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Delaware Court of Chancery Rejects Attempt by Creditors of Insolvent LLC to Bring Derivative Claims

ROBERT S. REDER AND NEHAL M. SIDDIQUI

Court focuses on difference between LLC and corporate statutes in limiting standing for derivative claims to LLC members

In *CML V, LLC v. Bax, et al.*,¹ the Delaware Court of Chancery recently addressed the widely-held assumption that creditors of an insolvent limited liability company (“LLC”) have standing to bring derivative claims against LLC managers and members for breaches of fiduciary duty. The court rejected this assumption, focusing instead on the literal language of the Delaware Limited Liability Company Act (“LLC Act”) in concluding that the statute does *not* grant creditors of an insolvent LLC the same right that creditors of an insolvent corporation have to sue derivatively.² The court also noted, however, that the LLC Act, with its flexible approach and emphasis on freedom of contract, affords creditors of LLCs the ability to bargain for protections that are not available to a corporation’s creditors.

BACKGROUND

JetDirect Aviation Holdings, LLC, is a “private jet management and charter company” which provides aircraft charter and management servic-

Robert S. Reder is a partner at Milbank, Tweed, Hadley & McCloy LLP in the Global Corporate Group. Nehal M. Siddiqui is a corporate associate at the firm. The authors may be contacted at rreder@milbank.com and nsiddiqui@milbank.com, respectively.

es to its clientele. Beginning in 2005, JetDirect undertook an “aggressive expansion” strategy which resulted in a “highly leveraged balance sheet and volatile cash flows.” The following year, JetDirect’s board of managers became aware of “serious deficiencies” in its accounting systems and “material weaknesses,” “significant deficiencies,” and “control deficiencies” in its internal controls, most notably “the failure of JetDirect’s management to properly collect and account for financial data from JetDirect’s subsidiaries.” These deficiencies were exacerbated by a “botched” attempt by management to consolidate JetDirect’s billing operations. To make matters worse, JetDirect’s outside auditors refused to issue an audit opinion with respect to the company’s annual financials “because JetDirect’s internal controls lacked sufficient integrity....”

CML V, LLC entered the picture in 2007 when it loaned approximately \$34 million to JetDirect in two separate transactions. With this funding in hand, JetDirect completed four additional acquisitions despite the board’s “lacking current information” about the company’s financial condition. Then, in June 2007, JetDirect defaulted on its loan obligations to CML and, by January 2008, the company was insolvent.³ To address JetDirect’s precarious position, its managers began liquidating various assets, including sales to entities purportedly controlled by certain of the managers.

Subsequently, CML sued JetDirect and its managers in the Delaware Court of Chancery, asserting both derivative and direct claims. CML alleged derivatively on behalf of JetDirect that the managers (i) “breached their duty of care” by approving the 2007 acquisitions “without informing themselves of critical information about JetDirect’s financial condition”; (ii) “acted in bad faith by consciously failing to implement and monitor an adequate system of internal controls”; and (iii) breached their duty of loyalty by approving “self-interested asset sales.” CML also brought a direct claim against JetDirect for breach of its loan agreement with CML. The managers moved to dismiss the derivative claims on the ground that LLC creditors do not have standing to sue derivatively.⁴ The court agreed and granted the managers’ motion.

THE COURT'S ANALYSIS

Pursuant to § 1001 of the LLC Act:

A member...of a limited liability company 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 refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.

LLC Act § 1002 specifies that in any such derivative action:

the plaintiff must be a member...of a limited liability company...at the time of bringing the action and...[a]t the time of the transaction of which the plaintiff complains....

Faced with what it viewed as unambiguous language, the court acknowledged that its role is “limited to an application of the literal meaning of the words.” The court then concluded that “the literal terms of the LLC Act... bar a creditor of an insolvent LLC from suing derivatively.”

Although the court was persuaded by its reading of the literal language of the LLC Act, it nevertheless felt compelled to address the “awkward fact” that “[d]espite the ostensibly obvious implications of the statute, virtually no one has construed the derivative standing provisions as barring creditors of an insolvent LLC from filing suit.” Indeed, the court observed that if the statute had such an effect, “one would expect treatises, articles, and commentaries to call attention to that fact,” as well as targets of such derivative actions to raise the “statutory provisions as a defense.” Instead, the court noted, “[m]any commentators...have assumed that creditors of an insolvent LLC can sue derivatively.” Moreover, two previous Court of Chancery decisions “assumed, implicitly, that a creditor of an insolvent alternative entity can sue derivatively for breach of fiduciary duty.” Because neither case “specifically interpreted the statutory derivative standing provisions,” however, the court treated these discussions as “*dicta*” and, therefore, without precedential effect.

To address this “apparent tension between the plain language of the LLC Act and the commonly-held understanding of the provisions,” the court cited other sources of authority in support of its conclusion. First, the court contrasted the “exclusive language” of the LLC Act with the “non-exclusive language” of § 327 of the Delaware General Corporate Law (“DGCL”). DGCL § 327 provides 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...at the time of the transaction....” Delaware courts have ruled that DGCL § 327 “does not create the right to sue derivatively and, by its terms, does not say that stockholders can sue derivatively. Instead, it merely limits the subset of derivative suits ‘instituted by a stockholder of the corporation’....”

Given this flexibility, Delaware courts have been willing to take the position that “equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation” because “[w]hen a corporation is insolvent, the creditors become ‘the principal constituency injured by any fiduciary breaches that diminish the firm’s value.’” In response to CML’s argument that the “same equitable considerations” should extend to creditors of an insolvent LLC, the court concluded that the “plain language” of the LLC Act did not give it such leeway. From the court’s perspective, DGCL § 327 “demonstrates that the General Assembly can readily adopt a non-exclusive limitation on derivative standing” when it wants to do so. But, in the court’s view, it did not do so in the case of the LLC Act.⁵

Next, the court turned to the comparable provisions of the Delaware Limited Partnership Act (“LP Act”). The court explained that the LLC Act was “modeled on the popular Delaware LP Act” and that both statutes contain language with regard to derivative claims that is “phrased identically.” The court also noted that the derivative standing provision of the LP Act has historically been interpreted as exclusive to partners. The court concluded that these factors “strongly support[] a similarly exclusive reading of the LLC Act.”

Finally, CML argued that the court had the power to “disregard the literal language” of the LLC Act by applying the principle that “a statute will be deemed ambiguous ‘if a literal reading of the statute would lead to an

unreasonable or absurd result not contemplated by the legislature.” Specifically, CML contended that a literal reading of the LLC Act “generates an absurd distinction between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot.” The court disagreed, finding “nothing absurd about different legal principles applying to corporations and LLCs.” In fact, “courts should be wary of uncritically importing requirements” from the DGCL into the context of alternative entities, including LLCs. Because the philosophy underlying the LLC Act is to give “maximum effect to the principle of freedom of contract,” the court observed, creditors (such as CML) have the ability under the LLC Act to “bargain for express contractual rights in the LLC agreement while remaining a non-party,” or “to make creative use” of other LLC Act sections by actually becoming a party to the LLC Agreement. In any event, the court admonished, “[c]reditors generally are presumed to be ‘capable of protecting themselves through the contractual agreements that govern their relationships with firms.’” In short, “in light of the expansive contractual and statutory remedies that creditors of an LLC possess,” the court concluded that “it does not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC.”

CONCLUSION

The *Bax* decision is another example of the important distinctions that Delaware courts often draw between corporations, which are largely creatures of statute, and alternative entities such as LLCs and limited partnerships, which are largely creatures of contract. Generally, Delaware courts are reluctant to broadly construe provisions of the LLC Act so as to grant rights that LLC constituents could have bargained for, but failed to include, in their contractual arrangements. While LLC creditors may not be pleased with the *Bax* decision, they should take solace in their ability to fashion remedies in their agreements with LLCs that are not otherwise provided to them in the LLC Act.

NOTES

¹ C.A. No. 5373-VCL (Del. Ch. Nov. 3, 2010).

² The Court of Chancery's decision has been appealed to the Delaware Supreme Court and, therefore, may not be the final word on the subject.

³ In addition, JetDirect's operating subsidiaries filed for bankruptcy protection.

⁴ The parties agreed that if the derivative claims were dismissed, then the court would lack jurisdiction over the direct claim.

⁵ Presumably, on appeal, CML will argue (among other things) that the literal language of LLC Act §§ 1001 and 1002 should be read as non-exclusive, much as the courts have interpreted DGCL § 327. As noted above, LLC Act § 1001 does not expressly deny standing to creditors, but rather grants LLC members the right to bring derivative claims. And LLC Act § 1002 requires that the member bringing the derivative claim had been a member at the time of the transaction in question. While certainly not identical, the language of LLC Act §§ 1001 and 1002 also does not seem to be altogether different from that of DGCL § 327. It will be interesting to see if the Delaware Supreme Court agrees with the Court of Chancery that the statutes should be interpreted differently.