

Members Only: Delaware Court Rules that Creditors Lack Standing to Pursue Claims on Behalf of Debtor

Update

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Creditors do not have standing to assert derivative claims on behalf of a bankrupt Delaware limited liability company, according to a recent ruling by Delaware's bankruptcy Judge John Dorsey in *In re Ector County Energy Center LLC*.

The ruling, handed down orally on August 15, cuts off one avenue for creditors seeking to force a debtor to prosecute legal claims that it is otherwise unwilling to pursue. Instead, as Judge Dorsey noted, creditors taking issue with the estate's administration should seek to oust management by moving for the appointment of a bankruptcy trustee or by seeking to convert the case to a liquidation under chapter 7.

Ector County Energy Center LLC (the "Debtor"), the owner of a natural gas-fired generation facility in Ector County, Texas, filed for chapter 11 bankruptcy protection on April 11, 2022. The company was left insolvent in the wake of February's winter storm and undertook a sale of the generation facility to Ector County Generation LLC.

Direct Energy Business Marketing LLC ("Direct Energy") is the estate's largest unsecured creditor with a roughly \$400 million disputed litigation claim. Dissatisfied with the Debtor's determination not to pursue certain claims that Direct Energy believed would bring additional value into the Debtor's estate, on May 25, Direct Energy filed a motion seeking standing (the "Standing Motion") to pursue certain claims against the Debtor's parent entities and secured lender.

Direct Energy alleged in the Standing Motion that the Debtor's parent entities caused the Debtor to incur a \$75 million obligation to certain secured lenders through a prepetition amendment to the credit agreement that relieved a parent entity of its obligation to make a mandatory prepayment upon a sale of the Debtor's assets and instead transferred that obligation to the Debtor. In addition

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to the Standing Motion, Direct Energy previewed a complaint seeking to avoid the \$75 million obligation incurred by the debtor as a fraudulent transfer, subrogation of the amount, and contribution from certain affiliated guarantors, as well as damages for breach of fiduciary duty and other relief. Direct Energy argued that conflicts of interest and the parent's control of the Debtor's board precluded the Debtor from pursuing these claims.

Direct Energy's Standing Motion drew objections from the Debtor, its prepetition lenders, and the parent entity. The Debtor argued in part that the causes of action would be better left for a litigation trustee pursuant to the plan process, rather than Direct Energy. The parent entity argued that the claims were not colorable because Sections 18-1001 and 18-1002 of the Delaware Limited Liability Act authorize only a member or assignee to bring a derivative action against a limited liability company.¹

A hearing was held on August 17, 2022. At the hearing, Judge Dorsey agreed with the Debtor and the objectors. He denied the motion in an oral ruling from the bench, noting that standing is a creature of state law, and Delaware state law limits who may bring a derivative action. However, he clarified that Direct Energy is not without recourse, as unsecured creditors are free to object to any releases proposed in a chapter 11 plan and may seek to either convert the case to a chapter 7 liquidation or move for the appointment of a trustee if they disagree with how the case has been administered. Finally, Judge Dorsey indicated to the parties that he would reserve judgment on potential plan releases of the Debtor's management and parents until those issues were properly before him at plan confirmation. Counsel for Direct Energy indicated that they would be challenging any proposed release of the Debtor's parent entity.

Creditors and parties seeking standing should take care to investigate the relevant jurisdiction's corporate statutes and relevant case law to determine if those statutes address who has standing to bring derivative actions.

Additionally, if standing is limited, creditors seeking to change the administration of the estate should carefully consider their options under the code for appointing a trustee or converting the case to a liquidation.

1. See *Objection [of the Parent Entity] to Motion for Order Authorizing Direct Energy Marketing, LLC to Commence and Prosecute Claims on Behalf of the Estate*, Case No. 22-10320-JTD, Docket No. 204.