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Abstract

The distinction between direct and derivative claims follows necessarily from the concept of a legal person being separate and distinct from its owners, raises and resolves a question of standing, has serious practical consequences in litigation, and is central to the governance of any business entity. In a closely held business, the distinction usually protects the deal the owners have made for themselves. On some occasions, however, the distinction helps shelter a miscreant majority owner who has managed to harm a fellow owner indirectly.

This column will briefly describe the three approaches to the direct-derivative distinction found in the case law, explain why the "direct harm" approach is logically and doctrinally correct, and outline the distinction's practical consequences. With that information as background, the column will address the issue reflected in the column's caption—that is, how can a party to a contract lack standing to sue another party for breach?

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How Can I Be a Party to a Contract and Yet Lack Standing to Sue Another Party for Breach?

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This column will briefly describe the three approaches to the direct-derivative distinction found in the case law, explain why the "direct harm" approach is logically and doctrinally correct, and outline the distinction's practical consequences. With that information as background, the column will address the issue reflected in the column's caption—that is, how can a party to a contract lack standing to sue another party for breach?

Courts have considered three different approaches to the direct-derivative distinction: (i) direct harm, (ii) special injury, and (iii) to whom the duty is owed. The last-named approach, which by far has the fewest judicial adherents, makes the distinction by looking at the duty alleged to have been breached and asks, "to whom is that duty owed?" The approach makes no sense either practically or conceptually. As a practical matter, courts frequently refer (imprecisely) to a duty owed to both the entity (e.g., an LLC) and its owners (e.g., members). As to concept, standing is everywhere else an issue of injury rather than duty.

The second-listed approach deems any claim derivative unless the owner asserting the claim can prove a type of injury different than the type of injury suffered by other owners. It is true that an injury suffered by an entity indirectly causes the same type of injury to all the entity's owners. However, the converse is not necessarily true—that is, suppose this statement is true: *if P then Q*. The converse, *if Q then P*, might happen to be true *but is not necessarily so*. (Logic geeks will recognize "the fallacy of affirming the consequent.")

Think, for example, of the famous *Revlon* duty to use appropriate efforts to maximize shareholder benefits when a publicly traded corporation is destined to be sold. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506, A.2d 173 (Del. 1986). The special injury rule would deem a shareholder's *Revlon* claim to be derivative, which makes no sense.

The direct injury approach is both simple and conceptually sound. Has an owner been harmed directly or merely as a result of an injury suffered by the entity? As ULLCA (2103) § 801(b) provides, a claim is derivative unless the member asserting the claim can "plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company." See also *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*,

845 A.2d 1031 (Del. 2004) (abandoning the special-injury approach in favor of the direct-harm analysis).

Whether a claim is direct or derivative has substantial, often dispositive, consequences. First, in almost all jurisdictions, a derivative plaintiff must either: (i) *before bringing suit*, address the entity's top-level managers (e.g., a corporate board, the managers of a manager-managed limited liability company) and demand that they address the alleged problem, or (ii) plead (typically with particularity) that demand would be futile. In some jurisdictions, a plaintiff who makes a demand creates almost insurmountable obstacles to bringing a derivative claim if (typically when) the managers reject the demand.

Second, even when demand is excused as futile, a derivative claim may be subject to a "special litigation committee" (SLC) appointed by the top-level managers with the power to investigate and decide whether the entity's best interests will be served by the claim going forward under the control of the derivative plaintiff, being dismissed, or continuing under the control of the SLC. As a matter of fact, almost all SLCs decide in favor of dismissal (sometimes conditioned on changes in the entity's policies or practices) and so recommend to the court. If the would-be derivative plaintiff contests the SLC's recommendations, in most instances the court will adopt the recommendation. No such ADR technique exists for direct claims.

Third, with a direct claim, any recovery comes directly to the plaintiff-owner(s). With a derivative claim, the recovery goes to the entity, with no guarantee that the entity will distribute any of the recovery to the entity's owners. *Wilderman v. Wilderman*, 315 A.2d 610, 612 (Del. Ch. 1974), is a classic example. The case involved a corporation in which, as the result of a divorce court's error in judgment, an ex-husband was the majority shareholder and the ex-wife was the minority shareholder. The ex-wife believed the corporation was paying excess compensation to the ex-husband. She sued derivatively to recover the excessive compensation and directly to have the corporation distribute any recovery to the shareholders. The ex-wife won on the derivative claim but lost on the direct. The court was unwilling to interfere with the discretion of the board of directors regarding dividends, even though the board consisted solely of the ex-husband and one of his hunting buddies.

Against this backdrop, we come now to this question: how can a person (e.g., a member of a limited liability company) be a party to a contract (e.g., the company's operating agreement) and yet lack standing to sue another party (e.g. a fellow member) for breach of the agreement? Such is the situation. As the Delaware Supreme Court has opined (for example), Delaware law:

> does not support the proposition that any claim sounding in contract is direct by default, irrespective of [the direct harm analysis]. Nor does [Delaware law hold that a person's] status as a limited partner and party to the LPA [limited partnership agreement] enable him to litigate directly every claim arising from the LPA. Such a rule would essentially abrogate [the direct harm analysis] with respect to alternative entities merely because they are creatures of contract.

El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff, 152 A.3d 1248, 1259–60 (Del. 2016) (footnotes omitted).

Similarly, the official comment to ULLCA § 801(b) states that, "[a]lthough in ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract," the situation is different with an operating agreement:

> A member does not have a direct claim against a manager or another member merely because the manager or other member has breached the operating agreement. . . . To have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the limited liability company.

The comment provides several examples, of which the following is a composite:

> The manager of a manager-managed LLC engages in grossly negligent conduct, in violation of ULLCA § 409(c) (duty of care) and in breach of an express provision of the operating agreement. As a result, the LLC's net assets shrink by fifty percent. In turn, and as an indirect result, the value of the membership interest of Member A (who perforce is a party to the operating agreement) shrinks by $3,000,000. Member A has no standing to bring a direct claim—neither on the statute nor on the agreement. Member A's damages are merely derivative of the damage first suffered by the LLC.

Thus, to paraphrase James Carville's famous statement about the economy being a key political issue, *it's all about standing*.