

Delaware Court Holds That Creditors Lack Standing To Pursue Derivative Claims On Behalf of Insolvent LLCs

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On November 3, 2010, in *CML V, LLC v. Bax, et al.*, (C.A. No. 5373-VCL), 2010 Del. Ch. LEXIS 220 ("CML"), Vice Chancellor Laster of the Court of Chancery of the State of Delaware held that unlike in the corporate context, where creditors may pursue derivative claims on behalf of insolvent corporations, creditors lack standing to pursue derivative claims on behalf of Delaware limited liability companies ("LLCs"), even in insolvency.

Background

It is by now established that creditors of an insolvent Delaware corporation have standing to maintain derivative claims against directors on behalf of the insolvent corporation for breaches of fiduciary duties. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("*Gheewalla*"). In *Gheewalla*, the Delaware Supreme Court reasoned that while the directors' fiduciary duties run to the corporation for the benefit of its stockholder owners, when a corporation reaches the stage of insolvency, the creditors become "the principal constituency injured by any fiduciary breaches that diminish the firm's value." As such, while the creditors of a corporation are not owed fiduciary duties directly, "equitable considerations" give such creditors standing to pursue derivative claims on behalf of the insolvent corporation.

In the recent *CML* case, a creditor sought to assert derivative claims for breach of fiduciary duty against various "Individual Defendants," on behalf of JetDirect Aviation Holdings, LLC, a Delaware LLC; the Court acknowledged that JetDirect's operating subsidiaries were in bankruptcy and that the complaint plausibly pleaded that JetDirect was insolvent. The Individual Defendants were alleged, among other things, to have approved certain acquisitions without critical information at a time of distress, and to have failed to implement and monitor an adequate system of internal controls. However, the creditor's derivative claims were dismissed for lack of standing.

Discussion

While acknowledging that "many have assumed that creditor derivative standing exists" in the LLC context, Vice Chancellor Laster rejected the argument that the same equitable considerations relied upon by the *Gheewalla* court in the corporate context entitle creditors to sue derivatively on behalf of insolvent LLCs. To the contrary, in the LLC context, the right to bring a derivative action is created by statute -- the Delaware Limited Liability Company Act (the "LLC Act") - - and the Court construed the literal terms of that statute as barring a creditor of an insolvent LLC from suing derivatively.

Specifically, Section 18-1001, entitled "Right to Bring Action," creates the right of a "member or an assignee of a limited liability company interest" to bring such an action, and section 18-1002, entitled "Proper Plaintiff," provides, among other things, that 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"

In reaching its decision, the Court noted by comparison that Delaware's Limited Partnership Act ("LP Act") -- which uses nearly identical phrasing to the LLC Act, except for substituting "partner" and "limited partnership" for "member" and "limited liability company" -- has derivative standing provisions that similarly have been interpreted as exclusive. The Court noted that read literally, the LP Act prevents creditors from suing derivatively in the limited partnership setting, and that this treatment strongly supports a similar exclusive reading of the LLC Act.

Vice Chancellor Laster also found that in contrast to the corporate statute (Section 327 of the Delaware General Corporation Law), which references stockholder derivative actions but does not say that only stockholders may bring such suits, the "plain language" of the LLC Act limits standing to bring derivative actions to "a member or an assignee," and read literally, denies such standing to creditors of an insolvent LLC.

The Court observed that there is "nothing absurd about different legal principles applying to corporations and LLCs." After discussing the "expansive contractual and statutory remedies that creditors of an LLC possess," the Court reasoned that "it does not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC," and that doing so "fulfills the statute's contractarian spirit."

Observations

The *CML* decision answers a question that has been the subject of debate, and provides another important reminder of the several critical differences in law governing Delaware corporations and LLCs, respectively. As an aside, in the opinion, Vice Chancellor Laster commented that if a creditor is willing to become party to the LLC agreement, it might be able to make creative use of Section 18-1101(c) of the LLC Act, which provides that to the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) to a limited liability company, such duties may be expanded or restricted or eliminated. The Court suggested that an "LLC agreement conceivably could provide for duties triggered by insolvency that would include an obligation to preserve assets for creditors."

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