Feature Article

Direct or Derivative? Direct Injury Test Applied to LLC Member from Asserting Claims

by Joanna M. Roberto

Traditionally, courts apply the direct injury test to determine if a shareholder's claim must be raised derivatively. The issue in these situations becomes whether the primary injury for which relief is sought directly affects an interest the claimant holds, or if it injures a legal entity's interest, which then derivatively injures the claimant. In other words, the critical question posed by this test is whether the damages a plaintiff sustains are derivative of an injury to a third party. If answered in the affirmative, then the injury is indirect. If answered in the negative, the injury is direct. Importantly, a general or limited partner bringing a direct action should plead and prove an actual and threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited partnership.

Direct or Derivative Claim

In direct suits, the action is brought by an employee or person not necessarily connected with the corporation and asserts a claim against it or its board. Whereas, derivative suits are claims against a board member on behalf of a corporation. For example, where shareholders alleged the officers and directors mismanaged or looted corporate assets and entered into self-serving deals to sell assets to third parties, culminating in the corporation's involuntary liquidation, this has been said to be derivative in nature.

There are sound policy considerations to support a firm distinction between direct and derivative actions. For instance, prior to filing a derivative lawsuit, a plaintiff must typically surmount several procedural hurdles, including placing a formal demand upon the corporation's board of directors, or, alternatively, establishing that such a demand would be futile. The underlying rationale for these requirements is that corporate directors are presumed to have the best interests of a corporation in mind and therefore, should have an initial opportunity to investigate the merits of a potential lawsuit and respond accordingly.

In contrast, a direct action circumvents these predicate procedural requirements and, importantly, provides recovery directly to a plaintiff, rather than recovery filtered through the corporate coffers. As a matter of practical concern, allowing direct recovery when the action is properly a derivative one fails to protect corporate creditors because the proceeds avoid the legal ordering of creditors and investors. *See Kagan v. Edison Bros. Stores, Inc.,* 907 F.2d 690, 692 (7th Cir. 1990).

Direct Injury Test

The terms "target area" and "direct injury" have been said to be shorthand methods of identifying the two major approaches to the interpretation of "by reason of". The direct injury test was among the first antitrust tests federal courts employed. Under this test, to have standing, a plaintiff must have been in a direct commercial relationship with the defendant at the time of the injury. *Loeb v. Eastman Kodak Co.*, 183 F. 704 (3d Cir.1910); *Ames v. American Telephone and Telegraph Co.,* 166 F. 820 (C.C.D.Mass.1909). Some courts have also required privity of contract. See Note, 61 Wash.U.L.Q. at 1073 n. 22. The direct injury test requires the trial judge to make the subjective determination of which injuries are direct and which are not direct. See Berger & Bernstein, *An Analytical Framework for Antitrust Standing*, 86 Yale L.J. 809, 819 (1977).

Some circuit courts grant standing only to persons within the market affected by the antitrust violation. *Blue Shield of Virginia v. McCready*, 457 U.S. 465, 478 n. 14, 102 S. Ct. 2540, 2548 n. 14, 73 L. Ed. 2d 149 (1982). The Fifth Circuit follows the "target area test" where the plaintiff must show that she is within the sector of the economy threatened by the breakdown of competition. *Associated Radio Service Co. v. Page Airways, Inc.*, 624 F.2d 1342, 1362 (5th Cir.1980), cert. denied, 450 U.S. 1030, 101 S. Ct. 1740, 68 L. Ed. 2d 226 (1981). The Eleventh Circuit has adopted the "target area" test used by the Fifth Circuit. See *Construction Aggregate Transport, Inc. v. Florida Rock Industries, Inc.,* 710 F.2d 752, 762 (11th Cir.1983). The Sixth Circuit created a third test in *Malamud v. Sinclair Oil Corp.,* 521 F.2d 1142 (6th Cir.1975), and the Supreme Court adopted it in *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 97 S. Ct. 690, 50 L. Ed. 2d 701 (1978). Under the Sixth Circuit test, to have standing to sue for antitrust injuries, the plaintiff's injuries must fall within the zone of interest protected by the antitrust laws. Indistinguishable in its requirements from the zone of interest test is that of the *Brunswick* test, which requires a showing that the injury is of the "type that the statute was intended to forestall." *Id.,* 429 U.S. at 487-88, 97 S. Ct. at 697. The final test of antitrust standing is that applied by the Third Circuit. It is a policy-balancing test containing many factors in lieu of a "talismanic test capable of resolving all . . . standing problems." *Bravman v. Bassett Furniture Industries, Inc.,* 552 F.2d 90, 99 (3d Cir.1977). While the traditional target area test requires

that the antitrust violators "aim" at the plaintiff, proof of conspiratorial intent to injure is not necessary. All that is required is that the plaintiff be in the sector of the economy which is the target of the antitrust violation. *McCready*, 457 U.S. at 479 n. 15, 102 S. Ct. at 2548 n. 15; *Florida Rock*, 710 F.2d at 765.

To the other extreme, no California state court has squarely decided whether the principles of derivative lawsuits applicable to corporations also apply to a limited liability company. *Miele v. Perlstein*, 379 Fed. Appx. 626 (9th Cir. 2010), *see, e.g., Barth v. Barth*, 659 N.E.2d 559, 560 (Ind. 1995) (Indiana law adheres to the principle "that shareholders of a corporation may not maintain actions at law in their own names to redress an injury to the corporation even if the value of their stock is impaired as a result of the injury"). By way of further example, although District law does not provide a definite test for evaluating shareholder standing, the D.C. Court of Appeals refused to allow a corporate shareholder to sue individually where it lacked a separate "legal interest" that had been harmed. *See Estate of Raleigh v. Mitchell*, 947 A.2d 464, 470 (D.C. 2008) (holding that because plaintiff "had no legal interest in the real property belonging to the corporation, it could not sue individually to redress any alleged wrongs against the corporation's property interests."). The shareholder standingrules in Delaware and Maryland similarly require a separate, legal interest. *See Kramer v. W. Pac. Indus., Inc.,* 546 A.2d 348, 351 (Del. 1988) (requiring "more than an injury resulting from a wrong to the corporation" and insisting that plaintiff be "injured directly or independently of the corporation"); *Mona v. Mona Elec. Group*, 176 Md. App. 672, 934 A.2d 450, 464 (Md. Ct. Spec. App. 2007) ("A shareholder may bring a direct action . . . to enforce a right that is personal to him.").

Worthy of note is that a number of courts have also abandoned the distinction between direct and derivative actions in the context of closely held corporations. See *Marcuccilli v. Ken Corp*., 766 N.E. 2d 444, 450 (Ind. Ct. App. 2002);*Sharkey v. Emery*, 272 B.R. 574, 582-83 (Bankr. D.N.J. Nov. 2001); *Hubbard v. Tomlinson*, 747 N.E. 2d 69, 71-72 (Ind. Ct. App. 2001); *DeHoff v. Veterinary Hospital Operations of Central Ohio, Inc.,* 2003 WL 21470388, at *14 (Ohio App. 10 Dist. June 26, 2003); *Fritzmeier v. Krause Gentle Corp.,* 669 N.W.2d 699, 707-08 (2003).

As a matter of course, courts generally do not allow personal actions based on emotional distress deriving from economic damages suffered by the corporation. See, *e.g., Guides, Ltd. v. Yarmouth Group Prop. Mgmt., Inc.*, 295 F.3d 1065, 1072-73 (10th Cir. 2002); Pagan, 448 F.3d at 29 ("The fact that the complaint contains a demand for emotional distress damages . . . is insufficient to confer individual standing on any of the stockholders."). However, the principles of equity usually command that a shareholder may maintain a direct action against a third party who harmed a corporation if the shareholder had a separate contractual agreement with the third party or the corporation that exposed the shareholder to a unique harm such as personal exposure on a loan guarantee.

2010 Decisions of Interest

Cavalry Construction, Inc. v. WDF, Inc., 2010 U.S. LEXIS 49408 (S.D.N.Y., Mar. 30, 2010), echoed New York's distaste in direct actions by a shareholder in closely held corporations seeking to recover for fraud or waste.

At issue in *Cavalry* were two contracts involved for the Bronx Law Project. The first contract was the agreement that established a joint venture between two parties, Cavalry and WDF. The second contract was a third-tier subcontractor masonry agreement between the Joint Venture and Cavalry. One of the issues involved was whether WDF was liable to Cavalry on either contract. WDF asserted that Cavalry failed to adequately plead a breach of fiduciary duty claim. The court was faced with whether Cavalry could directly assert the Joint Venture's fiduciary duty claim against WDF or alternatively, whether WDF owed an independent fiduciary duty to Cavalry.

WDF primarily argued that Cavalry could not assert a claim because a partner does not have standing to sue individually to recover assets due to the partnership. WDF further argued that Cavalry was permitted to enforce the Joint Venture's rights against Silverite once WDF had refused to do so and that, in any case, once Cavalry assumed the burden of such litigation by suing in the Bankruptcy Court, the Joint Venture; hence, WDF was relived of such obligation.

To the contrary, Cavalry argued that WDF failed to adequately protect the assets of the Joint Venture. WDF took the position that its fiduciary duties could have been fulfilled by Cavalry, and have been fulfilled, and that WDF is therefore not in breach of its fiduciary obligations.

Capitalizing on the underlying Bankruptcy Court decision, the Southern District found convincing that there was already a determination that WDF had breached its fiduciary duties on two paragraphs contained in the Venture Contract. The Venture Contract established duties running from WDF to the Joint Venture, and not fiduciary duties running from WDF to Cavalry. Thus, Cavalry's injury was an indirect injury, and Cavalry was not entitled to pursue a direct claim against WDF.

In certain circumstances, New York allows limited partners to bring derivative claims against third parties. Limited partners have the right "to sue for the benefit of the trust in a cause of action which belongs to the trust if the trustees refuse to perform their duty in that respect." However, a limited partner may bring a derivative action—not that a limited partner must bring such an action or forfeit other rights.

Recently, in *Makowski v. United Bhd. & Joiners of Am.,* 189 L.R.R.M. 2147 (S.D.N.Y. Aug. 2, 2010), the court addressed the direct injury test in a RICO claim. The *Makowski* court dismissed plaintiff's amended complaint agreeing, in pertinent part, that courts consistently hold that "shareholders, creditors, and employees of a corporation lack standing to sue under RICO where their injuries derive from direct injuries to the corporation itself." *Id.* The court relied on judicial instruction from the District Court for the Eastern District of New York, which explained that, in general, a plaintiff:

> will not be permitted to bring a suit under RICO, in a personal capacity, where the injury he alleges has been incurred by an association or organization of which he is a member, and any derivative injury to him is no different from that sustained by similarly situated members of the same association or organization. *Pappas v. Passias*, 887 F. Supp. 465,

471 (E.D.N.Y. 1995).

This general prohibition on members of organizations suing for derivativeinjuries shared by all members of the organization recognizes that a "RICO claim [is] essentially . . . an asset of the association or organization that has been injured through a violation of 18 U.S.C. § 1962, and that the prosecution of a RICO suit by a single member in his own right would impair the rights of other similarly situated members . . . to this asset." *Commer v. Am. Fed'n of State. County & Mun. Employees*, No. 01 Civ. 4260(RWS), 2003 U.S. Dist. LEXIS 12569, 2003 WL 21697873 (S.D.N.Y. July 22, 2003).

The Fifth Circuit also recently spoke its position on apply standing to a RICO based case. In *Joffroin v. Tufaro*, 606 F.3d 235, 238 (5th Cir. 2010), the RICO plaintiffs were members of a homeowners association who alleged that officers of the association breached their fiduciary duties and diverted association fees to their personal benefit. The Fifth Circuit held that the members lacked standing to sue. Since the RICO plaintiffs brought claims analogous to shareholder derivative claims, the court applied a three-part test to determine whether the plaintiffs satisfy general standing requirements. The first prong of the three-part test was satisfied because the claims were for monies diverted from the association's treasury, and the plaintiffs did not allege that defendants committed any fraudulent acts with the direct intent to injure plaintiffs. The second prong was satisfied because the alleged injury to the members was based on the defendant's breach of fiduciary obligations owed to the association, and therefore, the injury was merely derived from, and was not distinct from, the injury to the homeowner's association. Finally, the third prong was satisfied because the court found that under Louisiana law, the cause of action for breach of a fiduciary duty owed to a homeowners association accrued in the association, and not its members.

In the most recent case, *Weidberg v. Barnett*, 2010 U.S. Dist. LEXIS 124968 (E.D.N.Y., Nov. 27, 2010), the court engaged in a careful assessment of whether claims against LLC members and managers are direct or derivative in order to ensure that a party with appropriate standing is bringing the claims. The underlying facts were that in 2001, Plaintiff Clinton Weidberg and defendant Stephen Barnett formed Iron Horse Bicycle Co., LLC ("Iron Horse") taking equal stakes in the company. Barnett and Weidberg also owned equal shares in two other bicycle companies. From 1996 to 2008, Barnett managed the day to day operations of all three companies. In 1999, Barnett hired Aversano to prepare financial statements for one of the companies, and Aversano was later named CFO of Iron Horse.

Weidberg alleged that Barnett and Aversano engaged in a scheme to loot Iron Horse by personally retaining payments from the company's distributors, accepting kickbacks from suppliers, and by covering their fraud by paying suppliers with funds unrelated to the sales of the supplier's products. Thereafter, defendants allegedly conspired to inflate Iron Horse's financial condition for purposes of concealing their actions. Sometime in 2008, Weidberg became aware of the scheme to overstate the financial condition of the company after Aveersano conceded that he had been instructed to do so. In 2009, Iron Horse filed a petition for Chapter 7 bankruptcy which was later converted to Chapter 11.

In March 2009, Weidberg commenced suit against defendants

alleging as to Barnett breach of fiduciary duty, breach of contract, and fraudulent inducement to contract. As to Aversano, plaintiff alleged breach of fiduciary duty and aiding and abetting Barnett's breach of fiduciary duty. After limited discovery, defendants filed a motion for summary judgment pursuant to FRCP 56(c), contending that plaintiff's causes of action belonged to the LLC (Iron Horse) rather than Weidberg as a member. All parties were in agreement that claims belonging to the LLC could only be asserted by the bankruptcy trustee.

In deciding the motion, the critical question for the court was whether plaintiff's claims were direct or derivative. Applying New York law, the court noted initially that members and managers of LLC's owe fiduciary duties both to the LLC and its members. In order to determine whether the claims asserted against members and/or managers are direct or derivative, the "direct injury test" must be employed. Under this test, the court must discern whether a party's damages are derivative to a third party's injury. If so, the injury is indirect and the claim must be asserted derivatively.

Applying the "direct injury test" to the facts, the court concluded that the allegations that defendants breached their fiduciary duties by taking improper payments from Iron Horse distributors, diverting funds to themselves, and generally looting Iron Horse were derivative claims which could only be asserted by the LLC. The court reasoned that plaintiff's damages resulted from the deteriorating financial condition of Iron Horse, which diminished the value of plaintiff's ownership interest, a "quintessentially derivative claim." Thus, the court dismissed these claims without leave to re-plead. The court, did, however, permit plaintiff to re-plead an additional claim that his reputation in the bicycle industry had been irreparably harmed, his credit rating had been ruined, and he had incurred thousands of dollars in legal and other professional fees.

In general, courts have wide discretion to determine whether an action is derivative or direct and in doing so, will look to the adequacy of the remedies under derivative and direct actions. The availability to LLC members of derivative rights has had a substantial impact on limited liability member relations. The availability of this type of suit has also impacted and directed the kind of litigation that may ensue when members seek judicial recourse. It has in effect given members holding minority interests in LLCs a voice as well as recourse against majority abuses that caused direct injury only to the LLC. Whether a member of an LLC may bring a direct action continues to be the subject of much judicial discourse.

Joanna Roberto
Goldberg Segalla
Mineola, NY
Mail to: jroberto@goldbergsegalla.com

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