recently, Judges Denny Chin and Robert W. Sweet of the U.S. District Court for the Southern District of New York each issued decisions addressing threshold issues relating to standing to bring derivative actions.

Judge Chin's decision in Bischoff v. Boar's Head Provisions Co., opens the door to a class of potential plaintiffs, holding that members of a limited liability company (LLC) have the right to bring derivative litigation on behalf of the LLC, despite the lack of express statutory authorization for such suits. Judge Sweet's decision in Henik v. Labranche, closes the door to derivative plaintiffs where another plaintiff, suing on behalf of the same corporation, has already made an unsuccessful effort to establish demand futility. Judge Sweet held that the doctrines of res judicata and collateral estoppel bar relitigating that question, even where the plaintiff in the subsequent action did not participate in the first lawsuit.

**LLC Derivative Actions**

Bischoff concerned the allocation of profits between a pair of family-owned businesses that manufacture and distribute Boar's Head brand meats. The plaintiff as well as the defendants were all descendants of Frank Brunckhorst, who founded the business a century ago. All the parties had an ownership interest in both companies, although the plaintiff was entitled to a higher share of the profits in the company that handled distribution (FB Co.), while the defendants had a greater interest in the company that manufactured the processed meats (Provisions).

Plaintiff claimed that the defendants, who were directors and controlling shareholders of FB Co., a limited liability company, had improperly used that control to divert revenues from FB Co. to Provisions, thereby increasing their own profits.

Plaintiff initially filed suit in New York State Supreme Court, asserting derivative claims on behalf of FB Co. for breach of fiduciary duty, waste, unjust enrichment and money had and received. Defendants removed the action to federal court and moved to dismiss, arguing that plaintiff had no right under New York law to sue derivatively on behalf of an LLC. Plaintiff opposed that motion, and cross-moved to remand the case to state court for lack of federal subject matter jurisdiction because the presence of FB Co. as a defendant destroyed diversity.

In denying the motion to dismiss and ordering the case remanded to state court, Judge Chin had to navigate his way around two significant and related obstacles in order to find that a member of an LLC has the right to maintain a derivative action. First, although the statute authorizing the formation of LLCs is silent on the right of members to bring derivative suits, the legislative history reveals that a provision authorizing such suits was contained in the original version of the bill, but was dropped from the final version “to avoid jeopardizing passage of the balance of the law,” after some legislators raised questions about that provision. The second obstacle to finding a right to sue derivatively on behalf of an LLC was the fact that based on this legislative history, the only four state court decisions to address this question had all ruled that members of an LLC were prohibited from commencing derivative actions under New York law.

**Common-Law Right**

Despite these apparent barriers, Judge Chin concluded that under the common law, a member of an LLC had a right to sue derivatively, and that that right was not overridden by either the statute creating LLCs or the decisions of the lower New York courts to the contrary. He stressed that the common law right to sue derivatively, stemming from recognition of a beneficiary's right to bring an action belonging to a trust, extended back to the 1800s. He noted that in reliance on this common-law right, the New York Court of Appeals had recognized under common law, first the right of corporate shareholders to sue derivatively, independent of any statutory authorization, which in both cases followed recognition of the right under common law.

Judge Chin reasoned that because an LLC is essentially a hybrid of the corporate and limited partnership forms (“offering the tax benefits and operating flexibility of a limited partnership with the limited liability protection of a corporation”) members of an LLC would “undoubtedly” have the common law right to sue derivatively, just as their shareholder and limited partner counterparts do. He then observed that only “a clear and specific” expression of legislative intent is sufficient to displace a common-law right, and found that the legislature’s silence on the question of derivative rights did not constitute such a clear statement. He acknowledged that changes to proposed legislation are a factor in determining legislative intent, but expressed hesitation to read the Legislature’s omission of the derivative rights provision as an abrogation of the common-law derivative right. Judge Chin found support for this position elsewhere in the legislative history of the statute, noting testimony before the New York State Assembly during consideration of the bill, that an LLC member would have the common-law right to bring a derivative suit “whether or not the statute contains such an express right.” Observing that legislation is presumed to take place “against a backdrop of common law adjudicatory principles,” Judge Chin concluded that the Legislature’s failure to include the derivative rights provision was not a bar to enforcing such rights under common law.

Judge Chin had previously recognized the common-law right to sue an LLC derivatively in his decision in Cabrini Dev. Council v. LCA-Vision, Inc., as had U.S. District Judge Jacob Mishler for the Eastern of New York in Weber v. King. Judge Chin concluded that the four New York State courts which had subsequently reached the opposite conclusion were unpersuasive because they had relied on the Legislature’s decision to omit the derivative rights provision without addressing (except for one case) the need to view the legislation against the backdrop of the common law right discussed.
the plaintiffs in that action had not adequately
LaBranche filed by other plaintiffs, holding that
State Supreme Court Justice Helen E. Freedman
LaBranche & Co., based on allegations that
that action sought to assert derivative claims
respect to the same underlying claim. Plaintiffs in
for failure to allege adequately that a pre-suit
dismissal of previous derivative plaintiffs' claims
Other Shareholders Bound
The plaintiffs' second objection to the application of either collateral estoppel or res
judicata was that because these particular plaintiffs did not have an opportunity to litigation the question of demand futility in Brown, they should not be barred from doing so, whatever the preclusive effect of the Brown decision with respect to the plaintiffs in Brown. Judge Sweet acknowledged that as a general rule, preclusion should not be imposed on individuals who have not had an opportunity to litigate in the initial action. He noted, however, that "privity among shareholder plaintiffs in the derivative litigation context presents an atypical situation."17
He explained that unlike most lawsuits, where standing questions turn on the characteristics of the individual plaintiff and will thus differ from one potential plaintiff to another, the plaintiff in a derivative suit is actually the corporation, and the facts about the corporation's board will not differ based on the identity of the shareholder who is suing in the corporation's name.

Although no court in the U.S. District Court for the Southern District of New York had previously ruled on the preclusive effect of one plaintiff's unsuccessful attempts to establish demand futility on other shareholders' attempts to do so, Judge Sweet noted that his analysis was bolstered by a number of longstanding decisions holding that a judgment on the merits in a derivative action is res judicata on shareholders that were not parties to the original litigation.18 He concluded that "[i]f the fact that the Brown dismissal was based upon the standing to sue derivatively and not upon the merits of the underlying action bears not on the fact that the suit was commenced and litigated on behalf of the LaBranche corporation and all of its shareholders."19

In holding that the decision in Brown precluded the Henik plaintiffs from relitigating the question of demand futility, Judge Sweet noted that the result might differ if the plaintiffs in the second action could make a showing that the plaintiffs in the first did not adequately represent the interests of all of the shareholders by, for example, failing to put forward all of the available evidence in support of demand futility. Because the Henik plaintiffs made no such claim, Judge Sweet concluded that there was no reason to question the diligence of the Brown plaintiffs in representing the interests of all the LaBranche shareholders. He further noted that the Henik plaintiffs knew of the Brown litigation and could have intervened in that action to put forward any arguments they deemed appropriate. Having failed to do so, Judge Sweet held that they were precluded from relitigating the question of demand futility and granted the defendants' motion to dismiss.

Conclusion
Judge Chin's decision in Bischoff, paves the way for members of an LLC to avail themselves of a very useful and powerful tool in policing the management and operations of this relatively new class of business entity. Judge Sweet's decision in Henik makes clear, however, that those who enjoy the right to sue derivatively are effectively all in the same boat when it comes to exercising those rights, and should monitor closely any derivative litigation brought in the company's name because the first case filed may be the only opportunity for adjudication of those rights.