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Affirming Creditor's Lack of Derivative Standing, Supreme Court Underscores Plain Meaning of LLC Act

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Earlier this month, in *CML V LLC v. Bax*, the Delaware Supreme Court held that a creditor of an insolvent limited liability company lacks standing under the Delaware Limited Liability Company Act to bring a derivative action against the LLC's former managers.

In so doing, the court gave effect to the plain meaning of the LLC Act and drew a sharp distinction between the rights of creditors of insolvent LLCs and those of creditors of insolvent corporations. The court also rejected the argument that the LLC Act is unconstitutional if it bars the Court of Chancery from exercising its equitable jurisdiction to extend standing to sue derivatively in cases where derivative standing is necessary to prevent a complete failure of justice.

The issue arose when CML, a junior secured creditor of JetDirect Aviation Holdings LLC, sued JetDirect's present and former officers directly and derivatively for breach of their fiduciary duties. JetDirect had pursued an aggressive strategy that left it with a highly leveraged balance sheet and volatile cash flows. In 2006, JetDirect's board of managers learned about serious deficiencies in its accounting system. In 2007, the company's outside auditor refused to complete its audit because the company's internal controls lacked sufficient integrity and the auditor could not rely on its internal accounting books and records. At the same time, the company's board undertook to consolidate its billing, accounting and other operations, further exacerbating the internal control deficiencies. In late 2007, despite lacking current information about the company's true financial condition, the board proceeded to approve four major acquisitions. In April 2007, CML loaned the company in excess of \$34 million dollars. The company defaulted on the loan and by January 2008, it was insolvent.

CML asserted derivatively that the individual defendants, JetDirect's present and former managers, breached their duty of care by approving the late 2007 acquisitions without informing themselves of the company's true financial condition; the individual defendants acted in bad faith by consciously failing to implement and monitor an adequate system of internal controls and by hiding critical information from the board; and certain of the defendants breached their duty of loyalty by benefiting from self-interested asset sales upon the company's liquidation in 2008.

The Court of Chancery dismissed the claims against the individual defendants on the grounds that CML, as a creditor, lacked standing to pursue derivative claims on behalf of the company. The Supreme Court en banc affirmed the decision.

At issue was the effect of the derivative standing provisions of the Limited Liability Company Act, 6 Del. C. §§ 18-1001 and 18-1002. The former states that "a member or an assignee of a limited liability company interest" may bring a derivative action on behalf of an LLC. The latter states 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 and at the time of the transaction that is the subject of the complaint.

CML argued that these provisions were ambiguous: It contended that Section 18-1001 guarantees derivative standing to members or assignees but does not limit standing to those persons, and that Section 18-1002 regulates derivative suits brought by equity holders, but does not address suits brought by creditors of an insolvent LLC. CML argued that Section 18-1002 mirrored the language of Section 327 of the Delaware General Corporate Law, which the Supreme Court had held in its 2007 decision *North American Catholic Educational Programming Foundation Inc. v. Gheewalla* did not bar creditors of insolvent corporations from derivative standing. At oral argument, attorneys for CML argued that the key error committed by the Court of Chancery was its failure to properly give effect to *Gheewalla*.

The Supreme Court rejected these arguments. First, it held that Section 18-1002 was unambiguous on its face and dictates that a proper derivative action plaintiff "must be a member or an assignee of a limited liability company interest." According to the court, "The statutory language is clear, unequivocal, and exclusive, and operates to deny derivative standing to creditors who are not members or assignees of membership interests." Second, it dismissed the notion that the policies underlying derivative standing mandated that there be no difference between LLCs and corporations. "The General Assembly is free to elect a statutory limitation on derivative standing for LLCs that is different than that for corporations, and thereby preclude creditors from attaining standing." The court noted that LLCs and corporations are different, and investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights.

CML also argued that if Section 18-1002 limits derivative standing exclusively to "members or assignees," it is unconstitutional because it strips the Chancery Court of equitable jurisdiction to extend standing to sue

derivatively in cases where derivative standing is necessary to prevent a complete failure of justice.

The Supreme Court disagreed. The court recognized that at common law, courts of equity granted equitable derivative standing to corporate stockholders to sue on behalf of the corporation in order to prevent failures of justice. Courts of equity may extend judicially created equitable doctrines so long as the extension is consistent with the principles of equity. This is the basis of *Gheewalla*. However, both the corporate form and corporate derivative standing pre-date the Delaware General Corporate Law statutes, and Section 327 of the DGCL does not create derivative standing, but merely limits it. LLCs, on the other hand, did not exist at common law and are solely a creature of statute.

The high court held that the Court of Chancery's common law equitable power cannot override the LLC Act's express provisions, particularly since the General Assembly both created the right to sue derivatively on behalf of an LLC and expressly limited that right to members and assignees. For that reason, the limitation itself does not unconstitutionally impinge upon the constitutional jurisdiction of the Court of Chancery.

In the end, the high court does not leave creditors of insolvent LLCs without a remedy, but it puts the onus on them to negotiate the remedies ahead of time when they make their loans. CML could have negotiated a contractual remedy at law that would not have required the equitable extension of derivative standing.

For example, the court suggests that CML could have negotiated for a provision that would convert its interests to that of an "assignee" in the event of insolvency or it could have negotiated for a provision that would have given it control of the company's governing body in such an event. As the Court of Chancery recognized in its opinion, Section 18-101(7) authorizes an LLC agreement to provide rights to nonparties, so a creditor can bargain for express contractual rights in the LLC agreement while remaining a nonparty to the agreement. Section 18-1101 enables creditors to expand their available remedies, so that an LLC agreement could provide for duties triggered by insolvency that would include an obligation to preserve assets for creditors.

Other provisions of the LLC Act offer creditors opportunities to secure further protection, including requiring a member or manager to be personally obligated for any of the debts, obligations or liabilities of the company. The Court of Chancery also mentioned a creditor's right to protect itself by

seeking the appointment of a receiver under certain circumstances or by enforcing a member's obligation to make a contribution to the LLC.

The Court of Chancery summed it up well: "In light of the expansive contractual and statutory remedies that creditors of an LLC possess, it does not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC." In the end, both the Court of Chancery and the Supreme Court paid homage to the "contractarian spirit" of the LLC Act.

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