on behalf of Delaware LLCs and limited partnerships. For example in *Emerge*, the DIP-financing order provided that the debtors' stipulations regarding the propriety and effectiveness of the liens would be binding on "all other parties-in-interest" unless, among other things, "a party-in-interest, including but not limited to any Creditors' Committee appointed in these cases, with requisite standing, has timely filed an adversary proceeding or contested matter."<sup>10</sup>

The creditors' committee sought derivative standing to assert claims of the debtors' estates under various sections of the Bankruptcy Code and the Declaratory Judgment Act (18 U.S.C. § 2201).<sup>11</sup> The debtors objected, arguing that the creditors' committee "does not and cannot have derivative standing to pursue claims of the Debtors."<sup>12</sup> As previously discussed, the debtors' position, if adopted by the court, would effectively moot the challenge period contained in the DIP-financing order because no party-in-interest, other than the debtors, would be able to obtain standing to pursue claims challenging the liens.

Likewise, in *In re Avenue*, the DIP-financing order provided for separate challenge periods for the creditors' committee to assert challenges to the debtors' first lien and subordinated lender's liens.<sup>13</sup> The order provided that if the creditors' committee filed a motion for standing (along with a draft complaint) prior to the expiration of the challenge period, the challenge period would be extended with respect to the committee until three business days following the entry of an order granting the committee with standing to pursue

the claims identified in the draft complaint.<sup>14</sup> Because that extended challenge period did not apply to a subsequently appointed chapter 7 trustee, and the holdings in *In re Citadel* and *In re Pennysaver* presented significant risks that a chapter 7 trustee might not be able to pursue claims originally asserted by the creditors' committee, the committee ultimately determined to seek conversion of the cases to chapter 7 in advance of the initial challenge deadline.<sup>15</sup> The U.S. Trustee also requested conversion to avoid the risk that the estate would lose the potential claims identified by the committee in its investigation.<sup>16</sup>

**[I]f a creditors' committee's derivative standing in bankruptcy is limited to the same extent it is with respect to derivative claims under state law, the challenge period is effectively worthless.**

## A Proposed Path Forward

Anticipating the future problems that subsequently arose in *In re Emerge* and *Avenue*, the creditors' committee in *In re Bayou Steel* filed an objection to the debtors' cash-collateral motion that, among other things, requested that the debtors be deemed to assign the estates' fiduciary-duty claims to the committee to the extent necessary to pursue such claims.<sup>17</sup> As a result of this objection, the parties ultimately agreed to add language to the final cash-collateral order that contemplated that (1) the creditors' committee could obtain authority "derivatively or otherwise" and (2) the filing of a motion seeking authority to commence a challenge will toll the challenge period until 14 days after the entry of an order with respect to such motion.<sup>18</sup> Unlike the challenge deadline in *Avenue*, the challenge deadline in *Bayou Steel* would permit the parties to continue to extend the hearing on the creditors' committee's standing motion until confirmation of a plan assigning the debtors' claims to a liquidating/litigation trustee, the appointment of a chapter 11 trustee or conversion of the cases to chapter 7. It would also permit the bankruptcy judge to refrain from ruling on the standing motion if necessary to preserve potential estate claims, pending one of the events previously identified.

Although the language added to the cash-collateral order in *Bayou Steel* represents a significant first step toward a practical resolution of the potential challenge period issues discussed herein, it does not go far enough to preserve a creditors' committee's potential challenge rights. First, the *Bayou Steel* order only provides a chapter 7 trustee with 10 calendar days to file a complaint commencing a challenge. Even with

<sup>10</sup> *In re Emerge Energy Servs. LP*, Case No. 19-11563 (KBO) at D.I. 209, ¶ 26 (emphasis added).

<sup>11</sup> *Id.* at D.I. 520.

<sup>12</sup> *Id.* at D.I. 568, ¶ 32.

<sup>13</sup> See *Avenue*, Case No. 19-11842 at D.I. 223, at ¶ IX.A.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at D.I. 448 (unsealed version at D.I. 458).

<sup>16</sup> *Id.* at D.I. 441.

<sup>17</sup> See *In re Bayou Steel Holdings LLC*, Case No. 19-12153 (KBO) (D.I. 171), ¶ 59.

<sup>18</sup> *Id.* at D.I. 241, ¶ 73.

the extended deadline afforded the committee following the filing of a standing motion, a chapter 7 trustee will almost always need more than 10 calendar days to evaluate the creditors' committee's proposed causes of action and to file an adversary proceeding. Since the chapter 7 trustee receives none of the benefit from the extended challenge period prior to conversion, he/she must be granted enough time to speak with counsel to the creditors' committee and review their work. The 30-day period typically provided for a trustee appointed prior to the expiration of a challenge period would be more appropriate here.<sup>19</sup>

Second, the filing of a motion to appoint a chapter 11 trustee or a motion to convert the case to chapter 7 should toll the challenge period to allow the newly appointed trustee to investigate and pursue the claims at issue. While the "derivatively or otherwise" language in the *Bayou Steel* order is an improvement over the typical language that only contemplates the creditors' committee seeking derivative standing, if the committee determines that the risk of seeking standing itself, either on behalf of creditors or the estate, is too great, it should be able to file a motion to convert or a motion to appoint a chapter 11 trustee prior to the expiration of the challenge period, with the period extended until 14 days after the resolution of such motion. This tolling would avoid the "fire drill" that resulted in *Avenue*, where both the committee and U.S. Trustee filed motions to convert on shortened notice.

Litigation, especially expedited litigation, is expensive and does not benefit the debtor's estate or its creditors. The filing of these motions usually results in an "event of default" under DIP-financing orders anyway, so the secured lenders should not be adversely affected by either of these motions. Of course, the creditors' committee would also need to consider the effects of such a default in deciding what motion to file.

Third, the list of items subject to the challenge period should match the list of items that are the subject of the debtors' waivers and/or stipulations. The debtor's stipulations often grant broad waivers and releases of claims against the secured lenders. For example, in *Bayou Steel*, the debtors stipulated that the lenders' claims were "non-avoidable" and that such claims "shall not be subject to any offset, defense, counterclaim, avoidance, recharacterization or subordina-

tion (whether equitable or otherwise), recovery, challenge or claim pursuant to the Bankruptcy Code or other applicable law."<sup>20</sup> Yet the challenge rights in *Bayou Steel* do not refer to any specific causes of action; they only refer to an ability to challenge the "stipulations, admissions, releases, and waivers" in the order.<sup>21</sup> At a minimum, the location of these items in the order should be expressly noted in the challenge rights paragraph. A better practice would be to clearly set forth the claims that are intended to be included within the challenge period in the challenge rights paragraph itself; anything not expressly identified should not be subject to the challenge period. Without this level of detail, the secured lenders would, at best, acquire additional leverage by challenging the committee's standing to bring such claims and, at worst, achieve a waiver of such claims as a *fait accompli* if the court rules that the committee never had standing to pursue those claims in the first place.

Fourth, if a creditors' committee will be left without standing based on the debtors' stipulations and waivers, the DIP order can provide for those waivers to be "undone." Then, any claims that the court finds to be colorable and worth pursuing can be assigned to the committee or a litigation trustee or other trust for the benefit of the estate.

## Conclusion

With the risk that a debtor's waiver of challenges to the liens of its secured lenders will result in the permanent allowance of those claims in the first month of the bankruptcy case involving a Delaware LLC or limited partnership, creditors' committees must take care to preserve the estate's rights — not just their own — in connection with the challenge period provided in the DIP-financing or cash-collateral order. While future cases will likely help clarify the distinction between "derivative claims" and "derivative standing," if a creditors' committee's derivative standing in bankruptcy is limited to the same extent it is with respect to derivative claims under state law, the challenge period is effectively worthless. To maintain maximum flexibility pending the ultimate resolution of this issue, creditors' committees should be diligent from the date of their formation to reserve, and preserve, these potentially valuable causes of action. **abi**

<sup>20</sup> See *Bayou Steel*, Case No. 19-12153 at D.I. 241, ¶ 12.

<sup>21</sup> *Id.* at ¶ 73.

<sup>19</sup> See *Avenue*, Case No. 19-11842 at D.I. 223, ¶ IX.A.