

Delaware Supreme Court Holds That Creditors of Delaware LLC Lack Standing to Assert Derivative Claims

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In a recent *en banc* decision by the Delaware Supreme Court in *CML V, LLC v. Bax*, 2011 Del. LEXIS 480 (Del. Sept. 2, 2011), the Delaware Supreme Court held that creditors of a Delaware limited liability company (LLC) have no standing to assert derivative claims on behalf of an LLC, even if the LLC is insolvent. The ruling rests on the plain language of Section 18-1002 of the Delaware Limited Liability Company Act (the LLC Act), which expressly provides that only members and assignees of an interest in an LLC have standing to bring derivative claims in the right of the LLC.

The Delaware Supreme Court's decision in *Bax* makes it clear that creditors of an insolvent Delaware LLC have lesser rights than creditors of an insolvent Delaware corporation because creditors of an insolvent Delaware corporation do "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("Gheewalla").¹

The recent decision in *Bax* has significant implications for Delaware LLCs and their stakeholders, counterparties, creditors, managers and affiliates.

Background

The facts in *Bax* are straightforward. The plaintiff, CML V (the creditor), made a subordinated secured loan to the defendant, JetDirect Aviation Holdings, LLC (Jet-LLC), a Delaware LLC that was a private jet management and charter company. Jet-LLC failed to repay the loan and began liquidating its assets to reduce its debt burden. The creditor sued Jet-LLC and its senior management in the Delaware Court of Chancery, asserting derivative claims for breach of fiduciary duty by alleging that senior management failed to adequately inform themselves of Jet-LLC's financial condition, failed to institute and monitor proper internal financial controls, hid negative information from Jet-LLC's board and engaged in self-interested transactions, with the result that Jet-LLC entered into a series of ill-fated acquisitions at a time when it lacked adequate working capital. The creditor asserted that these and other acts constituted breaches of management's fiduciary duties of care, loyalty and good faith. (The creditor also asserted a direct claim for breach of a loan agreement, but the parties agreed that the Court of Chancery did not have jurisdiction over that claim unless the derivative claims survived a motion to dismiss.)

The individual defendants moved successfully in the Court of Chancery to dismiss the creditor's derivative claims. The Court of Chancery agreed with the defendants that Section 18-1002 of the LLC Act affords standing to assert derivative claims on behalf of the LLC only to members of an LLC and their assignees by providing: "[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...." 6 Del. C. § 18-1002 (emphasis added).

¹ Since *Gheewalla*, there have been numerous examples of derivative claims filed by creditors of Delaware corporations and their representatives, including trustees appointed under Chapter 11 plans. See, e.g., *Kirschner v. Wachovia Capital Markets, LLC*, 2009 WL 3571331 (W.D. Pa. Sept. 16, 2009) (opinion in action where litigation trustee asserts claims for breach of fiduciary duty against former directors and aiding and abetting claims against third parties); *Shandler v. DLJ Merchant Banking, Inc.*, 2010 Del. Ch. LEXIS 154 (Del. Ch. July 26, 2010) (opinion addressing breach of fiduciary duty claims by trustee for insolvent corporation).

The Delaware Supreme Court Decision

The creditor appealed to the Delaware Supreme Court, arguing that Section 18-1002 of the LLC Act should be construed to permit creditors of a Delaware LLC to assert derivative claims on behalf of the LLC. The creditor also argued that if Section 18-1002 is read to deny LLC creditors' standing to assert derivative claims it is an unconstitutional limitation of the Delaware Court of Chancery's equity jurisdiction.

The Delaware Supreme Court rejected both arguments. Relying on the plain language of Section 18-1002, the court concluded that the LLC Act imposes a clear and unambiguous limitation on standing to assert derivative claims:

Because section 18-1002 is unambiguous, is susceptible of only one reasonable interpretation, and does not yield an absurd or unreasonable result, we apply its plain language. Only LLC members or assignees of LLC interests have derivative standing to sue on behalf of an LLC — creditors do not.

In reaching its conclusion, the court observed that a choice of entity type is significant, and that creditors are well-advised to give consideration to the structure of their counterparty before extending credit: “[u]ltimately, 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.” The court did not agree with the creditor’s position that it was “absurd” to interpret the LLC Act in a way that would establish different derivative standing rules for Delaware LLCs and corporations.² Rather, the court referred to the policy of the LLC Act to give maximum effect to the principles of freedom of contract, which allows parties to “define the contours of their relationships with each other to the maximum extent possible.” *See* 6 Del. C. § 18-1101. Accordingly, stakeholders in an LLC are free to contractually agree to their respective rights and remedies.

The court also rejected the creditor’s argument that interpreting Section 18-1002 to preclude derivative standing to LLC creditors is unconstitutional under Article IV, Section 10 of the Delaware Constitution, which prohibits the Delaware legislature from passing statutes that limit the equity jurisdiction of the Court of Chancery.³ Accordingly, the Supreme Court affirmed the dismissal of all of the creditor’s derivative claims.

Implications

Bax has important implications for agreements, transactions and litigations involving Delaware LLCs. Lenders and other counterparties contracting with a Delaware LLC might seek contractual rights and remedies, including provisions in the LLC’s organizational documents, or other rights and protections, in lieu of standing to assert derivative claims.⁴ Provisions that could be included in LLC

² The court explained that “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 General Assembly is well suited to make that policy choice and we must honor that choice.”

³ The court emphasized the distinctions between corporations and LLCs. Corporations, and the right to bring a derivative claim on behalf of a corporation, predated the enactment of the Delaware General Corporation Law (DGCL) and were well-established parts of the common law when Delaware ratified its Constitution in 1792. In contrast, LLCs are recent creatures of a statute that did not exist in 1792. Accordingly, the court concluded that the Delaware legislature is not constitutionally prohibited from passing statutes that create a right to assert a derivative claim on behalf of an LLC and that limit the standing of those who may assert it.

⁴ The Delaware Supreme Court suggested as examples provisions that would automatically make a creditor an assignee of an LLC member upon the LLC’s insolvency, or which would give the creditor control of the LLC’s governing body. However, such provisions may or may not be enforceable in bankruptcy. *See* 11 U.S.C. § 541(c) (invalidating *ipso facto* clauses); *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (invalidating contract provision in agreement with one entity due to commencement of chapter 11 case by another entity).

agreements include information rights, rights to recover from specific LLC assets, rights to become an assignee or member upon the LLC's default of debt or other obligations and limitations on distributions to members. LLC creditors also might insist upon guarantees or other direct contractual rights of recovery against LLC members and managers, approval rights, and other creditor-protective terms and conditions.

Moreover, parties involved in current or potential Chapter 11 cases involving a Delaware LLC or Delaware limited partnership⁵ should consider the holding in *Bax* before negotiating Chapter 11 plan terms that transfer derivative LLC or partnership claims to litigation trusts or third parties. Assignees of such claims may encounter limits on their standing to pursue such derivative claims.

5 *Bax* is likely to be followed in matters concerning Delaware limited partnerships, as the Delaware Revised Uniform Limited Partnership Act includes provisions equivalent to Section 18-1002 of the LLC Act. See 6 Del. C. § 17-1002 (“In a derivative action, the plaintiff must be a partner or an assignee of a partnership interest....”).