The Estate's Potential Claims Against Management for Failure to Prevent Sexual Misconduct

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I. Introduction.

The *#MeToo* movement has had a seismic impact over the last two years. The media reports of egregious sexual misconduct by Dr. Larry Nasser and producer Harvey Weinstein, which surfaced against Nasser in November 2016 and against Weinstein in October 2017, highlighted the horrific behavior of two notorious sexual predators. While there are others too numerous to mention, Nasser and Weinstein are particularly notable to restructuring professionals because USA Gymnastics, Inc. ("USAG") and the Weinstein Company, LLC and its parent company The Weinstein Company Holdings, LLC ("The Weinstein Company") ultimately ended up in chapter 11 proceedings as a result of their conduct, which generated an the avalanche of lawsuits and caused the revenue of both entities to contract. Undoubtedly, there is more trouble on the horizon—for example, the history of sexual abuse within the Boy Scouts of America (BSA) is an open secret and the multiple lawsuits against BSA have led to widespread speculation that it will ultimately end up in a chapter 11 proceeding as well.

In bankruptcy cases where sexual abuse has been perpetrated on this scale, debtors in possession, trustees, creditors' committees, and their advisors should take a close look at potential claims against officers and directors of the debtor for failure of oversight or actually enabling the abuse to occur. To the extent these claims exist, they are likely covered by a directors and officers liability insurance policy, which may be one of the few sources of recovery for unsecured creditors. This article summarizes the key considerations in evaluating such claims.

II. Choice of Law.

Although a comprehensive choice-of-law analysis is beyond the scope of this article, a court considering claims for breach of duty against the members of the board will apply the "internal affairs doctrine," which provides that the law applicable to breach-of-duty claims is that of the state of formation of the entity unless another state has a more significant relationship with the parties and the dispute.

III. Standing Issues When the Debtor Is a Limited Liability Company or Limited Partnership.

Recent decisions of the Delaware bankruptcy court and the Delaware chancery court cast doubt on whether a creditors' committee can obtain standing to prosecute the claims of the debtor against members and managers of a limited liability company or general partners of a limited partnership for breach of duty where applicable state statutes do not permit derivative claims.

In *CML V LLC v. Bax,*[1] the Delaware Court of Chancery held that creditors of an LLC cannot be granted derivative standing to sue fiduciaries of the LLC for breach of fiduciary duty even if the LLC is insolvent. The court relied on the language of sections 18-1001[2] and 18-1002[3] of Delaware's LLC statute. The decision creates a different rule for LLCs than for corporations; creditors of an insolvent corporation can obtain derivative standing to sue officers, directors, or controlling stockholders for breach of fiduciary duty.[4]

In *Official Comm. v. Comvest Group Holdings (In re HH Liquidation, LLC)*[5], the Delaware bankruptcy court relied on *Bax* in determining, *posttrial,* that a creditors' committee of an LLC debtor cannot obtain standing to sue the fiduciaries of the debtor for breach of duty even where the bankruptcy court has entered an order approving a stipulation between the debtor and the committee granting derivative standing to the committee to prosecute the claims. The court's ruling on committee standing was an alternative holding made "separately and independently from the merits of the fiduciary duty claims"[6] that it had already determined failed on the merits. The court held that "a standing order does not act as a bar to raising standing issues."[7] Relying on *Bax*, the court interpreted the language of section 18-1002, which prescribes the proper plaintiff in a derivative action against an LLC. "The Delaware Limited Liability Company Act ('LLC Act') is clear and unambiguous about who can bring a derivative action: the plaintiff 'must be a member or an assignee.' . . . The Committee is neither a member nor an assignee. Under the plain language of the statute, the Committee has no standing to bring a breach of fiduciary duty claim."[8]

The court in *HH Liquidation* distinguished *Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy)*,[9] which allowed a chapter 7 trustee to sue fiduciaries of an LLC debtor for breach of fiduciary duties. Unlike a chapter 7 trustee, who is empowered by statute to act as "the sole representative of the estate with the authority to sue and be sued," a creditors' committee is a collection of unsecured creditors.[10] "Its rights to assert derivative claims are limited to the derivative standing of its members, none of whom have standing as creditors of a Delaware LLC to assert derivative claims of breach of fiduciary duty on behalf of the company."[11]

In *Gavin/Solmonese LLC v. Citadel Energy Partners, LLC (In re Citadel Watford City Disposal Partners, L.P.)*,[12] the standing limitations on creditors' committees set forth in *HH Liquidation* were reaffirmed and applied to an LP[13] debtor and LLCs organized outside of Delaware. The court also expanded the standing limitation to prohibit a liquidation trustee from prosecuting the debtors' claims. The claims at issue were initially filed by a creditors' committee pursuant to an order by the bankruptcy court granting the committee standing to prosecute the claims. The claims were subsequently assigned to the liquidation trustee

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pursuant to a confirmed plan of reorganization. The court reasoned that because the liquidation trustee took the claims by assignment from the creditors' committee, the claims were subject to the same standing defects as when they were held by the committee. *Citadel* does not address what would happen if the claims were not "tainted" by assignment to a committee in the first instance but rather were assigned directly by the debtor's estate to the liquidation trustee.

The focus of these two Delaware bankruptcy court decisions on state law derivative-standing statutes may be misplaced. Other courts have discussed the ability of bankruptcy courts to allow committees to bring estate claims on behalf of the debtor (subject to certain conditions) as a special occurrence in bankruptcy cases based on bankruptcy courts' broad powers under Bankruptcy Code section 105 and the statutory powers and role of creditors' committees. Under the reasoning of these cases, the authority to pursue estate claims conferred by bankruptcy courts to committees is *similar* to derivative suits by shareholders authorized by state statutes, but the power of the bankruptcy courts is *not* derived from or predicated on the derivative standing provisions under the state statutes.[14]

Nevertheless, *HH Liquidation* and *Citadel* are the most recent decisions on the issue from an influential bankruptcy court. If these decisions are followed, a bankruptcy court will look to the law of the state of formation of the debtor in evaluating whether a creditors' committee can obtain derivative standing to prosecute the LLC or LP debtor's claims for breach of duty against members, managers, and partners. Because the LLC and LP statutes of most states are based on the same uniform statute, committees (and trustees if they receive the claims from a committee) will face standing hurdles in bringing breach-of-duty claims irrespective of what state law is applicable. In light of the uncertainty concerning standing, consideration should be given to assigning claims against third parties to a litigation trust pursuant to a plan of reorganization rather than having a committee prosecute the claims. The litigation trustee would have a strong argument that *HH Liquidation* and *Citadel Energy Partners* should not apply to impair a trustee's standing.

IV. Applicable Legal Standards.

This article focuses on Delaware corporate law because the decisions of its bankruptcy and chancery courts are influential and because a disproportionate number of corporations, LLCs, and LPs are organized under Delaware law.

A. Delaware Law Permits the Limitation or Elimination of Fiduciary Duties Under an LLC or LP Agreement.

Unlike corporations, which can only eliminate liability of directors (but not officers) for monetary liability for breaches of the duty of care,[15] Delaware LPs and LLCs are permitted to eliminate the fiduciary duties of their members, managers and partners, including liability for a breach of the duty of loyalty.[16] Delaware law requires enforcement of clear exculpation provisions that eliminate legal duties and personal liability.[17] Therefore, it is critical to review the exculpation provisions of the applicable operating agreements or partnership agreements as part of any evaluation of claims against fiduciaries for breach of duty.

B. The Duties Owed to the Debtor by Its Corporate Fiduciaries.

The officers and directors of a corporation owe fiduciary duties to the entity. Fiduciary duties are also owed by managers and managing members of an LLC and general partners of an LP, where those duties have not been eliminated by exculpation provision.[18]

The duty of care requires that fiduciaries exercise informed business judgment in managing the company. This means that they must consider "all material information reasonably available to them" before making a decision.[19] Courts presume that a director's business judgment was informed and made in good faith and in the honest belief that the action taken was in the best interest of the company. Accordingly, a breach of the duty must involve gross negligence.[20] Corporations may exculpate directors from monetary liability arising from breach of the duty of care.[21]

The duty of loyalty is the duty of fidelity to the organization and includes the duty to act in good faith.[22] Liability for breaches of the duty of loyalty cannot be exculpated by corporations but can be by LPs and LLCs. If the exculpation provisions carve out claims based on acts or omissions that were not in good faith, this species of breach-of-loyalty claim will remain viable. Where sexual misconduct is involved, acting with a purpose other than advancing the best interests of the entity or acting with intent to violate the law constitutes a failure to act in good faith.[23] Additionally, the management can be liable for failure to exercise proper oversight.

1. Failure of Oversight.

Fiduciaries[24] can be liable for breach of duty for failing to exercise oversight, as articulated in the Delaware chancery court's decision *In re Caremark Int'l Inc. Derivative Litigation.*[25]

Caremark was indicted on charges arising from illegal kickbacks paid to a physician in exchange for prescribing Caremark-delivered drugs. Caremark settled the criminal charges by pleading guilty to mail fraud, paying criminal fines, and making a monetary settlement of the civil claims. It also settled private lawsuits brought by insurance company payors. Caremark paid about $250 million to resolve all claims arising out of the misconduct.[26]

In the shareholder derivative litigation that followed, plaintiffs claimed that the directors should have known that certain officers and employees of Caremark were involved in illegal conduct. The plaintiffs claimed that the Caremark directors breached their fiduciary duty for having "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[27]

In evaluating the proposed settlement of the claims, the Delaware Court of Chancery formulated the following standard for assessing the liability of directors where the directors are unaware of employee misconduct that results in the corporation being held liable:

> only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[28]

The Delaware Supreme Court has repeated the *Caremark*

court's observation that proving liability for a failure of oversight is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[29] The *Caremark* standard places an extremely high burden on a plaintiff to state a claim for director liability for a failure to perceive the extent of a debtor's risk from the sexual misconduct of an employee.

The Delaware Supreme Court adopted the *Caremark* standard and clarified that in order to impose personal liability on directors for a failure of oversight, there must be evidence that "the directors knew that they were not discharging their fiduciary obligations."[30] To survive a motion to dismiss, a plaintiff must plead particularized facts that satisfy one of the necessary conditions for director oversight liability articulated in *Caremark*: either that (1) "the directors utterly failed to implement any reporting or information system or controls"; *or* (2) "having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[31]

This liability standard "draws heavily upon the concept of director failure to act in good faith."[32] The Delaware Supreme Court explained the "'intentional dereliction of duty'" or "'conscious disregard for one's responsibilities'" that "is more culpable than simple inattention or failure to be informed of all facts material to the decision" reflects that directors have acted in bad faith and cannot, by default, avail themselves of defenses grounded in a presumption of good faith.[33] In order to plead a *Caremark* claim, a plaintiff must plead facts that allow a reasonable inference that the directors acted with scienter which, in turn, "requires not only proof that a director acted inconsistent with his fiduciary duties and most importantly, that the director knew he was so acting."[34]

To satisfy this standard, a complaint must plead facts indicating that "the directors were conscious of the fact that they were not doing their jobs."[35] Even gross negligence is insufficient to support a claim of bad faith.[36] "For reasons *Caremark* well-explained, to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care."[37] Typically, directors are not charged with preventing illegal actions by company employees unless certain "red flags" make it inescapable that the board acted with illegal intent, or in bad faith ignored a duty to act to prevent a violation.[38]

"Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.' As a result, a fiduciary of a Delaware entity cannot be loyal to the entity by knowingly causing it to seek profit by violating the law."[39] "Illegal corporate conduct is not loyal corporate conduct."[40]

2. Cases Dealing With Sexual Misconduct and Breach of Fiduciary Duty.

The two cases discussed below, *White v. Panic*[41] and *In re American Apparel S'holder Deriv. Litigation*,[42] are instructive because they (i) address the duties of directors in responding to sexual misconduct allegations and (ii) illustrate difficulty of drafting a complaint that will survive a motion to dismiss.

a. White v. Panic

ICN Pharmaceuticals and its CEO were the subjects of a *U.S. News & World Report* cover story in 1998[43] that reported on a pattern of sexual harassment and misconduct against the CEO. Six women complained that the CEO propositioned and groped them repeatedly and rewarded or punished them based on whether they complied or complained.

The board said it had no knowledge of the CEO's conduct for years. Even after they did learn of his conduct, they kept the CEO on at the company and continued to highly compensate him. After the *U.S. News & World Report* article was published, a shareholder filed a derivative action alleging claims for breach of fiduciary duty against the CEO for sexual misconduct and against the directors for taking actions that absolved the CEO of responsibility for his behavior and for failing to implement proper control mechanisms.

The complaint alleged that board members covered up the CEO's misconduct by requiring employees to submit grievances to confidential arbitration[44] and the company guaranteed a $3.5 million loan to settle a paternity suit.[45] The complaint also alleged that the board had made additional payments to settle harassment claims against the CEO, but lacked details regarding the amount or nature of these settlements.[46]

In dismissing the complaint for failure to meet the requirements for "demand futility,"[47] the Delaware Court of Chancery observed, among other things: (i) plaintiff's pleading burden in meeting the demand-futility requirements are more onerous than required to withstand a motion to dismiss because plaintiff must overcome the powerful presumptions of the business judgment rule before being permitted to pursue a derivative claim,[48] (ii) the plaintiff had not conducted any type of pre-suit investigation, (iii) the allegations in the complaint "with several limited exceptions"[49] were copied almost verbatim from the *U.S. News and World Report* article and the "facts reported in the article did not bear the interpretation given to them by plaintiff,"[50] and (iv) the CEO had "never been legally found to have engaged in sexual harassment" and that even if he had, "companies with an individual of such essential value as the CEO face a dilemma" referencing statements in the article by a director suggesting that his fiduciary duties to shareholders "was best served by not creating any trouble for the CEO."[51] The Delaware Supreme Court affirmed, noting the allegations of the "board's knowledge and conduct are sparse."[52]

Even though the plaintiff chose not to pursue a *Caremark* claim for failure of oversight,[53] the chancery court concluded that a *Caremark* claim would not have survived because the board responded to the CEO's harassment.[54] Among other things, the board formed a special committee in 1995 to review sexual harassment claims against the CEO and retained "reputable counsel" to investigate and report on the allegations.[55] These steps were apparently sufficient to constitute more than the "utter failure" of oversight required to satisfy the *Caremark* standard.

The Delaware Supreme Court found allegations that the board approved the use of corporate funds to settle the sexual misconduct claims against the CEO and the company did not rebut the business-judgment presumption applicable to claims for

breach of the duty of care, stating "the plaintiff has not pleaded facts indicating that the challenged settlements were anything other than routine business decisions in the interest of the corporation."[56] Instead, "the alleged settlements, in which neither the CEO nor the company admitted wrongdoing, are consistent with a desire to be rid of strike suits and to avoid the cost of protracted litigation."[57]

b. American Apparel

In 2010, shareholders of American Apparel filed a derivative action in the District Court for the Central District of California against the company, its CEO, CFO, and current and former directors alleging breaches of fiduciary duties related to sexual harassment, violations of labor and immigration law, and accounting irregularities, among other claims.

Applying Delaware law because American Apparel was incorporated in Delaware, the district court relied on *White v. Panic* in dismissing the complaint. The district court acknowledged that the complaint was more specific than the pleading in *White,* that "reports documenting the CEO's sexual proclivities and the company's unconventional work environment support an inference that the directors knew or should have known that there was possible cause for concern,"[58] that the complaint drew upon "multiple sources in contrast to the complaint in *White,* which relied almost entirely on a single news article,"[59] and that the Equal Employment Opportunity Commission's ("EEOC") finding of sexual harassment at the company "lends some credibility to plaintiffs' claims."[60] However, the court found "plaintiffs have not pled particularized facts indicating that the board failed to act despite actual or constructive knowledge of problems with the company's work environment."[61] "The bare allegation that the CFO's sexual proclivities were widely known is insufficient to support a lack of oversight claim."[62] The court refused to disqualify the directors for demand futility and granted the defendant's motion to dismiss.

The CEO was subsequently terminated by the board in 2014 after an internal investigation revealed that he had allowed an employee to post nude photos online of a former female employee who had sued him for sexual harassment and misused company funds.[63] Subsequently, two American Apparel shareholders filed new derivative actions against the company, the CEO, and former and current directors, which were also unsuccessful.[64]

According to the district court, the sexual harassment claims against the CFO ceased after 2011 and "the Board may reasonably have believed that the CEO's alleged sexual proclivities were no longer a significant issue for the Company especially given that significant financing was contingent on the Company retaining him as CEO and the difficulties in providing evidence sufficient to terminate him for cause under his employment contract."[65] When the allegations of the nude photo postings were known, the directors "did take action for precisely the reasons Plaintiffs assert they should have."[66] The Ninth Circuit affirmed without a published decision.[67]

3. Claims Against the Perpetrator Directors for Breach of Fiduciary Duties.

Acts of officers or board members with a purpose other than advancing the best interests of the entity or with intent to violate the law are bad-faith breaches of duty.[68] Sexual harassment by a board member acting on behalf of the entity should constitute a bad-faith violation of the duty of loyalty or as breach of the duty of care not protected by the business judgment rule. When a CEO or other agent of the entity exploits a position of power to harass and assault, the individual is not acting to advance the entity's interests. Such actions can cause actionable damage to the entity as discussed below.

4. Claims Against Other Board Members.

Notwithstanding the difficulty of proving *Caremark* claims, a board's failure to effectively act in the face of known "red flags" of sexual misconduct or abuse should constitute one of the unusual situations where a *Caremark* claim can succeed. The recent revelations of the horrendous abuses committed by Harvey Weinstein and Larry Nasser, among others, along with the well-publicized travails of the Catholic Church, have made our society more sensitive to the plight of the victims of sexual abuse. This may cause judges to view claims against corporate fiduciaries that permit or enable the abuse to occur to be evaluated more sympathetically than the courts did in *American Apparel* and *White v. Panic.*

Moreover, depending on circumstances, claims of ignorance in the face of multiple "red flags" can also support a *Caremark* claim to the extent it shows the board failed to respond to warning signs that an employee was a grave threat to the entity and its employees or others to whom the entity may owe a duty. If the board members are unaware of an employee's sexual misconduct and harassment, the adequacy of its internal monitoring system becomes an issue and suggests that the board may have intentionally ignored "red flags."

In addition to claims that board members breached their fiduciary duties by failing to monitor sexual misconduct, consideration should be given to whether facts exist to support a claim that a board enabled the illegal sexual harassment and misconduct. For example, if board members know that a CEO or other powerful employee is a serial sexual predator and is harassing and assaulting employees or others to whom the entity owes a duty, but nevertheless determine that the best option for the entity is to protect the abuser and the illegal behavior, that conduct would likely meet the *Caremark* standard.

V. Damages.

A plaintiff alleging a breach-of-fiduciary-duty claim must prove its damages by a preponderance of the evidence. The court cannot award damages that are based on mere speculation or conjecture. Generally speaking, the plaintiff should be entitled to recover what the debtor would have received but for the breach of fiduciary duty.

There are at least four grounds upon which a plaintiff may be able to show that management's failure of oversight over a sex abuser caused damage to the entity: (i) reputational damage and the loss of identifiable business opportunities and revenue resulting from revelations of sexual misconduct; (ii) direct costs of litigation related to the perpetrator's misconduct, including attorney's fees and settlements; (iii) employee turnover and the increased costs for recruiting, hiring, and training as well as indirect costs relating to declining morale among employees;

and (iv) impairment of the entity's productivity due to the hostile atmosphere created by the sexual misconduct.

Cases involving nonfeasance or failure to act present a more difficult causation question than those involving an affirmative act of wrongdoing. A plaintiff would ultimately have to prove that the board was required to take certain actions that they did not take and that, had those actions been taken, the loss to the entity would have been averted.

VI. Insurance Considerations.

The *insured v. insured* exclusion has appeared in management liability-insurance policies for over thirty years. It was first developed in the early 1980s as a response to claims asserted by struggling banks against their own officers to access the proceeds of their own directors and officers insurance liability policies. Insurance companies considered such efforts "collusive" and sought to limit claims to those made by "true" third parties and not the insured entity or insured persons. The *insured v. insured* exclusion ("IVI exclusion") has two common exceptions for claims brought by the insured entity: (1) claims on behalf of an insured entity that are totally independent of assistance by an insured (e.g., shareholder derivative actions brought nominally in the name of the insured entity) and (2) claims brought on behalf of the insured entity by an "independent" party, such as a trustee, examiner, receiver or (more recently) creditors' committees.[69]

Courts have consistently rejected the "totally independent" exception to the IVI exclusion where the insured entity is a debtor and has participated in a plan of reorganization or liquidation that provides for prosecution of D&O claims.[70] However, the second exception to the IVI exclusion will usually be available to a trustee.

A. General Principles Concerning IVI Exclusion.

Several decisions address whether the IVI exclusion precludes coverage for a claim by an assignee of the debtors. Those seeking insurance coverage in the face of the IVI exclusion have argued that the debtor (the insured company) is an entity separate from the entity that received the assignment of the claims (e.g., a litigation trustee, a chapter 7 or 11 trustee, or a creditors' committee). A discussion of the leading IVI exclusion decisions is beyond the scope of this article. However, the following general principles emerge from these IVI exclusion cases:

- Chapter 7 and chapter 11 trustees are considered different entities from the insured company and outside of the IVI exclusion.
- On the other hand, trustees of litigation trusts created by debtors under plans of reorganization or liquidation are generally considered to be equivalent to the insured company and barred by the IVI exclusion where the policy does not have a "trustee" exception. There is a strong argument that "the trustee" exception to the IVI exclusion that commonly appears in D&O policies includes a litigation trustee under a plan or is at least ambiguous and should be construed against the insurer. However, there is some uncertainty because there are no reported decisions on this issue.
- The reorganized debtor has been considered the same as the debtor and, as the insured company, barred by the IVI exclusion.

B. Coverage for *Caremark* Claims.

The *Caremark* claims for breach of the duty of loyalty against board members (other than against the perpetrator) should be covered unless the facts demonstrate the conduct is within a policy exclusion or coverage of that conduct is against public policy. The insurers may argue that the *Caremark* standard requires proof of intentional conduct (or inaction), which by definition is not a covered occurrence under the policy at issue, or that coverage for intentional acts is against public policy. The majority of jurisdictions preclude insurance coverage for intentional wrongdoing where either the insured acts with the intent to cause harm or where the harm is the inherent result of the conduct, and therefore intent can be inferred from the conduct (such as assault). Gross negligence and recklessness do not rise to those levels, but lack of good faith requires conduct beyond gross negligence, and arguably intentional conduct. If the conduct is subjectively intentional, or is so inherently harmful that subjective intent to harm can be inferred, coverage can be denied, either as a matter of insurance law or as a matter of public policy.

With respect to subjective intent, if the defendant in a *Caremark* claim action acts with subjective intent to harm, state law may preclude coverage. However, New York law has long recognized that insurable accidental results may flow from intentional causes. In *Slayco v. Security Mutual Ins. Co.*,[71] New York's highest court held that the intentional-acts exclusion did not preclude coverage for an insured who shot his friend "accidentally." Although the insured intentionally pointed the gun, he thought it was not loaded. There will rarely be evidence that that any board member intended that the perpetrator assault or harass anyone.

With respect to inferring subjective intent, New York law favors finding coverage when the harm is the inherent result of the conduct. In *J.P. Morgan Sec. Inc. v. Vigilante Ins. Co.*,[72] the state's highest court ruled on a situation where the SEC found Bear Stearns had willfully violated numerous federal securities laws. The New York Court of Appeal explained: "The public policy exception for intentionally harmful conduct is a narrow one, under which it must be established not only that the insured acted intentionally but, further, that it acted with the intent to harm or injure others."[73]

Notwithstanding the forgoing potential issues, a *Caremark* claim alleging that board members failed to implement any reporting system or knew of the perpetrator's misconduct yet acted in bad faith by consciously disregarding their duty to address that misconduct (but did not intend to cause harm to the victims) should be covered by D&O insurance. 🏛

ENDNOTES:

1. 6 A.3d 238 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011).
2. "A member or an assignee of a limited liability company interest may bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed." 6 Del. Code § 18-1001.

[3] "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: (1) At the time of the transaction of which the plaintiff complains; or (2) The plaintiff's status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction." *Id.* § 18-1002.

[4] *See North Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

[5] 590 B.R. 211, 284 (Bankr. D. Del. 2018).

[6] *Id.* at 283-84.

[7] *Id.* at 284 (quoting 6 Del. Code § 18-1002; citing *Adelphia Recovery Tr. v. Bank of America,* 390 B.R. 80, 88-89 (S.D.N.Y. 2008) (a prior standing order only addressed "the question of which party—the Debtors or the Creditors' Committee—would be authorized to prosecute any claims on behalf of the Debtors' estates.... It did not reach the question of whether the Creditors' Committee had standing to prosecute specific claims . . . .").

[8] *Id.*

[9] 548 B.R. 410, 413 (Bankr. D. Del. 2015).

[10] *HH Liquidating*, 590 B.R. 284.

[11] *Id.* (citing *CML V, LLC v. Bax*, 6 A.3d 238, 242 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011)).

[12] No. 15-11323, 2019 Bankr. LEXIS 1375, at *17 (Bankr. D. Del. May 2, 2019).

[13] The Delaware LP Act contains virtually identical standing provisions as the Delaware LLC Act. Section 17-1001, entitled "Right to Bring Action," states:

A limited partner or an assignee of a partnership interest may bring an action in the Court of Chancery in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed.

6 Del. C. § 17-1001.

Section 17-1002, entitled "Proper Plaintiff," states:

In a derivative action, the plaintiff must be a partner or an assignee of a partnership interest at the time of bringing the action and:

(1) At the time of the transaction of which the plaintiff complains; or

(2) The plaintiff's status as a partner or an assignee of a partnership interest had devolved upon the plaintiff by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner or an assignee of a partnership interest at the time of the transaction.

6 Del. C. § 17-1002.

[14] *See, e.g., Official Comm. v. NewKey Group, LLC (In re SGK Ventures, LLC)*, 521 B.R. 842, 848 (Bankr. N.D. Ill. 2014): *Official Comm. v. Chinery (In re Cybergenics Corp.)*, 330 F.3d 548, 568 (3d Cir. 2003) ("ability to confer derivative standing upon creditors' committees is a straightforward application of bankruptcy courts' equitable powers.").

[15] 8 Del. Code. § 102(b)(7).

[16] Section 18-1101 of the Delaware LLC statute provides:

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to it is otherwise bound by a limited liability company agreement, the member'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.

. . . .

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company 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.

6 Del. Code § 18-1101.

Section 17-1101(d) of the Delaware LP statute provides:

To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or 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 . . . .

6 Del. Code § 17-1101(d).

[17] *See Stanziale v. Versa Capital Mgmt.(In re Simplexity, LLC)*, No. 16-50212, 2017 Bankr. LEXIS 1506, at *9 (Bankr. D. Del. June 1, 2017); *R & R Capital v. Buck & Doe Run Valley Farms*, No. 3803, 2008 Del. Ch. LEXIS 115, at *13 (Aug. 19, 2008) (unpublished) ("Delaware's LLC Act leaves to the members of a limited liability company the task of 'arranging a manager/investor governance relationship'") (quoting Myron T. Steele, *Judicial Scrutiny of Fid. Duties in Del. Ltd. P'ships & LLCs*, 32 Del. J. Corp. L. 1, 5 (2007)), *TravelCenters of Am. v. Brog*, No. 3516, 2008 Del. Ch. LEXIS 199, at *3 (Apr. 3, 2008) (unpublished)(finding that under Delaware law "limited liability companies are creatures of contract" and thus drafters enjoy broad freedom in creating bylaws); *In re Grupo Dos Chiles*, No. 1447, 2006 Del. Ch. LEXIS 54, at **5-6 (Mar. 10, 2006) (unpublished)("Limited liability companies are designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved").

[18] *See Boxer v. Husky Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981) (general partners); *VGS, Inc. v. Castiel*, No. 17995, 2000 Del. Ch. LEXIS 122, at **12-13 (Del. Ch. Aug. 31, 2000) (managers and managing members), *aff'd*, 781 A.2d 696 (Del. 2001); 6 Del. Code §§ 17-101(d) and 18-1101(c).

[19] *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984).

[20] *Smith v. Van Gorkom*, 488 A.2d 858, 872, 881 (Del. 1985).

[21] 8 Del. Code § 102(b)(7).

[22] *Stone v. Ritter,* 911 A.2d 362, 370 (Del. 2006).

[23] *Id.* at 362, 369 (failure to act in good faith may be shown where fiduciary intentionally acts with a purpose other than advancing best interests of entity or acts with intent to violate applicable law); *In re Goldman Sachs Grp. Inc. S'holder Litig.*, No. 5215, 2011 Del. Ch. LEXIS 151, at *65 (Oct. 12, 2011) (unpublished) (illegal conduct is not loyal conduct).

[24] Although the vast majority of cases applying *Caremark* deal with directors, there is authority that it applies to officers as well. *Miller v. McDonald (In re World Health Alternatives, Inc.)*, 385 B.R. 576, 590 (Bankr. Del. 2008).

[25] 698 A.2d 959 (Del. Ch. 1996).

[26] *Id.* at 960-61.

[27] *Id.* at 967.

[28] *Id.* at 971.

[29] *Id.* at 967.

[30] *Stone v. Ritter,* 911 A.2d at 370 ("Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.") (footnotes omitted).

[31] *Id.*

[32] *Id.* at 369.

[33] *Brehm v. Eisner (In re Walt Disney Co. Deriv. Litig.)*, 906 A.2d 27, 66 (Del. 2006) (quoting lower court's opinion, 907 A.2d 693, 755 (Del. Ch. 2005)).

[34] *In re Massey Energy Co.*, No. 5430, 2011 Del. Ch. LEXIS 83 at *83 (May 31, 2011) (unpublished).

[35] *Guttman v. Jen-Hsun Huang,* 823 A.2d 492, 506 (Del. Ch. 2003).

[36] *Stone*, 911 A.2d at 369.

[37] *Desimone v. Barrows,* 924 A.2d 908, 935-36 (Del. Ch. 2007).

[38] *Kandell v. Niv*, No. 11812, 2017 Del. Ch. LEXIS 640, at **5-6 (Sep. 29, 2017).

[39] *Massey Energy Co.*, 2011 Del. Ch. LEXIS 83, at **72-74.

[40] *Goldman Sachs*, 2011 Del. Ch. LEXIS 151, at *65; *see Guttman*, 823 A.2d at 506 ("One cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.").

[41] 793 A.2d 356, 359 (Del. Ch. 2000), *aff'd*, 783 A.2d 543 (Del. 2001).

[42] No. 10-06576, 2012 U.S. Dist. LEXIS 146970 (C.D. Cal. July 31, 2012).

[43] Miriam Horn, *Sex and the CEO*, U.S. NEWS & WORLD REPORT at 32 (July 6, 1998).

[44] *White v. Panic,* 793 A.2d at 363.

[45] *Id.*

[46] *Id.* at 368-69.

[47] In order to bring a shareholder derivative action, a shareholder is required to either first make demand on the board to bring the action or establish "demand futility" in its pleadings. A litigation trustee will not have the burden of establishing demand futility, which is only required in a shareholder derivative suit. However, cases assessing demand futility are relevant because the standard involves determining whether, at the time the complaint was filed, the directors could have exercised independent and disinterested business judgment in responding to a demand. Rales v. Blasband, 634 A.2d 927 (Del. 1993). A director is considered "interested" when there is a "'substantial likelihood" of director liability. *Aronson v. Lewis,* 473 A.2d 805, 815 (Del. 1984); *In re Baxter Int'l*, 654 A.2d 1268, 1270 (Del. Ch. 1995). This can only be found if a nonexculpated claim based on particularized facts is pleaded. *Guttman,* 823 A.2d at 501.

[48] *White v. Panic,* 793 A.2d at 363-64.

[49] *Id.* at 360.

[50] *Id.* at 361.

[51] *Id.* at 362.

[52] *White v. Panic,* 783 A.2d 543,552 (Del. 2001).

[53] *Id.* at 551-52.

[54] 793 A.2d at 371.

[55] *Id.* at 368.

[56] 783 A.2d at 553.

[57] *Id.*

[58] *American Apparel S'holder Deriv. Litigation,* 2012 U.S. Dist. LEXIS 146970.

[59] *Id.* at **99-100.

[60] *Id.* at *102.

[61] *Id.* at *100.

[62] *Id.*

[63] Elizabeth A. Harris, *American Apparel Ousts Its Founder, Dov Charney, Over Nude Photos*, N.Y. Times (June 21, 2014), https://www.nytimes.com/2014/06/22/business/in-firing-dovcharney-american-apparel-cites-posting-of-naked-pictures.html.

[64] *In re American Apparel, Inc.*, No. 14-05230, 2015 U.S. Dist. LEXIS 191466, at *24-25 (C.D. Cal. Apr. 28, 2015), *aff'd*, 696 F. App'x 848 (9th Cir. 2017).

[65] *Id.* at *60.

[66] *Id.* at *52.

[67] 696 F. App'x 848 (9th Cir. 2017).

[68] *See supra* n. 23.

[69] Creditors' committee standing issues are discussed at section III, *supra*.

[70] *See, e.g., Terry v. Fed. Ins. Co.*, 315 B.R. 674, 682 (Bankr. W.D.Va. 2003).

[71] 98 N.Y.2d 289 (N.Y. 2002).

[72] 21 N.Y.3d 324 (N.Y. 2013).

[73] *Id.* at 335.