

DELAWARE BUSINESS COURT INSIDER

Bankruptcy Code Preempts LLC Act's Statute of Repose for Recovery of Distributions

In *Miller v. Black Diamond Capital Management (In re Bayou Steel BD Holdings)*, Adv. Pro. No. 21-51013 (KBO), 2022 WL 3079861 (Bankr. D. Del. Aug. 3, 2022), U.S. Bankruptcy Judge Karen B. Owens held that Delaware's three-year statute of repose on the liability of a member for distributions from a limited liability company, measured from the date of distribution, was preempted by Section 546 of the Bankruptcy Code.

By Barry M. Klayman and Mark E. Felger | August 31, 2022



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In *Miller v. Black Diamond Capital Management (In re Bayou Steel BD Holdings)*, Adv. Pro. No. 21-51013 (KBO), 2022 WL 3079861 (Bankr. D. Del. Aug. 3, 2022), U.S. Bankruptcy Judge Karen B. Owens held that Delaware's three-year statute of repose on the liability of a member for distributions from a limited liability company, measured from the date of distribution, was preempted by Section 546 of the Bankruptcy Code, which provides that a trustee must bring an avoidance action under Section 544 within two years from the entry of a debtor's order for relief. The effect of the decision is to give the Chapter 7 trustee more time to commence an avoidance action to recover distributions made by a debtor LLC to its members.

The adversary proceeding involved an action by the Chapter 7 trustee against various defendants concerning a prepetition distribution and secured loan. The debtors, Delaware limited liability companies, manufactured and sold steel products. Defendants Fund IV and BDCM purchased the debtors through a combination of equity and debt, the latter funded by a revolving loan with several banks. After the acquisition, BDCM appointed two of its managing directors and three independent directors to the board of directors. From June through December 2016, the debtors operated at a loss.

In March 2017, the debtors executed an amendment to the revolving loan in order to permit a distribution of \$30 million from one of the debtors to Fund IV. The trustee found no record of any involvement by the independent directors in approving the distribution, and there were no resolutions or consents of the board of directors with respect to the amendment of the loan documents to permit the distribution or the distribution itself.

Throughout 2017, the debtors continued to face severe liquidity issues and a struggling business, which the trustee later alleged was a direct result of the distribution. By late 2017, the debtors were running out of cash and BDCM explored providing additional funding. In December 2017, the debtors entered into a subordinated loan and security agreement with an initial \$15 million credit line with Fund IV as lender. In exchange for the loan, the debtors granted a continuing security interest and lien upon substantially all of their property to Fund IV. Notwithstanding the loan and increases in their credit line, the debtors continued to face financial difficulties. On Oct. 1, 2019 (petition date), the debtors filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Following the sale of substantially all of their assets under Section 363 of the Bankruptcy Code, the debtors converted their cases to cases under Chapter 7 and the trustee was appointed.

On Aug. 11, 2021, the trustee filed the adversary complaint. The trustee sought to avoid the distribution and the lien grant as fraudulent transfers, recover the distribution, and recover damages for breaches of fiduciary duty, aiding and abetting, and corporate waste. The trustee sought to avoid the distribution as an actual and constructive fraudulent transfer pursuant to the Delaware Uniform Fraudulent Transfer Act (DUFTA) and the strong-arm provision of Section 544(b) of the Bankruptcy Code. Section 544(b) provides that the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor where a creditor of the debtor would have such a right under state law.

Fund IV and BDCM raised several arguments in favor of dismissal of the fraudulent transfer claims, including that the claims were barred under Section 18-607 of the Delaware Limited Liability Company Act, 6 Del. C. Section 18-607. That section of the LLC Act provides a three-year statute of repose measured from the date of distribution. Specifically, Section 18-607 provides that a member of an LLC who receives a distribution from the LLC shall have no liability for the amount of the distribution after the expiration of three years from the date of the distribution unless an action to recover the distribution was commenced prior to the expiration of the three-year period. The defendants argued that the trustee's claims were untimely because they were brought more than four years after the March 17, 2017, distribution.

The trustee responded by invoking Section 546(a) of the Bankruptcy Code, which specifies when a trustee must bring an avoidance action under Section 544 and, with limited exceptions, allows the trustee two years from the entry of the debtor's order for relief to do so. The petition date, and thus the date when the debtors' order for relief was entered, was Oct. 1, 2019. Since the trustee commenced the adversary action on Aug. 11, 2021, it was brought less than two years from the petition date in compliance with Section 546(a). The trustee argued that Section 546(a) preempts and extends the time to bring the state law avoidance claims because they were not time-barred as of the petition date.

The defendants argued that Section 546(a) did not preempt Section 18-607(c) of the LLC Act because it is a statute of repose targeted at regulating the corporate affairs of business entities organized in Delaware, a unique state interest.

Owens sided with the trustee. To determine if a state statute is preempted by federal law, the court looks to the intent of Congress. She found no express preemption or occupation of the field by Congress. The latter occurs when Congress adopts a scheme of federal regulation so comprehensive as to leave no room for supplementary state regulation. However, Owens found there was conflict preemption, whereby federal law preempts state law to the extent it actually conflicts with federal law. In so doing, she noted that the overwhelming majority of courts that have decided whether Section 546(a) preempts a state statute of repose have concluded that it does under conflict preemption. She adopted the explanation proffered by a bankruptcy judge in the District of New Jersey, who explained that Congress intended to provide trustees bringing avoidance claims under Section 544 some breathing room to determine what claims to assert to fulfill their goal of maximizing the bankruptcy estate for the benefit of creditors. If the state statute were to apply, it would severely restrict the trustee's ability to recover property for the benefit of the bankruptcy estate and obstruct the achievement of the purposes and objectives of Congress in enacting the Bankruptcy Code.

Owen rejected the defendants' argument that Section 18-607(c) governed a person's capacity to be sued, an area in which Congress had not expressed a clear intent to preempt. She distinguished the policies underlying so-called nonclaim statutes, such as those governing suits against dissolved corporate entities or decedents' estates. Those statutes limit a party's capacity to be sued and have been held not to be preempted by federal law. The capacity of a state's citizens to be sued is a traditional right of state regulation and a matter that Congress expressly left to state law when it incorporated Federal Rule 17(b) into the Bankruptcy Code through Bankruptcy Rule 7017. Statutes of repose like Section 18-607(c) are distinct. They create a substantive right to be free from liability related to specific wrongful actions, but do not determine capacity to sue or be sued. Like statutes of limitations, they are mechanisms designed to limit the temporal extent or duration of liability for tortious acts. Section 18-607(c) imposes a temporal limit on liability related to distributions received by members of an LLC, but it does not address a member's ability to come into federal court to litigate or defend as a general matter under Federal Rule 17(b) as does a nonclaim statute.

Section 18-607(c), if applicable to DUFTA claims, truncates the state law time period to assert fraudulent transfer claims related to distributions to three years. If not preempted by Section 546(a), it would significantly impede Congress's intent in enacting that provision to provide time for trustees to identify valuable causes of action and pursue them for the benefit of all creditors. Given this conflict, Owens concluded that Section 546(a) must prevail and preempt Section 18-607(c) of the Delaware LLC Act.

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