

Bankruptcy & Restructuring Law Monitor

PROVIDING COMMENTARY AND THE LATEST UPDATES ON BANKRUPTCY & RESTRUCTURING LAW

PUBLISHED BY



Lenders Beware: Delaware Supreme Court Holds Creditors of Insolvent LLC Lack Derivative Standing

September 22, 2011 by Therese A. Scheuer

The Delaware Supreme Court recently held that creditors lack standing to bring a derivative suit on behalf of an insolvent Delaware limited liability company (an “LLC”) under the Delaware Limited Liability Company Act (the “LLC Act”). *CML V, LLC v. Bax*, No. 735, 2011 WL 3863132 (Del. Sept. 2, 2011, corrected Sept. 6, 2011). In an opinion written by Chief Justice Steele, the Delaware Supreme Court affirmed the Court of Chancery’s dismissal of claims brought by a junior secured creditor against the LLC’s present and former officers directly and derivatively for breaching their fiduciary duties. The Delaware Supreme Court’s holding was based on a plain reading of *6 Del. C. § 18-1002* which requires that a plaintiff be a “member” or an “assignee” of a limited liability company interest to bring a derivative action on behalf of an LLC.

Facts and Procedural History

Defendant JetDirect Aviation Holdings, LLC (“JetDirect”), a Delaware limited liability company, was a private jet management and charter company. In 2005, JetDirect began a series of transactions to acquire small and midsized competitor and charter service companies which left the company heavily leveraged. Between 2006 and 2007, JetDirect’s officers and board of managers learned of “serious deficiencies” in the company’s accounting system and internal controls. Nevertheless, the board continued its aggressive acquisition strategy. In April 2007, on the basis of outdated information, CML V, LLC (“CML”) made a loan to JetDirect of approximately \$26 million, which later increased to approximately \$34 million. Shortly thereafter, in June 2007, JetDirect

defaulted on its loan obligations to CML, and by January 2008, JetDirect was insolvent and began to liquidate its assets.

CML filed a complaint in the Delaware Court of Chancery asserting derivative claims against JetDirect's present and former managers for: (1) breach of the duty of care for their approval of transactions without informing themselves of JetDirect's financial condition; (2) bad faith for consciously failing to implement adequate internal controls; and (3) breach of the duty of loyalty for benefitting from self-interested asset sales. CML also brought a direct claim for money damages against JetDirect for breach of the loan agreement, but the parties agreed that the Court of Chancery would only have jurisdiction over the direct claim if any of the derivative claims survived a motion to dismiss. The Court of Chancery granted JetDirect and the individual defendants' motion to dismiss the claims on the basis that "CML, as a creditor, lacks standing to pursue derivative claims on behalf of JetDirect." CML appealed to the Delaware Supreme Court.

Delaware Supreme Court Ruling

CML advanced the following arguments on appeal: (1) the LLC Act does not deny creditors standing to bring derivative actions on behalf of insolvent LLCs and (2) if the LLC Act denies the Court of Chancery jurisdiction over such derivative actions, it places an unconstitutional limit on the Court of Chancery's equitable powers. The Delaware Supreme Court rejected both arguments.

The Delaware Supreme Court first addressed the plain language of § 18-1002 of the LLC Act, which provides:

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:

- (1) At the time of the transaction of which the plaintiff complains; or
- (2) The plaintiff's status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transactions.

6 *Del. C.* § 18-1002.

The court reasoned that this provision is clear and unambiguous—only a member or an assignee of an LLC interest can bring a derivative action. The court found it significant that § 18-1002 uses the term “must” be a member or assignee rather than “may”, and applies to “a derivative action” rather than “the derivative action.” Although a different section of the LLC Act, § 18-1001, provides that a member or assignee “may” bring “the derivative action”, the court reasoned that § 18-1001 created the right to file a derivative action by members and assignees while § 18-1002 explicitly limited that right to members and assignees. The court rejected CML’s argument that the General Assembly intended to take the corporate rule of derivative standing (which allows creditors of an insolvent corporation to sue derivatively) and apply it to the LLC context. The court reasoned that the General Assembly is well suited to make a policy choice to deny derivative standing to creditors of an LLC, but allow such standing for creditors of a corporation, to promote business entity diversity. The court further acknowledged the freedom of contract provided under the LLC Act.

The Delaware Supreme Court next rejected CML’s argument that limiting the Court of Chancery’s jurisdiction over derivative standing to members or assignees violates Article IV, Section 10 of the Delaware Constitution. Under Delaware law, the General Assembly cannot limit the equity jurisdiction of the Court of Chancery to less than the general equity jurisdiction of the High Court of Chancery of Great Britain when Delaware first ratified its constitution. The court observed that, unlike a corporation, an LLC as an entity did not exist at the time of enactment of the Delaware Constitution. Accordingly, the Delaware Constitution does not prevent the General Assembly from limiting the Court of Chancery’s jurisdiction over derivative claims to members and assignees of LLC interests. Moreover, the LLC is a creature of statute and the LLC Act was passed “in derogation of the common law.” Accordingly, common law may supplement, but cannot override, the LLC Act’s express provisions, including § 18-1002. Finally, the court reasoned that CML had an ample remedy at law, as it could have negotiated remedies by contract.

Conclusion

In structuring a finance transaction, lenders should be mindful of the differences in lending to a corporation, LLC or other Delaware business entity. The Delaware Supreme Court emphasized the flexibility of an LLC as a business entity, and the freedom of contract available to its creditors. The court suggested adding provisions that would, in the event of insolvency, convert the creditor's interests to that of an "assignee" or give the creditor control of the LLC's governing body. Such provisions, however, place a creditor at risk of being viewed as an "insider", or having its debt recharacterized as equity if the borrower becomes insolvent and files for bankruptcy. An alternative solution not mentioned by the court would be to include a contractual fiduciary duty to creditors in the LLC agreement (to the extent permitted by law), and provide that creditors are third-party beneficiaries of such provision with a right of enforcement. The lender could also enter into an agreement directly with the managers of the LLC, outlining the managers' duties and providing a mechanism for enforcement. Time will tell whether creditors are able, by these or other measures, to create enforceable protections against LLC managers' misdeeds.

Cole, Schotz, Meisel, Forman & Leonard, P.A.

Court Plaza North
25 Main Street
Hackensack, NJ 07601
Phone: (201) 489-3000

900 Third Avenue
16th Floor
New York, NY 10022
Phone: (212) 752-8000

500 Delaware Avenue
Suite 1410
Wilmington, DE 19801
Phone: (302) 652-3131

300 East Lombard Street Suite 2000

Baltimore, MD 21202

Phone: (410) 230-0660

301 Commerce Street

Suite 1700

Fort Worth, TX 76102

Phone: (817) 810-5250