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## Delaware Chancery Court Denies Creditors of an Insolvent LLC the Right to Bring Derivative Actions Against the Board

It is a settled principle of Delaware corporate law that creditors of an insolvent corporation have standing to pursue a derivative action on behalf of the corporation against the directors for breaches of fiduciary duties. Many commentators and two Delaware cases have assumed that this right also existed for creditors of Delaware limited liability companies. In *CML V, LLC v. John Bax et al.* (Del. Ch. Ct. November 3, 2010), however, the Delaware Chancery Court held that the Delaware Limited Liability Company Act (“Delaware LLC Act”) does not grant standing to creditors to bring a derivative claim against directors on behalf of the limited liability company (“LLC”). The Court found that the language of Section 18-1002 of the Delaware LLC Act unambiguously limited standing to bring a derivative claim to holders of membership interests in an LLC and their assignees. It rejected arguments by a creditor that the same considerations present in corporate law should permit similar claims on behalf of an insolvent LLC.

Section 79-29-1101 of Mississippi’s current Limited Liability Company Act (“Mississippi LLC Act”) , which applies to existing Mississippi LLCs until December 31, 2011, outlines the procedure required for a *member* to maintain a derivative action. Unlike the Delaware LLC Act, though, this provision never expressly states that “a plaintiff must be a member.” It merely states that a member may bring such an action if certain conditions are met. In the language of the *CML V* case, the Delaware statutory provision is *exclusive*, but the Mississippi LLC Act provision—like the Delaware General Corporation Law provision discussed in *CML V*—is *non-exclusive*. Interestingly, Section 79-29-1101 tracks the language of the Mississippi Business Corporation Act found in Section 79-4-7.41 very closely, and all of Article 11 of the Mississippi LLC Act appears to have been modeled on its counterpart in the Mississippi Business Corporation Act. While no case law exists interpreting whether a creditor of a Mississippi LLC may bring a derivative action, a creditor has an argument that the non-exclusive language of the statute, along with its similarity to the corporate statutes, gives the creditor of an insolvent limited liability company the right to maintain a derivative action.

Mississippi’s Revised Limited Liability Company Act (“Mississippi

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Revised LLC Act”), which will take effect on January 1, 2011, for new Mississippi LLCs and on January 1, 2012, for all Mississippi LLCs, adopts the Delaware LLC Act’s language nearly verbatim. Section 79-29-1103 of the Mississippi Revised LLC Act provides that “[i]n a derivative action, the plaintiff must be a member or an owner of a financial interest.” “Owner of a financial interest” is the Mississippi Revised LLC Act’s term that replaces the current Mississippi LLC Act’s use of “assignee.” Section 79-29-705 of the Mississippi Revised LLC Act goes a step further than Delaware, clarifying that a judgment creditor who has obtained a charging order on a financial interest “shall have no rights to bring a proceeding under Article 11 [Derivative Actions] of this chapter.” Thus the Mississippi Revised LLC Act, along with Delaware case law interpreting virtually identical statutory language, appears to prohibit creditors from bringing derivative claims.

The *CML V* Court outlined a number of ways LLC creditors can protect themselves from an inability to maintain a derivative action:

1. Creditors can bargain for express contractual rights in an LLC Agreement, such as covenants restricting distributions to members or prohibiting additional indebtedness, while remaining a non-party to the Agreement;
2. Creditors can bargain for penalties and consequences in an LLC Agreement for members upon the occurrence of specific events or if creditors’ rights are breached;
3. Creditors can require an expansion of fiduciary duties of the members and managers to include duties to creditors triggered by insolvency, if the creditors are willing to become a party to the LLC Agreement;
4. Creditors can require personal guaranties from members and/or managers;
5. Creditors can require that an LLC Agreement establish one or more designated series of LLC assets that would carry separate rights, powers or duties to supplement the Creditors’ security interest;
6. Creditors can require a provision in the LLC Agreement conditioning the approval of any amendment to the LLC Agreement on creditor consent or the satisfaction of conditions;
7. Creditors can secure the appointment of a receiver for the LLC in certain circumstances;
8. Creditors can enforce by statutory right a member’s obligation to make a capital contribution to the LLC if the creditor has extended credit in reliance on the member’s obligation to do so.

The Delaware LLC Act (and Mississippi’s Revised LLC Act) includes a broad legislative purpose to “give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements” and creditors are encouraged to use their bargaining power to obtain contractual protections.



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