WILMERHALE

TRANSACTIONAL | LITIGATION/CONTROVERSY

June 8, 2017

Bankruptcy Alert

Insolvency at Its Limits: What Management and Creditors of Insolvent LLCs and LPs Should Know About Fiduciary Duties Waivers and Standing, Inside and Outside of Bankruptcy

By Isley M. Gostin, Craig Goldblatt and George W. Shuster, Jr.

Delaware law allows members and partners of limited liability companies (LLCs) and limited partnerships (LPs) to waive the fiduciary duties of their management in their LLC or LP agreements. When an LLC or LP is insolvent, however, the residual claimants of the entity are its creditors, who, unlike members and partners, are generally not parties to the LLC or LP agreement and therefore have not agreed to waive any otherwise applicable duties. That raises the question: Are there insolvency "limits" to the effectiveness of waivers of fiduciary duties? When the LLC or LP is insolvent, are fiduciary duty waivers still operative, or may creditors of the entities assert (either directly or derivatively) breach of fiduciary claims to the extent management fails to exercise reasonable diligence in looking out for the interests of creditors or the enterprise more broadly?

The answers to these questions may depend on whether the insolvent LLC or LP is in bankruptcy. Accordingly, the filing of a bankruptcy case for an LLC or LP may alter the fiduciary duties owed by management.

Outside of bankruptcy, management of an insolvent Delaware LLC or LP that has waived all fiduciary duties in its operating agreement owes no fiduciary duties, even though the entity's residual beneficiaries (creditors) never agreed to the fiduciary duty waivers in the first place. And even if the entity has not waived all fiduciary duties, creditors of an LLC or an LP (unlike creditors of an insolvent *corporation*) do not have derivative standing to bring breach claims in that context. In other words, the shift from solvency to insolvency of a Delaware LLC or LP is not enough *either* to overcome the express fiduciary duty waiver *or* to provide creditor standing to sue.

Were the entity in bankruptcy, by contrast, even if the LLC or LP agreement disclaimed all fiduciary duties, management (whether a chapter 11 trustee or directors and officers of a debtor in possession) would nevertheless owe fiduciary duties to the estate, which includes creditors, during the bankruptcy. And creditors of the entity (or, at least, an official committee representing their interests) could most likely obtain derivative standing to assert claims for breaches of those duties (where the debtor itself unreasonably declined to assert the claims), at least when those alleged breaches occurred post-petition.

I. Fiduciary Duties of Directors and Officers of a Debtor in Possession Are Governed by Federal Common Law

Courts generally agree that officers and directors of debtors in possession have the same duties as a chapter 11 trustee—that is, their duties *during the bankruptcy* case are governed by federal common law rather than by the applicable state law that would govern were the entity not in bankruptcy.[1] There are good reasons for this: *first*, applying federal common law rather than applicable state law furthers the interest in uniformity across bankruptcy cases; *second*, it ensures that duties owed by management of the debtor are the same regardless of whether a chapter 11 trustee is appointed (otherwise, assuming duties under state law were less stringent, the appointment of a chapter 11 trustee would arguably *always* be in the best interest of the estate); and *third*, while members or partners of the debtor may have agreed by contract that the law of a particular state should apply, creditors were not a party to that agreement.[2]

In most cases, the state law vs. federal common law issue is academic because the duties of a chapter 11 trustee and/or officers and directors of debtors in possession under federal common law are generally the same as classic state-law fiduciary duties.[3] These duties generally fall into two categories: a duty of loyalty and a duty of care.

First, the duty of loyalty requires the fiduciary to refrain from self-dealing and to avoid conflicts of interest and the appearance of impropriety.[4] The duty of loyalty also includes the duty to treat all constituents fairly, or remain impartial in the event of conflicts between constituencies. This duty of impartiality is sometimes considered a separate duty and is sometimes considered part of the duty of loyalty.[5]

Second, the duty of care requires trustees and managers of debtors in possession, like officers and directors outside of bankruptcy, to exercise the measure of care, diligence and skill that an ordinarily prudent person would exercise under similar circumstances.[6] The duty of care operates slightly differently in bankruptcy because certain actions of the trustee or debtor in possession require court approval.

---

[1] *See Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) ("[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession."); *Wolf v. Weinstein*, 372 U.S. 633, 649 (1963) ("so long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession"); *see also* Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back—Something May Be Gaining On You,*" 68 Am. Bankr. L. J. 155, 185 (1994) ("The Code does not specifically describe the content of the fiduciary obligations imposed upon the DIP or the trustee in chapter 11. As a result, courts have developed a federal common law of fiduciary obligations to govern the behavior of the trustee and, derivatively, the DIP.").

[2] That said, the recently released report of the American Bankruptcy Institute Commission to Study Chapter 11 Reform explained that the Commission "analyzed whether creating a new fiduciary standard under federal bankruptcy law would better serve the purposes of the Bankruptcy Code" and ultimately "agreed that state law adequately governs fiduciary duties and should continue to govern the fiduciary duties of directors, officers, and similar managing persons in bankruptcy." American Bankruptcy Institute, Commission to Study the Reform of Chapter 11: Final Report and Recommendations 24-25 (2014). In addition, voluntary creditors of an entity are generally aware, or could easily determine, the organizational jurisdiction of a counterparty entity, putting them on actual or constructive notice of the state law generally applicable to fiduciary duties of the entity's management.

[3] *See LaSalle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279, 292 (D. Del. 2000) ("The fiduciary duties that a debtor owes the estate are comparable to the duties that the officers and directors of a solvent corporation owe their shareholders outside bankruptcy."); Russell C. Silberglied, *Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment*, 10 J. Bus. & Tech. L. 181, 208 (2015) ("the majority of courts hold that the fiduciary duties of a DIP are similar or the same as those of an officer and director outside of bankruptcy. Thus, even if there is a distinction between whether federal or state fiduciary duties are owed, the distinction might be without a difference").

[4] *See, e.g.*, *In re Eurospark Indus., Inc.*, 424 B.R. 621, 627 (Bankr. E.D.N.Y. 2010); *In re Coram Healthcare Corp.*, 271 B.R. 228, 235 (Bankr. D. Del. 2001); *In re Bowman*, 181 B.R. 836, 843 (Bankr. D. Md. 1995); *see also* 7 Collier on Bankruptcy ¶ 1108.09 (Alan N. Resnick and Henry R. Sommer eds., 16th ed. 2016).

[5] *Eurospark Indus.*, 424 B.R. at 627; *Bowman*, 181 B.R. at 843.

[6] *Lange v. Schropp (In re Brook Valley VII)*, 496 F.3d 892, 900 (8th Cir. 2007); 7 Collier on Bankruptcy ¶ 1108.04.

Outside of bankruptcy, management's decisions are usually evaluated after the fact, and are usually subject to the business judgment rule. Under the business judgment rule, courts will not second-guess management's decisions so long as they are free from conflict (including conflicts arising from the individual interests of the decision-makers) and made on an informed basis. Like actions taken outside of bankruptcy, actions taken in bankruptcy that are within the ordinary course of business do not require court approval and therefore are usually challenged and evaluated only after the fact; such decisions are also generally subject to the business judgment rule.[7]

By contrast, some decisions made by management routinely in bankruptcy cases—the assumption or rejection of an executory contract, the sale or use of estate property outside the ordinary course of business, and the incurrence of debt by the debtor outside the ordinary course of business—require court approval.[8] Therefore, those decisions are evaluated by the court *before* the fact. While bankruptcy courts evaluating such decisions often refer to the "business judgment rule," as many commentators have noted, a more stringent standard is applied in practice. The business judgment rule requires courts to defer to the judgment of management so long as the process that led to the judgment was proper. But in deciding whether to approve actions by the debtor that require court approval, bankruptcy courts require the debtor to articulate a "rational business purpose" or "good business reason" for the decision,[9] and, while perhaps giving management some latitude on close questions of business judgment, will frequently evaluate the merits of the transaction and its effect on the estate.[10] Accordingly, "courts are not so much deferring to as they are concurring in the business judgment of the trustees and debtors in possession."[11]

There is a substantial, but somewhat inconsistent, body of case law about whether and to what extent bankruptcy trustees are immune from liability that might otherwise arise from their acts or omissions in administering the bankruptcy estate. Courts agree that chapter 11 trustees have quasi-judicial (and complete) immunity for actions approved by the bankruptcy court provided there was full disclosure.[12] Courts also agree that chapter 11 trustees have no immunity for breaches of the duty of loyalty.[13] There is a debate, however, as to whether chapter 11 trustees have immunity for breaches of the duty of care (on matters not subject to court approval), and what the scope of that immunity is. Some courts of appeals have held that chapter 11 trustees

---

[7] *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 797 (Bankr. D. Del. 2007); *In re Curlew Valley Assocs.*, 14 B.R. 506, 513 (Bankr. D. Utah 1981).

[8] 11 U.S.C. §§ 363(b)(1); 365(a).

[9] *See, e.g., In re Friedman's, Inc.*, 336 B.R. 891, 895 (Bankr. S.D. Ga. 2005) ("The business judgment rule is a 'policy of judicial restraint born of the recognition that directors are, in most cases, more qualified to make business decisions than are judges.' The rule is intended to protect directors and officers from liability when they make good faith decisions in an informed, deliberate manner. Courts should approve an exercise of a debtor's business judgment unless it is 'so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.' It is the Debtors' burden to establish that its use of property outside of the ordinary course of business is an exercise of sound business judgment." (internal citations omitted)); *Dai-Ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 242 B.R. 147, 153 (D. Del. 1999) ("In evaluating whether a sound business purpose justifies the use, sale or lease of property under section 363(b), courts consider a variety of factors, which essentially represent a 'business judgment test.'"); *see also In re MF Glob. Inc.*, 467 B.R. 726, 730 (Bankr. S.D.N.Y. 2012) ("[w]here the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the debtor's conduct").

[10] *See, e.g., In re Glob. Crossing Ltd.*, 295 B.R. 726, 746 (Bankr. S.D.N.Y. 2003) ("Assuming that the business judgment test permits and requires this Court, even without making the business decision *ab initio*, to gauge the Board's business judgment on a 'reasonableness' standard, the Board's business judgment plainly passes that test as well.").

[11] *See* 7 Collier on Bankruptcy ¶ 1108.07[2]; *see also In re Efoora, Inc.*, 472 B.R. 481, 488 (Bankr. N.D. Ill. 2012) ("The 'business judgment' test, as it is sometimes called, differs from the business judgment rule under corporate law. The bankruptcy court reviews the trustee's business judgment 'to determine independently whether the judgment is a reasonable one.'" (internal citation omitted)).

[12] *See Harris v. Wittman (In re Harris)*, 590 F.3d 730, 742 (9th Cir. 2009); *LeBlanc v. Salem (In re Mailman Steam Carpet Cleaning Corp.)*, 196 F.3d 1, 8 (1st Cir. 1999); *Richardson v. Monaco (In re Summit Metals, Inc.)*, 477 B.R. 484, 501 (Bankr. D. Del. 2012).

[13] *See Hunter v. Madrid (In re Hunter)*, 553 B.R. 866, 873 (Bankr. D.N.M. 2016) ("If a bankruptcy estate beneficiary alleges that a trustee breached her duty of loyalty (by, for example, self-dealing or improper self-enrichment), courts are in agreement that quasi-judicial immunity offers no protection.").

are liable for even negligent breaches of the duty of care.[14] Other courts of appeals have held that a chapter 11 trustee may be held liable for gross negligence but not for ordinary negligence.[15] Finally, some courts of appeals have held that chapter 11 trustees may be held liable only for willful and deliberate violations of the duty of care;[16] those decisions, however, appear to be based on a misreading of the Supreme Court's decision in *Mosser v. Darrow*, 341 U.S. 267 (1951), in which the Supreme Court explained that willful and deliberate acts of the reorganization trustee or his employees against the interest of the estate will incur personal liability. Those courts erroneously read *Mosser* to mean that *only* willful and deliberate violations can give rise to liability.

Do directors and officers of debtors in possession, who as a matter of law are performing the role of a trustee, enjoy the same immunity? A few courts have recognized or suggested that officers and directors of a debtor in possession, like chapter 11 trustees, are immune from liability for actions approved by the bankruptcy court after full disclosure.[17] Regardless, as a practical matter, management decisions that are approved by the bankruptcy court will not likely be subject to any breach of fiduciary duty claim later: absent misrepresentation to the court or a similar defect in the court approval process itself, court approval effectively cleanses the decision of any later claim against management, and estoppel principles may apply to parties in interest who receive adequate notice of the decision and court approval process. It appears that no court, however, has addressed whether a chapter 11 trustee's (partial) immunity for breaches of the duty of care also applies to officers and directors of debtors in possession.

II. Under Delaware, LLCs and LPs May Waive Fiduciary Duties

In 2004, the Delaware Limited Liability Corporation Act (DLLCA) and the Delaware Revised Uniform Limited Partnership Act (DRULPA) were amended to provide that (a) any duties (including fiduciary duties) can be limited or eliminated by LP or LLC agreement, except for the implied contractual covenant of good faith and fair dealing, and (b) liability for breaches of any duties, including fiduciary duties, can be limited or eliminated by LLC or LP agreement, except liability for a bad faith violation of the implied contractual covenant of good faith and fair dealing.[18] These amendments resolved a controversy among Delaware courts.

Even prior to 2004, the DLLCA and DRULPA provided parties to LLC and LP agreements a great deal of flexibility in defining their duties and rights, including allowing parties to expand or restrict traditional, common-law fiduciary duties. While it was settled that fiduciary duties could be constricted by contract, questions remained about whether these duties could be eliminated altogether by an entity's operating agreement.

The issue had been taken up by both the Delaware Chancery and the Delaware Supreme Courts in the *Gotham Partners* case. In that case, then-Vice Chancellor Strine stated in *dicta* that the DRULPA allowed parties to eliminate fiduciary duties completely, so long as they did so clearly and explicitly and such intention was clear.[19] On appeal, however, the Delaware Supreme Court specifically addressed that *dicta*, stating that it was doing so to avoid it being

---

[14] *See In re Gorski*, 766 F.2d 723 (2d Cir. 1985) (no immunity for negligent actions taken by the case trustee).
[15] *See Dodson v. Huff (In re Smyth)*, 207 F.3d 758, 762 (5th Cir. 2000) ("trustees should not be subjected to personal liability unless they are found to have acted with gross negligence"); *DiStefano v. Stern (In re J.F.D. Enters., Inc.)*, 223 B.R. 610 (Bankr. D. Mass. 1998) (adopting gross negligence standard), *aff'd*, 236 B.R. 112 (D. Mass. 1999), *aff'd*, 215 F.3d 1312 (1st Cir. 2000).
[16] *See Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 462 (6th Cir. 1982) ("We can find Robert Weaver liable in his official capacity only if he was negligent and personally liable only if he willfully and deliberately violated his fiduciary duties"); *Sherr v. Winkler*, 552 F.2d 1367, 1375 (10th Cir.1977) ("a trustee in bankruptcy is not to be held personally liable unless he acts willfully and deliberately in violation of his fiduciary duties").
[17] *See Sam Rei, LLC v. Cont'l Grp., LLC (In re Strata Title, LLC)*, Adv. Proc. No. 14-00319, 2014 WL 6685470, at *2 (Bankr. D. Ariz. Nov. 25, 2014); *In re Pilgrim's Pride Corp.*, No. 08-45664, 2010 WL 200000, at *5 (Bankr. N.D. Tex. Jan. 14, 2010).
[18] *See* Del. Code. Ann. tit. 6, § 18-1101(c) & (e) (2013) (DLLCA); Del. Code. Ann. tit. 6, § 17-1101(d) & (f) (2010) (DRULPA).
[19] *See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, No. 15754, 2000 WL 1476663, at *10 (Del. Ch. Sept. 27, 2000).

"misinterpreted in future cases as a correct rule of law."[20] The Supreme Court acknowledged that the relevant section of the DRULPA allowed duties to be expanded or restricted. But it stated, "[t]here is no mention in § 17-1101(d)(2), or elsewhere in DRULPA at 6 Del. C., ch. 17, that a limited partnership agreement may *eliminate* the fiduciary duties or liabilities of a general partner." The Court further explained: "Finally, we note the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly. Accordingly, although it is not appropriate for us to express an advisory opinion on a matter not before us, we simply raise a note of concern and caution relating to this dubious dictum in the Vice Chancellor's summary judgment opinion."[21] That "dubious dictum," however, was enacted into law by the legislature in 2004.

III. Fiduciary Duty Waivers Do Not Apply in Bankruptcy

What happens when an LLC or LP in which fiduciary duties have been limited or eliminated by the governing agreement goes into bankruptcy? It appears that only two courts have addressed the issue, and both concluded that federal common law—and the imposition of fiduciary duties thereunder—trumped any state-law fiduciary duty limitations or waivers.

In re Hampton Hotel Investors, L.P. addressed the effect in bankruptcy of terms in an LP agreement limiting fiduciary duties.[22] The issue in that case was whether cause existed to convert the chapter 11 case of a New York limited partnership to chapter 7. As part of that inquiry, the court considered "whether, by reason of the terms of the Partnership Agreement, [the general partner's] self-dealing and conflicts of interest [during the pendency of the bankruptcy case] are permissible and/or can be excused."[23] For three reasons, the court found that they could not be, thus requiring the conversion to chapter 7.

First, the court found that the particular partnership agreement at issue in that case permitted conflicts only in connection with the purchase of goods and services, which was not applicable. *Second*, the court found that the limitation of liability in the partnership agreement was only granted by, and only applied to claims by, the limited partners: "No explanation has been proffered, nor can the Court see any, as to how any such safe harbors would address any duties to creditors." *Third*, the court found that the fiduciary duty limitations had no effect in bankruptcy: "And as a matter of law, the Court finds that provisions of that type (aside from the injustice of purporting to bind creditors, who were non-parties to the agreement), even if present, could not trump the duties of a debtor in possession, which, with exceptions not relevant here, takes on duties of a trustee under law."[24]

In re Houston Regional Sports Network, L.P. addressed complete fiduciary duty waivers in an LP agreement.[25] The debtor in that case, a Delaware limited partnership, was a regional sports network that broadcast sports games.[26] The debtor had entered into media rights agreements with the Houston Astros and Houston Rockets, pursuant to which the debtor paid those teams for the exclusive rights to broadcast their games in certain territories.[27]

The debtor's LP agreement provided that the debtor's partners (affiliates of Comcast Corp., the Houston Astros and the Houston Rockets) waived all fiduciary duties (and liability for breaches thereof), and also gave each partner a veto right over any substantial decision or action by the

---

[20] *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167-68 (Del. 2002). 817 A.2d 160, 167-68 (Del. 2002).
[21] *Id*.
[22] 270 B.R. 346 (Bankr. S.D.N.Y. 2001).
[23] *Id.* at 360.
[24] *Id.* at 361.
[25] 505 B.R. 468 (Bankr. S.D. Tex. 2014).
[26] *Id.* at 471.
[27] *Id.*

entity.[28] Pre-bankruptcy, the debtor defaulted on its media rights agreement with the Astros, which gave the Astros the right to terminate its media rights agreement following the expiration of a cure period.[29] The termination by the Astros of their media rights agreement would have forced the debtor to liquidate. Prior to the expiration of the cure period, affiliates of Comcast put the debtor into an involuntary bankruptcy to prevent the Astros from terminating the media rights agreement.[30]

In opposing the entry of an order for relief on the involuntary petition, the director of the debtor's general partner appointed by the Astros argued that the reorganization of the debtor would be futile: because all fiduciary duties had been waived, he was permitted to focus exclusively on the interests of the Astros, and could veto any decisions of the debtor that might benefit the bankruptcy estate at the expense of the Astros.[31] The bankruptcy court disagreed: "With the entry of the order for relief, management became duty-bound to meet fiduciary responsibilities. As fiduciaries, the Court expects that the four directors will act in the best interest of the Network. Although the Astros threaten to have their appointed director veto any arrangement (with the intention of terminating the Astros' Media Rights Agreement), implementation of such a wholesale threat would be a breach of the Astros-appointed-director's fiduciary duty."[32]

These cases confirm that fiduciary duties in bankruptcy are governed by federal common law. Otherwise, state law could operate to frustrate the purpose and process of bankruptcy: management of the estate for the benefit of creditors.[33]

IV. Under Delaware Law, Creditors of LPs and LLCs Lack Standing to Assert Fiduciary Duty Claims, Even Derivatively, and Even if the Entity Is Insolvent

As described in Part II, under Delaware law (since the enactment of the 2004 provisions), waivers of fiduciary duties by limited partners and members of LLCs are clearly valid and enforceable as against the parties that agree to those waivers. That then raises the question: Can the waivers be enforced against creditors who did not expressly waive any duties? The court in *Hampton Hotel*, for example, held that state-law fiduciary duty waivers did not apply against creditors in bankruptcy because creditors were not parties to the debtor's LP (or LLC) agreement, and in bankruptcy, creditors (at least of insolvent debtors) bear the risk of estate losses.

That same logic would, on its face, also apply to creditors of insolvent entities that are *not* in bankruptcy. They too bear the risk of losses to the entity and were not parties to the LLC or LP agreement (and, in the case of involuntary creditors such as tort victims, would have no reason to know the terms of the LLC or LP agreement before becoming creditors). Furthermore, one of the fundamental rationales for fiduciary duties—and for not permitting their waiver in the corporate context—is that corporations have separate ownership and control.[34] When an LLC or LP is insolvent, the same separation of ownership and control exists, since creditors are the residual owners. So how does Delaware law deal with creditors of *insolvent* LLCs or LPs that have waived fiduciary duties in their operating agreements?

The language of the statute might suggest that the waivers cannot be enforced against creditors. Specifically, the provisions of the DLLCA and DRULPA that permit LLCs and LPs to waive fiduciary duties in their operating agreements clarify that what may be waived are duties owed

[28] *Id.* at 479.
[29] *Id.* at 471.
[30] *Id.* at 478.
[31] *Id.* at 479.
[32] *Id.* at 480-81.
[33] Based on a similar rationale, the right to veto a bankruptcy filing, when coupled with a waiver of fiduciary duties, may be void as a matter of public policy. *See In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016).
[34] *See, e.g.*, *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

to (a) the LLC (or LP) itself, (b) to another member or manager (or partner), or (c) to another person who is a party to or is otherwise bound by the agreement.[35] Creditors, of course, fall into none of these categories. This might suggest that fiduciary duties owed *to creditors* cannot be waived by LLC or LP agreement under Delaware law.

Delaware law, of course, separately makes clear that fiduciary duties are never owed to the creditors directly. Rather, as the Delaware Supreme Court explained in *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, those duties are owed to the corporate entity—and can simply be *enforced* by creditors, derivatively, when the entity becomes insolvent on a balance sheet basis.[36] *Gheewalla* explained that when a corporation is insolvent, "equitable considerations give creditors standing to pursue derivative claims against the directors" because in the event of insolvency, the corporation's creditors are its residual claimants.[37]

Like corporations, LLCs and LPs rely on the common law as the source of fiduciary duties; accordingly, *Gheewalla*'s holding that common-law fiduciary duties are owed only to the entity itself, and not to creditors, applies equally to LLCs and LPs. The language of DLLCA and DRULPA expressly permits LLC and LP agreements to waive duties owed to the LLC or LP itself.[38] Nevertheless, because *Gheewalla* recognized that creditors of an insolvent corporation have derivative standing to assert fiduciary duty claims—and because creditors are not parties to LLC or LP agreements—there was still considerable debate after *Gheewalla* about the effect of fiduciary waivers applied to creditors in the event of insolvency by the LLC or LP.

That issue was effectively mooted, however, in 2010. In *CML V, LLC v. Bax*, Vice Chancellor Laster of the Delaware Chancery Court held that creditors of an LLC (whether solvent or insolvent) do not have standing to assert derivative claims.[39] The court reasoned that sections 18-1001 and 18-1002 of the DLLCA—which grant standing to bring derivative claims only to "a member or an assignee of a limited liability company interest"—did not include creditors.[40] And that plain language, the court explained, trumped the "equitable considerations" recognized in *Gheewalla* that give creditors standing to pursue derivative claims against the directors of an insolvent corporation.[41] The court also contrasted the Delaware General Corporation Law, finding that it contained no analogous section limiting derivative standing.[42] The court noted that "[m]any commentators … have assumed that creditors of an insolvent LLC can sue derivatively. In light of this assumption, they have debated vigorously whether an LLC agreement can limit the fiduciary duties that the creditors would invoke. That question never arises if creditors lack standing to sue under Section 18-1002."[43] The Delaware Supreme Court affirmed.[44] (*Bax* at

---

[35] *See* Del. Code. Ann. tit. 6, § 18-1101(c) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) *[1] to a limited liability company or [2] to another member or manager or [3] to another person that is a party to or is otherwise bound by a limited liability company agreement*, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." (emphasis added)); Del. Code. Ann. tit. 6, § 17-1101(d) ("To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) *[1] to a limited partnership or [2] to another partner or [3] to another person that is a party to or is otherwise bound by a partnership agreement*, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." (emphasis added)).

[36] 930 A.2d 92 (Del. 2007).
[37] *Id.* at 102.
[38] *See* Del. Code. Ann. tit., § 18-1101(c) & (e) (DLLCA); Del. Code. Ann. tit., § 17-1101(d) & (f) (DRULPA).
[39] 6 A.3d 238 (Del. Ch. 2010).
[40] *Id.* at 241.
[41] *Id.* at 240-41.
[42] *Id.* at 242.
[43] *Id.* at 243.
[44] 28 A.3d 1037 (Del. 2011).

least arguably applies equally to LPs; as the court noted, the DRULPA contains substantially identical language limiting derivative standing.[45])

Because creditors of Delaware LLCs (and at least arguably LPs) never have derivative standing to assert fiduciary duty claims (even in the event of insolvency), the question of whether fiduciary duty waivers can eliminate creditors' derivative standing in insolvency under Delaware law is therefore moot.

Regardless of whether *Bax* is correct as a matter of statutory interpretation, it certainly raises interesting policy questions. For example, the court in *Bax* explained that creditors of LLCs have ways to protect themselves other than by asserting fiduciary duty claims derivatively.[46] Specifically, the court pointed to provisions of the DLLCA that "authorize[] an LLC agreement to 'provide rights to any person, including a person who is not a party to the [LLC] agreement, to the extent set forth therein,'" and reasoned that "[a] creditor therefore can bargain for express contractual rights in the LLC agreement while remaining a non-party to the agreement."[47] But most creditors, other than perhaps primary lenders, would not have the opportunity or leverage to strike such a bargain, and such protections are not available to involuntary creditors.

V. In Bankruptcy, Creditors of Delaware LLCs and LPs (Through a Committee) Likely Could Obtain Standing to Assert *Post-Petition* Fiduciary Duty Claims, and Possibly Could Obtain Standing to Assert *Pre-Petition* Claims, Notwithstanding *Bax*

Does the decision in *Bax* have implications in bankruptcy?

Several federal courts of appeals have held that bankruptcy courts may grant standing to a creditors' committee (and, in some cases, creditors) to pursue *pre-petition or post-petition* breach of fiduciary duty and other estate claims when colorable claims exist and the trustee or debtor in possession (1) unreasonably refuses to bring suit on its own[48] or (2) consents.[49] Prior to the Delaware Supreme Court's decision in *Bax*, "virtually no one ha[d] construed the derivative standing provisions as barring creditors of an insolvent LLC from filing suit" and "[m]any commentators … assumed that creditors of an insolvent LLC can sue derivatively."[50] And it seems that no court has squarely addressed the issue of whether, following *Bax*, a bankruptcy court may grant derivative standing to a creditor or creditors' committee to pursue breach of fiduciary duty claims where the debtor is a Delaware LLC or LP.

As explained above, the general view is that federal common law governs fiduciary duties post-petition; accordingly, as to *post-petition* claims, there is a strong argument that federal common law should apply, and that—just as state-law fiduciary duty waivers do not limit fiduciary duties during a bankruptcy case—state-law limitations on derivative standing do not limit derivative standing for breaches of fiduciary duties committed during a bankruptcy case.

---

[45] 6 A.3d at 245-46 (discussing Del. Code. Ann. tit. 6, § 17-1002).

[46] 6 A.3d at 250 ("Creditors generally are presumed to be 'capable of protecting themselves through the contractual agreements that govern their relationships with firms.' 'Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections.' To limit creditors to their bargained-for rights and deny them the additional right to sue derivatively on behalf of an insolvent entity comports with the contractarian environment created by the LLC Act." (internal citations omitted)).

[47] *Id*.

[48] *See Hyundai Translead, Inc. v. Jackson Truck & Trailer Repair, Inc. (In re Trailer Source, Inc.)*, 555 F.3d 231, 233 (6th Cir. 2009); *PW Enters., Inc. v. N.D. Racing Comm'n (In re Racing Servs., Inc.)*, 540 F.3d 892, 898 & n. 7 (8th Cir. 2008); *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 583 (3d Cir. 2003) (en banc); *Fogel v. Zell,* 221 F.3d 955, 965 (7th Cir. 2000); *La. World Exposition v. Fed. Ins. Co.,* 858 F.2d 233, 247-48 (5th Cir. 1988); *Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters.)*, 779 F.2d 901 (2d Cir. 1985).

[49] *Smart World Techs., LLC v. Juno Online Servs. (In re Smart World Techs., LLC)*, 423 F.3d 166, 176, n.15 (2d Cir. 2005); *Avalanche Mar., Ltd. v. Parekh* (*In re Parmetex, Inc.*), 199 F.3d 1029, 1031 (9th Cir. 1999).

[50] 6 A.3d at 242-43.

Even as to *pre-petition* fiduciary duty claims, which are generally governed by state law, there is a plausible argument that federal bankruptcy law governs standing to assert such claims on behalf of the estate (though state law would govern the merits of the claims[51]).

But courts may reach the opposite conclusion: that *Bax* limits standing in bankruptcy to assert pre-petition claims. For example, *In re Golden Guernsey Dairy, LLC*, a chapter 7 trustee of a Delaware LLC asserted claims against insiders of the debtor for *pre-petition* breaches of their fiduciary duties (where the asserted claims apparently had not been waived in the LLC agreement).[52] The defendants argued that the claims should be dismissed because "the potential harm [from the alleged breaches] is to the general unsecured creditors and … such creditors of a limited liability company do not have standing to bring suit for the breaches of fiduciary duty" under section 18-1002 of the DLLCA, which "limits derivative standing to sue for breaches of fiduciary duty to a 'member or an assignee of a limited liability company interest.'"[53] The court rejected that argument, explaining that the trustee was not asserting claims on behalf of creditors but rather was a representative of the *estate* asserting claims of the debtor that had passed to the estate.[54]

Notably, the court in *Golden Guernsey* did not conclude that state law was wholly inapplicable to questions of standing in bankruptcy. Rather, the court ruled that *Bax* simply did not apply to the specific claim at issue because it was a cause of action that pre-bankruptcy belonged to the debtor and was being asserted on behalf of the estate. But the fact that the cause of action belonged to the debtor and was being asserted on behalf of the estate is not a persuasive basis for distinguishing *Bax*; indeed, the same is true of the claim that the creditors sought derivative standing to assert in *Bax*. By definition, derivative actions are claims of the entity asserted on the entity's behalf. To the extent that *Golden Guernsey* was instead attempting to draw a distinction between claims asserted by the entity itself (or by a trustee as a representative of the entity) on the one hand and claims asserted *derivatively* on the other, it at least suggests that the DLLCA may continue to apply to pre-petition breach of fiduciary claims—and bar creditors or creditors' committees from derivative standing—even in bankruptcy.[55]

VI. The Bottom Line

The fiduciary duties owed by management of an insolvent Delaware LLC or LP—and the ability of creditors to enforce those duties—may be substantially different depending on whether the entity is in bankruptcy.

Under Delaware law, LLCs and LPs can waive all fiduciary duties and liability for breaches thereof. And regardless of whether fiduciary duties have been waived, creditors of LLCs (and

---

[51] Thus, where fiduciary duties had been waived, such waivers would still provide a defense to claims for pre-petition breaches of fiduciary duties.

[52] *Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy, LLC)*, 548 B.R. 410 (Bankr. D. Del. 2015).

[53] *Id.* at 413.

[54] *Id.*

[55] In addition, it is worth noting that some courts have held that fiduciary duty actions by chapter 7 trustees *are derivative actions on behalf of creditors*. *See, e.g.*, *Leslie v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 660 F. App'x 546, 548 (9th Cir. 2016) (quoting statement in *Gheewalla,* 930 A.2d at 103, that "*creditors … have no right to assert direct* claims for breach of fiduciary duty against corporate directors" as applying to chapter 7 trustee), *petition for cert. filed*, No. 16-1136 (Mar. 15, 2017); *Mims v. Fail (In re VarTec Telecom, Inc.)*, Adv. Pro. No. 06-03506, 2007 WL 2872283, at *4 (Bankr. N.D. Tex. Sept. 24, 2007) ("The essence of a derivative action is that it is brought in the stead of a direct action brought by the corporation itself. Consistent with the holding in *Gheewalla*, the Chapter 7 Trustee in this case is bringing such a derivative action *on behalf of the corporations' creditors*." (emphasis added)). Courts adopting this view may therefore find that chapter 7 and chapter 11 trustees of Delaware LLCs and LPs cannot assert pre-petition breach of fiduciary duty claims. Indeed, one court declined to decide whether a chapter 7 trustee's breach of fiduciary duty claim against a Delaware LP's former partner was a derivative claim on behalf of creditors or was a direct claim but noted that under *Bax*, the chapter 7 trustee lacked standing to bring a derivative claim. *See Tow v. Amegy Bank N.A.*, 976 F. Supp. 2d 889, 904 (S.D. Tex. 2013).

arguably LPs) lack derivative standing to bring breach of fiduciary duty claims, even if the LLC or LP is insolvent.

In bankruptcy, by contrast, state-law fiduciary duty waivers are likely ineffective: courts generally hold that post-petition, management of a debtor in possession owes, as a matter of federal common law, traditional state-law fiduciary duties to the estate. As to post-petition breach of fiduciary duty claims, federal common law will likely also govern when and whether creditors have derivative standing to assert such claims. As to breach of fiduciary duty claims that arose pre-petition, however, it remains to be seen whether bankruptcy courts will rely on federal common law or applicable state law to determine whether creditors have standing to assert those claims.

FOR MORE INFORMATION ON THIS OR OTHER BANKRUPTCY MATTERS, CONTACT:

Isley M. Gostin +1 202 663 6551 isley.gostin@wilmerhale.com
Craig Goldblatt +1 202 663 6483 craig.goldblatt@wilmerhale.com
George W. Shuster, Jr. +1 212 937 7232 george.shuster@wilmerhale.com