

November 11, 2010

Delaware Court of Chancery Holds That Creditors of Delaware LLCs Do Not Have Derivative Standing When LLC Is Insolvent

In *CML V, LLC v. Bax*, the Court of Chancery held that a creditor of JetDirect Aviation Holdings, LLC, a Delaware limited liability company ("JetDirect"), did not have derivative standing to assert breach of fiduciary duty claims against the board of managers of the insolvent JetDirect. The creditors would have had standing if JetDirect were a Delaware corporation, but the Court found that the Delaware LLC Act does not allow an LLC's creditors to bring derivative claims when a Delaware LLC is insolvent (or at any other time).

JetDirect provided private jet services and engaged in various related businesses. Beginning in 2005, the company acquired several similar private jet and charter services and, in doing so, became highly leveraged. By 2006, the company's accounting system was known to be deficient in tracking the company's financial status. An effort to consolidate the company's billing operations "was botched, and JetDirect's billing cycle expanded dramatically." Nevertheless, the company's board approved additional acquisitions in 2007. The plaintiff creditor, CML V, LLC ("CML"), lent the company approximately \$34 million in 2007.

In the suit, CML claimed that JetDirect's board should have had accurate information that would have allowed it to conclude that the company lacked sufficient working capital to finance the acquisitions. CML claimed that lacking financial information, making uninformed decisions and selling assets to interested parties below market value were breaches of fiduciary duties that CML could enforce as a creditor because JetDirect had become insolvent by January 2008.

The Court of Chancery rejected creditor standing to sue derivatively on behalf of an LLC. The court held that "the literal terms of the LLC Act control, and they bar a creditor of an insolvent LLC from suing derivatively." "The LLC Act creates a statutory right to bring a derivative action," but the LLC Act also specifies that members or their assignees are the only proper plaintiffs under the LLC Act to bring derivative claims.

The court held that the derivative standing provision of the General Corporation Law of the State of Delaware (the "DGCL") is fundamentally different than the analogous LLC Act provision at issue. Section 327 of the DGCL limits derivative standing to stockholders who held stock at the relevant time and continued to do so through the time the derivative suit is filed. Thus, Section 327 resembles the LLC Act which provides that a member suing derivatively must likewise have been a member at the relevant time and have continued to be so through the time the suit is filed. But Section 327 does not provide for exclusivity and the Delaware courts have construed it to impose limits on the class of stockholders who can sue derivatively, not to limit derivative actions exclusively to stockholders. The LLC Act, in

contrast, does provide that only members or their assignees can bring derivative claims. Unlike corporations, the court held that no equitable background comes into play for LLCs which could give rise to an extension of derivative standing to the creditors of LLCs.

The court canvassed decisions from other jurisdictions, commentaries and the legislative history of the LLC Act and the Limited Partnership Act from which the LLC Act derives but found that the plain reading of the LLC Act limiting derivative actions only to members and their assignees prevailed over any contrary interpretation. Had this result been absurd, the court could have departed from that plain meaning, but the court concluded that the result was not absurd because creditors have many and various ways to protect their interests. The court suggested five methods for creditors to protect their interests including penalties for breach of creditors' rights, expansion of fiduciary duties to creditors, or personal guarantees. The court also suggested that LLC creditors could contract for a right to preserve assets upon insolvency, but such a right would not be enforced through a derivative action. Notably absent from the suggested remedies is protecting creditor rights through an agreement to provide creditors with derivative standing, a result that would run afoul of the court's reading of the LLC statute.

The decision demonstrates that the contractual freedom that is available to Delaware LLCs has two sides. Parties can agree to most provisions they can imagine, but if they do not contract for specific rights, they may not have those rights because the LLC Act does not bring with it the general equitable background of the corporate law.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to Stephen P. Lamb (302-655-4411), Alan W. Kornberg (212-373-3209) and Joseph Christensen (302-655-4412).

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