

September 12, 2011

## Delaware Supreme Court Affirms That Creditors of Delaware LLCs May Not Sue Derivatively

On September 2, the Delaware Supreme Court affirmed a holding by the Court of Chancery that creditors of insolvent Delaware limited liability companies do not have standing to sue derivatively. This contrasts with Delaware corporations: the Delaware courts have recognized that when a corporation becomes insolvent, creditors become the residual risk-bearers and are permitted to sue derivatively on behalf of a corporation to the same extent as stockholders.

The Delaware Supreme Court, like the Court of Chancery, held that the plain language of the Delaware Limited Liability Company Act ("LLC Act") limits an action to sue derivatively to an LLC's members or their assignees. Unlike the Delaware General Corporation Law (the "DGCL"), the LLC Act leaves no room for the court to imply a right of action to sue derivatively because the LLC Act provides that "[i]n 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 . . . ." The court found that use of the word *must* in the LLC Act unequivocally was meant to exclude other potential plaintiffs. The DGCL has a comparable provision. The DGCL provision (Section 327) only allows derivative suits "instituted by a stockholder" to be brought if the stockholder was a stockholder when the alleged fiduciary violation occurred. The court construed these provisions quite differently. Section 327 imposes a contemporaneous stock ownership requirement in stockholder-initiated derivative suits; it does not exclude other potential plaintiffs. The LLC Act, however, not only requires contemporaneous membership, but also expressly limits derivative actions to members (or their assignees). The court held that, given this unambiguous statutory language, only the legislature could imply a right of creditors to bring derivative actions.

The Supreme Court noted that "LLCs and corporations are different; 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." In the case of LLCs, Delaware's legislature "has espoused its clear intent to allow interested parties to define the contours of their relationships with each other to the maximum extent possible."

Lenders to Delaware LLCs should keep these principles in mind when making financing decisions and consider seeking protections to compensate for the lack of derivative standing. As the Supreme Court and Court of Chancery observed, creditors can obtain derivative standing by negotiating for the automatic assignment of membership interests upon

© 2011 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this advisory may be considered attorney advertising. Past representations are no guarantee of future outcomes.

insolvency. Credit agreements, or the LLC's operating agreement itself, can also explicitly provide for expanded legal duties to creditors, include personal guarantees, a duty to preserve assets upon insolvency or stiff penalties if creditor rights are violated.

\* \* \*

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 should be directed to:

Lewis R. Clayton  
212-373-3215  
[lclayton@paulweiss.com](mailto:lclayton@paulweiss.com)

Alan W. Kornberg  
212-373-3209  
[akornberg@paulweiss.com](mailto:akornberg@paulweiss.com)

Stephen P. Lamb  
302-655-4411  
[slamb@paulweiss.com](mailto:slamb@paulweiss.com)

*Joseph L. Christensen contributed to this client alert.*

**NEW YORK**

1285 Avenue of the Americas  
New York, NY 10019-6064  
+1-212-373-3000

**BEIJING**

Unit 3601, Fortune Plaza Office  
Tower A  
No. 7 Dong Sanhuan Zhonglu  
Chao Yang District, Beijing 100020  
People's Republic of China  
+86-10-5828-6300

**HONG KONG**

12th Fl., Hong Kong Club Building  
3A Chater Road  
Central Hong Kong  
+852-2846-0300

**LONDON**

Alder Castle, 10 Noble Street  
London EC2V 7JU  
United Kingdom  
+44-20-7367-1600

**TOKYO**

Fukoku Seimei Building, 2nd Floor  
2-2, Uchisaiwaicho 2-chome  
Chiyoda-ku, Tokyo 100-0011  
Japan  
+81-3-3597-8101

**TORONTO**

Toronto Dominion Centre  
77 King Street West, Suite 3100  
P.O. Box 226  
Toronto, ON M5K 1J3  
Canada  
+416-504-0520

**WASHINGTON, D.C.**

2001 K Street NW  
Washington, DC 20006-1047  
+1-202-223-7300

**WILMINGTON**

500 Delaware Avenue, Suite 200  
Post Office Box 32  
Wilmington, DE 19899-0032  
+1-302-655-4410