Direct Versus Derivative and the Law of Limited Liability Companies

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Direct Versus Derivative and the Law of Limited Liability Companies

Abstract
The hybrid nature of limited liability companies causes us to re-invent, or at least re-examine, many doctrinal wheels. This Article will reexamine one of the most practical of those wheels—the distinction between direct and derivative claims in the context of a closely-held limited liability company.

Case law concerning the direct/derivative distinction is still overwhelmingly from the law of corporations, although LLC cases are now being reported with some frequency. LLC cases routinely analogize to, or borrow from, the corporate law. This Article encompasses that law, analyzes LLC developments, and argues that courts should (i) avoid the "special injury" rule, (ii) embrace the "direct harm" approach, and (iii) engraft to the direct harm approach an exception applicable when those in control of a limited liability company harm the company with the "purpose and effect" of injuring a particular member.

Keywords
LLC, limited liability company, derivative

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DIRECT VERSUS DERIVATIVE AND THE LAW OF LIMITED LIABILITY COMPANIES

Daniel S. Kleinberger*

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I. INTRODUCTION

The hybrid nature of limited liability companies causes us to re-invent, or at least re-examine, many doctrinal wheels. This Article will re-examine one of the most practical of those wheels—the distinction between

1 T.S. ELIOT, Little Gidding, in FOUR QUARTETS 59 (Harvest Books 1968) (1943).

1. **DIRECT VERSUS DERIVATIVE**

   Direct and derivative claims in the context of a closely-held limited liability company.

   Case law concerning the direct/derivative distinction is still overwhelmingly from the law of corporations, although LLC cases are now being reported with some frequency. LLC cases routinely analogize to, or borrow from, the corporate law. This Article encompasses that law, analyzes LLC developments, and argues that courts should (i) avoid the "special injury" rule, (ii) embrace the "direct harm" approach, and (iii) engraft to the direct harm approach an exception applicable when those in control of a limited liability company harm the company with the "purpose and effect" of injuring a particular member. The analysis proceeds as follows:

   Part II – The Relevance of Corporate Case Law.


   Part IV – The Conceptual Fundamentals for Making the Distinction (Without Regard to Closely Held Character).

   Part V – A Special Rule for Closely Held Entities.

   Part VI – Special Queries with Regard to Limited Liability Companies.


   Part VIII – Conclusion.

II. THE RELEVANCE OF CORPORATE CASE LAW

The data is overwhelming. Almost all LLC cases addressing the direct/derivative distinction follow rules developed in corporate-law cases.

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3 *E.g.*, VGS, Inc. v. Castiel, No. C.A. 17995, 2003 WL 723285, at *11 (Del. Ch. Feb. 28, 2003) ("[T]he provision [in the Delaware LLC statute providing for derivative suits] originates from the well-developed body of Delaware law governing derivative suits by stockholders of a corporation. Accordingly, case law governing corporate derivative suits is equally applicable to suits on behalf of an LLC."); *see also infra* Part II.

4 *See id.*

5 One treatise offers the following collection of cases:
For cases using the corporate analogy, see Safety Techs., L.C. v. Biotronix 2000, Inc., 136 F. Supp. 2d 1169, 1172 n.3 (D. Kan. 2001) ("The court believes that the Kansas Supreme Court would also apply [corporate] precedent limiting lawsuits by individual shareholders to limit lawsuits by members of limited liability companies . . . . The rationale of the rule, preventing the danger of multiplicitous suits by each shareholder . . . applies equally to corporations and limited liability companies"). But see Ayres v. AG Processing, Inc., 345 F. Supp. 2d 1200, 1208 (D. Kan. 2004) (stating, with reference to Nebraska law, that "the Court is not convinced that [corporate] law should apply to members of a LLC" but eschewing a decision on the issue because the corporate rule would allow the plaintiffs to bring a direct claim). See also Glod v. Baker, 2002-988, 2003 WL 21804398, at *6 (La. 3d Cir. Aug. 6, 2003) (quoting with approval the trial court's observation that the same direct/derivative issues arise in "closely held corporations, partnerships or limited liability companies owned by a very few people, who are . . . severely personally damaged as a result of the wrongs done to their entities," but discussing corporate precedent in detail and at length). For a case applying corporate principles and terminology without noticing that the "entity" involved was an LLC, see Giuliano v. Pastina, 793 A.2d 1035, 1036-37 (RI 2002) (repeatedly referring to plaintiff's ownership interest in Plainridge Racing Company, LLC as "a shareholder's ownership interest," and affirming dismissal of plaintiff's complaint because "the plaintiff's claims, if valid, belonged to the corporation"). See also Paclink Communications Int'l, Inc. v. Superior Ct., 109 Cal. Rptr. 2d 436 (Ct. App.-2d Dist. 2001) and Taurus Advisory Group, Inc. v. Sector Management, Inc., 1996 WL 502187 *2 (Conn. Super. Ct. Aug. 29, 1996); Taurus Advisory Group, Inc. v. Sector Mgmt., Inc. No. CV 960150830, 1997 WL 241153 at *2 (Conn. Super. Ct. May 6, 1997) (reiterating the earlier holding and noting that, although the facts underlying the direct claims may also implicate "claims on behalf of Taurus L.L.C., 'where a shareholder's complaint sets out a cause of action that is both individual and derivative, the shareholder may proceed with the individual action'") (quoting Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985), aff'd, 500 A.2d 1346 (Del. 1985)). Accord Ayres v. AG Processing, Inc., 345 F. Supp. 2d 1200, 1209 (D. Kan. 2004). The door swings both ways. See Brock v. Baskin-Robbins USA Co., 5:99-CV-274, 2000 WL 1357711 at *13 (ED Tex., Sept. 18, 2000) (analyzing the direct/derivative question for corporations and citing, inter alia, an LLC case, In Beaver Constr. Co., Inc. v. Lakehouse, L.L.C., 742 So.2d 159 (Ala. 1999)).

2 BISHOP & KLEINBERGER, supra note 2, ¶ 10.01[2][b] n.39.1; see also Dawson v. Atlanta Design Assocs., Inc., 551 S.E.2d 877, 880 n.1 (N.C. Ct. App. 2001) (relying on a partnership case, which in turn had relied on a corporate case, and stating that "[n]either party argues in its brief to this Court, and we see no reason why, the teaching of Energy Investors [the partnership case that quoted the corporate case] should not apply to limited liability companies" (citing Energy Investors Fund, L.P. v. Metric Constr. Inc., 525 S.E.2d 441 (N.C. 2000)).
Recent examples of this reliance include *Stoker v. Bellemeade, LLC*, *Solutia Inc. v. FMC Corp.*, *DDH Aviation, L.L.C. v. Holly*, and *Godfrey v. Lafavour.*

6 615 S.E.2d 1, 7 (Ga. Ct. App. 2005) ("Because the LLCs at issue are all closely held entities with some corporate characteristics, we address this issue by looking to the analogous situation presented under similar circumstances in the context of closely held corporations.").

7 385 F. Supp. 2d 324, 331 n.1 (S.D.N.Y. 2005) (stating that "New York corporate law applies in full force to limited liability companies" in matters relating to derivative suits). The case repeatedly refers to shareholders, but acknowledges that the joint venture vehicle at issue was a Delaware limited liability company. *Id.* at 331 (stating that the parties became "shareholders in a Delaware limited liability company").

8 No. Civ.A.3:02-CV-2598-P, 2005 WL 770595, at *5 (N.D. Tex. Mar. 31, 2005) (rejecting the application of a statutory exception for closely-held-corporation shareholders [allowing derivative claims brought by such shareholders to be treated as direct claims] to claims by members of a closely held LLC, but only because the plaintiffs had not claimed in their pleadings the entity was closely held). *Contra Ayres v. AG Processing Inc.*, 345 F. Supp. 2d 1200, 1206–09 (D. Kan. 2004) (stating that (i) the court could find no Nebraska precedent; (ii) "the Court is not convinced that [the corporate rule] should apply to members of a LLC[]" and (iii) declining to decide the question because the plaintiffs would qualify under the corporate rule to bring a direct action). *But see Safety Techs., L.C. v. Biotronix 2000*, Inc., 136 F. Supp. 2d 1169, 1172 n.3 (D. Kan. 2001) ("The court believes that the Kansas Supreme Court would also apply [corporate] precedent limiting lawsuits by individual shareholders to limit lawsuits by members of limited liability companies. The rationale of the rule, preventing the danger of multiplicitous suits by each shareholder, applies equally to corporations and limited liability companies.") (citations omitted).

9 No. J05-005 CV JWS, 2005 WL 2340714, at *4 (D. Alaska Sept. 12, 2005) (applying in an LLC case and without explanation the corporate rule that a direct claim exists only """"(1) where the shareholder suffered an injury separate and distinct from that suffered by other shareholders, and (2) where there is a special duty, such as a contractual duty, between the alleged wrongdoer and the shareholder"""") (citing *Hikita v. Nichiro Gyogo Kaisha*, Inc., 713 P.2d 1197, 1199 (Ala. 1986)); *see also Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 293 (Del. 1999) ("The derivative suit is a corporate concept grafted onto the limited liability company form."); *Monroe v. Baron One, LLC*, 902 So. 2d 529, 531–35 (La. Ct. App. 2005) (directly applying corporate rules, without any mention of the fact that an LLC was involved); *Gottsacker v. Monnier*, 697 N.W.2d 436, 448 n.4 (Wis. 2005) (Roggensack, J., concurring) (noting that """"[t]he concept of derivative claims has been engrained into the law of limited liability companies"); *Albers v. Guthy-Renker Corp.*, No. 02-56673, 2004 WL 540697, at *1 (9th Cir. Mar. 17, 2004) (applying the corporate rule to determine that members of an LLC did not have standing to sue for alleged misrepresentations by the defendant, which caused the LLC to lose money and noting that the fact """"[t]hat [the plaintiffs' company] is a limited liability company... rather than a corporation, does not change this result"); *Taurus Advisory Group, Inc. v. Sector Mgmt., Inc.*, No. CV 960150830, 1997 WL 241153, at *2–*3 (Conn. Super. Ct. May 6, 1997) (applying the corporate special injury rule """"by way of analogy").
The derivative nature of the LLC case law makes conceptual sense. Courts understand the direct/derivative distinction as a separate entity characteristic, which they associate with corporateness. An LLC is emphatically an entity separate from its members, and so it follows that the corporate approach to the direct/derivative distinction should carry over into the law of LLCs. Indeed, even when a court looks to a partnership


11 E.g., Bailey v. United States, 53 Fed. Cl. 251, 257 (2002) (stating that corporations are separate entities, that shareholders therefore do not have a legal interest in the corporation's property, and that injuries to the corporation's property are "recoverable only by the corporation in a direct action or by the shareholders in a derivative action") (quoting *Crocker v. Fed. Deposit Ins. Corp.*, 826 F.2d 347, 349 (5th Cir. 1987)); Moore v. Simon Enters., Inc., 919 F. Supp. 1007, 1012 (N.D. Tex. 1995) ("Under corporate law, a corporation is a legal entity distinct from its shareholders and not even a person owning all of a corporation's shares can represent the interests of the corporation in a lawsuit."); Sabey v. Howard Johnson & Co., 5 P.3d 730, 735 (Wash. Ct. App. 2000) ("Ordinarily, a shareholder cannot sue for wrongs done to a corporation, because the corporation is a separate entity: the shareholder's interest is viewed as too removed to meet the standing requirements. Even a shareholder who owns all or most of the stock, but who suffers damages only indirectly as a shareholder, cannot sue as an individual.") (footnote omitted).

12 See, e.g., *SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props.*, LLC, 375 F. Supp. 2d 238, 243 (S.D.N.Y. 2005) ("Under Delaware law, a limited liability company ... is a 'separate legal entity' distinct from the members who own an interest in the LLC."); *Bubbles & Bleach, LLC v. Becker*, No. 97 C 1320, 1997 WL 285938, at *4 (N.D. Ill. May 23, 1997) ("[I]t is this characteristic of limited liability companies— their distinct legal existence as an entity apart from their constituent members—which allows them to shield their members from personal liability and distinguishes them from both general and limited partnerships."); *In re Watson*, 322 B.R. 740, 747 (Bankr. E.D. Va. 2005) ("[T]he individual who establishes a corporation or a limited liability company for the purpose of business operation and asset ownership has created a wholly separate, legally identifiable entity apart from his individual legal existence."); see also UNIF. LTD. LIAB. CO. ACT § 201 (rev. 1996), 6A U.L.A. 578 (1996) (stating that "[a] limited liability company is a legal entity distinct from its members"); DEL. CODE ANN. tit. 6, § 18-201(b) (2005) (stating that "[a] limited liability company formed under this chapter shall be a separate legal entity"); see generally 1 BISHOP & KLEINBERGER, supra note 2, ¶ 5.05[1][e].

13 See Stoker v. Bellemade, LLC, 615 S.E.2d 1, 7 (Ga. Ct. App. 2005) ("Because the LLCs at issue are all closely held entities with some corporate characteristics, we address this issue by looking to the analogous situation presented under similar circumstances in the context of closely held corporations."); see also *In re Real Marketing Servs.*, LLC, 309 B.R. 783, 788 (Bankr. S.D. Cal. 2004) (determining whether the bankruptcy estate of an LLC owned particular claims by (i) first noting that "[a]n action is derivative of the corporation’s rights, and hence not independent of them, if 'the gravamen of the complaint is injury to the corporation ... or it seeks to recover assets for the corporation or to prevent the dissipation of its assets,'” and then (ii) holding that "[w]ith regard to limited liability corporations ("LLC’s"), members of an LLC hold no direct ownership interest in the company’s assets and therefore are not directly injured when the company suffers an improper deprivation of those assets"). In support of its position, the court
The partnership law in this area itself derives from corporate cases. As explained in Part III, the direct/derivative case law can be divided into three subcategories, depending on which of three approaches the court has used to make the direct/derivative distinction. In general, the LLC-corporate connection carries through into these subcategories. Where the corporate rule is direct harm, that rule will typically apply to LLCs as cited and quoted PacLink Communications International, Inc. v. Superior Court, 109 Cal. Rptr. 2d 436 (2001), an LLC case, which in turn had cited Jones v. H.F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969), a corporate case.

E.g., Dawson v. Atlanta Design Assocs., Inc., 551 S.E.2d 877, 880 n.1 (N.C. Ct. App. 2001) (applying a variation of the special injury rule, borrowed from a partnership case, which in turn had applied the rule used in corporate cases: "We acknowledge that the business entity at issue in Energy Investors was a partnership, while the business entity at issue in the case sub judice is a limited liability company. Neither party argues in its brief to this Court, and we see no reason why, the teaching of Energy Investors should not apply to limited liability companies." (citing Energy Investors Fund, L.P. v. Metric Constr. Inc., 525 S.E.2d 441 (N.C. 2000)).

Lenz v. Associated Inns & Rests. Co. of Am., 833 F. Supp. 362, 379–80 (S.D.N.Y.1993) ("In both the corporate and partnership context, the determination of whether a suit is derivative or direct turns on the nature of the injury alleged and the entity which sustains the harm."); see also Abeloff v. Barth, 119 F.R.D. 332, 334 (D. Mass. 1988) (requiring the procedures of Federal Rule of Civil Procedure 23.1 to be followed in a derivative suit filed by limited partners against general partners, even though the rule only refers to corporations: "Although this rule speaks in terms of shareholders of corporations, there appears to be no dispute that it is equally applicable to partnerships."); Strain v. Seven Hills Assocs., 75 A.D.2d 360, 371 (N.Y. App. Div. 1980) (finding that a limited partner could bring a derivative lawsuit against a general partner for breach of fiduciary duty, in part through a comparison to a corporate case: "By logical extension it appears that a limited partner's power to vindicate a wrong done to the limited partnership and to enforce redress for the loss or diminution in value of his interest is no greater than that of a stockholder of a corporation."); Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P., 829 A.2d 143, 149–50 (Del. Ch. 2003) ("The test for distinguishing direct from derivative claims in the context of a limited partnership is substantially the same as that used when the underlying entity is a corporation. . . . The test looks to the nature of the injury and to the nature of remedy that could result if the plaintiffs are successful.")) (footnotes omitted); Dawson, 551 S.E.2d at 880 n.1 (determining the issue in an LLC case by relying on a partnership case, which in turn had applied the rule used in corporate cases); Nauslar v. Coors Brewing Co., 170 S.W.3d 242, 249–51 (Tex. App.—Dallas 2005, no pet. h.) (applying without comment the corporate direct harm rule to hold that the plaintiffs, Nauslar Investments, LLC, the limited partner in a partnership and the limited partner in that partnership's general partner and Nausler, sole member and owner of Nausler Investments, LLC, could not assert a direct injury against the defendant for unreasonably disapproving the partnership merger with another entity; explaining that it was the partnership that suffered the direct injury—harm to its value—and loss to the plaintiffs from its lower sale price was derivative of the partnership's right of action).

See infra Part III.
well.\textsuperscript{17} So too in jurisdictions applying the special injury rule or the rule of "duty owed" or "rights infringed."\textsuperscript{18}

### III. Why the Direct/Derivative Distinction Matters Practically\textsuperscript{19}

The direct/derivative distinction is governed by the law of the entity's jurisdiction of organization\textsuperscript{20} and has at least five major practical ramifications: the risk of dismissal for mistaking the distinction, the demand requirement, the special litigation committee, the ownership of any

\textsuperscript{17}Compare PacLink Commc'ns, 109 Cal. Rptr. 2d at 438, 440 (explicitly applying direct harm rule for corporations to LLCs; holding plaintiff members who lost the value of their investments had no standing to bring a direct action against other members, who allegedly transferred the company's assets to other entities they owned without paying the plaintiffs or getting their permission, because the plaintiffs were not directly injured), \textit{with Jones}, 460 P.2d at 470 (holding the plaintiff's claims against other shareholders for breach of fiduciary duty could be brought individually because the "gravamen of her cause of action" was a direct injury to herself and other minority shareholders). \textit{See also} Godfrey \textit{v. Lafavour}, No. J05-005 CV JWS, 2005 WL 2340714, at *4 (D. Alaska Sept. 12, 2005) (discussed supra note 9); \textit{Dawson}, 551 S.E.2d at 877 (discussed supra note 14).

\textsuperscript{18}Compare \textit{Giuliano v. Pastina}, 793 A.2d 1035, 1036–37 (R.I. 2002) (using the duty owed approach as an alternative to the direct harm approach and holding that the involvement of the defendant, an LLC employee, in an illegal telephone betting scheme damaged the company itself, not the plaintiff LLC member, and that the employee owed a duty only to the LLC, his employer, not to the plaintiff), \textit{with} \textit{Lawton v. Nyman}, 327 F.3d 30, 50 (1st Cir. 2003) (applying Rhode Island law and explaining that if an injury results from a "violation of a duty owed directly to shareholders, they may sue on their own behalf").

\textsuperscript{19}For a theoretical approach to the distinction, see \textit{infra} Part IV.

\textsuperscript{20}\textit{Fogel v. Zell}, 221 F.3d 955, 966 (7th Cir. 2000) (stating that under "standard choice of law rules . . . the law of the state of incorporation determines who can bring a derivative suit"); \textit{see also} \textit{Smith v. Waste Mgmt., Inc.}, 407 F.3d 381, 384 n.1 (5th Cir. 2005) (stating that under the applicable state law "the determination of whether a plaintiff's claims are direct or derivative depends upon the law of the company's state of incorporation"); \textit{Bagdon v. Bridgestone/Firestone, Inc.}, 916 F.2d 379, 382 (7th Cir. 1990) (stating that "[t]he choice between derivative and direct litigation is a choice about how (and by whom) the internal affairs of the firm are managed"); \textit{Fleeger v. Clarkson Co. Ltd.}, 86 F.R.D. 388, 395 (N.D. Tex. 1980) (stating that "in a shareholder derivative suit the court must apply the law of the place of incorporation"); \textit{Kessler v. Sinclair}, 641 N.E.2d 135, 137 (Mass. App. Ct. 1994) ("The issue is one of corporate governance in the sense of locating who is to exercise control of the alleged corporate claim. In these circumstances, the law of Massachusetts and general law as well direct us to apply the law of the State of incorporation.").
amount recovered, and the availability *vel non* of attorneys’ fees for a victorious plaintiff.21

A. The Risk of Dismissal (Whose Claim Is It?)

The most fundamental consequence for a plaintiff who mischaracterizes a derivative cause of action as direct is the risk of dismissal of the claim.22 A derivative claim belongs to the entity, and an owner has no standing to bring the claim except on behalf of the entity.23 For example, *Giuliano v. Pastina* concerned a limited liability company involved in “harness racing and video simulcasting.”24 A member of the LLC believed that “an agent and/or employee” of the LLC had damaged the business and the member’s ownership interest through “involvement in illegal telephone betting.”25 The member sued directly (in his own right), rather than derivatively (on behalf of the company).26 The trial court dismissed, and the Rhode Island Supreme Court affirmed: “[P]laintiff’s claims, if valid, belonged to the corporation [sic], and the plaintiff’s complaint was in reality a derivative action that had not been filed in accordance with Rule 23.1 [the rule governing pleadings in a derivative action].”27

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21 There are other procedural ramifications, including the “contemporaneous ownership requirement.” For an overview of these ramifications, see DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 4.1, at 4-2 (2003). See also Daniel S. Kleinberger & Imanta Bergmanis, Direct vs. Derivative, or “What’s a Lawsuit Between Friends in an ‘Incorporated Partnership?’,” 22 WM. MITCHELL L. REV. 1203, 1226-29 (1996).

22 Marcoux v. Prim, 04 CVS 920, 2004 NCBC 5, at ¶ 36-38 (N.C. Bus. Ct. Apr. 16, 2004), available at http://www.ncbusinesscourt.net/opinions/2004%20NCBC%205.htm (“If this is a derivative action rather than a direct action, the plaintiff made three crucial mistakes as to the Complaint filed in this action . . . [including not making] allegations with respect to demand futility required by Delaware law. If this is a derivative action, it is subject to dismissal.”).

23 In re Sagent Tech., Inc., 278 F. Supp. 2d 1079, 1085 (N.D. Cal. 2003) (“A shareholder does not have standing to sue in an individual capacity for injury to the corporation.”).

24 793 A.2d 1035, 1036 (R.I. 2002).

25 Id.

26 Id.

27 Id. at 1036-37. The court’s incorrect reference to “corporation,” and earlier in the opinion to “shareholder,” reflects a continuing, albeit lessening, phenomenon of judicial confusion as to the nature of, and correct terminology for, limited liability companies. See 1 BISHOP & KLEINBERGER, supra note 2, ¶ 1.01[3][f]; Kleinberger, *Soup*, supra note 2, at 15 (“More than one court has referred to an LLC as ‘a limited liability corporation’ or to LLC members as shareholders, and one case referred to an LLC’s members as ‘limited liability partners.’”).
In most circumstances, dismissal of a claim incorrectly pled as direct will be without prejudice, but even so the dismissal may be dispositive.\(^{28}\) A plaintiff may well decide to eschew amending the complaint, in light of the procedural barriers facing a derivative claim.\(^{29}\) If the language of the complaint itself eschews a derivative claim, the dismissal will be with prejudice.\(^{30}\)

The distinction between a direct and derivative claim generally precludes a member’s direct action to enforce a contract made by an LLC,\(^{31}\)

\(^{28}\) *Cf.* Simon v. Value Behavioral Health, Inc., 208 F.3d 1073, 1084 (9th Cir. 2000) (holding that it was proper to deny the plaintiff leave to further amend the complaint to allege direct injury because plaintiff had already had three opportunities to do so); FS Parallel Fund L.P. v. Ergen, No. 19853, 2004 WL 3048751, at *3 (Del. Ch. Nov. 3, 2004) (holding that it was proper to dismiss with prejudice a count purporting to state a direct claim, “because StarBand [the corporation] is the injured party and because the recovery for that injury would accrue to StarBand, Count I states a derivative claim, and it therefore would be futile to permit the amendment [sought by shareholder plaintiffs in lieu of a dismissal with prejudice] because StarBand has released all claims against the defendants”). If the statute of limitations has not run, a plaintiff whose direct claim has been dismissed should be able to file a derivative claim. Neither res judicata nor collateral estoppel apply because the real parties in interest are different. The direct claim belongs to and occasions adjudication of the rights of the plaintiff itself, while “in derivative litigation the substantive claim belongs to the corporation.” DEMOTI, *supra* note 21, § 4.99, at 4-243 to 4-242. Of course, to proceed derivatively the plaintiff must comply with the special procedural requirements for a derivative claim. See *id.* § 4.1; *see also infra* Part III.B.

\(^{29}\) *See infra* Part III.B.


\(^{31}\) Brock v. Baskin-Robbins USA Co., 113 F. Supp. 2d 1078, 1092 (E.D. Tex. 2000) (holding, in a dispute between franchisees and their franchisor, that members of an LLC lacked standing to sue for damages allegedly suffered by the LLC as a franchisee). In one case, the LLC members asserted that they were not bound by a contract’s arbitration provision because they were separate and distinct from the LLC and were not signatories to the contract. Beaver Constr. Co. v. Lakehouse, LLC, 742 So. 2d 159, 165 (Ala. 1999). The Court rejected that assertion: “[B]y arguing that they were not signatories to the Construction Contract between Beaver and Lakehouse, their *corporation*, they have conceded that they have no viable individual claims based on the transactions between Beaver and Lakehouse.” *Id.* (footnote omitted); *see also* Maile v. Webster Bank, N.A., No. CV040527763, 2005 WL 590403, at *2–*3 (Conn. Super. Ct. Feb. 10, 2005) (holding that a sole member lacked standing to sue the bank for allowing an unauthorized withdrawal from the LLC’s bank account); Ark Entm’t, L.L.C. v. C.J. Gayfer & Co., Inc., No. CIV.A. 99-1929, 1999 WL 717631, at *3 (E.D. La. Sept. 14, 1999) (dismissing individual claims by LLC members that they were harmed by the alleged breach of a lease agreement because only the LLC, not the members, were parties to the lease, but allowing the LLC’s claims on the same matter to go forward).
applies even when the limited liability company has only one member, and is often pivotal in disputes between or among members of an LLC.

_In re Tri-River Trading, LLC_ provides an interesting, if somewhat atypical, example of that pivotal role. The LLC was a river barge trading company composed of two members, a grain company that agreed to provide substantial business to the LLC and an individual who served as the LLC’s manager. A manager of the grain company made unsuccessful sexual advances toward the member-manager and then caused the grain company to withdraw its business from the LLC. The member-manager sued and obtained a settlement. In subsequent bankruptcy litigation, it became important to determine to what extent the settlement reflected claims of the LLC (that is, derivative claims) and to what extent claims of the LLC manager as an individual. The bankruptcy appellate panel parsed the claims carefully, and held that, while the claims for breach of contract due to the withdrawal of the grain company’s business belonged to the LLC, the counts relating to fraud in the inducement were individual.

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32 E.g., Kogut v. Church Homes, Inc., No. CV000436717S, 2002 WL 31662388, at *4 (Conn. Super. Ct. Nov. 06, 2002) (holding that the sole member of an LLC did not have standing to file a lawsuit for breach of a contract because the contract was between a nursing home and the LLC itself, not the member and dismissing the claim because the court lacked subject matter jurisdiction based on the member’s lack of standing); _Maile_, 2005 WL 590403, at *2-*3 (holding that an LLC’s sole member lacked standing to sue a bank for allowing an unauthorized withdrawal from the LLC’s bank account).

33 DEMOTT, supra note 21, § 2.1 (“It is often attractive to a shareholder as a prospective plaintiff to be able to assert a claim in an individual or direct action. Doing so avoids the complications associated with derivative litigation as a form of representative litigation, as well as requirements and doctrines specific to derivative litigation. Thus much turns on the determination whether the claim concerns an injury that is individual to the plaintiff or, instead, concerns an injury to the corporation, in which case the shareholder must bring a derivative suit.”); _see also_ Norman v. Nash Johnson & Sons' Farms, Inc, 537 S.E.2d 248, 254 (2000) (observing that “derivative litigation is obviously more unwieldy and inspires more litigation of ancillary issues than an individual action by plaintiff minority shareholders”).

34 329 B.R. 252, 267-70 (B.A.P. 8th Cir. 2005).
35 _Id._ at 257.
36 _Id._ at 258.
37 _Id._ at 258-59.
38 _Id._ at 257, 267-68.
39 _Id._ at 267 (“Because all contracts involved in these Counts were Tri-River’s, and not DeBold’s, Counts I, II, and V belonged to Tri-River . . . . DeBold could recover on these counts only derivatively as a member of the limited liability company which was the party with standing to assert them.”) (citation omitted). The court also found these claims barred by a provision of the LLC’s operating agreement. _Id._; _see also_ Albers v. Guthy-Renker Corp., 92 Fed. Appx. 497, 499.
The distinction was worth more than $400,000 to the former manager.41

B. The Key Procedural Barriers

In most member-to-member conflicts, the direct/derivative distinction plays out more simply. Depending on one's point of view, the typical structure involves:

(i) a disgruntled minority member who objects to a majority member's legitimate exercise of management power, seeks a judicially enforced put right, and brings a direct claim in an effort to evade the procedural protections provided the LLC by the derivative pathway; or

(ii) a conniving majority that despoils the LLC with the purpose and effect of injuring only the minority member,

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40 According to the panel:

The bankruptcy court held that DeBold [the LLC’s member-manager] had not proven a case of misrepresentation based on sexual harassment, and therefore could not recover under Counts III and IV. But, that was not what DeBold was claiming. DeBold never asserted a sexual harassment claim. Her attorney so testified. While she alleged sexual harassment, and would use the sexual advances to establish background, her claim was for misrepresentation of the viability of the business based on Thornton’s statements and his commitment that Jersey Grain intended to deal exclusively with Tri-River. Contrary to the bankruptcy court’s holding, there was ample evidence in the record to suggest that Thornton intentionally provided information for the guidance of a limited group of persons to form Tri-River. The pro formas were in evidence and DeBold testified that she received them before entering into the transaction. Had she gone to trial, we believe, based on the record in this case, that she could have made a submissible case against the defendants on these two Counts, and therefore her claims had significant settlement value.

Id. at 265 (footnotes omitted).

41 Id. at 269–70.
counting on the tribulations of the derivative pathway to deter, or at least delay, the minority’s quest for justice.\textsuperscript{42}

However characterized, the derivative pathway involves two major constraints: (1) the demand requirement and (2) the possibility of a special litigation committee. Both stand between the plaintiff and a judicial decision on the merits. Both reflect the fundamental notion that, except in extraordinary circumstances, those who manage a business entity should have control over all of the entity’s important business decisions, including a decision as to whether, when, and how the entity should pursue litigation.\textsuperscript{43}

\textsuperscript{42}See Durham v. Durham, 871 A.2d 41, 46 (N.H. 2005) (explaining, in adopting a special rule allowing direct suits in certain circumstances for shareholders in close corporations, that the procedures required by a derivative lawsuit can be disastrous for the plaintiff: “[W]e also recognize that the derivative proceeding involves burdensome, and often futile, procedural requirements when a minority shareholder seeks to redress wrongful behavior by the majority shareholders.”).

\textsuperscript{43}Starrels v. First Nat’l Bank of Chicago, 870 F.2d 1168, 1173 (7th Cir. 1989) (Easterbrook, J., concurring) (“The persuasive rationale for the demand requirement is that it allows directors to make a business decision about a business question: whether to invest the time and resources of the corporation in litigation.”); Halpert Enters., Inc. v. Harrison, 362 F. Supp. 2d 426, 430 (S.D.N.Y. 2005) (“The demand rule is meant ‘to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation’s affairs.’”); Kaufman v. Kan. Gas & Elec. Co., 634 F. Supp. 1573, 1577 (D. Kan. 1986) (“Practically speaking, the demand requirement promotes a form of ‘alternative dispute resolution’—that is, the corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation.”); Werbowsky v. Collomb, 766 A.2d 123, 133 (Md. 2001) (“As a general rule, the business and affairs of a corporation are managed under the direction of its board of directors . . . Shareholders are not ordinarily permitted to interfere in the management of the company; they are the owners of the company but not its managers. Thus, any exercise of the corporate power to institute litigation and the control of any litigation to which the corporation becomes a party rests with the directors or, by delegation, the officers they appoint . . . The shareholder’s derivative action was developed in the mid 19th Century as an extraordinary equitable device to enable shareholders to enforce a corporate right that the corporation failed to assert on its own behalf.”); In re Pozen S’holders Litig., No. 04 CVS 1540, No. 04 CVS 1542, 2005 NCBC 7, at ¶ 82 n.4 (N.C. Bus. Ct. Nov. 10, 2005), available at http://www.ncbusinesscourt.net/opinions/2005%20NCBC%207.htm (“The demand requirement is premised on the idea that the decision of whether to bring a lawsuit is a business one that is properly in the hands of the corporation’s directors, whose role it is to manage the business and affairs of the corporation.”); Greene v. Shoemaker, No. 97-CVS-2118, 1998 WL 34032497, at *5 (N.C. Super. Ct. Sept. 24, 1998) (“The demand requirement reinforces the basic norms of corporate governance by protecting the ability of the directors to make a business judgment about what is in the best interest of the corporation and all of its shareholders.”); see
C. The Demand Requirement

The demand requirement establishes a prerequisite to the filing of a derivative claim. A would-be derivative plaintiff must either (i) first make demand on those in control of the entity, permitting them to consider whether to cause the entity to bring suit in its own name, or (ii) be able to plead facts to show that a demand would be futile. The current draft of

also Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95–97 (1991) (holding that demand requirement is a matter of substantive law); Ishimaru v. Fung, No. Civ.A. 929, 2005 WL 2899680, at *12 (Del. Ch. Oct. 26, 2005) (noting, in a case involving an LLC, that the demand requirement is a matter of “substantive law”). The demand requirement is also intended to prevent or at least constrain “strike” suits. Kamen, 500 U.S. at 95–97 (“To prevent abuse of [the derivative] remedy...equity courts established as a precondition ‘for the suit’ that the shareholder demonstrate that ‘the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions.’” (quoting Ross v. Bernhard, 396 U.S. 531, 534 (1970) (footnote omitted))).

44 The Uniform Limited Liability Company Act (ULLCA), section 1103, provides: “In a derivative action for a limited liability company, the complaint must set forth with particularity the effort of the plaintiff to secure initiation of the action by a member or manager or the reasons for not making the effort.” UNIF. LTD. LIAB. CO. ACT § 1103 (rev. 2001), 6A U.L.A. 647 (2003); see also Allison ex rel Gen. Motors Corp. v. Gen. Motors Corp., 604 F. Supp. 1106, 1118 (D. Del. 1985) (finding lawsuit filed two and a half months after the demand was premature because the “magnitude and complexity” of the issues was too great for the corporation’s board of directors to adequately investigate them during that time), aff’d, 782 F.2d 1026 (3d Cir. 1985); McCann v. McCann, 61 P.3d 585, 588 (Idaho 2002) (dismissing a closely held corporation shareholder’s derivative suit for failing to comply with the statutory requirement of waiting ninety days after delivering a written demand to the corporation before filing a lawsuit); Bartlett v. N.Y., N.H. & H.R. Co., 109 N.E. 452, 454 (Mass. 1915) (stating that a shareholder who makes a demand prior to filing a derivative lawsuit must wait “a reasonable time to afford the directors opportunity either to institute proceedings or to refuse to do so” and holding that filing the lawsuit one week after mailing letters to the directors was not sufficient).

45 McGee v. Best, 106 S.W.3d 48, 65 (Tenn. Ct. App. 2002) (dismissing an LLC member’s claims of fraud and misrepresentation against other LLC members for allegedly withholding information from him, which detrimentally affected the way he managed the affairs of the LLC, because the wrong was to the LLC; holding the plaintiff had claimed derivative, not direct, harm, but had neglected to follow the procedures for bringing a derivative claim); see also 13 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5963 (perm ed., rev. vol. 2004 & Supp. 2005) (stating that making a demand that the corporation take the desired action is a requirement of filing a derivative lawsuit under Federal Rule of Civil Procedure 23.1, in most states (by statute or rules of civil procedure), and under the Model Business Corporation Acts). The American Law Institute has recommended that the futility exception be eliminated, PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (“Exhaustion of Intracorporate Remedies”), and a noteworthy Seventh Circuit concurrence muses in the same
the Revised Uniform Limited Liability Company Act (Re-ULLCA) provides that:

A member may maintain a derivative action to enforce a right of a limited liability company if:

(1) the member first makes a demand on the other members in a member-managed limited liability company, or the managers of a manager-managed limited liability company, requesting that they cause the limited liability company to bring an action to enforce the right, and the managers or other members do not bring the action within a reasonable time; or


A few states have eliminated the futility exception. For example, North Carolina law provides:

No shareholder may commence a derivative proceeding until:

(1) A written demand has been made upon the corporation to take suitable action; and

(2) 90 days have expired from the date the demand was made unless, prior to the expiration of the 90 days, the shareholder was notified that the corporation rejected the demand, or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

N.C. GEN. STAT. § 55-7-42 (2005).

In most states, however, the traditional approach remains in place. Werbowsky, 766 A.2d at 141 (stating that, as of 2001, "[a]t least 17 States have, by statute, adopted [a universal demand requirement under] the Model Business Corporation Act and one more, Florida, established a universal demand requirement in different language, [and that] [t]he Pennsylvania Supreme Court adopted a number of sections of the [ALI] Principles, including § 7.03 [the universal demand requirement], by judicial decision") (footnotes omitted).

Texas has adopted a universal demand requirement similar to that under the Model Business Corporation Act (MBCA), but exempts derivative proceedings involving closely held corporations from the requirement. TEX. BUS. CORP. ACT. ANN. art. 5.14, §§ C, L(1) (Vernon 2003) (applying until 2010 to Texas corporations formed prior to January 1, 2006); TEX. BUS. ORG. CODE ANN. § 21.553, 21.563(b) (Vernon Supp. 2005) (applying to Texas corporations formed on or after January 1, 2006 and to all Texas corporations, regardless of when formed, beginning January 1, 2010). The same approach is followed in the LLC context. TEX. BUS. CORP. ACT ANN. art. 5.14 §§ C, L(1) (Vernon 2003) (applying until 2010 to Texas LLCs formed prior to January 1, 2006 pursuant to TEX. REV. CIV. STAT. ANN. art. 1528n, art. 8.12 (Vernon Supp. 2005)); TEX. BUS. ORG. CODE ANN. §§ 101.453, 101.463(b) (Vernon Supp. 2005) (applying to Texas LLCs formed on or after January 1, 2006 and to all Texas LLCs, regardless of when formed, beginning January 1, 2010).
(2) a demand would be futile.\textsuperscript{46}

Complying with the demand requirement involves delay and at least some additional cost, and most derivative claims assert demand futility. The requirements for pleading demand futility have been delineated most specifically by Delaware law,\textsuperscript{47} which has significantly influenced the law of other states.\textsuperscript{48}

Under Delaware law, to plead demand futility the derivative plaintiff must allege, without the benefit of discovery, "particularized facts [so that] a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of


\textsuperscript{47}The seminal Delaware case is a corporate case. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000). Delaware applies the Aronson standard across the entity board. Ishimaru v. Fung, No. Civ. A. 929, 2005 WL 2899680, at *11 (Del. Ch. Oct. 26, 2005) ("Delaware law rightly takes seriously the task of evaluating when a suit by an entity should proceed at the instance of a derivative plaintiff, rather than the entity’s governing authority. That is why our corporate law imposes a specific burden to plead demand futility, and why that has been replicated in our statute addressing LLCs.") (footnote omitted); Litman v. Prudential-Bache Props., Inc., Civ. A. No. 12137, 1993 WL 5922, at *2-*6 (Del. Ch. Jan. 4, 1993) (recognizing that the standard for showing demand futility in a derivative suit is identical for corporations and limited partnerships).

\textsuperscript{48}See, e.g., Silver v. Allard, 16 F. Supp. 2d 966, 969 (N.D. Ill. 1998) (applying Aronson standard under Illinois law); In re Westinghouse Sec. Litig., 832 F. Supp. 989, 996-97 (W.D. Pa. 1993) (same under Pennsylvania law); Blumenthal v. Teets, 745 P.2d 181, 185-86 (Ariz. Ct. App. 1987) (same under Arizona law); In re Prudential Ins. Co. Derivative Litig., 659 A.2d 961, 970 (N.J. Super. Ct. Ch. Div. 1995) (same under New Jersey law). But see Raymond Napoli Diamond, P.C. v. Haymond, No. Civ.A. 02-721, 2005 WL 1840160, at *6 (E.D. Pa. Aug. 2, 2005) (stating, with regard to Pennsylvania law, "‘Cuker, which established that a demand is excused only if irreparable harm to the corporation is shown, changed the law on demand requirements in derivative actions.’ Demand is now excused if the shareholder shows irreparable injury to the corporation would otherwise result, and then demand should be made promptly after commencement of the action. If irreparable injury would not result, the court should dismiss a derivative action that is commenced before the response of the board to a demand unless the board does not respond within a reasonable time.") (citations omitted); Werbowsky v. Collomb, 766 A.2d 123, 143 (Md. 2001) ("Although, due to the respect properly accorded Delaware decisions on corporate law, the Delaware approach is often mentioned and the business judgment rule is generally regarded as applicable in a demand futility analysis, few, if any, States have abandoned their existing law in favor of that approach, and some of the criticism of it needs to be taken into account."). If the Delaware entity is a corporation, pre-suit investigation may be carried out through a shareholder demand to access corporate records. See infra note 51.
a valid exercise of business judgment."\textsuperscript{49} As recently explained by the Delaware Court of Chancery (in a case involving a limited liability company):

Under the substantive law of Delaware, a court will find demand futility where "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."\textsuperscript{50}

The allegations must be quite specific:

Pleadings in derivative suits . . . must comply with stringent requirements of factual particularity that differ substantially from the permissive notice particularity that differ substantially from the permissive notice pleading governed solely by [general rules of pleading. The derivative pleading requirement] is not satisfied by conclusory statements or mere notice pleading. On the other hand, the pleader is not required to plead evidence. What the pleader must set forth are particularized factual statements that are essential to the claim. Such facts are sometimes referred to as "ultimate facts," "principal facts" or "elemental facts." Nevertheless, the particularized factual statements that are required to comply with the [derivative suit] pleading rules must also comply with the mandate . . . that they be "simple, concise and direct."\textsuperscript{51}

\textsuperscript{49}\textit{Aronson}, 473 A.2d at 814. The \textit{Aronson} court mistakenly used the conjunction "and" rather than "or," but the latter is correct. \textit{See}, e.g., VGS, Inc. v. Castiel, No. C.A. 17995, 2003 WL 723285, at *11 n.60 (Del. Ch. Feb. 28, 2003) (replacing the "and" with "or").

\textsuperscript{50}\textit{Ishimaru}, 2005 WL 2899680, at *12 (quoting Rates v. Blasband, 634 A.2d 927, 934 (Del. 1993)).

\textsuperscript{51}\textit{Brehm}, 746 A.2d at 254 (footnotes omitted); \textit{see} Salsitz v. Nasser, 208 F.R.D. 589, 592 (E.D. Mich. 2002) (applying the \textit{Brehm} standard under Delaware law); McCall v. Scott, 239 F.3d 808, 815 (6th Cir. 2001) (applying the \textit{Brehm} standard under Delaware law). \textit{See generally 13 FLETCHER, supra note 45, § 6003 (compiling pleading rules for derivative lawsuits).}

Delaware law has harsh consequences for the derivative plaintiff who fails to plead adequately demand futility - dismissal with prejudice. As explained recently by North Carolina's Special Superior Court Judge for Complex Business Cases:
The pleading requirement can be difficult or impossible to overcome when a majority of the entity’s governing body is not involved in the alleged misconduct. In the closely-held context, however, the derivative

[It is well-settled under Delaware law that, as a general rule, a plaintiff should not be afforded the opportunity to amend the complaint where he or she fails to properly plead demand futility ... [T]his rule is designed to encourage plaintiffs to investigate their claims before filing a complaint so that they have a basis at the outset to make particularized factual allegations in the complaint" ... Therefore, the Amended Complaint [in this case] must be dismissed with prejudice.

The Court notes that it was within the plaintiffs’ powers as ... shareholders to avail themselves of information that may have allowed them to plead facts with sufficient particularity to survive the defendants’ motion. While not entitled to discovery in order to prove demand futility, had plaintiffs brought a motion under Section 220 of the Delaware General Corporation Law seeking inspection of [the corporation’s] books and records, they may have discovered facts that would have allowed them to raise a reasonable doubt as to the directors’ disinterest and independence. While stopping short of requiring plaintiffs to conduct an inspection of the corporation’s books and records before commencing a derivative action, Delaware courts have offered strong words for plaintiffs who, after failing to do so and filing inadequate pleadings, cause substantial cost to the parties and the judiciary. ... Beam v. Stewart, 833 A.2d 961, 981 (Del. Ch. September 30, 2003) ([noted] that “it is troubling to this Court that, notwithstanding repeated suggestions, encouragement, and downright admonitions over the years both by this Court and by the Delaware Supreme Court, litigants continue to bring derivative complaints pleading demand futility on the basis of precious little investigation beyond perusal of the morning newspapers”).


Possibly the most famous example is Grobow v. Perot, a case in which the court held that the plaintiff shareholders had failed to establish demand futility despite the plaintiffs’ allegations that the corporation’s board of directors was not disinterested or independent when it agreed to an improperly favorable buy-out of one director’s interest, purportedly to silence the director’s criticisms of the corporation’s management. 526 A.2d 914, 919, 925 (Del. Ch. 1987); see VGS, Inc., 2003 WL 723285, at *11 (stating, in a derivative case involving an LLC with a three-person board of managers, that “[b]oth the Castiel Parties and the Sahagen Parties concede that the sole issue relating to whether demand on the Virtual Geo board would have been futile depends on whether Ambassador (Ret.) Gerald Helman would be disinterested and independent in a demand made by Sahagen to pursue litigation against Castiel for breach of fiduciary duty ... because Castiel and Sahagen are the other two members of Virtual Geo’s three-person Board of Managers”).
plaintiff typically names as defendants all those with the power to control the entity. In such circumstances, demand futility is essentially a given.\footnote{Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254, 1260 (D. Kan. 2000) ("[T]he facts alleged throughout the complaint make it clear that it would have been futile for the Carson Trust [derivative plaintiff in a case involving an LLC] to make a demand of the board of managers. Plaintiffs allege in their complaint that subsequent to Lynch Multimedia filing a lawsuit against Carson Communications, the Carson Trust had no influence over or input into the decisions of the board and that Lynch Multimedia deliberately oppressed the Carson Trust. The Carson Trust, therefore, did not need to make a demand of the board of managers before filing this lawsuit."); Ishimaru, 2005 WL 2899680, at *12 (stating that "the amended complaint pleads particularized facts demonstrating that Fung, as managing member [who controls a majority of the membership interests], cannot disinterestedly determine whether Paradigm [the LLC] should sue Ivy Asset [a third party allegedly involved in misconduct with the managing member]"); Vertical Computer Sys., Inc. v. Ross Sys., Inc., 784 N.Y.S.2d 499, 502 (App. Div. 2004) (recognizing demand futility where the operating agreement required a 70\% vote of membership interests to authorize a suit and a member holding a thirty-five percent interest improperly refused to agree to the suit).}

D. The Special Litigation Committee

Regardless of whether demand is required or excused, in a derivative suit the entity can, and typically does, insert a special litigation committee (SLC) into the process.\footnote{Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. CHI. L. REV. 1, 38 (1991).} An SLC is a committee selected by an entity’s top managers to act in their place to investigate the alleged misconduct and make a business judgment as to the entity’s position on the litigation.\footnote{Grover C. Brown et al., Director and Advisor Disinterestedness and Independence Under Delaware Law, 23 DEL. J. CORP. L. 1157, 1188 (1998).} An SLC can be appointed pre-suit (in response to a demand) or after a derivative suit has begun.\footnote{James D. Cox, Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 961 n.9 (1982).} Once a court has jurisdiction over the matter, the SLC (or the entity) can move for an order (i) staying discovery pending the SLC’s investigation,\footnote{See Allan M. Terrell, Jr. & Samuel A. Nolen, Recent Developments in Delaware Corporate Law, 7 DEL. J. CORP. L. 407, 409 (1983) (discussing Pompeo v. Hefner, Civ. A. Nos. 6806, 6872, 1983 WL 20284 (Del. Ch. Mar. 23, 1983), in which the court granted a stay of discovery pending

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the entity (with or without some settlement with the defendants), or (iii) allowing the SLC to take control of the lawsuit and prosecute on behalf of the entity.

SLCs are controversial. Depending on the observer’s point of view, the SLC mechanism is either:

(i) an instrument of the devil employed to:

(a) stack the deck in favor of management, and

(b) frustrate legitimate claims of mismanagement or oppression; or

(ii) a respectable and useful form of alternate dispute resolution, necessary to prevent diabolic agents (i.e., the plaintiffs’ bar) from using litigation to:

(a) reset the agreed-upon deal,

(b) shift management control from the majority to a dissident who does not like the business strategy chosen by the majority, and thereby

(c) frustrate the legitimate right of “selfish ownership,” (i.e., the right of the majority to run the business).

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Brown et al., supra note 55, at 1188; Model Bus. Corp. Act §§ 7.44, 7.45 (2002) (discussing dismissal and discontinuance or settlement respectively); see, e.g., Thompson v. Scientific Atlanta, Inc., 621 S.E.2d 796, 798 (Ga. Ct. App. 2005) (finding no abuse of discretion in trial court’s dismissal of a derivative suit, “where the over 900-page report of the SLC reflected a detailed and documented investigation, including the backgrounds and qualifications of its members[, and the plaintiff, h]aving received a copy of the report . . . failed to initiate any discovery . . . in an effort to show that the SLC did not make a determination in good faith after conducting a reasonable investigation”).

Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (holding that, in a closely held corporation, unlimited shareholder-to-shareholder fiduciary duties “will result in the imposition of limitations on legitimate action by the controlling group in a close corporation

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the decision of a special litigation committee about the action); Model Bus. Corp. Act §§ 7.43–7.44 (2002) (addressing stay of proceedings and dismissal).


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58 Brown et al., supra note 55, at 1188; Model Bus. Corp. Act §§ 7.44, 7.45 (2002) (discussing dismissal and discontinuance or settlement respectively); see, e.g., Thompson v. Scientific Atlanta, Inc., 621 S.E.2d 796, 798 (Ga. Ct. App. 2005) (finding no abuse of discretion in trial court’s dismissal of a derivative suit, “where the over 900-page report of the SLC reflected a detailed and documented investigation, including the backgrounds and qualifications of its members[, and the plaintiff, h]aving received a copy of the report . . . failed to initiate any discovery . . . in an effort to show that the SLC did not make a determination in good faith after conducting a reasonable investigation”).

59 Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (holding that, in a closely held corporation, unlimited shareholder-to-shareholder fiduciary duties “will result in the imposition of limitations on legitimate action by the controlling group in a close corporation
Even the Delaware Supreme Court has recognized the dangers of structural bias in SLCs:

[W]e must be mindful that directors [appointed to the special litigation committee] are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse. 60

The Massachusetts Supreme Judicial Court has expressed similar concerns, 61 as has the Iowa Supreme Court. 62 Moreover, there are a few which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned" and noting that “[t]he majority, concededly, have certain rights to what has been termed ‘selfish ownership’ in the corporation which should be balanced against the concept of their fiduciary obligation to the minority”).

60 Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).
61 Houle v. Low, 556 N.E.2d 51, 55 (Mass. 1990) (explaining that reviewing the special litigation committee only for the adequacy of its investigation and independence of its members may “not realistically deal with the danger of structural bias in the special litigation committee device”).
62 Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983) (noting that commentators have expressed concerns about the potential in SLCs for structural bias and stating that “it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them,” particularly in cases where the members of the committee also are directors); see also Cox, supra note 56, 959–60, 1008 (calling the SLC the “latest threat” to the derivative suit, which, “[l]ike the heroine in a Saturday matinee, . . . has repeatedly appeared to be at the cliffs of disaster;” arguing that to combat “structural bias” inherent in the SLC’s being chosen by the corporation’s board, “a court should use its own independent judgment to determine whether dismissal would be in the corporation’s best interests”); James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 84–85, 89, 100 (arguing that non-defendant board members’ decisions about derivative lawsuits are affected by factors including directors’ fears of their own personal liability, their belief that derivative suits usually deliver negligible benefits to the corporation while enriching the plaintiff’s lawyers, social connections between defendants and remaining directors, and the favorable bias people generally have for members of groups to which they belong; concluding that these psychological factors “can be expected to generate subtle, but
cases that uphold an SLC decision even though, from the reported facts, the decision seems questionable. For example, in *Marcuccilli v. Ken Corp.*, the court followed an SLC’s recommendation that derivative claims be dismissed, even though the SLC had determined that the majority shareholders in two related close corporations had breached fiduciary duties. The amount in controversy was at least $500,000, and the derivative plaintiff, a minority shareholder, alleged that the majority shareholders had taken personal loans at below-market interest rates from one corporation and had failed to disclose the true terms of an agreement that sold a parcel of land belonging to another corporation.

In *Abramowitz v. Posner*, the court approved an audit committee’s recommendation that the corporation not pursue a lawsuit if the directors reimbursed some $1 million in funds they had allegedly misappropriated, even though the committee acknowledged the corporation might recover more in litigation.

On the other hand, the Delaware Supreme Court has praised the SLC as a form of ADR: “by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether.” The SLC is also an entity’s best (albeit still costly) protection against strike suits and an

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64 *Id.* at 446–47. The plaintiffs also brought direct claims, which the court dismissed because the minority shareholders did not allege “a breach of a duty owed especially to the minority... shareholders, separate and distinct from the duties owed to [the corporation]....” *Id.* at 451.

65 See 513 F. Supp. 120, 123–24 (S.D.N.Y. 1981), *aff’d*, 672 F.2d 1025 (2d Cir. 1982); Cox, *supra* note 56, at 980–81 (describing the *Abramowitz* decision as displaying “a marked bias toward the defendants” and stating that the committee members “rationalized their generosity” by explaining that the defendant directors had otherwise “greatly benefited the corporation” and that procedures to prevent a reoccurrence of such behavior had been implemented).

66 *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000) (citing *Grimes v. Donald*, 673 A.2d 1207, 1216–17 (Del. 1996)); *see* Kleinberger & Bergmanis, *supra* note 21, at 1235 (“[S]pecial litigation committees are a form of alternative dispute resolution. They sift facts and make recommendations in the shadow or context of litigation proceedings, but they do not directly consume court resources and are not laden with all the procedural paraphernalia of litigation.”); *see also* *Kaufman v. Kan. Gas & Elec. Co.*, 634 F. Supp. 1573, 1577 (D. Kan. 1986) (“Practically speaking, the demand requirement promotes a form of ‘alternative dispute resolution’—that is, the corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation.”).
important bulwark against attempts to use litigation to "re-make" a previously agreed upon deal or allocation of power.\(^{67}\)

On the "re-make the deal" argument, a Massachusetts trial court opinion is instructive. In *Leslie v. Boston Software Collaborative, Inc.*, the court considered a derivative lawsuit brought by a minority shareholder in a close corporation.\(^{68}\) The plaintiff alleged that the other shareholders had mismanaged the business, and in the abstract the claims seemed attractive.\(^{69}\) The plaintiff accused the defendants of paying themselves excessive compensation, needlessly spending money to open another office, moving the corporation's offices, and unjustifiably increasing employee benefits.\(^{70}\) However, the court determined that the suit was without merit because the decisions were "appropriate business judgments" and, therefore, properly within the defendants' discretion.\(^{71}\)

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\(^{67}\) Janssen v. Best & Flanagan, 645 N.W.2d 495, 498 (Minn. Ct. App. 2002) (stating that SLCs are an important way for corporations to avoid "meritless or harmful litigation"); Landstrom v. Shaver, 561 N.W.2d 1, 14 n.16 (S.D. 1997) ("Those who operate and manage these [small, corporate] farms and businesses, often the majority shareholders, should not be subject to the demands of minority shareholders whose concern may be solely that of dividends and not the farm or business itself. Many of these small corporations and their management are ill-prepared to invest the time and money required to fend off a minority shareholder suit and are therefore influenced by the mere threat of such litigation."). The case did not involve an SLC, but the strike suit issue led the court to reject the ALI exception to the direct/derivative distinction in close corporations. See id. at 13–14 (noting defendants' argument that a direct lawsuit could be abused by a disgruntled minority shareholder in a close corporation). The ALI rule is discussed infra notes 175–183.


\(^{69}\) Id. at *5.

\(^{70}\) See id. at *5–*6.

\(^{71}\) See id. at *10. The case did not involve an SLC but nonetheless illustrates the problem of using litigation to reset an agreed upon allocation of power. See also Solomon v. Atlantis Dev., Inc., 516 A.2d 132, 134–37 (Vt. 1986) (holding that the sale of a close corporation's assets to a major shareholder for one dollar in exchange for the shareholder's assumption of the corporation's debts was a legitimate business decision in light of the corporation's financial situation, and thus that the sale did not amount to a breach of fiduciary duties to minority shareholders); cf. *Kaufman*, 634 F. Supp. at 1577 ("Practically speaking, the demand requirement promotes a form of 'alternative dispute resolution'—that is, the corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation."); *Wilkes*, 353 N.E.2d at 663 (recognizing that unbridled access to litigation by minority owners "will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned.").
E. Proceeds and Attorneys’ Fees

The fourth and fifth practical ramifications concern the results of a lawsuit. From this perspective, plaintiffs in closely-held entities much prefer direct claims. If the claim is direct, the recovery is due directly to the plaintiff,72 and except in unusual circumstances the plaintiff must pay its own attorneys’ fees and litigation expenses.73 If the claim is derivative, except in extraordinary circumstances, the proceeds belong to the entity,74 and the plaintiff is entitled to attorneys’ fees and other expenses.75


73 See Trieweiler v. Sears, 689 N.W.2d 807, 838, 846 (2004) (holding that “in the case of a closely held corporation, a court in its discretion may permit an individual recovery to the plaintiff in an action raising derivative claims, if it finds that to do so will not unfairly expose the corporation or defendants to a multiplicity of actions, materially prejudice the interests of creditors of the corporation, or interfere with a fair distribution of the recovery among all interested persons”; noting that, as a consequence of the plaintiff’s individual recovery, the plaintiff is not entitled to attorneys’ fees “because . . . there is no evidence to suggest that this action resulted in the ‘substantial benefit to the corporation’ [as contemplated by the statute] permitting attorney’s fees in derivative actions) (citations omitted).

74 If the normal derivative remedy will reward owners who were the malefactors, courts sometimes order that the recovery be made directly to the plaintiffs. E.g., Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir. 1955) (holding that minority shareholders should each recover an individual share of the premium wrongfully obtained by a controlling shareholder who, during a steel shortage, sold his shares in a steel corporation (and with these shares the power to control product distribution) to a buying group composed of steel users; noting that giving the corporation the recovery would benefit the new controlling shareholders). See generally DEMOTT, supra note 21, § 7:6, at 7-45 (explaining that courts have sometimes “depart[ed] from the conventional rule that only the corporation may benefit from a judgment in a derivative suit and [ordered] instead that damages be paid directly to certain of the corporation’s shareholders”).

75 E.g., UNIF. LTD. P’SHP ACT § 1005(a)(1), (b) (rev. 2001), 6A U.L.A. 103-04 (2003) (providing that “any proceeds or other benefits of a derivative action . . . belong to the limited partnership and not to the derivative plaintiff” but stating that “[i]f a derivative action is successful in whole or in part, the court may award the plaintiff reasonable expenses, including reasonable attorney’s fees, from the recovery of the limited partnership”); UNIF. LTD. LIAB. CO. ACT § 1104 (rev. 1996), 6A U.L.A. 647 (2003) (providing that “[i]f a derivative action for a limited liability company is successful, in whole or in part . . . the court may award the plaintiff reasonable expenses, including reasonable attorney’s fees, and shall direct the plaintiff to remit to the limited liability company the remainder of the proceeds received”); see, e.g., In re Cendant Corp., 232 F.
The case of Wilderman v. Wilderman provides a "Catch-22" illustration of the proceeds distinction. A divorce ended the Wilderman marriage but left the ex-spouses as the only shareholders in a corporation controlled by Mr. Wilderman. Mrs. Wilderman brought a successful derivative claim alleging that her ex-husband had received excessive compensation, and the court ordered the excess returned to the corporation. However, the court rejected Mrs. Wilderman's request that the returned funds be paid out as dividends. Mrs. Wilderman had no recovery, although her attorneys' fees were paid.

IV. THE CONCEPTUAL FUNDAMENTALS FOR MAKING THE DISTINCTION (WITHOUT REGARD TO CLOSELY HELD CHARACTER)

As explained in Part I, when courts address the direct/derivative distinction in the context of limited liability companies, the courts typically

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76 See generally 315 A.2d 610 (Del. Ch. 1974).
77 See id. at 613-14.
78 Id. at 616.
79 Id.
80 See id.
turn to the law of corporations for guidance. The corporate case law contains two major, discordant approaches to the direct/derivative distinction: the direct harm approach and the special injury approach. There is also a third line of cases—involving the “duty owed” or “whose rights infringed” approach—which sometimes produces the correct results, but, at least as often, produces confused and confusing opinions.  

A. The Direct Harm Approach

The direct harm approach is simple. It asks: who got hurt first—the entity or its owner(s)? “An individual cause of action exists only if damages to the shareholders were not incidental to damages to the corporation.” Therefore, “the inquiry should focus on whether an injury is suffered by the shareholder that is not dependent on a prior injury to the corporation.”

81 See Kleinberger & Bergmanis, supra note 21, 1249–50 (explaining direct harm and special injury rules). G & N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 234–35, 237 (Ind. 2001) (rejecting both the direct harm and special injury approaches; holding that the proper inquiry is whose rights the shareholder is asserting). A few decisions appear to adopt two approaches in the alternative. E.g., In re Adelphia Commc’ns Corp., 322 B.R. 509, 526 (Bankr. S.D.N.Y. 2005) (“Where, however, the third-party’s wrong inflicts an injury on stockholder’s rights rather than on the corporation, the stockholder may seek direct relief in its own favor against the third-party. This can occur in two situations: where the allegedly wrongful conduct violates a separate duty to the complaining shareholder independent of the fiduciary duties that the wrongdoer owes to all of the shareholders, or where the conduct causes an injury to the plaintiff distinct from any injury to the corporation.” (quoting In re Granite Partners, 194 B.R. 318, 325 (Bankr. S.D.N.Y. 1996) (citations and emphasis omitted)); Grace Bros. v. Farley Indus., Inc., 450 S.E.2d 814, 817 (Ga. 1994) (holding that plaintiff shareholders who sought specific performance or damages for the breach of a merger agreement could not bring direct claims because they met neither the direct harm nor the special injury standard since their claims were “founded upon injuries which are no different from that suffered by the corporation or the other shareholders”). As shown infra Part IV.B, any situation that satisfies the special injury rule will also satisfy the direct harm rule, but not vice versa.

82 Schuster v. Gardner, 25 Cal. Rptr. 3d 468, 474–75 (Cal. Ct. App. 2005) (holding that, under California law, the plaintiff shareholder’s attempted class action lawsuit against officers and directors of a corporation for breaching fiduciary duties by overstating revenues, understating expenses and issuing stock to pay “for an ill-conceived acquisition spree,” all of which led to a loss in shareholders’ stock value, would be a derivative lawsuit because the harm to shareholders was “incidental” to the corporation’s injury).

83 Agostino v. Hicks, 845 A.2d 1110, 1115, 1122, 1127 (Del. Ch. 2004) (holding that the plaintiff shareholders whose shares were eliminated without consideration in bankruptcy court had only derivative claims against fellow shareholders, who were also associated with entities that were creditors of the corporation in question, and who received new shares in the corporation in
Under the direct harm approach, mismanagement by the entity's managers gives rise to only a derivative claim because the owners' loss in value—no matter how real and substantial—is a consequence of a prior injury to the entity.\textsuperscript{84} In contrast, if a manager fraudulently induces a person to become an owner (or to increase or decrease the person's ownership interest),\textsuperscript{85} the resulting claim is direct.\textsuperscript{86} The injury is to the owner; if anything, the entity will have benefited from the fraud.\textsuperscript{87}
Claims that management has sold out too cheaply in a merger are also examples of direct claims. Even assuming actionable mismanagement, the entity has suffered no injury. The consideration runs to the owners, not the entity, so any consideration "left on the table" would not have benefited the entity. The harm, therefore, is not only first, but also exclusively, to the owners.

88 Such claims can conveniently be labeled Revlon claims, after Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985), the seminal Delaware Supreme Court case holding that, when the sale of a corporation becomes inevitable, the directors owe the shareholders a duty to use reasonable efforts to maximize the sale value.

89 Higgins v. N.Y. Stock Exch., Inc., No. 601646/2005, 2005 WL 2140168, at *5, *10 (N.Y. Sup. Ct. Sept. 2, 2005) (holding that plaintiff seatholders could bring a class action lawsuit against the corporation’s CEO and board members on their claims that they would receive inadequate compensation under a proposed merger agreement because the seatholders’ equity interests in the corporation would be harmed by the merger agreement, while the corporation would be benefited by retaining more of its own equity and bringing that equity into the newly merged entity). At one point, this issue was in doubt under Delaware law:

The primary reason [being] that . . . most plaintiffs in Delaware file a derivative action to challenge the fulfillment of Revlon duties. Delaware courts usually excuse demand when Revlon complaints are properly pled. As a result, Delaware courts have not had the opportunity to tackle the issue of whether or not plaintiffs can file these claims as a direct action.

Marcoux v. Prim, 04 CVS 920, 2004 NCBC 5, at ¶45 (N.C. Bus. Ct. Apr. 16, 2004), available at http://www.ncbusinesscourt.net/opinions/2004%20NCBC%205.htm. But see Parnes v. Bally Entm’t Corp., 722 A.2d 1243, 1245 (Del. 1999) (explaining that stockholders may sue directly for injuries “that are independent of any injury to the corporation” and concluding that a shareholder could bring a direct class action claim alleging shareholders had received unfair payments for their interests from a merger under which the corporation’s CEO demanded he be given large sums of money and certain corporate assets). For a succinct and thoughtful review of Delaware precedent in this area, see Marcoux, 2004 NCBC ¶¶ 41–60 ("[T]he focus of the Supreme Court in Tooley [v.
Any other conclusion would produce absurd results. Consider the following example:

Entity A agrees to be merged into Entity B. The managers of Entity A are grossly negligent in their “due diligence” and negotiating tactics and agree to a price far below any reasonably “fair” level. The gross negligence comes to light only after the merger has become effective. If the claims are derivative, they have transferred by operation of law to Entity B, the surviving entity which was benefited rather than harmed by the breach of the duty of care committed by the managers of Entity A.  

Besides avoiding absurd results, the direct injury approach also makes conceptual sense. The direct/derivative distinction is a question of standing, and standing is a matter of injury. The role of injury in standing is doctrinally fundamental, whether the context is the loftiest constitutional matters or prosaic questions of “good fences make good neighbors.”

For example, the U.S. Supreme Court has explained that:

[A]t an irreducible minimum, Art. III requires the party who invokes the [federal] court’s authority to show that he

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Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004),] on the ‘injury’ involved leads to the conclusion that a plaintiff may bring a pure Revlon claim as a direct claim. The ‘injury’ results from the diminished value that a shareholder would receive from a merger process that prevents the shareholders from achieving the highest value for their shares in a change of control merger. The treasury of the shareholder is depleted, not the treasury of the corporation.”.

The situation is arguably different when the merger-related claim is against a third party for somehow affecting the price the entity achieves by merging itself with another entity. See Nauslar v. Coors Brewing Co., 170 S.W.3d 242, 249-51 (Tex. App.—Dallas 2005, no pet. h.) (holding that plaintiffs (Nauslar Investments, LLC, the limited partner in a partnership and the limited partner in that partnership’s general partner, and Nausler, sole member and owner of Nauslar Investments, LLC) had no standing to contest whether defendants unreasonably disapproved a proposed merger of the partnership with another entity, stating that the partnership suffered the direct injury—harm to its value—and loss to the plaintiffs from its lower sale price was derivative of the partnership’s right of action for withholding approval).

90 As will be discussed shortly, almost equally absurd results actually do occur under the special injury approach to the direct/derivative distinction.

91 E.g., Conn. State Med. Soc’y v. Oxford Health Plans (CT), Inc., 863 A.2d 645, 652 (Conn. 2005) (explaining standing and using variations of the words “harm” and “injury” each three times within a 100-word passage).

92 Robert Frost, Mending Wall, in North of Boston 12 (H. Holt & Co. 1915).
personally has suffered some actual or threatened injury as a result of the putatively illegal conduct of the defendant, and that the injury fairly can be traced to the challenged action and is likely to be redressed by a favorable decision.\textsuperscript{93}

The Utah Supreme Court has characterized "the traditional standing test" as a question of whether the plaintiff has suffered "legal injury,"\textsuperscript{94} and the Texas Supreme Court has stated: "As a general rule of Texas law, to have standing, ... a plaintiff must demonstrate that he or she possesses an interest in a conflict distinct from that of the general public, such that the defendant's actions have caused the plaintiff some particular injury."\textsuperscript{95}

In a "good fences/good neighbors" decision, the Maine Supreme Court used a "particularized injury" test to determine whether landowners had standing to challenge the Phippsburg Board of Appeal's decision to permit the building of a home adjacent to the plaintiffs' properties.\textsuperscript{96} The court held that standing existed because the "proposed construction may displace water and redirect it onto abutting properties."\textsuperscript{97}

\begin{itemize}
  \item \textsuperscript{93}Valley Forge Christian Coll. v. Ams. United for Separation of Church and State, 454 U.S. 464, 472 (1982) (citations and internal quotations omitted); ERWIN CHEMERINSKY, FEDERAL JURISDICTION § 2.3.2, at 61 (4th ed. 2003) (stating that requiring an injury ensures the parties have an actual dispute and are not simply asking for an advisory opinion, preserves scarce judicial resources for "remedying concrete injuries," and gives the plaintiff "an incentive to vigorously litigate and present the matter to the court in the manner best suited for judicial resolution"); see also Nat'l Collegiate Athletic Ass'n v. Califano, 622 F.2d 1382, 1385–86 (10th Cir. 1980) (explaining that a plaintiff has standing to sue if he has suffered an "injury in fact"—a "concrete and certain harm" that can be redressed by the court can grant; holding that the NCAA could sue on behalf of its members to challenge Health, Education and Welfare Department regulations affecting intercollegiate sports programs); Harrington v. Bush, 553 F.2d 190, 208 (D.C. Cir. 1977) (summing up Supreme Court doctrine on standing by explaining that the plaintiff must allege "a distinct and palpable injury to himself," amounting to "a claim of specific present objective harm or a threat of specific future harm;" holding the plaintiff, a member of Congress, did not present any concrete injury to himself even assuming his claim of illegal CIA activity was true) (citations omitted).
  \item \textsuperscript{94}Haymond v. Bonneville Billing & Collections, Inc., 89 P.3d 171, 174 (Utah 2004) ("Having suffered no legal injury, [the plaintiff] has no standing under the traditional standing test.").
  \item \textsuperscript{95}Williams v. Lara, 52 S.W.3d 171, 178 (Tex. 2001).
  \item \textsuperscript{96}Norris Family Assoc., LLC v. Town of Phippsburg, 879 A.2d 1007, 1012 (Me. 2005).
  \item \textsuperscript{97}Id. at 1010, 1013–14 (Me. 2005) (holding that the plaintiffs had standing to sue both the Government and the would-be home builder). "The issue of standing focuses upon whether the complaining party is the proper one to invoke the court's power. As such, to establish standing, a party must demonstrate a personal stake in the outcome of the lawsuit and that the injury is a
In sum, under the direct harm approach:

(i) if the owner’s injury occurs only through the medium of some injury first suffered by the entity, then the owner’s claim is indirect—that is, derivative of the entity’s injury—and the owner has no standing to bring a direct action; but

(ii) if the injury affects the owner first—not as a consequence of an injury suffered by the entity—then the claim, like the injury, is direct and the owner has the standing in his, her, or its own right. 98

B. The Special Injury Rule

The special injury rule is just as easily stated, but far more difficult to apply. The difficulties become comprehensible once it is understood, as will be shown, that the special injury approach is conceptually flawed and, as a matter of doctrine, heretical. 99

Under the special injury rule, an owner has a direct rather than derivative claim only if the owner has suffered an injury that is special and distinct from not only any injury suffered by the entity but also any injury suffered by other owners. The paradigmatic example of such special injury involves a claim by an owner under some separate contract with the result of the other party’s conduct.” In re Estate of Bender, 806 N.E.2d 59, 65 (Ind. Ct. App. 2004) (holding that a party to an option contract with an LLC lacks standing to assert that the person who exercised the option on the LLC’s behalf acted improperly: “[T]he Estate [the party that had granted the option] does not have a personal stake to challenge whether Bodkin [one of the managers of the LLC] properly exercised the Option on Beto’s [the LLC’s] behalf, nor can the Estate establish any injury resulting from the Option being exercised by Bodkin on behalf of Beto.”).

98 Donahue v. Rodd Electrotype Co. of New Eng., 328 N.E.2d 505 (Mass. 1975), a seminal case on fiduciary duty among shareholders in a close corporation, illustrates the importance of properly framing the relevant injury. When the corporation redeemed the controlling shareholder’s interest, the complainant minority shareholder did not attack the transaction as involving self-dealing or waste. Id. at 510–11. Those claims would have been derivative. Instead, the plaintiff hypothesized, and the Massachusetts Supreme Judicial Court adopted, an “equal opportunity rule” under which the minority shareholder had a right to the same opportunity for redemption accorded the controlling shareholder. Id. at 518–19. Denying the minority shareholder this opportunity caused direct injury.

99 See infra notes 112–124 and accompanying text.
entity or an “oppression claim”—that is, a claim that an owner has been singled out for mistreatment.

100 E.g., Citibank, N.A. v. Data Lease Fin. Corp., 828 F.2d 686, 693 (11th Cir. 1987) (holding that a former shareholder that pledged its controlling block of stock in a bank to Citibank, which then appointed directors who allegedly mismanaged the corporation in order to be able to buy shares at a reduced price, could bring a direct claim against the directors of the bank because, as a pledgor, the shareholder was situated differently from other shareholders: “The fact that his pledge is stock and that if the manipulated depreciation of the stock is proven would also give rise to a derivative suit by defendant as stockholder should not foreclose the suit as pledgor.”) (citations omitted). When the contract involves all shareholders in their capacities as shareholders, i.e., a shareholders agreement, two cases hold that any breach of that agreement gives rise to a direct claim even though all shareholders have suffered the same injury and that injury is merely a consequence of a harm suffered by the corporation. See Hikita v. Nichiro Gyogyo Kaisha, Ltd., 713 P.2d 1197, 1199–1200 (Alaska 1986) (holding that a plaintiff shareholder could sue a fellow shareholder for breaching the shareholders’ agreement by withdrawing from the venture “suddenly and without notice”); Harrington v. Batchelor, 781 So. 2d 1133, 1135 (Fla. Dist. Ct. App. 2001) (allowing a shareholder to bring a direct suit for a breach of a shareholders’ agreement, despite the fact that all shareholders would be affected in the same way by the breach: “[A] shareholder can sue for breach of [a] contract to which he is a party, even if he has not suffered an injury separate and distinct from that suffered by other shareholders.” (quoting Hikita, 713 P.2d at 1200)).

101 E.g., Ayres v. AG Processing, Inc., 345 F. Supp. 2d 1200, 1204, 1208–09 (D. Kan. 2004) (holding LLC minority members who were “terminated as managers, employees and members” of the LLC after complaining about defendants’ management actions had suffered special injury allowing them to bring direct claims); River Mgmt. Corp. v. Lodge Props. Inc., 829 P.2d 398, 403, 405 (Colo. Ct. App. 1991) (holding that a minority shareholder had a valid direct cause of action against the close corporation’s majority shareholder for oppressing the plaintiff by frontloading the corporation’s expenses for a building project, then ousting the plaintiff from the board of directors and buying the plaintiff’s shares when their value was low); Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 903 (Del. Ch. 1999) (allowing a shareholder to bring a direct claim based on a special injury when the other shareholders sold the corporation’s assets with the purpose of eliminating the plaintiff and another shareholder from continuing participation in the business); Fischer v. Fischer, No. C.A. 16864, 1999 WL 1032768, *1, *3–*4 (Del. Ch. Nov. 4, 1999) (holding that special injury had been alleged by a plaintiff who claimed to have been wrongfully cut out of a corporation by the defendants selling real estate at an unfairly low price to another corporation they owned, then dissolving the corporation in which the plaintiff had shares). Pleading can be crucial. For example, Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254, 1259–60 (D. Kan. 2000), concerned alleged breaches of fiduciary duty that had an obviously direct effect on the minority member (a revocable trust) and the member’s grantor. Among the alleged misconduct were: “terminating the management agreement [with an affiliate of the minority member], terminating Mr. Carson [the grantor of the minority member] as president and general manager [of the LLC], severing [the LLC’s] ties with Carson Communications [an affiliate of the minority member] and failing to pay Mr. Carson.” Id. at 1259. Even so, the court characterized the claims as derivative because the complaint itself described the injury as affecting the LLC rather than the member: “The complaint alleges that
The special injury rule has an interesting history.\textsuperscript{102} When the Delaware Chancery Court first used the phrase "special injury" in the direct/derivative context, the phrase seemed merely another way of stating the direct harm analysis:

There are cases . . . in which there is injury to the corporation and also special injury to the individual stockholder. In such case a stockholder . . . may proceed on his claim for the protection of his individual rights rather than in the right of the corporation. The action would then not constitute a derivative action. Here the wrong of which plaintiff complains is not a wrong inflicted upon him alone or a wrong affecting any particular right which he is asserting,—such as his pre-emptive rights as a stockholder, rights involving the control of the corporation, or a wrong affecting the stockholders and not the corporation,—but is an indirect injury as a result of the wrong done to the corporation.\textsuperscript{103}

Unfortunately and inexplicably, in later decisions the formulation morphed, and the reference to indirect injury dropped out.\textsuperscript{104} For example, in 1985, in \textit{Moran v. Household International, Inc.}, the Delaware Chancery

\textsuperscript{102} For an interesting discussion of the case law history, see generally Kurt M. Heyman & Patricia L. Enerio, \textit{The Disappearing Distinction between Derivative and Direct Actions}, 4 DEL. L. REV. 155 (2001).

\textsuperscript{103} Elster v. Am. Airlines, Inc., 100 A.2d 219, 222 (Del. Ch. 1953) (citations omitted). The plaintiff asserted a direct claim for dilution, alleging the issuance of stock to executives and supervisors for insufficient consideration. \textit{Id.} at 220–22. The court rejected the assertion, not because dilution could never be a direct claim, but rather because, in this instance, no plaintiff could show significant dilution. \textit{Id.} at 223–24.

Any injury which plaintiff may receive by reason of the dilution of his stock would be equally applicable to all the stockholders of defendant, since plaintiff holds such a small amount of stock in proportion to the amount of stock outstanding that the control or management of defendant would not be affected by the granting of these options, and, further, since there is no averment that the pre-emptive rights of plaintiff as a stockholder are affected by their issuance.

\textit{Id.} at 222.

\textsuperscript{104} This was so even in cases quoting Elster. See Heyman & Enerio, supra note 102, at 159–60.
Court stated the issue as whether the plaintiffs had suffered an "injury distinct from that suffered by other shareholders." Eight years later, the Delaware Supreme Court stated the rule as follows:

It is well settled that the test used to distinguish between derivative and individual harm is whether the plaintiff suffered "special injury." A special injury is established where there is a wrong suffered by plaintiff that was not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote.

The special injury rule has its adherents. For example, in Loewen v. Galligan, the Oregon Court of Appeals considered a suit by shareholders who alleged breach of fiduciary duties in the wake of corporate mergers that decimated the value of their stock. The court held that the plaintiffs could not bring their lawsuit directly because all the shareholders had suffered the same injury: "A special injury is established where there is a wrong suffered by the shareholder [that was] not suffered by all shareholders generally or where the wrong involves a contractual right of the shareholders, such as the right to vote."

APA Excelsior III, L.P. v. Windley is another example. Applying Georgia law, a federal district court held that the plaintiffs could not bring their claims for breach of fiduciary duties directly against the majority...
shareholder because the injury that the plaintiff shareholders suffered was not "separate and distinct" from that suffered by other shareholders.\textsuperscript{110} The opinion contains language that would preclude any class action by shareholders under state law, but also flirts with a formulation that might resonate with the direct harm approach: "To determine whether such a direct action is properly brought, courts consider 'whether the plaintiff is similarly situated to other shareholders, suffers the same injury, and retains the same opportunity to be made whole by a corporate recovery from the wrongdoer.'"\textsuperscript{111}

Despite its adherents, the special injury rule produces both conceptual contortions and practical difficulties. The contortions can be illustrated by a trio of cases: \textit{Curtis v. United States},\textsuperscript{112} \textit{Gonzalez v. Fairgale Properties Co., N.V.},\textsuperscript{113} and \textit{In re Gaylord Container Corp. Shareholders Litig.}\textsuperscript{114}

\textit{Curtis} correctly held that the former sole shareholder in a dissolved, closely held corporation could not bring an individual claim for breach of a contract to which the corporation, not the shareholder, had been a party.\textsuperscript{115} But the special injury rationale made no sense. What does it mean to refer to "a wrong suffered by the shareholder not suffered by all shareholders generally," when the corporation only has one shareholder?\textsuperscript{116}

\textsuperscript{110} Id. at 1360.

\textsuperscript{111} Id. (quoting Citibank, N.A. v. Data Lease Fin. Corp., 828 F.2d 686, 693 (11th Cir. 1987)). The first two factors suggest that class actions are impossible because any claims suitable for class action treatment will necessarily be derivative. In contrast, the third factor suggests direct harm.

\textsuperscript{112} 63 Fed. Cl. 172, 179-80 (2004).

\textsuperscript{113} 241 F. Supp. 2d 512, 516 (D. Md. 2002).

\textsuperscript{114} 747 A.2d 71, 78, 80 (Del. Ch. 1999).

\textsuperscript{115} Curtis, 63 Fed. Cl. at 180-81.

\textsuperscript{116} Id. at 179; see also Sparling v. Hoffman Constr. Co., Inc., 864 F.2d 635, 640-641 (9th Cir. 1988) (reaching the right result but for the wrong reason and upholding a ruling that a married couple who were the sole shareholders in a corporation did not have standing to assert a direct RICO claim based on an alleged fraud perpetrated against their corporation: "Because they are the sole shareholders they cannot show an injury distinct from that to other shareholders."); cf. Godfrey v. Lafavour, No. J05-005 CV JWS, slip op., 2005 WL 2340714, at *4 (D. Alaska) (explaining that a direct lawsuit may be brought only when the plaintiff shareholder's injury is "separate and distinct" from that of other shareholders or when there is a "special duty" between the shareholder and the wrongdoer; holding that one member of a two-member LLC had direct claims against the other member for misrepresentation and usurpation of an LLC opportunity stemming from the other member's failure to tell the plaintiff that the LLC's right of first refusal on property had been triggered by a third party's offer to buy the property; stating that the plaintiff was "the only LLC member harmed by Defendant La[f]avour's actions and... Defendant
Gonzalez illustrates a prevalent conceptual "work around" involving voting rights. When those who manage an entity somehow infringe the voting rights of all the owners, the special injury rule threatens to convert a clearly direct claim into a derivative one. The work around is to characterize voting rights not as aspects of stock ownership (or membership) but rather as contractual rights. This characterization permits the voting rights claim to proceed directly, under the contractual right rubric of the special injury rule.

Thus, in Gonzalez the federal court stated that a shareholder who was not given a chance to vote on a sale of the corporation’s land could bring an individual lawsuit because her contractual right to vote had been compromised—even though all the other shareholders had suffered the same deprivation. The result is correct, but it is at best a contortion to characterize as a contract right one of the basic property “sticks” of a species of property created by statute.

In In re Gaylord Container Corp., the court went beyond the contractual right contortion and came tantalizingly close to a direct harm analysis. Without expressly rejecting the special injury rule, which was then still the

La[flavour owed him fiduciary duties in his individual capacity”) (internal quotations and footnote omitted).


118 Id. at 516 (commenting in dicta on Delaware law, before dismissing the suit for lack of subject matter jurisdiction because neither federal question nor diversity jurisdiction existed); see, e.g., In re Chalk Line Mfg., Bankr. No. 94-42773 (11), 1994 WL 394978, at *9 (Bankr. N.D. Ala. July 26, 1994); Lipton v. News Int’l, Plc., 514 A.2d 1075, 1076, 1079 (Del. 1986).

119 MODEL BUS. CORP. ACT § 7.21(a) (2002) (providing, that, with limited exceptions: [E]ach outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders’ meeting. Only shares are entitled to vote.”); UNIF. LTD. LIAB. CO. ACT § 404(a) (rev. 1996), 6A U.L.A. 594 (2003) (“In a member-managed company: (1) each member has equal rights in the management and conduct of the company’s business; and (2) . . . any matter relating to the business of the company may be decided by a majority of the members.”); NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, REV. UNIF. LTD. LIAB. CO. ACT § 407(a) (Teleconference Draft May 2005), available at http://www.law.upenn.edu/bll/ulc/ulc_frame.htm (last visited Mar. 5, 2006) (“In a member-managed limited liability company, the following rules apply: (1) Each member has equal rights in the management and conduct of the limited liability company’s activities . . . .”); DEL. CODE ANN. tit. 6, § 18-402 (2005) (“Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling . . . .”).

120 747 A.2d 71, 78, 80 (Del. Ch. 1999).
prevailing rule in Delaware,\(^{121}\) the Delaware Chancery Court permitted a class comprised of all non-defendant shareholders to bring a direct claim against board members who had taken entrenchment actions.\(^{122}\) Those actions had made it impractical for any entity to obtain control of the corporation without the board members' approval.\(^{123}\) Noting that a derivative claim belongs to the enterprise, the Court asked:

[W]hy should damages be awarded to the enterprise to remedy the economic harm caused because its owners were not permitted to sell their personal property? . . . The mere fact that such an injury is to the economic property rights of all the stockholders rather than to their voting rights does not make the injury suffered any less "special" and non-corporate.\(^{124}\)

Without conceptual contortions, the special injury rule can produce some very bad results, especially where the plaintiffs claim breach of

\(^{121}\) As explained infra text accompanying notes 144–155, the Delaware Supreme Court recently recanted the heresy of the special injury rule and adopted the direct harm rule.

\(^{122}\) Gaylord, 747 A.2d at 83.

\(^{123}\) Id. at 73. The court cites Revlon Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986), to support its point that shareholders may directly challenge defensive measures taken by a corporation's board in response to an actual acquisition proposal because the defensive measures affect shareholders' individual interests. Id. at 77 n.8. The savvy reader will have noticed that, under the special injury approach, a class action direct claim should typically be an oxymoron. See G & N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 235 (Ind. 2001) (rejecting the special injury rule: "Some courts allow a direct action only if the shareholder's injury is distinct from the injuries sustained by other shareholders and the corporation. This is also problematic because some injuries may run to all shareholders—for example, refusal to convene an annual meeting—and be caused by a breach of the duty owed to every shareholder.") (citation omitted); Gaylord, 747 A.2d at 81 (stating that the special injury test's "focus on the similarity of treatment misses the central point that fundamental shareholder rights (e.g., voting and alienability) can be infringed by a variety of board actions that treat existing shareholders alike"); see also Heyman & Enerio, supra note 102, at 164–65 ("[I]f taken to its logical conclusion, the focus on whether a stockholder suffered a distinct injury from that suffered by other stockholders (as opposed to whether a stockholder suffered a distinct injury from that suffered by the corporation) as the prerequisite for maintaining a direct claim would mean that there could never be a class of all stockholders asserting direct claims.").

\(^{124}\) Gaylord, 747 A.2d at 80. Note that this decision is at odds with Moran v. Household International, Inc., which characterized the plaintiffs' claims to invalidate a "poison pill" plan that restricted the alienability and marketability of their shares as derivative and limited the plaintiffs' ability to engage in proxy contests. 490 A.2d 1059, 1064 (Del. Ch. 1985) aff'd, 500 A.2d 1346 (Del. 1985); see discussion supra note 105.
disclosure duties, improper dilution, or denial of voting rights. For example, in Bovee v. Lyndonville Savings. Bank & Trust, the Vermont Supreme Court ruled that shareholders could not bring a direct action against a bank corporation and several of its directors and officers for failing to provide certain requested information, because the claim failed to establish harm distinct from other shareholders.\textsuperscript{125} To deem a shareholder's claim for information from the corporation to be one belonging to the corporation is at best confused and at worst ludicrous.\textsuperscript{126}

The Eighth Circuit produced a similarly bad result in Arent v. Distribution Sciences, Inc.\textsuperscript{127} Plaintiffs brought direct claims against a corporation that was going to merge with the corporation in which they owned shares.\textsuperscript{128} The plaintiffs alleged fraudulent nondisclosure of information concerning the merger and the Eighth Circuit had to apply Minnesota law.\textsuperscript{129} Applying that law, the court rejected the direct claims because “[p]laintiffs do not allege that they suffered injury different than that suffered by other ... shareholders.”\textsuperscript{130} Thus, to paraphrase Abraham Lincoln, if you “fool all of the people some of the time,”\textsuperscript{131} they have no effective remedy under state entity law.\textsuperscript{132}

\textsuperscript{125} 811 A.2d 143, 146–47 (Vt. 2002).
\textsuperscript{126} Prior to abandoning the special injury rule, the Delaware Supreme Court got around the disclosure dilemma by associating the right to information to the fundamental contractual right to vote. See In re Tri-Star Pictures Inc., 634 A.2d 319, 331–32 (Del. 1993) (holding that even under the special injury rule, minority shareholders had individual causes of action against the corporation's controlling shareholder for breaching the duty to disclose material facts about a proposed business combination: “Thus, by its alleged breaches of the duty of disclosure, [the controlling shareholder] materially and adversely affected the minority class' right to cast an informed vote. Such conduct, if true, is an improper interference with exercise of the franchise. It is a unique special harm to each uninformed shareholder for which the wrongdoer is answerable in damages.”).
\textsuperscript{127} 975 F.2d 1370, 1372 (8th Cir. 1992).
\textsuperscript{128} Id.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
\textsuperscript{131} JOHN BARTLETT, FAMILIAR QUOTATIONS 451 (Justin Kaplan ed. 1992) (“You can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time.”).
\textsuperscript{132} Cf. Potter v. Janus Inv. Fund, No. 03-CV-0692-DRH, 2004 WL 1173201, at *3 (S.D. Ill. Feb 12, 2004) (concluding that the plaintiffs' claims of stock equity dilution arising from the defendant mutual funds' allowance of short term buying and selling by some investors, while the plaintiffs and others were encouraged to invest long-term, were based on a "direct and individual harm... a claim not actionable by the corporation itself" and could, thus, be brought directly).
The dilution cases are more complex, because some dilution claims are properly derivative. For example, if an entity sells new ownership interests too cheaply, the dilution suffered by the existing owners is a mere consequence of the entity having been harmed by a bad deal. However, this analysis is different when the dilution involves a QVC issue (i.e., when the dilution also results in the corporation having for the first time a controlling shareholder). In such situations, the owners lose forever the possibility of sharing in a "control premium," and the injury is therefore to them and not the entity.

This QVC-type harm is direct regardless of whether the party obtaining control is a pre-existing owner. Yet in In re Paxon Communication Corp., the Delaware Chancery Court held that some types of QVC claims are derivative. The case involved an arrangement under which a corporation, not already a shareholder, obtained shares of stock and stock options that allowed the acquiring corporation to obtain seventy percent of the voting rights in Paxon Communications. Stating, in essence, that a QVC claim is a direct action only if a significant existing shareholder's interest is increased at the expense of the other shareholders, the court held that direct claims had to be dismissed because (i) the company benefiting from the dilution was a third party; (ii) all existing shareholders suffered the same alleged harm; and therefore (iii) no shareholder could claim a special injury.

The Potter court could see the injury as special to some shareholders because not all of the shareholders were affected. In some circumstances, federal and state securities laws may provide direct relief in fool-them-all situations, but this Article is limited to claims brought under state entity law.

133 Gentile v. Rossette, No. Civ.A. 20213-NC, 2005 WL 2810683, at *4 (Del. Ch. Oct. 20, 2005) (holding that dilution simpliciter is a derivative claim); In re Berkshire Realty Co. S'holder Litig., No. Civ.A. 17242, 2002 WL 31888345, at *4 (Del. Ch. Dec. 18, 2002) ("Like waste claims, dilution claims are generally considered derivative claims. Such an alleged injury is indirect because it falls upon all shareholders equally and falls only upon the individual shareholder in relation to his proportionate share of stock as a result of the direct injury being done to the corporation.") (footnote omitted).

134 In Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1994), the Delaware Supreme Court held that Revlon duties, explained supra note 88, were triggered when a corporation's directors contemplated a deal that, while retaining the corporation intact, would have eliminated forever any chance for the shareholders to share in the control premium available when an entity is put up for sale.


136 Id. at *3.

137 Id. at *5; see also Grogan v. O'Neil, 307 F. Supp. 2d 1181, 1189 (D. Kan. 2004) (applying
Bad results are less frequent with voting claims, because, as explained above, special injury courts typically work around the problem. However, when a court misses the work-around the results are stark. Thus in Geer v. Cox, a federal district court held that the special injury rule barred a shareholder from bringing a direct claim against directors who had allegedly sold assets without the shareholder approval required by law.

then applicable Delaware law and holding, under the special injury rule, that a Revlon claim should have been brought derivatively because all shareholders suffered the same alleged injury of a reduced price for their shares; Dieterich v. Harrer, 857 A.2d 1017, 1027 (Del. Ch. 2004) (holding that a Revlon claim could not be filed directly by a shareholder because the corporation was the one hurt by the directors' alleged pre-merger sabotage of negotiations: "[The Revlon duty] is plainly the directors' normal duty to manage the affairs of the corporation, albeit in the context of a corporation searching for alternatives. That duty is owed to the corporation and not separately or independently to the stockholders."); cf In re Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 330 (Del. 1993) ("[A] claim of stock dilution and a corresponding reduction in a stockholder's voting power is an individual claim."). In re Tri-Star Pictures recited the special injury rule, but explained that the majority shareholder had benefited from the diluting action whereas the minority shareholders as a group had suffered, which was apparently personal enough to count as a direct special injury. In re Tri-Star Pictures, 634 A.2d at 330; see Lipton v. News Int'l, Plc., 514 A.2d 1075, 1075–76, 1079 (Del. 1986) (holding shareholder had a special injury and a direct cause of action arising from the corporation's exchange agreement with an investor, because the arrangement created significant "veto power over all shareholder actions subject to the 80% supermajority voting requirement" and because: "The right to vote is a contractual right that [a shareholder] possesses as a shareholder of [the corporation] which is independent of any right of [the corporation]."). But see In re Chalk Line Mfg., Bankr. No. 93-42773 (11), 1994 WL 394978, at *9 (Bankr. N.D. Ala. July 26, 1994) (holding that, even under special injury rule, minority shareholders had a direct claim of action for dilution of their proportionate ownership in the corporation because it was a breach of the majority shareholders' fiduciary duty to the minority but providing no detailed statement of facts); In re Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 980 (Del. Ch. 2005) (allowing plaintiff shareholders to bring lawsuit directly for breach of Revlon duties but holding that the corporation's board did not breach those duties); Marcoux v. Prim, 04 CVS 920, 2004 NCBC 5, at ¶ 53–60 (N.C. Bus. Ct. Apr. 16, 2004), available at http://www.ncbusinesscourt.net/opinions/2004%20NCBC%205.htm (applying Delaware law and holding that a shareholder's Revlon claim against a CEO who allegedly manipulated the merger process to give himself an "extravagant" benefit package using money that otherwise would have gone to shareholders could be brought directly: "The 'injury' results from the diminished value that a shareholder would receive from a merger process that prevents the shareholders from achieving the highest value for their shares in a change of control merger. The treasury of the shareholder is depleted, not the treasury of the corporation."). See also Gentile v. Rossette, No. Civ.A. 20213-NC, 2005 WL 2810683, at *6 n.58 (Del. Ch. Oct. 20, 2005) (applying Tooley and noting, in a bit of revisionist history, that generally "dilution claims emphasizing the diminishment of voting power have been categorized as direct claims").
The court stated that:

The right to vote is a right owed to all shareholders with voting status rather than a separate and distinct harm. Because plaintiff has failed to show that there was any duty owed to him that was not owed to all shareholders of his status, or that he suffered any harm individually, his direct claim must be dismissed. \[^{140}\]

Special injury is truly a confusing concept when used "as the test for determining whether a claim is derivative or direct."\[^{141}\] The confusion is inevitable, because the special injury rule rests on a logical error—the fallacy of affirming the consequent:\[^{142}\]

\[
[(A) s \ a \ matter \ of \ consequence \ when \ a \ shareholder's \ injury \ is \ indirect, \ all \ shareholders \ have \ in \ common \ the \ same \ (indirect) \ injury. \ It \ does \ not \ logically \ follow, \ however, \ that \ whenever \ shareholders \ have \ a \ common \ injury \ they \ necessarily \ suffered \ their \ injury \ indirectly.]
\]

In logical terms, the error is as follows:

\[
\text{if } P \text{ then } Q \text{ (if indirect, then necessarily common)}
\]

\[
\text{does not mean}
\]

\[
\text{if } Q \text{ then } P \text{ (if common, then necessarily indirect) [...]}\[^{143}\]
\]

In 2004, in Tooley v. Donaldson, Lufkin, & Jenrette, Inc., Delaware reconsidered its approach, corrected its logical error, and disavowed the special injury heresy: "In our view, the concept of ‘special injury’ that appears in some Supreme Court and Court of Chancery cases is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of ‘special injury’ as a tool in that analysis."\[^{144}\]

\[^{140}\] *id.*


\[^{143}\] Kleinberger & Bergmanis, *supra* note 21, at 1252 (footnote omitted).

\[^{144}\] 845 A.2d 1031, 1035 (Del. 2004).
As a replacement, the court adopted the direct harm approach: "[T]he stockholder must allege something other than an injury resulting from a wrong to the corporation."\(^{145}\) The court went on to add a second prong. Delaware courts must also consider "the relief that could result"—that is, whether the relief would properly go to the entity or directly to the owners.\(^ {146}\) However, the court acknowledged that the second prong is logically implicit in the first.\(^ {147}\)

Delaware's disavowal of special injury led promptly to greater coherence in this area of law. For example, the next year in *Weinstein v. Schwartz*, the Seventh Circuit applied *Tooley* and permitted a direct claim by a shareholder in a closely held corporation who was seeking a declaratory judgment that other shareholders had previously sold their shares and therefore could not vote on a sale of a horse farm owned by the corporation.\(^ {148}\) The plaintiff rented the farm from the corporation and opposed the sale.\(^ {149}\) The court considered where the alleged harm would fall (the first prong) and who would benefit from the proposed remedy (the second prong).\(^ {150}\)

The *Tooley* analysis also guided a New York state trial court to the correct result. In *Higgins v. New York Stock Exchange, Inc.*, seatholders on the New York Stock Exchange (NYSE) brought a class action lawsuit against the NYSE CEO and board, claiming breach of fiduciary duties and seeking to enjoin a proposed merger.\(^ {151}\) The complaint alleged that: (i) the consideration to be paid to NYSE seatholders under the merger agreement was unfair, (ii) the CEO had extensive ties to the other party to the merger, and (iii) that those ties had caused the CEO and board members to favor the other party during merger negotiations.\(^ {152}\) The complaint alleged "disparate allocation of equity, resulting in more seatholders' equity being contributed to the merged corporation, non-seatholder employees, and Archipelago [the other entity in the merger] shareholders, while 'short-changing' NYSE

\(^{145}\) *Id.* at 1038.

\(^{146}\) *Id.*

\(^{147}\) *Id.* at 1036.

\(^{148}\) 422 F.3d 476, 477–78 (7th Cir. 2005) (applying Delaware law).

\(^{149}\) *Id.* at 476–77.

\(^{150}\) *Id.* at 478. Ironically, the special injury rule may have produced the same result, as the plaintiff had a special contractual relationship with the corporation—i.e., the farm lease.


\(^{152}\) *Id.* at *1–*4.
seatholders from realizing the full value of their equity positions in the NYSE by a higher payout of shareholders’ equity.”

Applying Tooley, the court held that the complaint stated a direct claim:

Under the Tooley test . . . , the loss of seats in exchange for an unfairly low payout of shareholders’ equity individually harms the seatholders and is otherwise not dependent on a harm to the NYSE. In contrast, the NYSE is being benefited, or, put differently, is not injured; by paying less equity out to the seatholders, the NYSE retains more shareholders’ equity, translating into more assets appearing on the NYSE balance sheet that is being transferred to the merged corporation, which cannot be characterized as an injury to the corporate entity . . . . Moreover, under the second prong of Tooley, there is no monetary relief that would go [to] the NYSE for the alleged breaches of duty that results in more, rather than less, assets appearing on its balance sheet as a result of the lower payout of shareholders’ equity.

Whether Delaware’s conversion will eventually heal the schism in the law and completely eliminate the special injury line of analysis remains to be seen. The problem for LLC law is that, so long as some courts continue

153 Id. at *11.
154 Id. at *10.
155 It is perhaps worth noting that some other jurisdictions saw the light before Delaware, and some long before. See Strougo v. Bassini, 282 F.3d 162, 171 (2d Cir. 2002) (“To sue directly under Maryland law, a shareholder must allege an injury distinct from an injury to the corporation, not from that of other shareholders.”); Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) (“The individual wrong necessary to support a suit by a shareholder need not be unique to that plaintiff. The same injury may affect a substantial number of shareholders. If the injury is not incidental to an injury to the corporation, an individual cause of action exists.”); Mann v. Kemper Fin. Cos., 618 N.E.2d 317, 325 (Ill. App. Ct. 1992) (“We reject defendants’ proffered test of shareholder standing of whether a shareholder alleges unique harm. A plaintiff shareholder’s injury may not be unique to that particular shareholder, but a plaintiff’s cause of action could still be individual instead of derivative.”). Even after Tooley, some courts continue to misunderstand the relationship between harm to the entity and harm to the owners. In Shirvanian v. DeFrates, for example, the court determined that a shareholder’s state-law claim for fraud was derivative, because the fraud concerned alleged mismanagement of the corporate enterprise and the alleged misstatements would have not been misstatements without the alleged mismanagement.
to apply the special injury rule to corporations, those courts will likely (and perhaps ineluctably) give the same unfortunate treatment to limited liability companies.

C. The "Duty Owed" Cases

A third line of cases addresses the direct/derivative distinction by identifying the duty allegedly breached and then asking to whom that duty is owed or whose rights are infringed. For example, the Indiana Supreme Court rejected both the direct harm and special injury tests and stated that the "correct approach" is based on whose rights the shareholder asserts.\(^{156}\) If the action is based on "a primary or personal right belonging to the plaintiff-stockholder," rights derived from the corporation’s articles of incorporation, state law, agreements among shareholders or between the corporation and its shareholders, the claim is direct.\(^{157}\) In contrast, if the action vindicates a "primary right of the corporation," the claim is derivative.\(^{158}\)

To decide if the harm was to the corporation or to the stockholder individually, [Tooley] suggested the most relevant question is whether the stockholder can prevail without showing an injury to the corporation . . . . The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing a corresponding injury to the corporation. Applying those principles here leads to the conclusion that the Shirvanians’ complaints are derivative, not direct, and could be asserted only on behalf of the corporation. The misrepresentations the Shirvanians allege caused their injury were based on mismanagement of the corporation’s assets. The Shirvanians cannot prove their injury without proving an injury to the corporation. We hold, therefore, that the Shirvanians' suit is derivative under Delaware law.

161 S.W.3d 102, 110–11 (Tex.App.—Houston [14 Dist.] 2004, pet. filed). This holding turns Tooley on its head, or at least its side, because the alleged mismanagement directly caused harm to the corporation, but the alleged misrepresentation was about the corporation not to the corporation. With regard to the alleged misrepresentation, there was no cognizable harm to the corporation at all. See also Smith v. Waste Mgmt., Inc., 407 F.3d 381, 385 (5th Cir. 2005) (purporting to apply Tooley, relying on Shirvanian’s rationale, but also asserting that the alleged misrepresentations somehow harmed the corporation by occasioning a fall in the selling price of the corporation’s stock).


\(^{157}\) Id. at 235.

\(^{158}\) Id.; see also Chanoff v. U.S. Surgical Corp., 857 F. Supp. 1011, 1020, 1022 (D. Conn. 1994) (noting that corporate officers and directors are in a fiduciary relationship with, and owe duties to, the corporation itself and that any harm suffered by shareholders from the breach of
A federal district court has come to a similar conclusion, albeit expressed in terms of duty:

In short, what differentiates a direct from a derivative suit is neither the nature of the damages that result from the defendant’s alleged conduct, nor the identity of the party who sustained the brunt of the damages, but rather the source of the claim of right itself. If the right flows from the breach of a duty owed by the defendants to the corporation, the harm to the investor flows through the corporation, and a suit brought by the shareholder to redress the harm is one “derivative” of the right retained by the corporation. If the right flows from the breach of a duty owed directly to the plaintiff independent of the plaintiff’s status as a shareholder, investor, or creditor of the corporation, the suit is “direct.”

The law of general partnerships reflects the “duty owed” approach. See, e.g., Lefkovitz v. Wagner, 395 F.3d 773, 776 (7th Cir. 2005), cert. denied, 126 S. Ct. 333 (2005) (involving a dispute among partners of a general partnership). Judge Posner analyzed the matter as follows:

Jarnis is a Florida general partnership, and under Florida law the partners in a general partnership owe fiduciary obligations to each other. (This is the general rule, not anything peculiar to Florida.) So the plaintiffs were not required to file this as a derivative, or any kind of representative, suit. The plaintiffs could sue, and are suing, on their own behalf rather than on behalf of the partnership.

Id. at 777 (citations omitted). Of course, it is virtually axiomatic that derivative claims do not exist with regard to general partnerships. UNIF. P’SHP ACT § 405(b) cmt. 2 (rev. 1997), vol. 6, pt. 1 U.L.A. 150 (2001) (“Under subsection (b), a partner may bring a direct suit against the partnership or another partner for almost any cause of action arising out of the conduct of the partnership business. . . . RUPA does not authorize derivative actions . . . .”); see WILLIAM J. CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 14:9 n.1 (2004) (noting that RUPA does not authorize derivative actions); Kleinberger, Prism, supra note 2, at 841–42. For an analysis suggesting that the
Sometimes this approach produces correct results. For example, in *McCann v. McCann*, the Idaho Supreme Court rejected the attempt by a shareholder in a closely held corporation to bring a direct lawsuit against the other shareholders for breach of fiduciary duties, negligence, self-dealing, conversion, and waste.\(^{160}\) The direct harm approach would have characterized the alleged harms as first befalling the corporation. The court opined instead: "The duties that [the plaintiff] has alleged the directors breached in this case do not appear to be a 'special duty owed to the stockholder by the wrongdoer and having its origin in circumstances independent of the plaintiff's status as a shareholder.'"\(^ {161}\)

The duty owed approach also appears in *Mason v. F.D.I.C.*, in which a federal district court held that a shareholder could directly bring an action for breach of warranty in a letter of credit because a duty was owed to him under the warranty in his role as pledgor of security for the loan.\(^ {162}\) This holding is consistent both with the direct harm approach and the special injury rule. The court also characterized as direct the plaintiff's claim that another shareholder and the lender had conspired to push the corporation into bankruptcy.\(^ {163}\) The plaintiff alleged that the defendants meant to "deprive him of his rights as a director of [the corporation] and to deprive him of his stock in [the corporation]," which were individual wrongs.\(^ {164}\)

In general, however, the duty owned/rights infringed approach has the matter upside down. Standing is about harm, not duty. Certainly the phrase "cognizable injury" presupposes some breach of obligation, but the standing inquiry focuses on the injury component.\(^ {165}\)

The problem is more than doctrinal incoherence. Given the loose way in which some courts (and legislatures) describe the fiduciary duty of entity managers, the duty owed or rights infringed approach provides a bad lens through which to see the direct/derivative distinction. Courts often speak for an accounting has provided general partnerships with a rule functionally similar to the direct/derivative distinction, see Daniel S. Kleinberger, *There's No Accounting for Taste: The Role (If Any) for Partnership's 'Accounting' Remedy in the Modern World of Limited Liability Companies*, 41 TULSA L. REV. (forthcoming Summer 2006) [hereinafter Kleinberger, *Accounting*].

\(^{160}\) 61 P.3d 585, 590–91 (Idaho 2002).

\(^{161}\) *Id.* (quoting 19 AM. JUR. 2D CORP. § 2249 (1986)).


\(^{163}\) *Id.* at 808.

\(^{164}\) *Id.*

\(^{165}\) See discussion supra notes 91–97 and accompanying text.
loosely of directors owing fiduciary duties both to the corporation and to its shareholders, and some legislatures have taken a similar approach with limited liability companies. For example, the Alabama LLC statute provides that “[i]n a limited liability company managed by its members . . . the only fiduciary duties a member owes to the company or to its other members are the duty of loyalty and the duty of care.” The statute also suggests that the duty of care runs both to the LLC and its members.

Similar or even identical language can be found in statutes governing other unincorporated entities and in some corporate statutes as well. For instance, Florida’s newly enacted version of the Uniform Limited Partnership Act (ULPA) (2001) refers to the “fiduciary duties that a general partner has to the limited partnership and the other partners.” The Colorado statute governing exculpatory provisions in corporate charters states that, subject to certain limitations, “[i]f so provided in the articles of

\[\text{\textbf{166}}\ E.g., \text{Strougo v. Bassini, 282 F.3d 162, 173 (2d Cir. 2002)} \text{("But Maryland courts have clearly established the proposition that directors and officers owe fiduciary duties to both the corporation and the shareholders.")}; \text{\textit{In re Northgate Computer Sys., Inc.}, 240 B.R. 328, 357 (Bankr. D. Minn. 1999)} \text{("More recently, the Minnesota appellate courts have recognized that at least certain types of shareholders owe fiduciary duties to the corporation and, by extension, to other shareholders.")}; \text{\textit{In re Williams, 152 B.R. 123, 127} (Bankr. N.D. Tex. 1992)} \text{(stating that “prior to a bankruptcy filing management's fiduciary duty went to the corporation's shareholders”)}; \text{Manzo v. Rite Aid Corp., No. Civ.A. 18451-NC, 2002 WL 31926606, at *6 (Del. Ch. Dec. 19, 2002)} \text{("This obligation arises from the fiduciary duties that directors of Delaware corporations owe both to the shareholders and to the corporation itself.").}

\[\text{\textbf{167}} \text{\textit{ALA. CODE} \S 10-12-21(e) (1975).}

\[\text{\textbf{168}} \text{\textit{Id.} \S 10-12-21(g) (1975). The statute takes a parallel stance toward the duties of loyalty and care in a manager-managed LLC. \textit{Id.} \S 10-12-21(k) (1975).}

\[\text{\textbf{169}} \text{\textit{FLA. STAT. ANN.} \S 620.1408(1) (West 2006) (emphasis added). This formulation originated in the Revised Uniform Partnership Act, which does not contemplate or allow derivative claims, and was incorporated in the Uniform Limited Liability Company Act and the Uniform Limited Partnership Act (2001), which do. See \textit{CALLISON & SULLIVAN, supra} note 159, \S 14:9 n.1; see also \textit{UNIF. P'SHIP ACT} \S 405(b) cmt. 2 (rev. 1997), vol. 6, pt. 1 U.L.A. 150 (2001) ("Under subsection (b), a partner may bring a direct suit against the partnership or another partner for almost any cause of action arising out of the conduct of the partnership business . . . . Since general partners are not passive investors like limited partners, RUPA does not authorize derivative actions . . . ."). An official comment to ULPA (2001) seeks to explain that the formulation is not intended to override the direct/derivative distinction. \textit{UNIF. LTD. P'SHIP ACT,} \S 408(a) cmt. (rev. 2001), 6A U.L.A. 62-63 (2003) ("The reference to 'the other partners' does not affect the distinction between direct and derivative claims. See Section 1001(b) (prerequisites for a partner bringing a direct claim)."). Section 1001(b) is discussed \textit{infra} notes 206–210 and accompanying text.
incorporation, the corporation shall eliminate or limit the personal liability of a director to the corporation or to its shareholders . . . ." In sum, the duty owed or rights infringed approach cannot be the proper test for making the direct/derivative distinction, because the test would create only confusion.

V. A SPECIAL RULE FOR CLOSELY HELD ENTITIES

Corporate law has continually wrestled with the direct/derivative distinction in the context of closely held corporations, and, because almost all LLCs are closely held, it is important to understand how the closely-held-corporation law approaches the distinction.

Most United States jurisdictions do not have any special direct/derivative rule for closely held corporations. The Virginia

\[\text{COLO. REV. STAT. ANN. } \S 7-108-402 \text{ (West 1998) (emphasis added). This language is based on DEL. CODE ANN. tit. 8, } \S 102(b)(7), \text{ which was the Delaware Legislature's reaction to Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), and spawned copy cat legislation around the country. Matthew G. Dore, Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct, 1995 COLUM. BUS. L. REV. 127, 181 (1995).}\]

\[\text{See, e.g., Foster-Thompson, LLC v. Thompson, No. 8:04-CV-2128T30EAJ, 2005 WL 3093510, at *2 (M.D. Fla. Nov. 18, 2005) (granting summary judgment against the defendant's third party complaint/counterclaim for conversion of LLC assets because the claim was derivative, but denying summary judgment on the defendant's "personal breach of fiduciary duty claim" against his fellow members because the relevant LLC statute "creates a duty of loyalty and a duty of care to the limited liability company and its members").}\]

\[\text{It is beyond the scope of this Article to delineate in detail the nature of a closely-held entity. The following definition will suffice:}\]

\[\text{In this Article the phrase "closely held businesses" refers to businesses, regardless of legal form, that fit the following criteria: (i) few owners; (ii) ownership interests not freely transferable (due to legal or practical limitations, or both); and (iii) most (and often all) of the owners actively engaged in managing or otherwise working in the business.}\]

\[\text{Kleinberger, Prism, supra note 2, at 829.}\]

\[\text{See Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 384 (7th Cir. 1990) (refusing to adopt any special rules for direct lawsuits in the context of a close corporation: "Corporations are not partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted."); Wessin v. Archives Corp., 592 N.W.2d 460, 462 (Minn. 1999) (repudiating an intermediate court's effort at a more nuanced approach); Landstrom v. Shaver, 561 N.W.2d 1, 14 (S.D. 1997) (declining to adopt any special rule for close corporations: "[Plaintiff] seeks the best}\]
Supreme Court has stated that "[t]he overwhelming majority rule is that an action for injuries to a corporation cannot be maintained by a shareholder on an individual basis and must be brought derivatively."\textsuperscript{174} However, the American Law Institute (ALI) has proposed a special approach, which has become law in some jurisdictions.\textsuperscript{175} Under section 7.01(d) of the ALI's
Principals of Corporate Governance:

In the case of a closely held corporation, the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.\textsuperscript{176}

I have elsewhere criticized the ALI approach as providing courts insufficient guidance for when to "override" the direct/derivative distinction\textsuperscript{177} and for being insufficiently sensitive to the way the distinction protects the deal among closely-held entity owners:

As explained by the ALI, "the concept of a corporate injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders."

The problem with this approach is that it does not adequately understand (let alone take into account) the consequences of shifting from the entity construct to the aggregate. The ALI assumed that the procedural consequences of the direct-derivative distinction had no place in a close corporation, and was content to let the courts decide—without any additional guideposts—when to order the shift. But the procedural consequences of the distinction are not inevitably bulwarks for the oppressor. They may instead be an important part of the balance of power between majority and minority owners. In

\textsuperscript{176} 2 AM. LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(d) (1994).

\textsuperscript{177} Kleinberger, \textit{Prism}, supra note 2, at 854 n.129 (noting that comment e of section 7.01 provides that, once the ALI's three criteria are met, "[t]he court should then have equitable power to treat the action as direct if the corporation is closely held" and criticizing the comment for "stating no further guidelines for the exercise of that equitable power").
particular, those consequences help prevent a simple dispute over business judgment from becoming full-fledged litigation at the whim of a disgruntled holder of a minority interest.\(^\text{178}\)

It might seem inevitable that jurisdictions that adopted the ALI approach for close corporations will do the same for closely-held LLCs, but the advent of LLCs might provide ALI jurisdictions an opportunity to reconsider.\(^\text{179}\) Certainly, "back in the day" formal barriers inherent in corporate law doctrine made it difficult or even impossible to achieve appropriate remedies for oppression.\(^\text{180}\) At that time, as a result, almost all oppression claims likely had some merit. When the odds are harshly against plaintiffs, false or dubious claims are less likely to be made.\(^\text{181}\) But today in most jurisdictions, the situation is strikingly different; a claim of oppression is likely to survive a summary judgment motion, unless the claimant pushes the envelope too far.\(^\text{182}\)


\(^{179}\) Id. at 853 (stating that "courts that have adopted the [ALI] approach for close corporations will likely do so for LLCs" and noting that "[t]hat is what happened recently... in Georgia, where the court of appeals extrapolated from long-standing Georgia corporate case law to adopt the override approach for LLCs." (citing Stoker v. Bellemeade, LLC, 615 S.E.2d 1, 8 (Ga. Ct. App. 2005))); see supra note 168 (discussing Texas’s approach for closely held LLCs and closely held corporations compared to the ALI approach).


\(^{181}\) See, e.g., David A. Barrett, *Declaratory Judgments for Libel: A Better Alternative*, 74 CAL. L. REV. 847, 862–63 (1986) ("The distortions created by the focus on state of mind [requirement in libel cases]... make the current damage action almost worthless to an honest victim of a defamatory falsehood. That plaintiff faces less than a ten percent chance of ever seeing the falsity claim adjudicated, while spending years in expensive litigation over state of mind. Only rare individuals will take on such daunting odds."); Anna-Maria Marshall, *Closing The Gaps: Plaintiffs in Pivotal Sexual Harassment Cases*, 23 LAW & SOC. INQUIRY 761, 770–71 (1998) ("[I]n the early days of sexual harassment claims,] litigation was a costly tool... [B]ecause the law was unsettled in the area of sexual harassment, the plaintiffs had trouble finding lawyers willing to take on cases where the odds of winning were dubious. When they finally hired lawyers, they found that their cases went on for years in emotionally draining proceedings where their personal and professional lives were cracked open and subjected to harshly critical scrutiny.").

\(^{182}\) See, e.g., Edenbaum v. Schwarcz-Osztreicherne, 885 A.2d 365, 372, 377–81 (Md. Ct. Spec. App. 2005) (holding that a shareholder-employee’s “termination substantially defeated her reasonable expectations that she would be employed by the corporation, receive a salary, and take part in its management” even though the trial testimony showed evidence of serious misconduct
As a result, the flexibility and unguided discretion proposed by the ALI for trial courts translates into a serious threat to the stability of closely held businesses (many of which are also small businesses). As the South Dakota Supreme Court has explained in rejecting the ALI approach:

Those who operate and manage these [small, corporate] farms and businesses, often the majority shareholders, should not be subject to the demands of minority shareholders whose concern may be solely that of dividends and not the farm or business itself. Many of these small corporations and their management are ill-prepared to invest the time and money required to fend off a minority shareholder suit and are therefore influenced by the mere threat of such litigation.183

It is no answer to assert that closely held businesses and their owner-managers can rely on the discretion of the judiciary. There is no more

by the terminated employee; finding that the majority shareholder had not acted oppressively; but remanding for an inquiry into remedies short of dissolution, including a buy-out; noting that “dissolution itself remains an ultimate remedy should none of the others prove feasible”); Gunderson v. Alliance of Computer Prof’ls, Inc., 628 N.W.2d 173, 192 (Minn. Ct. App. 2001) (interpreting a shareholder agreement drafted at the behest of the plaintiff shareholder that provided for no-cause, involuntary withdrawal of any shareholder and a formula-based buy-out upon withdrawal; holding that the agreement rendered unreasonable the plaintiff’s claim of unfair prejudice relating to the involuntary withdrawal and buy-out, but remanding for a determination as to whether the corporation’s termination of the plaintiff’s employment was somehow “unfairly prejudicial” to the shareholder in his capacity as a shareholder-employee); Pooley v. Mankato Iron & Metal, Inc., 513 N.W.2d 834, 838 (Minn. Ct. App. 1994) (upholding the buy-out of a minority shareholder, without any discount, because the corporation had terminated the shareholder’s employment following his assault on a fellow shareholder and his criminal damage to a customer’s truck); Sawyer v. Curt & Co., Nos. C7-90-2040, C9-90-2041, 1991 WL 65320, at *2-*3 (Minn. Ct. App. Feb. 12, 1991) (upholding a buy-out for a minority shareholder on the grounds of a single incident of unfairly prejudicial conduct, even though the trial court had refused to permit the defendants to offer live testimony at an evidentiary hearing). But see Regan v. Natural Res. Group, Inc., 345 F. Supp. 2d 1000, 1012 n.7 & 1012-13 (D. Minn. 2004) (holding that a terminated shareholder-employee could not have had a reasonable expectation of continued employment in light of “the written agreements that [the shareholder-employer] executed, as well as [his] past conduct,” which included earlier acting as the corporation’s CEO in terminating another shareholder-employee).

183Landstrom v. Shaver, 561 N.W.2d 1, 14 n.16 (S.D. 1997); see also Leslie v. Boston Software Collaborative, Inc., No. 010268BLS, 2002 WL 532605, at *1-*6, (Mass. Super. Ct. Feb. 12, 2002) (involving initially appealing claims of oppression which, upon scrutiny, were revealed as merely disgruntlement over the majority’s legitimate exercise of business judgment).
fundamental doctrine in the law of business entities than the "business judgment rule," and that rule reflects that judiciary's long-standing wisdom that courts are poorly equipped to parse through the complexities and vagaries of business judgment.\textsuperscript{184}

It should be possible to do better than the ALI on this point. The author's suggestion for a more predictable and targeted special rule for closely-held entities appears in subpart VI.C.\textsuperscript{185}

\section*{VI. SPECIAL QUERIES WITH REGARD TO LIMITED LIABILITY COMPANIES}

\subsection*{A. Will the Pivotal Role of the LLC Operating Agreement Change or at Least Confuse the Direct/Derivative Analysis?}

Although an LLC is created by the public filing of a document,\textsuperscript{186} it is "[t]he member's contract—their operating agreement—that is typically the constitution of the enterprise."\textsuperscript{187} The Delaware Supreme Court has characterized the operating agreement as the "cornerstone" of the limited liability company,\textsuperscript{188} and all LLC statutes contemplate the operating agreement (however denominated) as the entity's foundational document \textit{inter se} the members.\textsuperscript{189}

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\textsuperscript{184} Joy v. North, 692 F.2d 880, 886 (2nd Cir. 1982) ("[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge."); 2 BISHOP & KLEINBERGER, supra note 2, ¶ 10.05[1](stating that the rule of judicial deference has a sensible rationale and recognizing "that business decision-making is not an exact science and that a regime of strict liability would chill innovation, deter risk-taking and discourage competent individuals from serving").

\textsuperscript{185} See infra notes 231–238 and accompanying text.

\textsuperscript{186} 1 BISHOP & KLEINBERGER, supra note 2, ¶¶ 5.05[1], 5.05[1][b] (explaining that, under all state LLC statutes, a specified public official must receive and file a "duly executed constitutive document"—typically called the articles of organization—in order to cause an LLC to come into existence).

\textsuperscript{187} Kleinberger, supra note 2, at 842–43.

\textsuperscript{188} See Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999).

\textsuperscript{189} For example, the Uniform Limited Liability Company Act section 203(c)(1) provides that "if any provision of an operating agreement is inconsistent with the articles of organization[,] the operating agreement controls as to managers, members, and members' transferees." 6A U.L.A.
An LLC’s operating agreement is a contract among its members, which creates an opportunity for direct/derivative confusion.\(^{190}\) It is entirely proper and even typical for an operating agreement to prescribe standards of conduct for those who manage the LLC. As a result, manager misconduct that damages the LLC will also be a breach of the contract among the members. In such circumstances, it may be tempting to argue that the direct/derivative distinction is irrelevant, because certainly a person has standing to sue for breach of a contract to which the person is a party. Indeed, “[i]n ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract.”\(^{191}\)

There are two corporate cases that support this view, albeit with meager analysis. The Alaska Supreme Court has held that “a shareholder can sue for breach of [a] contract to which he is a party, even if he has not suffered an injury separate and distinct from that suffered by other shareholders.”\(^{192}\) The Florida Court of Appeals has relied on the Alaska precedent to reach the same conclusion.\(^{193}\)

These cases do not consider the matter in any depth and have not spawned other precedent. More importantly, they are wrongly decided. Neither shareholder agreements nor LLC operating agreements are mere ordinary contracts. Rather, as authorized by their respective entity statutes, they are devices for privately re-ordering the default rules of entity governance provided by those statutes. Such agreements are “private organic rules,”\(^{194}\) and they fit together with the relevant “public organic

\(^{190}\) As for whether the LLC itself is, can or should be a party to the operating agreement, see Kleinberger, *Prism*, supra note 2, at 868–72.


\(^{193}\) See Harrington v. Batchelor, 781 So. 2d 1133, 1134 (Fla. Dist. Ct. App. 2001) (holding that a plaintiff shareholder could sue other shareholders directly for breaching the shareholder agreement among them, which called for using best efforts to promptly sell the corporation, because the plaintiff was a party to the shareholder agreement contract, even though she did not suffer an injury “separate and distinct” from the other shareholders).

\(^{194}\) The phrase is taken from the MODEL ENTITY TRANSACTIONS ACT (META) § 102(30) (2005), available at http://www.law.upenn.edu/bl/ulc/ue/2005OctMETAfinal.pdf, which defines the term to mean “the rules, whether or not in a record, that govern the internal affairs of an entity, are binding on all of its interest holders, and are not part of its public organic document, if any.”

580 (2003). *See generally* I BISHOP & KLIENBERGER, *supra* note 2, ¶¶ 5.06[1][b], 5.06[2][a] (explaining that operating agreements “govern[] the members’ relationships to each other and to the limited liability company” and describing the governance authority granted by state LLC statutes to operating agreements).
document”195 and “organic law”196 to govern the entity as well as its owners.

Case law involving limited partnerships expresses the correct approach for relating the direct/derivative distinction to contracts comprising organic rules. The approach is simple and should apply as well to LLCs: an agreement among an entity’s owners as to the structure, manner or conduct of entity governance does not eliminate the direct/derivative issue.

For example, in Golden Tee, Inc. v. Venture Golf Schools, Inc., a limited partner attempted a direct action for breach of the limited partnership agreement, naming as defendants the general partner and another limited partner.197 The plaintiff alleged that the defendant general partner had allowed the defendant limited partner to control the partnership in breach of the partnership agreement.198 For injury, the plaintiff alleged loss of its capital contribution and future profits.199 However, that injury resulted from injury to the limited partnership; the plaintiff might have been able to show breach but could not have shown direct harm.200 As a result, the Arkansas Supreme Court rejected the direct claim.201

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196 An entity’s organic law comprises “the statutes, if any,... governing the internal affairs of an entity.” Id. § 102(26).

197 969 S.W.2d 625, 629-31 (Ark. 1998) (“Actions for breach of the partnership agreement may be brought as individual actions or partnership actions, depending on which entity or party is primarily injured. Analogizing to corporate law, if the injuries alleged were those for which relief should have been granted to the Golf Partnership, and not to an individual partner, then derivative action should be the appropriate route for relief.”) (citations omitted); see also Contra City P’ship Co. v. Jones Intercable, Inc., 213 F.R.D. 576, 580, 591 (D. Colo. 2002) (holding that limited partners could bring a direct claim against a general partner who had allegedly breached the partnership agreement by using misleading information to try to gain the limited partners’ approval for a sale of partnership assets to the general partner; stating that “it is difficult to understand how the state law breach of contract claim may be brought derivatively since the limited partners are parties to the Partnership Agreements, but the Partnerships are not”). Note that a disclosure claim may well be a direct claim in any event. See supra notes 125–132; see also TIFD III-X LLC v. Fruehauf Prod. Co., L.L.C., 883 A.2d 854, 859–60 (Del. Ch. 2004) (“The fact that only [the partners], and not the Partnership itself, are the parties to the Partnership Agreement does not transform any breach of the Agreement by one party into a direct harm to the other...”).

198 Golden Tee, 969 S.W.2d at 629.

199 Id.

200 Id. at 629–30.

201 Id. at 630.
A direct claim is proper when the breach of contract directly causes injury. For example, if a limited partnership agreement promises a particular percentage of distributions to a particular limited partner and without excuse the general partner fails to distribute that percentage to that limited partner, the limited partner rather than the partnership suffers injury and the partner has a direct claim.\(^\text{202}\)

The result is different, however, when a partner's profit percentage falls as a result of damage to the enterprise. *TIFD III-X LLC v. Fruehauf Production Co., L.L.C.* illustrates this point.\(^\text{203}\) The case concerned a general partner's claim that a limited partner had breached the partnership agreement by taking part in the partnership's operations, causing the partnership to reap a smaller amount of profits than it otherwise would have, and keeping the partnership from reaching the economic marker at which the general partner's share of profits would have risen from one percent to twenty-five percent.\(^\text{204}\) The court held that the claim could not be brought directly despite the general partner's status as a signatory of the partnership agreement.\(^\text{205}\)

The ULPA (2001) codifies the case law rule.\(^\text{206}\) Section 1001(b) provides: "A partner commencing a direct action under this section [which covers direct actions by partners] is required to plead and prove an actual or

\(^\text{202}\) See *In re* Cencom Cable Income Partners, L.P., No. C.A. 14634, 2000 WL 130629, at *2-*4 (Del. Ch. Jan. 27, 2000); see also infra note 205 and accompanying text.

\(^\text{203}\) 883 A.2d 854 (Del. Ch. 2004).

\(^\text{204}\) Id. at 857.

\(^\text{205}\) Id. at *4; see *In re* Cencom Cable, 2000 WL 130629, at *2-*4 (holding a claim by a class of all the limited partners against the general partner for breaching the partnership agreement by "improperly terminat[ing] the limited partners' priority cash distributions" could be brought directly because the limited partners alone suffered the resulting injury; stating that the defendant partner's breach of the partnership agreement by "not valuing the assets on a 'going concern' basis" appeared to be a derivative injury because the resulting devaluation harmed the plaintiffs only indirectly; ruling that, due to the special circumstances in the case (the partnership was dissolved and the limited partners were in an adversarial relationship with the general partner), insisting on the direct/derivative distinction made no sense); see also Mieuli v. DeBartolo, No. C-00-3225 JCS, 2001 WL 777091, at *3, *15-*16 (N.D. Cal. May 7, 2001) (holding that a limited partner could not directly sue a de facto general partner for allegedly breaching the partnership agreement by taking money from the partnership to pay himself and benefit other entities he owned without the plaintiff's consent because the injury claimed was a drain on partnership funds: "Here, the injury alleged as a result of Defendant's breach of the Partnership Agreement, to the extent this claim is based on alleged mismanagement, conversion and self-dealing, is directly to the partnership. It is the Partnership that will be entitled to relief if Plaintiff's claim is proven.").

threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited partnership." 207 A comment to the section explains that agreements among an entity’s owners are not “ordinary contractual situations” and that “[w]ithin a limited partnership . . . different circumstances may exist.” 208 The comment states pointedly that “[a] partner does not have a direct claim against another partner merely because the other partner has breached the partnership agreement.” 209 There is no reasonable basis for reaching a different conclusion for limited liability companies. 210

207 Id.
208 Id. cmt. (b).
209 Id.
210 Indeed, the current draft of the Revised Uniform Limited Liability Company Act takes precisely the same approach. See infra notes 297–301; see also Excimer Assocs., Inc. v. LCA Vision, Inc., 292 F.3d 134, 139–40 (2d Cir. 2002) (analyzing whether a member of an LLC had a direct claim against another for allegedly breaching the operating agreement, by failing to make required contributions to the LLC; examining whether the plaintiff member was directly injured “independent of any injury [the LLC] may have suffered,” not whether the plaintiff was a party to the operating agreement; concluding that the case should be remanded to allow the plaintiff to “plead its claims of a direct injury with greater particularity”); In re Tri-River Trading LLC, 317 B.R. 65, 72 (Bankr. E.D. Mo. 2004) (holding that a member of an LLC could not recover damages when the other member breached the operating agreement by failing to purchase freight only through the LLC, because the member could not prove the breach had caused her an injury; allowing the LLC (which it apparently considered a third-party beneficiary to the contract) to recover damages, because it had suffered the direct injury of incurring $800,000 in damages “due to the unwinding of contracts”); Metro Commc’ns Corp. BVI v. Advanced Mobilecomm Techs., Inc., 854 A.2d 121, 168 (Del. Ch. 2004) (rejecting the plaintiff’s claim that the defendants’ alleged mismanagement of an LLC gave rise to a direct claim and explaining: “Metro’s contention that this claim is a direct one because it seeks contractual ‘expectation damages’ arising from Metro’s initial decision to enter into the LLC Agreement cannot be accepted. If it were, then every equity investor would be able to transform derivative claims alleging harm to the business into direct claims merely by casting them as contractual claims based on the original agreement by which the investor purchased its equity interest”). For another approach that would end-run the direct/derivative distinction, see Diaz v. Fernandez, 910 P.2d 96, 97 (Colo. Ct. App. 1995). Diaz held that members of an LLC may seek appointment of a receiver on grounds of mismanagement. Id. The court reasoned that a member’s interest in the LLC is personal property and cited a state rule allowing appointment of a receiver to protect a moving party’s interest in property. Id. (citation omitted). This case has not been followed; a KeyCite search, conducted November 24, 2005 3:14 PM, showed a number of commentaries but no cases. See also 2 Bishop & Kleinberger, supra note 2, ¶ 10.01[2][b][i] (stating that “[s]ome LLC statutes and many operating agreements give members the direct right to remove a manager on grounds of bad performance”).
B. Will Claims Asserting Oppression Provide an End-Run Around the Direct/Derivative Distinction?

Like most close corporations, most limited liability companies face the "lock in" problem and the corresponding susceptibility of minority owners to oppression by those in control.\(^{211}\) LLC case law is already following close corporation law; the question for present purposes is whether (and, if so, how) the corporate law and developing LLC law adjust the direct/derivative distinction in the context of claims of oppression.\(^{212}\)

In many instances, no adjustment is necessary. If those in control directly attack the minority's rights or expectations, the resulting claim is unquestionably direct. For example, in *Ayres v. AG Processing, Inc.*, the minority members of an LLC alleged that they were "terminat[ed] ... as managers, employees and members" after complaining about the defendants' management actions.\(^{213}\) Even while using the special injury rule, the court had no difficulty recognizing the claim as direct:

> Because Plaintiffs have alleged that Defendants' actions resulted in damages in the form of a loss to their equity ownership in AEP LLC and a decrease in financial benefits to them, the Court finds that Plaintiffs have alleged an injury separate and distinct from that suffered by other members of the LLC.\(^{214}\)

Adjustment is also unnecessary when a minority member or shareholder oppression claim is really a claim about mismanagement. The plaintiff will not have standing for a direct suit unless the relevant jurisdiction has adopted the ALI approach to the direct/derivative distinction.\(^{215}\)

Sometimes permitting a direct claim involves framing the conduct of the majority so as to establish a direct or special injury. For example, in


\(^{212}\) See generally Miller, *supra* note 211, at 1630–31 (noting that courts have been willing to apply close corporation (and partnership) precedents to "police the more obvious patterns of opportunistic conduct" in LLCs); 2 BISHOP & KLEINBERGER, *supra* note 2, ¶ 10.09.


\(^{214}\) *Id.* at 1209.

\(^{215}\) *See supra* note 176 and accompanying text.
Murphy v. Country House, Inc., the court allowed a plaintiff shareholder to bring a direct claim against the corporation for paying other shareholders (who were employees) what the corporation called "bonuses." The plaintiff had terminated his employment with the corporation and received no bonuses and no dividends. The court might have viewed the complaint as alleging corporate waste due to excessive bonuses. If so, the claim would have been derivative. Instead, the court held that, although the corporation "neither classified the payments as dividends nor distributed the monies ratably according to each shareholder's interest, it effectively paid dividends to some of its shareholders during its years of surplus profits" and that it must therefore give the plaintiff his pro-rata share of the dividends paid others.

C. Will the Direct/Derivative Distinction Protect Oppressors Who Injure the Entity with "the Purpose and Effect" of Injuring a Minority Owner?

Matters are more complex when those in control target the entity for the purpose and effect of injuring an owner. In an ALI jurisdiction, a court will have no difficulty allowing a direct claim. For example, the plaintiff in Durham v. Durham alleged a mixed bag of claims—mismanagement, exclusion from management, and misuse of corporate resources for personal enjoyment by those in control. The exclusion might well have been a direct claim under a traditional analysis, but not the claims of mismanagement and misuse. By adopting a modified version of the ALI

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217 Id. at 291.
218 Id. at 293.
219 Bishop & Kleinberger, supra note 2, ¶ 10.05[2] n.196.5 (stating that "in closely held businesses, majority owners often use usurpation as a method of oppressing minority owners"); see, e.g., Marcuccili v. Ken Corp., 766 N.E.2d 444, 450–51, 453 (Ind. Ct. App. 2002) (holding that a trust that was a minority shareholder in two close corporations could not bring direct claims against majority shareholders for not disclosing the true terms of sale of a parcel of land belonging to one corporation (thus denying the trust compensation of approximately $500,000) and taking personal loans at below-market interest rate from the other corporation; following the dismissal recommendation of an SLC, which had found that the majority shareholders had breached fiduciary duties but had nonetheless determined that the corporations' best interests would be served by not pursuing litigation).
220 See supra note 176 and accompanying text.
221 871 A.2d 41, 43 (N.H. 2005). The misuse involved those in control, their family, and their friends, having access at below-market rates or for free to cabins owned by the corporation. Id.
rule, the New Hampshire Supreme Court granted the trial court discretion to
determine whether the plaintiff could proceed directly on all his substantive
claims.\textsuperscript{222}

Courts that use the special injury approach should also have little
difficulty handling purpose and effect situations. Almost by definition,
such situations target for injury one or at most a few owners. Because the
special injury rule ignores the direct harm aspect of standing, damaging the
entity to get at the true victim does not undermine the victim's standing.\textsuperscript{223}

This point can be illustrated nicely with two Delaware Chancery Court
cases, both decided before Delaware abandoned the special injury rule.\textsuperscript{224}
In \textit{Boyer v. Wilmington Materials, Inc.}, the court allowed the plaintiff
shareholder to bring a direct claim based on a special injury when the other
shareholders had sold the corporation's assets in order to eliminate the
plaintiff and another shareholder from continuing participation in the
business.\textsuperscript{225} In \textit{Fischer v. Fischer}, the court permitted a direct claim upon
allegations that the defendants had sold corporate real estate at an unfairly
low price to another entity that they owned and had then dissolved the
corporation, all for the purpose of targeting the plaintiff.\textsuperscript{226} Although the
pivotal misconduct inflicted an injury on the corporation, the plaintiff
nonetheless alleged a special injury not suffered by the other
shareholders.\textsuperscript{227}

In a direct harm jurisdiction, plaintiffs face more significant barriers to
purpose and effect claims. Neither \textit{Boyer} nor \textit{Fischer} would satisfy the
direct harm analysis, nor, for example, would the following scenario: The
controlling shareholder "1) paid excessive salaries to himself and other
family members; 2) used corporate employees to perform services for him
and other family members without proper compensation to the company; 3)
dramatically lowered dividend payments [which prejudiced only the
minority shareholder]; and 4) appropriated company funds for personal
investments."\textsuperscript{228}

\textsuperscript{222} \textit{Id.} at 46. The court dismissed as moot a claim for information. \textit{Id.} at 47.

\textsuperscript{223} See \textit{supra} note 104 and accompanying text.

\textsuperscript{224} For a discussion of Delaware's approach to the direct/derivative distinction, see \textit{supra}
notes 102-106, 144-147 and accompanying text.

\textsuperscript{225} 754 A.2d 881, 903 (Del. Ch. 1999).

\textsuperscript{226} No. C.A. 16864, 1999 WL 1032768, at *1, *3 (Del. Ch. Nov. 4, 1999).

\textsuperscript{227} \textit{Id.}

659 N.E.2d 559 (Ind.1995)). \textit{Barth} invoked the ALI rule and remanded to the trial court. 659
Nor does the direct harm analysis work when minority members of an LLC lose the value of their investments because the controlling members transfer the LLC's assets for no compensation to other entities owned by the controlling members. Nor does the analysis work when the controlling member in a two member LLC uses LLC funds to buy property for his own account.

Earlier in this Article, I argued that the ALI rule is too blunt (or indeterminate) an instrument to provide a useful exception to the direct/derivative distinction. Some years ago, I urged the following purpose and effect exception as a substitute for the ALI approach:

The better rule is to allow transmutation [of a derivative claim into a direct claim]... when the derivative harm has occurred with the purpose and effect of causing an injury targeted at the minority shareholder. The effect requirement precludes claims based on mere allegation of
evil intent. The purpose requirement precludes claims that reflect mere differences in business judgment . . .232

Today, I propose the “purpose and effect” approach as a limiting clarification to the ALI rule. Such a gloss would provide substantial guidance to courts and go far to resolve the “re-make the deal” dangers inherent in the ALI rule.233

Careful pleading requirements would limit the “strike suit” dangers.234 That is, pleadings seeking an exception to the direct/derivative distinction should allege, with particularity:

(i) breaches of the duty of loyalty by the defendants;235

(ii) how the alleged harm to the entity has had the targeted effect of injuring only the plaintiffs and none of the defendants; and

(iii) that not only are all of the owners of the entity parties to the litigation236 but also that each is either a targeted victim of the misconduct or part of the “control group” committing, sanctioning, or benefiting from the misconduct.237

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232 Kleinberger & Bergmanis, supra note 21, at 1271. For a brief and shining moment one court seemed interested in this approach. See Wessin v. Archives Corp., 581 N.W.2d 380, 390–91 (Minn. Ct. App. 1998), rev’d, 592 N.W.2d 460 (Minn. 1999). However, a higher court had other ideas. See generally Wessin v. Archives Corp., 592 N.W.2d 460 (Minn. 1999).

233 For a discussion of these dangers, see supra note 67 and Part II.D.

234 For a discussion of these dangers, see supra notes 43, 67.

235 A purpose and effect case is necessarily a case about oppression, which is intentional misconduct. Breaches of the duty of care simply do not qualify. Moreover, permitting breach of care claims in this context would open the door wide to mere mismanagement claims, thereby resurrecting the “re-make the deal” problem.

236 This requirement is consonant with the ALI’s concern with multiplicity of suits. See supra Part V.

237 The concept of a controlling group is taken from the seminal close corporation case of Donahue v. Rodd Electrotypc Co. of New England, 328 N.E.2d 505, 518 (Mass. 1975). Donahue is instructive in this context because the case’s controlling group concept aligned all the shareholders as either part of the problem or part of the desired solution. See id. Of course, not all disputes within a closely held entity will fit this alignment. E.g., Barth v. Barth, 693 N.E.2d 954, 958–59 (Ind. Ct. App. 1998) (affirming the trial court’s refusal to allow the plaintiff to proceed directly in a case involving a three-shareholder corporation, in part because “there was a third shareholder who had not been joined or intervened in the minority shareholder’s action, giving
In addition, because the decision to allow a derivative claim to proceed directly so substantially changes the litigation dynamics and the litigants' balance of power, the decision should not be made solely on the pleadings. Instead, courts should borrow from their jurisprudence of temporarily injunctions, take evidence (typically, but not necessarily solely, by affidavit), and determine as a preliminary matter whether the facts support the allegations. This preliminary determination would (i) permit defendants to respond with minimum expense to strike suits, while (ii) allowing the court to encourage early settlement of cases where the defendants have actually despoiled the entity with the purpose and effect of targeting one or more minority owners.

rise to the possibility of multiple actions based on the same allegations, and interference with distribution of the damages").

238 Compare the Delaware rule to making the "demand excused" determination. See supra Part III.B.

239 11A CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 2949 (Supp. 2005) ("Evidence that goes beyond the unverified allegations of the pleadings and motion papers must be presented to support or oppose a motion for a preliminary injunction. Affidavits are appropriate on a preliminary injunction motion and typically will be offered by both parties.") (footnotes omitted); Ashcroft v. Am. Civil Liberties Union, 542 U.S. 656, 660, 666 (2004) (holding that a court considering whether to grant a preliminary injunction must determine "whether the plaintiffs have demonstrated that they are likely to prevail on the merits"; affirming the plaintiffs' preliminary injunction against enforcement of the Child Online Protection Act because the government had not presented evidence rebutting the plaintiffs' assertion that there were less restrictive alternative ways to achieve the government's goal of protecting children from Internet pornography); Goodman v. Illinois Dept. of Financial and Professional Regulation, 430 F.3d 432, 438 (7th Cir. 2005) (applying Illinois law; denying temporary injunction requested by chiropractor because in the preliminary hearing on the injunction issue he had presented no evidence supporting his claims that the telemarketing calls he wanted to make were protected speech and would not harm susceptible individuals); Town of Brookline v. Goldstein, 447 N.E.2d 641, 645–46 (Mass. 1983) (holding that town officials should be granted a preliminary injunction preventing a citizen from continuing his allegedly harassing telephone calls; noting that the town's submitted affidavits contained specific allegations supported by facts, while the citizen’s affidavits lacked facts backing up his denials; remanding the case to a lower court with instructions to issue the injunction).
D. Will Claims Seeking Judicial Dissolution Provide an End-Run Around the Direct/Derivative Distinction?  

To anyone schooled in the law of close corporations, this query may seem redundant of the oppression query. In many jurisdictions, courts developed protections against close-corporation oppression under the aegis of statutes permitting judicially-ordered dissolution.  

That development is certainly possible for LLCs, but many LLC statutes have another provision worth contemplating—the “not reasonably practicable” standard.  

240 An action for an accounting, independent of any dissolution, may also raise end-run issues. I seek to address those issues and others related to LLCs and accounting in Kleinberger, Accounting, supra note 159.  


242 Indeed, ULLCA section 801(4)(v) authorizes a court to decree dissolution “on application by a member or a dissociated member” if the court determines inter alia that “the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner.” UNIF. LTD. LIAB. Co. ACT § 801(4)(v) (rev. 1996), 6A U.L.A. 619–20 (2003). The current version of the Revised Uniform Limited Liability Companies Act includes a comparable provision. See infra notes 297–301. Michigan law authorizes the court to “issue an order or grant relief as it considers appropriate” if it determines “that acts of the managers or members in control of the limited liability company are illegal, fraudulent or constitute willfully unfair and oppressive conduct [to] the limited liability company or [to] the member.” MICH. COMP. LAWS ANN. § 450.4515 (West 2005). The statute provides a non-exclusive list of remedies that includes:  

(a) The dissolution and liquidation of the assets and business of the limited liability company.  

(b) The cancellation or alteration of a provision in the articles of organization or in an operating agreement.  

(c) The direction, alteration, or prohibition of an act of the limited liability company, or of members, managers, or other persons party to the action.  

(d) The purchase at fair value of the member’s interest in the limited liability company, either by the company or by the managers or other members responsible for the wrongful acts.  

Id; see also Gottier’s Furniture, LLC v. LaPointe, No. CV040084606, 2004 Conn. Super. LEXIS 3767 (Dec. 21, 2004) (holding that one member of a three-member LLC would not fairly represent the LLC, and, therefore, could not bring a derivative suit claiming managerial misconduct by another member, remitting the plaintiff to a claim for dissolution; referring to the power of the superior court to decree dissolution “if one or more of the members or managers of the limited
That standard derives essentially verbatim from the Revised Uniform Limited Partnership Act (1976/1985), which authorizes a court to decree dissolution of a limited partnership “whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.”243 By its terms, the action is direct, rather than derivative, and many (perhaps most) LLC statutes incorporate the RULPA language.244

To date, there is scant case law under the LLC version of “not reasonably practicable.” Virtually all available cases (whether or not officially reported) pertain to RULPA, and they involve acrimony rather than oppression. Nonetheless, it is possible for the “not reasonably practicable” standard to provide relief to a member who alleges unfair treatment and thereby moot the question of direct versus derivative harm.

The very un-Delaware case of Haley v. Talcott provides the first reported example.245 In Haley, the Delaware Court of Chancery analogized a two-member LLC to a two-shareholder corporation, and held it was no longer “reasonably practicable” to carry on the business of an LLC owning land on which a restaurant was built.246 The two fifty-percent owners had become deadlocked in their management decisions after one member fired the other from the operating business (a restaurant).247 The LLC’s operating agreement contained an agreed-upon exit mechanism, which should have defeated the discontented member’s “not reasonably practicable claim”—that is, applying the agreed upon exit mechanism should have been per se in conformity with the operating agreement.248 The Chancery Court determined to the contrary, however, deeming the agreed-
upon exit mechanism actionably inadequate because the exiting member would remain personally liable for the mortgage debt of the LLC. 249

In some respects, the Haley decision is shocking. 250 The case disregards the party’s deal, even though the Delaware LLC statute proclaims: “It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” 251 Equally surprising, the case imports a provision of the Delaware corporate code into a statute whose framers consider it the preeminent unincorporated business entity statute in the country. 252

However, the decision contains no auguries for the direct/derivative doctrine. The Haley plaintiff had suffered both direct harm and a special injury. 253 He had been fired from the operating business that, as a business matter, was inextricably linked to the LLC in which he and the person who fired him were the only members. 254

In sum, neither dissolution on account of oppression nor dissolution under the “not reasonably practicable standard” are likely to alter materially the direct/derivative analysis for LLCs.

E. In Federal Court, Might the Concerns of Diversity Jurisdiction Skew the Direct/Derivative Analysis?

LLC derivative cases do not belong in federal court. The entity is an indispensable party to a derivative suit, and, because an LLC has the citizenship of each of its members, a derivative suit necessarily lacks diversity. 255 However, in a case in which all the members are diverse, a

249 Id. at 88.
250 Id. at 93–94 (explaining that, when the two members of a Delaware LLC are deadlocked, “Case Law Under § 273 Of The Delaware General Corporate Law (“DGCL”) Provides An Appropriate Framework For Analysis”).
251 DEL. CODE ANN. tit. 6, § 18-1101(b) (2005).
252 See Haley, 864 A.2d at 93–97 (stating that case law decided under DEL. CODE ANN. tit. 8, § 273 should be used to interpret DEL. CODE ANN. tit. 6, § 18-802). For an analysis of the preeminence of Delaware’s LLC Act, see 2 BISHOP & KLEINBERGER, supra note 2, ¶14.01[2].
253 Haley, 864 A.2d at 91.
254 See id.
255 See Gen. Tech. Applications, Inc. v. Exro Ltda, 388 F.3d 114, 120 (4th Cir. 2004) (“In a derivative action, where there are three parties conceptually presented as ‘A’ v. ‘B’ v. ‘C,’ the parties must be aligned for diversity purposes. Generally, the represented entity (i.e., the entity on whose behalf the suit is initiated—‘B’)...is aligned as a defendant. But [the entity] can be realigned as a plaintiff under certain circumstances. In either case diversity jurisdiction does not
court might be tempted to disregard the direct/derivative distinction in order to preserve diversity. After all, “all the real parties are here,” and characterizing a derivative claim as *inter se* the owners (rather than as involving the rights of the LLC) could prevent remand to the state courts.

Although this attitude is reminiscent of Justice O’Connor’s dissent in *Carden v. Arkoma Associates*, a few lower courts have indeed “gone there” or at least flirted with the concept. The principal example is *HB General Corp. v. Manchester Partners, L.P.*, in which the Third Circuit held that a limited partnership was not an indispensable party in a suit among the partners. The court’s rationale included a concept of collateral estoppel, which rested on a Connor-like notion that the real parties in interest are all here: “[T]he Partnership, like a marionette, cannot make a move unless some human being pulls the strings. And all the people who, under the Partnership Agreement, have the power to cause the Partnership to bring suit ... are before the court.”

A more recent example is *Simon v. Mann*, decided in 2005 by the federal district court in Nevada. Expressly in order to preserve federal jurisdiction, the court held that Nevada law would allow a close corporation exception to the direct/derivative distinction. The court relied both on the ALI approach and on a version of the duty owed notion. As to the latter, the court stated:

> [T]he special duties owed to minority shareholders in closely-held corporations provide a more traditional means of obtaining individual relief. “It is well settled that an individual cause of action can be asserted when the wrong


256 494 US 185, 198 (1990). Although *Carden* involved a limited partnership, the case put “the handwriting on the wall” for limited liability companies and diversity jurisdiction. 1 BISHOP & KLEINBERGER, *supra* note 2, ¶ 1.03[3][a]–[b].

257 95 F.3d 1185, 1198–99 (3d Cir. 1996).

258 *Id.* at 1191.


260 *Id.* at 1199–1200.

261 See discussion *supra* notes 177–185.

262 *Simon*, 373 F. Supp. 2d at 1200.
is both to the stockholder as an individual and to the corporation.” Far West Fed. Bank, S.B. v. Office of Thrift Supervision-Dir., 119 F.3d 1358, 1364 (9th Cir.1997). Here, in addition to the individual wrong alleged by Plaintiff Donald Simon in having his director's fees terminated by Defendant, all Plaintiffs have alleged the wrong of breach of fiduciary duties to minority shareholders. An Oregon court allowed a direct action in similar circumstances. Noakes v. Schoenborn, 116 Or. App. 464, 471-72, 841 P.2d 682, 686-87 (1992). The court in Noakes noted the special fiduciary duties owed to minority shareholders by majority shareholders in closely-held corporations and found that a breach of those duties, such as “attempts to eliminate minority shareholders from the enterprise or deprive them of their proportionate powers and rights without a just equivalent,” constituted the kind of individual injury which allowed a shareholder to bring a direct suit.263

Judge Posner has mused in the direction of an even broader exception.264 In Lefkovitz v. Wagner, a case involving a general partnership, he wrote:

[A]lthough the corporation or other entity on whose behalf a suit is brought, being the owner of the claim sued upon, normally is an indispensable party, this observation is inapplicable to a suit such as the present one in which the partner (or shareholder) is allowed to sue in an individual rather than representative capacity. The next step, which however we [previously] declined to take... would be to allow a derivative suit to be brought instead as an individual suit whenever the corporation (the usual entity on behalf of which a derivative suit is brought) is closely held, at least where, as in this case (were Jarnis [the general partnership sub judice] a corporation), all the shareholders

263 Id.
264 See generally Lefkovitz v. Wagner, 395 F.3d 773 (7th Cir. 2005).
are before the court, so that there are no merely represented shareholders.265

A similar motivation may have been at work in another Seventh Circuit case, Weinstein v. Schwartz, in which the court determined that the plaintiff's claim was direct rather than derivative.266 The plaintiff shareholder sought a declaratory judgment that two other shareholders had previously sold their shares in the corporation and therefore could not vote on the proposed sale to a third party of a piece of corporate real estate the plaintiff was renting in his individual capacity.267 Correctly applying Tooley,268 the court held that the plaintiff's claim was direct because the plaintiff: (i) stood to gain directly from a decision in his favor (as he would then have the power to block the sale); and (ii) would suffer directly from an adverse decision (as he would lose possession of the horse farm he was renting from the corporation).269

The court's direct/derivative determination meant that the corporation could be dismissed from the lawsuit, which preserved complete diversity.270 A panel of the Second Circuit likewise avoided a remand in Excimer Assocs., Inc. v. LCA Vision, Inc., by determining that an LLC member’s failure to make a promised contribution to the LLC gave rise to a direct claim by another member who felt compelled to make up the shortfall.271

These cases are interesting, but they are not a trend, at least for the moment. Judge Posner's musings did not overrule Frank v. Hadesman & Frank, Inc., which a decade before rejected a close corporation

265 Id. at 777 (citations omitted).
266 See 422 F.3d 476, 477-78 (7th Cir.) (applying Delaware law), cert. denied, 126 S.Ct. 133 (2005).
267 Id. at 476-77.
268 For an explanation of the Delaware court's decision in Tooley, see supra note 144.
269 See Weinstein, 422 F.3d at 478.
270 See id.
271 See 292 F.3d 134, 139-40 (2d Cir. 2002). For a detailed discussion of this case, see infra notes 285-288. See also Matz v. Bennion, 961 S.W.2d 445, 454 (Tex. App.– Houston [1st Dist.] 1997, pet. denied) (concluding that the Texas statute governing dissolution of partnerships did not require the partnership to be a party to such an action as long as all the partners were present: “Inasmuch as all the beneficial owners of the partnerships were before the court, it had jurisdiction to judicially dissolve the partnerships and appoint a receiver to sell the assets” and holding that the lower court had jurisdiction to dissolve a partnership in a proceeding to enforce an exchange of property ordered in arbitration even though the partnership was not a party because both of the partners and the assignee of one of their interests were parties to the action).
exception, and *HB General Corp.* has not been followed. Weinstein and *Exicmer* are correct on the merits, and *Simon* involved not only facially direct claims but also a situation in which the purpose and effect of the injury to the entity was to inflict injury on the minority shareholders. There is, therefore, no substantial reason to believe that federal diversity concerns will distort the direct/derivative analysis for limited liability companies.

**F. Has the LLC’s Partnership Heritage Liberated Courts to Find a New Kind of Direct Injury?**

In this context, “partnership heritage” means viewing the LLC primarily as the result of an agreement among its members and not primarily as a free-standing entity. From this perspective, one member’s breach of an agreed duty occasions an inquiry into the consequential damages suffered by the other members and the efforts those other members might make to avoid or mitigate those damages. Put practically—notwithstanding legal fictions of juridical entities as separate persons—if one member defaults, another may have to step in and, in doing so, may suffer direct injury.

Partnership cases recognize this practical reality and allow partners who have stepped in to bring direct claims against those who wrongfully stepped

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272 83 F.3d 158, 161–62 (7th Cir. 1996) (citing policy concerns and also noting that the 7th Circuit, as a federal court, could not change applicable state law).

273 To the contrary, LLC cases view the LLC as an indispensable party. *See, e.g., Weber v. King,* 110 F. Supp. 2d 124, 128 (E.D.N.Y. 2000) (holding, in a lawsuit among an LLC’s three feuding members, that the LLC was a necessary and indispensable party, even though all of its members were involved in the lawsuit: “Plaintiffs cannot argue that the presence of all members of the Company before the Court is sufficient to protect the interests of the Company. Under New York’s Limited Liability Company Law (N.Y.LLCL), an LLC is a ‘separate legal entity.’ . . . [I]t has rights and obligations which are separate and distinct from those of its members. It follows that the Company’s interests may also be distinct from those of its members.”) (citations omitted); *Trademark Retail, Inc. v. Apple Glen Investors, LP,* 196 F.R.D. 535, 541–42 (N.D. Ind. 2000) (involving a claim by one member of a two member LLC that the other member had unreasonably refused to lease space in the LLC’s shopping mall so that one of the other member’s investors could lure tenants away to his own commercial space; holding that the LLC was a necessary and indispensable party, necessitating the dismissal of the suit for lack of diversity; stating that it was insufficient simply to have both LLC members involved in the lawsuit, because LLCs are considered separate legal entities, with the right to sue in their own names and with rights and obligations distinct from those of its members, and because here the LLC’s separate interests were threatened by the defendant’s behavior and needed to be protected).

274 For a discussion of the proposed purpose and effect test, see *supra* Part VI.C.

out. For example, the court in *Hansford v. Maplewood Station Business Park* permitted plaintiff partners to recover funds they had to advance when the defendant partner refused to contribute to cover the partnership’s development costs and pay off a partnership bank note.\(^\text{276}\) The partnership dissolved, and the appellate court held that the trial court “properly ordered the partnership property applied to discharge the partnership’s liabilities and [the defendant partner’s] debt to the remaining partners, which consisted of their contributions to cover his obligations to the partnership.”\(^\text{277}\)

*Canton West Associates v. Miller* reflects the same approach.\(^\text{278}\) After one partner failed to make $142,000 in capital contributions required under the partnership agreement, the other partners dissolved the partnership, reformed it without the defaulting partner, and contributed more capital to pay down the partnership’s debt.\(^\text{279}\) Those partners then sought payment from the defaulting partner.\(^\text{280}\) The court agreed with the plaintiffs, noting that: (i) the original partnership agreement “clearly imposed” the obligation to pay capital contributions equal to those paid by the other partners; and (ii) that the applicable Connecticut statute gave partners the right to claim damages from a partner who caused dissolution in breach of the partnership agreement.\(^\text{281}\)

Both *Hansford* and *Canton West Associates* involved claims pressed post-dissolution and relied on statutes calling for the settling of accounts *inter se* the partners during winding up.\(^\text{282}\) The dissolution of the partnership may have helped the courts see one partner’s nonperformance as the direct cause of another partner’s loss.

But dissolution does not eliminate the separate legal person (whether a partnership or an LLC),\(^\text{283}\) and dissolution *vel non* should not be


\(^{277}\) Id. at 351 (relying on a Uniform Partnership Act provision permitting partners to recover against co-partners who have wrongfully caused dissolution).


\(^{279}\) Id. at 1361–62.

\(^{280}\) Id. at 1362.

\(^{281}\) Id. at 1363.

\(^{282}\) *Hansford*, 621 N.E.2d at 349, 356 (citing Ind. Code § 23-4-1-40); *Canton W. Assocs.*, 688 A.2d at 1363 (citing Conn. Gen. Stat. § 34-76(2)(a)). Both of these statutes are part of the original Uniform Partnership Act § 38 (1914).

determinative. In 2002, a panel of the Second Circuit made a *Hansford*-
and *Canton West Associates*-like analysis in the context of LLCs and
without reference to dissolution statutes. One member of a two-member
LLC failed to make promised contributions, and the other member sued
asserting a direct claim. In the district court, the judge read the complaint
as asserting a claim belonging to the LLC:

In its complaint, LCA [the plaintiff member of Excimer
LLC] does not seek to recover the additional contributions
it claims it made to Excimer due to the P.C.’s [the other
member’s] alleged breach of its agreement to make capital
and other contributions. Rather, LCA seeks to recover the
money it claims the P.C. failed to contribute to
Excimer... The injury for which LCA seeks recompense
is neither direct nor independent of Excimer.

The Second Circuit reversed, having read the plaintiffs complaint in a
kinder, gentler way:

The last paragraph of Count One states that “[LCA] has
been damaged by the refusal of [PC] to pay the amount

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allege that defendants’ Detrimental Acts reduced the value of the partnerships’ assets, and
consequently injured I-Enterprise. Such a claim would be a derivative claim, as the injury to I-
Enterprise would be incidental to the injury to the assets of the partnerships. Rather, I-Enterprise
now seeks to recover damages for defendants’ alleged failure to provide contractually-owed notice
of their wrongdoing to I-Enterprise, which prevented it from taking actions to protect its own
interests by (a) withholding further capital contributions; (b) selling its limited partnership interest
in Fund V or VI; (c) seeking judicial dissolution of the Partnerships; or (d) obtaining a vote of
two-thirds in interest of the limited partners to terminate the Partnerships. As noted in the
December 15 Order, a claim for failure to provide notice to the limited partners is a direct claim.”)
(citations omitted).

285 See *Excimer Assocs., Inc. v. LCA Vision, Inc.*, 292 F.3d 134, 139–40 (2d Cir. 2002).

286 *Id.* at 136–37.

demanded of it, by having lost the additional amounts contributed by [LCA] to Excimer.” Thus, the district court’s statement that “LCA does not seek to recover the additional contributions it claims it made to Excimer” is questionable since, construing the complaint in LCA’s favor, as we must, this may well be what LCA is arguing. In other words, LCA appears to claim that, as a result of PC’s breach of the Operating Agreement, LCA contributed $495,218.93 over and above that which it was contractually obligated to pay, and it is now seeking to recover that amount from PC. Such a claim would seek recovery for a direct injury to LCA that is independent of any injury Excimer may have suffered.\footnote{Excimer, 292 F.3d at 140; cf. Int’l Flavors & Textures, LLC v. Gardner, 966 F. Supp. 552, 554 (W.D. Mich. 1997) (holding that a claim against a member for an unpaid contribution was derivative, not direct, because the “IFT Operating Agreement specifically gives IFT [(i.e., the limited liability company)], not just a member of IFT, the right to take ‘enforcement action’ to collect a member’s capital contribution”).}

The Second Circuit’s \textit{Excimer} decision was presaged by a Connecticut state court trial decision,\footnote{See Taurus Advisory Group, Inc. v. Sector Mgmt., Inc., No. CV 960150830, 1997 WL 241153, at *2 (Conn. Super. Ct. May 6, 1997) (allowing a direct claim where the alleged damage to the LLC caused an innocent corporate member “to take over the operations [of the LLC] at the expense of its own operations”).} but the two cases have hardly started a tidal wave.\footnote{On November 21, 2005: (i) a Westlaw search in the ALLCASES database for “Taurus Advisory” showed several cases citing that litigation, but none relating to the direct/derivative issue; (ii) a Westlaw KeyCite search on \textit{Excimer} showed 15 cases citing \textit{Excimer} but only one cite involved a headnote related to the direct/derivative distinction and that citing case referred also to and relied on New York case law pointing in the opposite direction. \textit{See} Solutia Inc. v. FMC Corp., 385 F. Supp. 2d 324, 334 (S.D.N.Y. 2005) (holding that an LLC member’s “additional expenditures [resulting from another member’s alleged failure to contribute technology to the LLC] do not constitute a direct injury sufficient to give [the plaintiff member] standing” to sue directly; citing Abrams v. Donati, 489 N.E.2d 751 (N.Y. 1985), for the proposition “that a shareholder has no individual cause of action for harm to the corporation that causes the shareholder to ‘incur personal liability in an effort to maintain the solvency of the corporation’”). Ultimately, \textit{Excimer} was equally unproductive for the plaintiff. \textit{See} LCA-Vision, Inc. v. New York Refractive Eye Assocs., P.C., No. 98 Civ.8387 DC, 2004 WL 213027, at *5 (S.D.N.Y. Feb. 3, 2004) (concluding on remand from the Second Circuit that no reasonable jury would sustain the plaintiff’s breach of contract claim and, therefore, granting summary judgment to the defendant).} The \textit{Excimer} theory may be useful in limited circumstances, but
neither it nor LLC's "partnership law heritage" seem likely to significantly affect the direct/derivative analysis for limited liability companies.

VII. HOW THE REVISED UNIFORM LIMITED LIABILITY COMPANY ACT PROPOSES TO ADDRESS THE MATTER

In 2003, the National Conference of Commissioners on Uniform State Laws (NCCUSL) began a project to revise the original Uniform Limited Liability Company Act. The drafting committee presented an initial report at the 2003 Annual Meeting of the Conference, and a draft of a new, Revised Uniform Limited Liability Company Act (Re-ULLCA) was read in part (line by line) at the Conference's 2004 Annual Meeting. The Act received its formal first reading at the 2005 Annual Meeting and is scheduled for its final reading at the 2006 Annual Meeting.

From the first very tentative draft, the new Act has taken seriously the direct/derivative distinction and embraced the direct harm rule. Borrowing from ULPA (2001) § 1001(b), the April 2004 draft of Re-ULLCA provided that: "A member commencing a direct action under this section [governing direct actions by members] is required to 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." The Reporters' Notes quoted the Comment to the ULPA provision, which explains that a breach of a partnership agreement does not automatically give each party to that agreement standing to sue directly for breach.

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291 NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, REV. OF UNIF. LTD. LIAB. CO. ACT 6 (Preliminary Report Annual Meeting 2003), available at http://www.law.upenn.edu/bll/ulc/ullca/ann-meet-draft03.pdf (last visited Mar. 6, 2006). The author serves as one of two co-reporters for this drafting project, but the statements and opinions in this Article are solely his own and are not the position of the NCCUSL, the drafting committee, the committee's chair, the other co-reporter or any member, advisor to or observer of the drafting committee.


294 This provision is discussed supra notes 206–210.


296 Id. § 901(b) reporters' note.
Subsequent Re-ULLCA drafts have preserved this approach and have also addressed the “duty owed” issue and the relationship of oppression claims to the direct/derivative distinction. On the “duty owed” issue, the new Act takes care to prevent confusion between duty and standing. Section 409, which delineates the duties of care and loyalty of those who manage an LLC, recognizes that some aspect of those duties may extend to members as well as the LLC. However, the section expressly subjects any resulting rights of a member to the direct harm requirement of Section 901(b).

On the question of oppression, the new Act provides for dissolution inter alia:

[O]n application by a member, a dissociated member that has retained a transferable interest, or a transferee, the entry by [appropriate court] of an order dissolving the limited liability company on the grounds that the managers or those members in control of the limited liability company:

(A) have acted, are acting, or will act in a manner that is illegal or fraudulent; or

(B) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant.

For a claim of illegal or fraudulent conduct, standing is available without regard to injury. But for the far more important subcategory of oppressive conduct, the Act expressly incorporates the direct harm approach.


298 Id. § 409(a) ("A member owes to the limited liability company and, subject to Section 901(b), the other members the fiduciary duties of loyalty and care stated in subsections (b) and (c). "). Subsections (b) and (c) repeated the “subject to” phrase, and section 409(f)(2) provides that “[i]n a manager-managed limited liability company ... a manager is held to the same standards of conduct prescribed for a member in subsections (a) through (d) ...” Id. § 409.

299 Id. § 701(a)(5). Subsection (b) authorizes a court to grant a lesser remedy. Id. § 701(b). At its February 2006 meeting, the Drafting Committee voted to delete “transferee.”

300 See, e.g., id. § 409 reporters’ notes (explaining that in some circumstances those who manage an LLC might have a duty of disclosure running directly to the members).

301 The new Act also removed language referring to an action for an accounting. The reporters’ note provides the following explanation:

At its February, 2005 meeting, the Drafting Committee deleted [from the section...
VIII. CONCLUSION

The spread of limited liability companies creates both the need and the opportunity for courts to re-examine the important question of "direct versus derivative" in closely held business enterprises. The analysis should be the same for both closely held corporations and LLCs, and courts should:

(i) reject the special injury rule; (ii) embrace the direct harm analysis; and (iii) engraft to the ALI exception the more determinate inquiry of "purpose and effect."

[providing for direct actions by members] the reference to "with or without an accounting," on the theory that partnership remedy of accounting reflected the aggregate nature of a partnership and is inappropriate for an entity such as an LLC. A comment will explain this point and make clear that the equitable claim for an accounting (in the nature of a constructive trust) is unaffected.

Id. § 901(a) reporters' notes.