Rumors of the Demise of Creditor Derivative Suits on Behalf of LLCs Not an Exaggeration

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A decision recently handed down by the Delaware Chancery Court, *CML V, LLC v. Bax*, indicates that creditors of a limited liability company ("LLC") organized under Delaware law do not have standing to institute derivative suits against an LLC's management, even when the LLC is insolvent, unless the right is expressly set forth in the LLC's organizational documents or external agreements.

Background

In April 2007, CML V, LLC ("CML"), loaned more than $25 million to JetDirect Aviation Holdings, LLC ("JetDirect"), a private jet management and charter company that, through subsidiaries, provided charter services, prepaid memberships for charter flights, aircraft management services, and maintenance and fuel services. The amount of the loan was later increased to more than $34 million. CML alleged that after this money was loaned, JetDirect's management approved four separate acquisitions despite lacking adequate information about JetDirect's finances and that JetDirect's working capital was insufficient to finance these acquisitions. In June 2007, JetDirect defaulted on CML's loan. According to a complaint later filed by CML, JetDirect then engaged in the liquidation of some of its assets. During this partial liquidation, some members of JetDirect's management allegedly caused various assets to be sold for inadequate consideration to entities controlled by members of management.

On the basis of these allegations, CML brought derivative actions asserting that certain officers, directors, and managers of JetDirect: (i) breached their duty of care by approving acquisitions after CML extended financing to JetDirect; (ii) acted in bad faith by failing to maintain and monitor an adequate internal control system and by concealing information from JetDirect's board; and (iii) breached their duty of loyalty when they benefited from the self-interested asset sales conducted during the partial liquidation of JetDirect's assets. CML also asserted a cause of action against JetDirect for breach of the loan agreement but conceded that the court would have jurisdiction over this claim only if CML had standing under one of the three derivative causes of action.

The defendants all moved to dismiss the derivative causes of action on the basis that CML, as a creditor of JetDirect, lacked standing to bring a derivative suit, because the Delaware Limited Liability Company Act (the "LLC Act") limits standing for derivative suits to holders or assignees of LLC membership interests. CML argued that once an LLC becomes insolvent, the fiduciary duties of directors and officers run to the benefit of the LLC's creditors, rather than its members, and thus creditors have standing to bring derivative actions against an insolvent LLC.

Ruling by the Chancery Court

The Chancery Court held that under the plain meaning of the LLC Act, only members or assignees of LLC interests have standing to bring derivative actions. Thus, the court concluded, creditors of LLCs never have standing to bring derivative actions on behalf of the LLC. In so ruling, Vice Chancellor Laster noted that this rule is in stark contrast to the settled jurisprudence on creditor derivative standing with respect to corporations, but he nevertheless held that the plain meaning of the statute bound him to this result. Vice Chancellor Laster further noted that

this same strict rule has already been applied to other "alternative entities" in Delaware. Finally, Vice Chancellor Laster noted that creditors of an LLC generally have the ability to protect themselves, both through their agreements with the LLC and through their insistence on the inclusion of creditor protections in the LLC agreement. Thus, he explained, this "plain meaning" interpretation of the LLC Act does not create an absurd result to the detriment of creditors.

Plain Meaning

The LLC Act contains an entire subchapter titled "Derivative Actions." The first section, section 18-1001, titled "Right to bring action," states as follows:

> 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.

The next section, section 18-1002, titled "Proper plaintiff," states as follows:

> 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:
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> (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.

The court noted that the only Delaware treatise to comment on the issue of creditor standing to bring a derivative suit on behalf of an LLC concludes that under the statute, a creditor is not a proper plaintiff. Additionally, a federal district court in Delaware, in an unpublished 2007 decision (*Magten Asset Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP*), interpreted a provision similar to section 18-1002 in the Montana limited liability company statute to preclude

creditor standing for derivative suits. The court in *CML* explicitly agreed with the conclusions of these two authorities, holding that section 18-1002 contains "exclusive language."

A New Precedent

Vice Chancellor Laster openly acknowledged that his decision creates a difference in creditor derivative standing between Delaware LLCs and Delaware corporations and also marks a departure from the general understanding of most commentators.

The Delaware Supreme Court recently reaffirmed creditor derivative standing in the case of insolvent corporations in *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*. However, in *CML*, Vice Chancellor Laster contrasted the "exclusive language" of section 18-1002 with the "non exclusive language" of section 327 of the Delaware General Corporation Law, the only statute that deals with derivative actions on behalf of corporations. Section 327 states that:

> [i]n any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.

The court pointed out that section 327 purports to limit standing only for suits "instituted by a stockholder," leaving open the question of whether any other entities may bring derivative suits. Section 18-1002, by contrast, speaks of the requirements of a plaintiff "[i]n a derivative action."

The court went on to acknowledge that, aside from the above-mentioned treatise, commentators have universally assumed that creditors of insolvent LLCs generally do have derivative standing, and they have moved on to debate the extent to which an LLC agreement may limit creditors'

rights in this regard. Additionally, two previous decisions of the Chancery Court assumed, in *dicta*, that derivative standing for creditors of insolvent LLCs exists. However, the *CML* court emphasized that these pronouncements were no more than *dicta* and that, while the overwhelming support in the scholarly community for creditor derivative standing has some persuasive value, it cannot overcome the plain meaning of the statute.

Origins of the Statute

In order to consider fully the intent of section 18-1002, the court examined the history of its language. Section 18-1002, like much of the LLC Act, was modeled on a similar provision in the Delaware Limited Partnership Act (the "DLPA"). The provision in the DLPA was revised to its current version in 1982, on the basis of language in the Revised Uniform Limited Partnership Act (the "RULPA"), which was promulgated in 1976. The court found particularly instructive the facts that: (i) prior to this revision, the DLPA provision was substantially identical to section 327 of the Delaware General Corporation Law, failing to limit all derivative actions to equity interest holders; and (ii) although Delaware did not adopt the entirety of the RULPA, it did adopt the provision limiting derivative standing to limited partners and certain successors to their interests. Thus, the court concluded, the Delaware legislature had the opportunity to adopt a less restrictive statute on derivative standing but elected to adopt the exclusive language now found in section 18-1002.

"Nothing Absurd"

The court ended its analysis by rejecting CML's contention that section 18-1002, while not ambiguous on its face, leads to an absurd result. CML asserted that different derivative-standing

rules for corporations and LLCs would result in indefensibly different treatment of creditors of LLCs and corporations, with corporate creditors being favored. Thus, CML asserted, section 18-1002 is ambiguous, despite any apparent facial clarity. The court disagreed strongly, holding that "there is nothing absurd about different legal principles applying to corporations and LLCs."

The court went on to hold that this plain-meaning interpretation of section 18-1002 does not conflict with the underlying purpose of the LLC Act. The act's guiding policy, according to section 18-1101(b), is to promote freedom of contract. The court outlined the various tools available to creditors of LLCs to protect their interests contractually, including: (i) section 18-101(7), which permits an LLC agreement to grant contractual rights to nonparties to the agreement; (ii) section 18-1101(c), which permits an LLC agreement to expand the duties of members and managers, including fiduciary duties; (iii) section 18-303(b), which permits personal guarantees of LLC obligations by members; (iv) section 18-805, which authorizes a creditor of a terminated LLC to seek appointment of a receiver; and (v) section 18-502(b), which allows a creditor to enforce a member's obligation under an LLC agreement to make a contribution or return a distribution, to the extent the creditor has relied on this obligation. Additionally, the court explained, creditors of insolvent LLCs are protected by state fraudulent-conveyance laws, as well as the avoidance provisions of the Bankruptcy Code, should the LLC file for bankruptcy protection.

Conclusion

CML represents an abrupt turn in the area of creditor derivative standing with respect to Delaware LLCs. However, the ruling also creates a simple, black-letter rule: creditors of Delaware LLCs must contract for any rights they desire when lending or extending credit to a

Delaware LLC. In particular, a creditor of such an LLC should seek affirmative contractual rights and remedies with respect to LLC members and managers in connection with the operation of the LLC's business, as the creditor cannot rely on a derivative suit to protect its interests should the LLC become insolvent.

LLC agreements (in Delaware and elsewhere) sometimes provide that the directors of the LLC bear fiduciary duties identical to those of a director of a corporation under applicable law. We are left to speculate whether the *CML* court might have reached a different conclusion had this been the case in the JetDirect LLC agreement. In addition, the ruling's impact in the bankruptcy context, where prepetition causes of action become property of the estate and where it is not unusual for committees and even individual creditors to be given derivative standing to prosecute such actions, would appear to be limited at best. In fact, at least in Delaware, initiating an involuntary bankruptcy case as a means of pursuing LLC managers or directors for alleged fiduciary improprieties may be the preferred strategy.

CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010).

Robert L. Symonds, Jr. & Matthew J. O'Toole, SYMONDS AND O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES § 9.09, at 9-61 n.270 (2007).

Magten Asset Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP, 2007 WL 129003 (D. Del. Jan. 12, 2007).

North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Vichi v. Koninklijke Philips Elecs. N.V., 2009 WL 4345724 (Del. Ch. Dec. 1, 2009).

Bren v. Capital Realty Grp. Senior Housing, Inc., 2004 WL 370214 (Del. Ch. Feb. 27, 2004).