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Creditors' Derivative Standing on Shaky Ground with LLCs

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It is well established by the Delaware courts that the creditors of an insolvent corporation have standing to bring a breach of fiduciary duty derivative suit against directors. [1] The basis for such standing heavily relied on "equitable considerations." [2] Many scholars—and even some courts—have assumed that such derivative standing extends to the creditors of a limited liability company (LLC). According to a recent Delaware Chancery Court ruling, they were wrong.

On Nov. 3, 2010, the *CML V LLC v. Bax* court held that creditors of an insolvent LLC lacked standing to maintain a derivative suit in the name of the LLC against its directors. [3] Hon. J. Travis Laster, writing for the court of chancery, found that "the literal terms of the LLC Act control, and they bar a creditor of an insolvent LLC from suing derivatively." [4] As the surprised reactions of many have already hinted, this ruling could have a large impact on the negotiations of lenders considering future extensions of credit to an LLC.

Facts

CML V LLC was a creditor of JetDirect Aviation Holdings LLC, a private jet management and charter company that through its subsidiaries provided charter services, prepaid memberships for charter flights, aircraft-management services and maintenance and fuel services. In 2005, JetDirect began an aggressive acquisition strategy of acquiring small- to mid-sized charter and service companies that left

JetDirect with a highly leveraged balance sheet.

In 2006, JetDirect's management team became aware of serious deficiencies in its accounting system. JetDirect's auditor at the time informed its management board of 19 "material weaknesses," "significant deficiencies" and "control deficiencies" in its internal controls. [5] A year later, JetDirect hired a new auditor who eventually declined to complete its audits because JetDirect's internal controls lacked sufficient integrity for the auditor to rely on the company's books.

In April 2007, CML loaned JetDirect $25,743,912, an amount that later increased to $34,243,912. Within two months of the increase, JetDirect defaulted on its loan obligations. Despite deficiencies in JetDirect's financial information raised by the two different auditors, the board approved four major acquisitions within the same time period. By January 2008, JetDirect was insolvent.

On March 26, 2010, CML filed a complaint against two former executives and 10 directors (the "defendants") asserting derivative claims for breach-of-fiduciary duties. The complaint alleged that the defendants (1) breached their duty of care by approving the late-2007 acquisitions without informing themselves of critical information regarding JetDirect's financial condition; (2) acted in bad faith by consciously failing to implement and monitor an adequate system of internal controls and the hiding of critical information from the board by a member of senior management; and (3) breached the duty of loyalty by engaging in self-interested sales of JetDirect's assets. CML also sued JetDirect for breach of its loan agreement. If CML was successful in its breach-of-fiduciary-duties suit, the directors would have had to pay damages to JetDirect, which would likely increase the recovery on the breach of the loan agreement suit.

The *CML* Decision

In deciding that only LLC members and their assignees may bring derivative suits on behalf of the LLC against management, the chancery court divided its analysis into four parts. First, it examined the language of §§ 18-1001 and 18-1002 of the Delaware Limit Liability Company Act (the "LLC Act"). Section 18-1001 creates a statutory right to bring a derivative action, providing that "[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 an action or if an effort to cause those managers or members to bring the action is not likely to succeed." [6] Section 18-1002, entitled "Proper Plaintiff," provides 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." [7]

The court found that the meaning of § 18-1002 was clear on its face, stating that "[u]nder the plain language of Section 18-1002, a plaintiff must be a 'member or an assignee.'" The court then contrasted § 18-1002's exclusive language with the non-exclusive language of § 327 of the Delaware General Corporation Law (DGCL). [8] Section 327, the only section in the DGCL to address derivative actions, does not provide any limits on who may sue derivatively. The court concluded that the Delaware General Assembly knew how to choose nonexclusive language when it wanted to, as in the DGCL, but consciously chose exclusive language with the adoption of § 18-1002 of the LLC Act.

While the court determined that it could resolve the case on the plain meaning of the statute alone, it also took into consideration: (1) how parallel provisions of other alternative entity statutes had been interpreted, specifically the Delaware Limited Partnership (LP) Act; (2) the source and development of the alternative entity derivative-standing provisions; and (3) whether enforcing the plain meaning of § 18-1002 would create an absurd result. Each line of inquiry supported the court's decision that the LLC Act limits derivative standing to LLC members and assignees.

Similarities with the LP Act
The LP Act contains derivative-standing provisions that are almost identical to §§ 18-1001 and 18-1002 of the LLC Act. Similar to the LLC Act, the LP Act facially bars any party other than a limited partner or assignee from suing derivatively. Recognizing that the LLC Act was modeled after the LP Act, the court was not surprised by this result. Unlike the lack of authority regarding the derivative standing of creditors of an LLC, Delaware courts have historically held that the exclusive language of the LP Act prevents creditors from suing derivatively. [9] Based on the almost identical language, the court found strong support for a similar "exclusive reading of the LLC Act." [10]

Origins of Alternative-Entity Standing
When the Delaware General Assembly passed the LLC Act in 1992, it adopted the derivative-standing provisions from the LP Act. Thus, to understand the origins of the LLC Act, the court looked to the origins of the LP Act.

Delaware adopted the Uniform Limited Partnership Act (ULPA) in 1973, which included express statutory authorization for limited partner derivative actions. For the most part, Delaware's original alternative-entity statute tracked the comparable provisions of the DGCL by not limiting who could sue derivatively. [11]

When the Revised Uniform Limited Partnership Act (RULPA) was presented to the Delaware legislature for adoption in 1982, the General Assembly affirmatively made the decision to replace the previously nonexclusive language with facially exclusive language. The court determined that "[a]t least for Delaware, the decision to implement the RULPA provisions suggests a conscious intent to make statutory standing exclusive." [12]

Plain Language Does not Lead to an Absurd Result

Lastly, the court examined whether a literal reading of the statute would lead to an unreasonable or "absurd" result not contemplated by the legislature. The plaintiffs argued that a plain reading of the LP Act generated an absurd distinction between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot. After all, many commentators relying on *Gheewalla* and *Prod. Res.* ignored any distinction when assuming that creditors of an LLC had derivative standing. The plaintiff further argued that because §§ 18-1001 and 18-1002 were intended to bring the demand and contemporaneous ownership requirements into world of LLCs, it would be inconsistent with the limited purpose of those requirements to apply the statute more broadly as exclusive provision.

The court disagreed, stating that "there is nothing absurd about different legal principles applying to corporations and LLCs." [13] The derivative-standing provisions were not solely adopted to "transport the corporate demand and contemporaneous ownership tunes into an alternative entity key." [14] Rather, the court found that the Delaware legislature made the affirmative decision to replace the previous standing provisions with RULPA, suggesting an intent to make standing exclusive.

In addition, the court decided that barring creditor derivative standing does not conflict with the overarching purpose or structure of the LLC Act. Rather, limiting creditors to their bargained-for rights and denying them an additional right to sue derivatively on behalf of an insolvent LLC actually "comports with the contractarian environment created by the LLC Act." [15]

In support of its ruling, the court pointed out specific features within the LLC Act that could be utilized to protect creditors without the need to grant them derivative standing. Under the LLC Act, an LLC agreement can provide rights even to those who are not a party to the agreement. [16] This allows creditors to potentially negotiate for penalties if certain events or breaches of contract occur. The court also cited § 18-1101(c), which is typically used to eliminate fiduciary duties, [17] stating that the section's language also permits creditors to push for expansion of such duties if the creditor is willing to be a party to the LLC agreement.

The court also highlighted that "a member or manager may agree in the LLC agreement 'or under another agreement' to be 'obligated personally for any or all of the debts, obligations and liability of the limited liability company.'" [18] The final two protections noted as available to creditors were the ability to appoint a trustee or receiver [19] and the right to enforce a member's obligation to make a contribution to the LLC. [20] The court concluded that "[i]n light of the expansive contractual and statutory remedies that creditors of an LLC possess, it does not create an absurd result to deny derivative standing to creditors of an insolvent LLC." [21]

Ramifications of *CML*

In choosing which type of business entity to extend credit to, it would seem that after *CML* the lending community would prefer corporations, at least in Delaware. With the increased amount of bankruptcy filings over the past few years, the risk of dealing with an insolvent debtor appears likely. On the opposite side of the coin, individuals seeking to form a business entity may find that an LLC is a more attractive vehicle. Based on the court's *dicta,* it could be asserted that even if an individual chooses to form an LLC, creditors could negotiate to put in place substitute fiduciary-duty protections. The relative bargaining power that creditors may have to make such demands and the impact these negotiations will have on transaction costs has yet to be seen. Going forward, it will be interesting to see how *CML* impacts the rates of formation for both corporations and LLCs.

Regardless of the future, *CML* should force present directors and officers of corporations and LLCs to more carefully evaluate what their fiduciary obligations are and to whom they may be owed as they approach insolvency. While many states have followed Delaware's lead in allowing creditors to bring derivative fiduciary duty claims, *CML* emphasizes just how important it is for attorneys and their clients to examine the specific statutes in their respective states. Similar to Delaware, when adopting uniform laws like RULPA, many states may not have adopted the full act. The statutory nuances in each state could result in a wide array of interpretation, specifically in the area of derivative standing.

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

2. *Prod. Res. Gp. LLC v. NCT Gp. Inc.*, 863 A.2d 722, 192 (Del. Ch. 2004).

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

4. *Id.* at 241.

5. *Id.* at 240.

6. 6 Del. C. § 18-1001.

7. 6 Del. C. § 18-1002.

8. 8 Del. C. § 327.

9. *See Vanderbilt Income & Growth Assocs. LLC v. Arvida/JMB Managers Inc.*, 1996 WL 652773, at *1 (Del. Ch. Nov. 4, 1996) ("Since the plaintiffs are not limited partners, they may not bring a derivative action."), *rev'd on other grounds*, 691 A.2d 609 (Del. 1996); *U-H Acq. Co. v. Barbo*, 1994 WL 34688, at *4 (Del. Ch. Jan. 31, 1994) (holding that tender offeror and assignee of LP interest could not satisfy § 17-1002).

10. *CML*, 6 A.3d at 246.

11. *See generally* 63 Del. Laws ch. 105 § 1732 (1973) ("An Action *may* be brought in the right of a limited partnership to procure a judgment in its favor by a limited partner.") (emphasis added).

12. *CML*, 6 A.3d at 249.

13. *Id.*

14. *Id.* at 250.

15. *Id.*

16. 6 Del. C. § 18-101(7).

17. 6 Del. C. § 18-1101(c).

18. *CML*, 6 A.3d at 249 (citing 6 Del. C. § 18-303(b)).

19. 6 Del. C. § 18-805.

20. *See* 6 Del. C. § 18-502(b)

21. *CML*, 6 A.3d at 255.