

The Rights Of Shareholders, Limited Partners And Non- Managing Limited Liability Company Members In Corporate Governance Disputes: Derivative Actions In Pennsylvania

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ABSTRACT

Derivative actions continue to be a viable method for addressing and litigating corporate governance disputes, i.e., attempts by members of collective enterprises such as corporations (closely-held or publicly-traded), limited liability companies ("LLCs") or limited partnerships to challenge the acts or omissions of management. The successful assertion of a derivative claim against a Pennsylvania corporation, LLC or limited partnership, however, relies on an understanding of the requirements of and relationships between substantive statutory law and the applicable procedural law. The purpose of this article is to provide an overview and primer of derivative law and procedure, particularly as it relates to establishing or challenging standing.

WHAT IS A DERIVATIVE ACTION?

The limitation on liability that a collective enterprise, be it in the form of a corporation, an LLC or a limited partnership, affords investors involves a trade-off. In ex-

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change for limiting liability to the amount of the investment, the investor foregoes his right to participate in the management of that investment. As a result, an investor has no right to directly challenge the acts or omissions of directors, managers or general partners. This right belongs only to the entity as a whole and only the directors, managers or general partners can usually bring suit on behalf of the entity.

The derivative action is the exception to this rule.¹ Equity provided the derivative action as a remedy for the mis- or malfeasance, of corporate directors, but only after the shareholder first demanded that the corporation address his concerns.² The law of Pennsylvania developed in accordance with these general principals.³ The derivative action is defined within the Pennsylvania Rules of Civil Procedure as:

... an action to enforce a secondary right brought by one or more stockholders or members of a corporation or similar entity because the corporation or entity refuses or fails to enforce rights which could be asserted by it.

Derivative actions are an exception to the general rule that prohibits shareholders, LLC members and limited partners from asserting claims against directors, managers and general partners for mis- or malfeasance.

Pa.R.C.P. 1506(a).⁴ The term “similar entity” is broadly construed and includes LLCs, professional associations, business trusts, or any other association which is regarded as an entity distinct from its members. . . .⁵ Thus, a de-

1. The Supreme Court of the United States described the history and relationship that required the development of the derivative actions as follows:

As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust. The business code became all too tolerant of such practices. Corporate laws were lax and were not self-enforcing, and stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust.

Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 547-548 (1949). In other words, far-flung shareholders had few remedies against the mis- or malfeasance of concentrated managers.

2. *Id.*

3. See, *Kelly v. Thomas*, 83 A. 307, 310 (Pa. 1912) (affirming dismissal of bill of equity brought by shareholder against director of corporation where bill was devoid of any allegations of demand upon corporation).

4. A “secondary” right is one that the shareholder does not assert in his personal capacity. Generally, when a shareholder sues a corporation or similar entity directly, that is—in his primary capacity, his claim must be one for harm to himself, and not to the corporation. *Hendrickson v. Vandling*, 41 Pa.D.&C. 3d 568, 571-72 (1983) (citing 13 W. Fletcher, *Cyclopedia of Corporations* Sec. 5911 at 309 (1980)). A primary cause of action for an investor arises when the action is based on the contract to which the plaintiff is a party, or a right belonging severally to him, or a fraud affecting the plaintiff directly. *Id.* When the primary harm is to the corporation or other entity, the shareholders or members have no right to sue in their own capacities. *Levy v. Affiliated Fund, Inc.*, 17 Pa.D.&C.2d 418, 424 (1980) (citing, *Ash v. Int'l. Business Machines*, 335 F.2d 491 (3d Cir. 1965) (*cert denied*, 384 U.S. 927 (1966))). Thus, a claim for harm to the corporation or entity is a secondary right.

5. See, Pa.R.C.P. 2176 (defining corporation for purposes of application of those Rules). This definition specifically excludes partnerships as defined by Rule 2126 and Rule 2126 includes limited partnerships. However, and as is discussed below at greater length, the Pennsylvania Revised Uniform Partnership Act specifically provides a derivative remedy for limited partners. See, Pa.C.S.A. Sec. 8591 (Purdons 1988). Pennsylvania's Limited Liability Law of 1994 has a similar provision permitting any member of the LLC

ivative action is an action brought by a shareholder, non-managing member of a limited liability company or limited partner against the relevant entity and its managers or directors to assert a claim either for malfeasance that resulted in harm to the entity as a whole or to compel the entity to pursue an action against a third-party.⁶

THE STATUTES, DECISIONS AND PROCEDURAL RULES GOVERNING DERIVATIVE PROCEDURE AND STANDING

Just as corporations, LLCs and partnerships are creatures of state law, so are the procedures and remedies for disputes between their members. In Pennsylvania, these remedies and procedures are found in three places: the statutes enacted by the General Assembly that define these entities and create the derivative remedy⁷; 2) in certain principles adopted by the Supreme Court of Pennsylvania,⁸ and; 3) in Rule 1506 of the Rules of Civil Procedure adopted by the Supreme Court under authority delegated to it by the General Assembly.⁹ Although much of the discussion of the procedural and substantive aspects of derivative claims is couched in terms of the procedures applied by the federal courts,¹⁰ it is state law that defines these rights and remedies and which must be considered in governance disputes.¹¹ Pennsylvania's statutes, rules and cases addressing these governance disputes are addressed below.

Statutes

The statutes that create corporations, LLCs and limited partnerships have different requirements for corporate governance disputes. These statutes and their differences are discussed below.

The Pennsylvania Business Corporation Law

The Prerequisites for a Derivative Claim Under the Pennsylvania Business Corporation Law: Fiduciary Duties and Personal Liability of Directors

so authorized to bring action on behalf of the LLC. *See*, 15 Pa.C.S.A. 8992(1) (providing any member of the LLC duly authorized to do so by vote of uninterested LLC members, to bring an action on behalf of the LLC). The application and implications of this section are discussed below.

6. This article addresses claims that involve exclusively derivative claims, i.e., those asserted by owners against managers for malfeasance or mismanagement; it does not address claims related to the purchase, sale or registration of shares or other form of ownership.

7. *See, e.g.*, 15 Pa.C.S.A. Secs. 1711; 1782 (re: the fiduciary duties owed to a corporation by its board of directors); 15 Pa.C.S.A. Sec. 8591 (re: a limited partner's rights to bring derivative actions); 15 Pa.C.S.A. Sec. 8992(2) (governing the right of LLC members to bring derivative actions if the Operating Agreement permits doing so).

8. *See, Cuker v. Mikalauskas*, 692 A.2d 1042, 1049 (Pa. 1997) (adopting §§7.02-7.10 and 7-13 of the American Law Institute's Principles of Corporate Governance ("the *Cuker*/ALI Principles") for use in derivative actions).

9. The adoption of such rules and procedures by the Supreme Court of Pennsylvania has the same power as the enactment of a statute. *Lohmiller v. Weidenbaugh*, 469 A.2d 578, 580 n.4 (Pa. 1983) (*citing, Dombroski v. City of Phila.*, 245 A.2d 238 (Pa. 1968) (rules of civil procedure promulgated by the Supreme Court of Pennsylvania have the same force and effect as statutes)). This is so because the enactment of rules of procedure is a power given to the Supreme Court not by the General Assembly, but by the Constitution of the Commonwealth of Pennsylvania. *Commw. v. McMullen*, 961 A.2d 842, 848 (Pa. 2008) (*citing*, Pa. Const. Art. 5, Sec. 10(c) ("The Supreme Court shall have the power to prescribe general rules governing practice, procedure and the conduct of all courts. . . .")). Thus, the rules adopted by the Supreme Court when it adopted the ALI Principles in *Cuker*, have the same force and effect as statutes.

10. This may be the result of diversity of citizenship or the provisions of the Security Litigation Uniform Standards Act of 1994, Pub. L. No. 105-353, 112 Stat. 3227 (1998), codified in various sections of 15 U.S.C.A., which require removal of derivative claims to state court if they are pleaded with other violations of federal securities laws, including fraud in the registration or sale of securities.

11. The Supreme Court of the United States has observed that the corporate entities are, ". . . wholly artificial creation[s] whose internal relations between management and stockholders are dependent

The Pennsylvania Business Corporation Law¹² includes 4 sections to be considered when asserting a derivative action. The first is Section 1712 which imposes fiduciary obligations on directors and requires that they use the “reasonable inquiry, skill and diligence as a person of ordinary prudence would use under similar circumstances.”¹³ Section 1713 provides for personal liability on the part of directors but only if they breach their fiduciary duties, act recklessly or engage in self-dealing, willful misconduct or recklessness.¹⁴ Section 1717 limits standing to assert claims for such liability to the corporation because the fiduciary duty is owed “solely to the business corporation” and “may not be enforced directly by a shareholder.”¹⁵

The Ownership, Demand and Refusal Requirements

Although the director’s duty may not be enforced *directly* by a shareholder, it may be enforced by a shareholder as a secondary right.¹⁶ Section 1782 of the Business Corporation Law, entitled “Derivative Actions,” provides:

(a) General rule.—Except as provided in subsection (b), in any action or proceeding brought to enforce a secondary right on the part of one or more shareholders of a business corporation against any present or former officer or director of the corporation *because the corporation refuses to enforce rights that may properly be asserted by it*, each plaintiff must aver and it must be made to appear that each plaintiff was a shareholder of the corporation or owner of a beneficial interest in the shares at the time of the transaction of which he complains, or that his shares or beneficial interest in the shares devolved upon him by operation of law from a person who was a shareholder or owner of a beneficial interest in the shares at that time.

(b) Exception.—Any shareholder or person beneficially interested in shares of the corporation who, except for the provisions of subsection (a), would be entitled to maintain the action or proceeding and who does not meet such requirements may, nevertheless in the discretion of the court, be allowed to maintain the action or proceeding on preliminary showing to the court, by application and upon such verified statements and depositions as may be required by the court, that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without the action serious injustice will result.¹⁷

In summary, a plaintiff in a derivative action must be a shareholder, or someone similarly situated, who is asserting a right that the corporation has already refused

upon state law. . .” and, as such, the derivative action is, “. . .one in the regulation of which the legislature of a state has wide powers.” *Cohen*, 337 U.S. at 549.

12. 15 Pa.C.S.A. §1101, *et seq.*

13. 15 Pa.C.S.A. §1712(a). This section provides:

A director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

Id.

14. 15 Pa.C.S.A. §1713. This section provides:

(a) General rule.—If a bylaw adopted by the shareholders of a business corporation so provides, a director shall not be personally liable, as such, for monetary damages for any action taken unless:

- (1) the director has breached or failed to perform the duties of his office under this subchapter; and
- (2) the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness.

Id.

15. 15 Pa.C.S.A. §1717. This section provides:

The duty of the board of directors, committees of the board and individual directors under section 1712 . . . is solely to the business corporation and may be enforced directly by the corporation or may be enforced by a shareholder, as such, by an action in the right of the corporation, and may not be enforced directly by a shareholder or by any other person or group.

Id.

16. As addressed in n.4, above, a “secondary right” is one that the shareholder does not assert in his personal capacity but in the name of the corporation.

17. 15 Pa.C.S.A. §1782 (emphasis added).

to assert. A refusal implies a demand. Therefore, in order to assert a derivative claim under Pennsylvania law, the plaintiff must first show that: 1) he was shareholder at the time of the transaction complained of, and; 2) that, before initiating the derivative claim, demanded that the corporation, acting through its board of directors (who under Section 1717 have sole standing to pursue such claims) pursue the claim, and; 3) the board of directors and corporation refused to do so.

The Pennsylvania Limited Liability Company Law of 1994

The derivative rights of LLC members are more complicated. In fact, the Committee Comment to the statutory section addressing litigation suggests that LLC members have no derivative rights absent a specific provision in the Operating Agreement.¹⁸ Courts, albeit in non-precedential rulings, have recognized that breach of fiduciary duty claims between members of LLCs are cognizable under certain circumstances.¹⁹ Close reading of the Limited Liability Company Law of 1994 shows that the question of whether a member of an LLC has standing to bring a derivative claim depends on whether the LLC is manager-managed or member-managed.

Fiduciary Obligations Imposed On the Managers of LLCs

In cases involving LLCs that are manager-, as opposed to member-managed, the Act incorporates the sections of the Business Corporation providing for a director's personal liability in the event of breach of fiduciary duty or misconduct.²⁰ These provisions include:

(a) General rule.—If a bylaw adopted by the shareholders of a business corporation so provides, a director shall not be personally liable, as such, for monetary damages for any action taken unless:

- (1) the director has breached or failed to perform the duties of his office under this subchapter; and
- (2) the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness.²¹

Thus, when considering whether the manager of an LLC can be personally liable to the members for breach of fiduciary duty relating to the LLC's management, one looks to the statutory section above while replacing "shareholders" with "members," "bylaw" with "provision of the operating agreement" and "business corporation" with "limited liability company." In summary, the member of an LLC may have the right to bring a derivative action for breach of fiduciary duty against its manager if the operating agreement specifically provides such a right.

Members of Member-Managed LLCs Have A Direct, Not A Derivative Remedy for Breach of Fiduciary Duty

In cases of fiduciary claims arising out of the management of member-managed LLCs, a direct action is appropriate. This is so because in member-managed LLCs, the members owe one another the same fiduciary duties owed between partners.²²

18. See, Committee Comment—1994 to 15 Pa.C.S.A. §8992 ("This section does not permit derivative suits unless they are provided for in the agreement.")

19. See, e.g., *Health and Body Store, LLC v. JUSTBRAND, Ltd.*, 480 Fed. Appx. 136, 143 (3d Cir. 2012) (holding that United States District Court abused its discretion by dismissing breach of fiduciary claims between LLC members); *Gem Laundry Services*, 2001 WL 1808556 * 10 (Phila. Cty. C.C.P. 2001) (overruling demurrers to breach of fiduciary duty claims between LLC members).

20. See, 15 Pa.C.S.A. §8943(b)(1) ("if the certificate or organization provides that the company shall be managed by one or more managers . . . Section 1711 (relating to alternative provisions) through 1717 (relating to limitation on standing) shall be applicable to representatives of the company.")

21. 15 Pa.C.S.A. Sec. 1713(a).

22. See, 15 Pa.C.S.A. §8904(a)(1) ("if the certificate of organization does not contain a statement to the effect that the limited liability company shall be managed by managers, the provisions of Chapters 81

General partners owe a fiduciary duty to one another.²³ Therefore, although members of member-managed LLC may have direct actions against one another for breaches of fiduciary duty, members of manager-managed LLCs are subject to the same derivative requirements imposed on corporate shareholders.

The Demand Requirement For Derivative Claims Related to the Management of a Manager-Managed LLC.

A distinctive demand requirement applies to member of a manager-managed LLC who wish to assert derivative claims. The statute provides that an action may be brought on behalf of the LLC by:

Any member of the company, whether or not the certificate of organization vests management of the company in one or more managers, who is duly authorized to sue by vote of members entitled to vote who do not have an interest in the outcome of the suit that is adverse to the interests of the company.²⁴

The Comment to the statute summarizes that, “[t]he main difference between the approach of this section and a derivative suit is that this section does not permit a single member to sue on behalf of the company without first being authorized to sue by the other members.”²⁵ In other words, if a member of a manager-managed LLC wishes to assert a claim for breach of fiduciary duty against the manager or managers, regardless of whether this suit is characterized as derivative or otherwise, he must first present the claim to the other LLC members. Thus, while in a corporation, the demand must be made to the board of directors, in a manager-managed LLC, it must be made to the other LLC members.

The Pennsylvania Revised Limited Partnership Act

The Pennsylvania Revised Limited Partnership Act is more direct than the analogous statutes. It provides:

A limited partner may bring an action in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed. The derivative action may not be maintained if it appears that the plaintiff cannot fairly and adequately represent the interests of the limited partners in enforcing the rights of the partnership.²⁶

Here, in one paragraph, the statute identifies the existence of the right of a derivative action for limited partners, a demand requirement, a futility exception to that demand requirement and an adequate representation requirement. In addition to explicitly requiring the demand implied by the Business Corporation law, the Revised Limited Partnership Act continues to require ownership at the time of the transaction and the litigation²⁷ and the pleading “with particularity” of “the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making this effort.”²⁸

(relating to general provisions) and 83 (relating to general partnerships) govern, and the members shall be deemed to be general partners for purposes of applying the provisions of those chapters.”)

23. See *Harbor Hospital Services v. Gem Laundry Services, L.L.C.*, 2001 WL 1808556 * 11 (Phila. Cty. C.C.P. 2001 (citing *Bracht v. Bracht*, 170 A. 297, 298 (Pa. 1933))).

24. 15 Pa.C.S.A. §8992(1).

25. Committee Comment—1994 to 15 Pa.C.S.A. §8992.

26. 15 Pa.C.S.A. §8591.

27. See, 15 Pa.C.S.A. Sec. 8592(a) (requiring that a limited partner who wishes to assert a derivative claim plead his status as a partner at the time of the transaction and at the time of bringing the action).

28. 15 Pa.C.S.A. Sec. 8593.

The Supreme Court of Pennsylvania's Adoption of the American Law Institute's Principles of Corporate Governance in *Cuker v. Mikalauskas*

Another set of rules for addressing and pleading derivative claims was adopted by the Supreme Court of Pennsylvania in its decision in *Cuker v. Mikalauskas*.²⁹ In *Cuker*, the Supreme Court addressed whether a Board of Directors could successfully move for summary judgment on the grounds that the Business Judgment Rule permits a board of directors to terminate a derivative action if the board, after reasonable and good-faith inquiry and analysis, determines that the action is not in the best interest of the corporation. Holding that the board could terminate such an action, the Court adopted the following formulation of the Business Judgment Rule:

It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. Absent an abuse of discretion, the judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.³⁰

The Court continued that decisions to pursue litigation, including derivative litigation, are subject to this presumption and that a "threshold mechanism" was needed when derivative lawsuits were brought, to determine whether the board of directors "exercised reasonable diligence" and "honestly and rationally believed that their decisions were in the best interests of the company" when they declined to pursue a claim.³¹ The Court also recognized that the derivative action might be stayed while this threshold inquiry was undertaken.³² To assist in this inquiry, the Court adopted certain sections of the American Law Institute's Principles of Corporate Governance while allowing Courts to adopt other sections as they see fit.³³ The following paraphrased sections of the ALI Principles were adopted by the Supreme Court in *Cuker*:

Section 7.02: Providing a holder of an equity security with standing to commence and maintain a derivative action if: a) he/she acquired the security prior to disclosure of the material facts on which the claim is based; b) continues to hold the security until the time of judgment, and; c) has complied with the demand requirement.

Section 7.03: Requiring that, prior to instituting suit, the plaintiff make a written demand, including reasonable specificity of the essential facts relied upon for each claim, on the board of directors to prosecute the action or take suitable corrective measures. Such demand is only to be excused if requiring it would cause irreparable injury to the corporation and, even so, demand must be made promptly after litigation is initiated.

Section 7.04: Requiring that the following facts be pleaded with specificity: a) the facts showing a breach of the directors' fiduciary duties be pleaded with specificity, and; b) facts showing demand was made and a written reply to the demand was provided, and; c) any facts showing why the allegations of the reply were not correct.

Section 7.05: Permitting a board of directors to move to dismiss an action for plaintiff's lack of standing or because the pursuit of the action is not in the best interests of the company.

Section 7.06: Authorizing a court to stay all discovery and proceedings until a motion addressing any issues raised under Section 7.04 are resolved.

29. *Cuker v. Mikalauskas*, 569 A.2d 1042 (Pa. 1997).

30. *Cuker*, 692 A.2d at 1045-46 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

31. *Cuker*, 692, A.2d at 1048.

32. *Id.*

33. See, *Cuker*, 692 A.2d 1049 (Pa. 1997) ("We specifically adopt §§7.02-7.10 and 7-13 of the ALI Principles.").

Sections 7.07-08: Requiring a Court to dismiss a derivative action if the board of directors determines that the pursuit of the action is not in the best interest of the company and the procedures of Section 7.09 were not followed.

Section 7.09: Describing the procedural standards for a board of directors', or a committee of such a board's, evaluation of whether a derivative action is in the best interests of the company (including the consideration by uninterested board members, appointment of counsel and preparation of a written report).

Section 7.10: Providing for a standard of review for any such motions to dismiss. If the acts complained implicate the Business Judgment Rule and the Court finds that the directors or officers acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company, then the court shall dismiss the action. If the action implicates other acts or omission to which the Business Judgment Rule does not apply, the action is to be dismissed if the board or committee was adequately informed and reasonable determined that dismissal was in the best interests of the company.

Section 713: Requiring the filing of the board's or committee's report, allowing for protective orders and discovery only on issues related to the plaintiff's standing and exhaustion of corporate remedies, and placing the burden of proof for these threshold issues on the plaintiff, not the defendant.³⁴

The Court also recognized that, "... Courts of the Commonwealth are free to consider other parts of [the ALI Principles] and utilize them if they are helpful and appear to be consistent with Pennsylvania law."³⁵ The Court found that all of these provisions were generally consistent with Pennsylvania law.³⁶

Rules of Civil Procedure

There are also specific state and federal procedural pleading rules that apply to derivative actions. As will be discussed throughout this article, these procedural rules are subject to Pennsylvania's statutory corporate law and do not identify all of the necessary facts needed for a plaintiff to establish a court's subject matter jurisdiction over a derivative claim. Parties should be mindful that they could comply with all applicable rules of civil procedure but still expose their claim and client to discovery on threshold issues of jurisdiction and, possibly, dismissal.

Pa.R.C.P. 1506

If the applicable statute permits the assertion of a derivative claim, that claim is governed by the procedural requirements of Pa.R.C.P. 1506. Because Rule 1506 is Pennsylvania's only rule of procedure governing derivative actions, it is worth reviewing in full:

(a) In an action to enforce a secondary right brought by one or more stockholders or members of a corporation or similar entity because the corporation or entity refuses or fails to enforce rights which could be asserted by it, the complaint shall set forth:

(1) that each plaintiff is a stockholder or owner of an interest in the corporation or other entity.

(2) the efforts made to secure enforcement by the corporation or similar entity or the reason for not making any such efforts, and

(3) either

34. *Cuker*, 692 A.2d at 614-624 (citing, American law Institute, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION, Secs. 7.02-7.10 and 7-13 (1994), hereinafter "*Cuker*/ALI Principles.").

35. *Cuker*, 692 A.2d at 614, n.5.

36. Much of the confusion regarding derivative procedures and requirements might be resolved not by reviewing case law, but by reviewing the Business Corporation Law and other applicable statutes. Many of the "new" requirements identified by the ALI and adopted in *Cuker*, were already part of Pennsylvania law as of the time of that decision. For example:

(i) that each plaintiff was a stockholder or owner of an interest in the corporation or other entity at the time of the transaction of which the plaintiff complains or that the plaintiff's stock or interest devolved upon the plaintiff by operation of law from a person who was a stockholder or owner at that time, or

(ii) that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without the action serious injustice will result.

(b) A plaintiff who files a complaint containing an allegation pursuant to subdivision (a)(3)(ii) shall forthwith file a motion to maintain the action. If the plaintiff sustains the allegation, the court shall allow the action to continue.³⁷

Rule 1506 applies to limited liability companies as well as corporations.³⁸ Rule 2176's definition excludes limited partnerships however, by specifically excluding partnerships as defined in Rule 2126, which definition includes limited partnerships. However, Rule 1506 specifically applies to derivative actions and the Limited Partnership Act, as discussed above, specifically provides for a derivative claim.³⁹ Moreover, the Uniform Partnership Act recognizes that limited liability companies and limited partnerships are to be treated identically.⁴⁰ It would be incongruous to have two such similar, entities, the governing statutes for which both provide for derivative claims by members, not to be governed by the same procedural rule.

Fed.R.Civ.P. 23.1

If the claim satisfies the requirements of diversity jurisdiction, or otherwise must be asserted in or removed to federal court,⁴¹ the plaintiff must comply with Federal Rule of Civil Procedure 23.1. This Rule, which was a model for Rule 1506⁴² provides:

(a) Prerequisites. This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce. The derivative action may not be maintained if it appears that the

15 Pa.C.S.A. Sec. 1721: Provides that the general powers of a corporation, including the power to sue, are to be exercised by the board of Directors;

15 Pa.C.S.A. Sec. 1715(d): Adopting the Business Judgment Rule by providing that the acts of the board of directors, committees of the board of directors and the individual directors are presumed to be in the best interest of the corporation absent breach of fiduciary duty, lack of good-faith or self-dealing;

15 Pa.C.S.A. Sec. 1717: Prohibiting direct assertion of breach of fiduciary duty claims by shareholders against directors, and;

15 Pa.C.S.A. Sec. 1782: Stating the ownership requirement and implying the demand requirement by requiring that the board of directors refuse to pursue a claim before a shareholder can assert it himself.

Furthermore, when a cause of action is created by a statute, such as these derivative actions are, the plaintiff's failure to exhaust all statutory requirements before commencing an action deprives the court of subject matter jurisdiction. *Hill v. Devecchio*, 625 A.2d 642, 646 (Pa. Super. 1993) *app. denied*, 645 A.2d 1316 (Pa. 1994). Lack of jurisdiction can be the basis for preliminary objections. *See*, Pa.R.C.P. 1028(a)(1) (providing for preliminary objection to a complaint for lack of jurisdiction over the subject matter or the person of the defendant). Thus, Pennsylvania's pre-*Cuker* law allowed for a demand, ownership and preliminary disposition of a derivative claim. It is true, however, that the *Cuker*/ALI Principles modified some of these requirements, including the demand requirement and the standard of proof for preliminary disposition. Still, this is a reminder that litigators should not hesitate to consider that many of their questions about corporate governance may be addressed by the BCL and other statutes more easily than they are addressed by case law.

37. Pa.R.C.P. 1506.

38. *See*, Explanatory Comment to Pa.R.Civ.P. 2176 (term "corporations and similar entities" includes limited liability companies).

39. *See*, 15 Pa.C.S.A. Sec. 1591.

40. *See*, 15 Pa.C.S.A. Sec. 8311(b) (Uniform Partnership Act and its remedies apply to both limited liability companies and limited partnerships).

41. For example, a derivative action that includes claims against officers and/or directors that are not exclusively derivative. *e.g.* claims related to the sale or registration of a security, is subject to removal to federal court. *See*, 15 U.S.C.A. Sec. 77p(f)(2)(B); 15 U.S.C.A. Sec. 78bb(f)(5)(c).

42. *See*, Pa.R.C.P. 1506, Explanatory Comment—1990 (discussing similarities between Rules 1506 and 23.1).

plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.

(b) Pleading Requirements. The complaint must be verified and must:

(1) allege that the plaintiff was a shareholder or member at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law;

(2) allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and

(3) state with particularity:

(A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and

(B) the reasons for not obtaining the action or not making the effort.⁴³

This Rule differs from other federal pleading rules in significant ways. In the first instance, the pleading must be verified by the plaintiff, not by the attorney as is generally required by Fed.R.Civ.P. 11.⁴⁴ The ownership requirement requires ownership or an analogous interest only at the time of the transaction complained.⁴⁵ However, as discussed below at greater length, courts will look beyond this procedural law to the substantive law of the state of incorporation or formation to determine the time at which a derivative plaintiff must own his interest to maintain standing.⁴⁶ Finally, like Rule 1506, Rule 23.1 contemplates a demand requirement.⁴⁷ This demand requirement, like the ownership requirement, is subject to the underlying substantive law of the state of formation or incorporation.⁴⁸

A Summary of the Statutory, *Cuker/ALI* and Procedural Requirements for Asserting a Derivative Claim Against A Pennsylvania Corporation, LLC or Limited Partnership

Comparing the Sources of Derivative Law in Pennsylvania

In summary, when a shareholder, non-managing member of a limited liability company or limited partner wishes to assert a claim either for mismanagement or malfeasance that resulted in harm to the entity as a whole, or to compel the entity to pursue an action against a third-party, there are six sources of guidance for the six general requirements to adequately plead the claim and establish standing. These are summarized by the following chart:

43. Fed.R.Civ.P. 23.1.

44. Compare, Fed.R.Civ.P. 11(a) (" Every pleading, written motion, and other paper must be signed by at least one attorney of record in the attorney's name—or by a party personally if the party is unrepresented."); Fed.R.Civ.P. 23.1(b) ("The [derivative] complaint must be verified. . . ."). This exceptional requirement of verification is imposed on federal derivative plaintiffs because a shareholder's demand to be permitted to participate in the conduct of the corporation is an exceptional claim that requires specific allegation of exceptional circumstances. *In re: Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir. 1973).

45. Fed.R.Civ.P. 23.1(b)(3)(A).

46. See, e.g., *Schilling v. Belcher*, 582 F.2d 995, 996 (5th Cir. 1978) (holding in a federal derivative action that because Florida (procedural statute) required ownership of shares throughout litigation, plaintiff's sale of shares resulted in loss of standing). In Pennsylvania, the substantive law has slightly differing rules regarding ownership. For a corporation, one need only own the shares at the time of the transaction complained of. 15 Pa.C.S.A. §1782(a). However, in the case of an LLC, ownership is required only at the time of litigation. 15 Pa.C.S.A. §8992(1). If the action is against the general partner of a limited partnership, the interest must be owned at both the time of the transactions complained of and the litigation. 15 Pa.C.S.A. §8592(a)(1).

47. Fed.R.Civ.P. 23.1(b)(3).

48. *Warden v. McElland*, 288 F.3d 105, 110-11 (3d Cir. 2002).

	Pa. Business Corp. Law	Limited Liability Co. Act of 1994, re: Manager-Managed LLCs	Pa. Ltd. Partnership Act	Cuker/ALI Principles	Pa.R.C.P. 1506	Fed.R.Civ.P. 23.1
Ownership at time of transaction complained of	15 Pa.C.S.A. §1782(a)		15 Pa.C.S.A. §8592(a)(1)	Sec. 7.02	1506(a)	23.1(b)(1)(3)(i)
Ownership at the time of litigation		15 Pa.C.S.A. §8992(1) (authorizing any member to bring suit)	15 Pa.C.S.A. §8592(a)	Sec. 7.02	1506(a)(1)	
Ownership at the time of judgment				Sec. 7.02		
Assertion of a secondary right	15 Pa.C.S.A. §1717; 15 Pa.C.S.A. §1782(a)	Rights of action determined by Agreement. 15 Pa.C.S.A. §8992	15 Pa.C.S.A. §8591		1506(a)	23.1(a)
After demand and refusal	Implied by 15 Pa.C.S.A. §1782(a) (re: director's refusal to pursue a claim or action)	Member may only bring action if authorized by non-interested members. 15 Pa. C.S.A. §8992.	15 Pa.C.S.A. §8591; 15 Pa.C.S.A. §8593 (including a futility exception)	Sec. 7.03	1506(a)(2)	23.1(b)(3)(A)
Adequate representation		Implied by requirement of majority vote of uninterested members	15 Pa.C.S.A. §8591	Sec. 7.02 (a)(4)	1506(c)	

Before turning to the application of these rules, review of this chart raises two issues. The first is whether these rules are equally applicable in state court and federal court. The second is whether the *Cuker/ALI* Principles apply to any entities other than the corporation's that case specifically addressed.

Applying Pennsylvania's Substantive State Law in Federal Courts

Most of these rules must be applied in both state and federal court, with the exception of the Rule 1506 requirements. It is beyond discussion that that state procedural rules are not applicable in federal courts.⁴⁹ Rule 1506 is a pleading rule, see, Pa.R.C.P. 1506(a) (" . . . the complaint shall set forth . . . ") included within Pennsylvania's Rules of Civil Procedure. It does not state a requirement of substantive corporation law.⁵⁰ Therefore, Rule 1506's requirements are likely to be construed as procedural and inapplicable in federal courts. However, corporate entities

49. *Gasparini v. Center for the Humanities*, 518 U.S. 415, 427 (1996) (citing, *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1939)).

50. *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 96 (U.S. 1991) (derivative rules of civil procedure establishes only a pleading requirement; to determine whether demand was undertaken sufficiently, one must look to underlying state corporation law and the statute creating the claim).

are, “. . . wholly artificial creation[s] whose internal relations between management and stockholders are dependent upon state law. . . .”⁵¹ As a result, the “internal affairs doctrine” requires that, when addressing issues of a corporation’s internal governance, federal courts apply the substantive law of the corporation’s state of incorporation.⁵² Thus, the statutory requirements and remedies of the Business Corporation Law, the Pennsylvania Limited Liability Company Act of 1994 and the Pennsylvania Limited Partnership Act should be applied by federal courts addressing derivative claims against Pennsylvania corporations and other entities.⁵³ Federal courts have also recognized the *Cuker*/ALI Principles as substantive law of Pennsylvania that they are required to apply in derivative actions against corporations incorporated in Pennsylvania.⁵⁴

The remaining question is whether the *Cuker*/ALI Principles also apply to limited liability companies or limited partnerships. Pennsylvania’s courts have not addressed this question. However, the Supreme Court adopted the *Cuker*/ALI Principles only to the extent that they were “. . . helpful and consistent with Pennsylvania law.”⁵⁵ Therefore, the *Cuker*/ALI Principles must be both helpful, to be determined by individual judges, and consistent with existing Pennsylvania law before they are applied to LLCs and limited partnerships. For example, if the *Cuker*/ALI Principles were applied to a derivative claim against the manager of a manager-managed LLC, the necessary demand required would be limited to making the demand on the other LLC members because that is what the existing statute requires. Similarly, in the case of a limited partnership, the demand requirement would be subject to a futility exception that is not applicable to corporation or LLCs, because that is what the statute requires.

APPLYING THE STATUTES, DECISIONS AND PROCEDURAL RULES GOVERNING DERIVATIVE PROCEDURE AND STANDING

Complying With Intra-Corporate Remedies Prior to Litigation

Applying these rules generally involves, or could involve, the following issues: 1) ownership; 2) whether the right is secondary or direct; 3) demand/refusal and/or whether this requirement should be excused; 4) adequate representation, and; 5) the procedure for addressing these issues. Ownership requires little or no analysis: the rule is clear. Questions of whether a claim is secondary or direct are addressed in Section I, above. Adequate representation is rarely, if ever, litigated. Therefore, this section will address the requirement of demand/refusal and attempts to reconcile the Pennsylvania Rules of Civil Procedure with the *Cuker*/ALI Principles.

Demand/Refusal

Demand/Refusal, Generally

It is worthwhile to review the exact words of the demand requirement stated in the *Cuker*/ALI Principles:

51. *Cohen*, 337 U.S. at 549.

52. *Boyer v. Travelers’ Protective Association of America*, 75 F.2d 440, 441 3d Cir. 1934); *Penn Mont Securities v. Frucher*, 502 F.Supp.2d 443, 458 n.11 (E.D.Pa. 2007).

53. *See, Garber v. Lego*, 11 F.3d 1197, 1201 (3d Cir. 1993)(court’s determination whether a plaintiff in a derivative action complied with or was excused from demand requirement required examination not of either Fed.R.Civ.P. 23.1 or Pa.R.C.P. 1506 but of Pennsylvania corporation statutes and case law).

54. *See, e.g., Warden v. McElland*, 288 F.3d 105, 110-11 (3d Cir. 2002) (applying ALI Principles adopted in *Cuker* to determine whether a derivative plaintiff established standing); *Hawaiian Structural Iron Workers Pension Trust Fund v. Belda*, 2008 WL 2705548 **5-6 (applying ALI Principles developed in *Cuker* to determine whether and how the federal court was to apply the derivative demand requirement).

55. *Cuker*, 692 A.2d at 614 n.5.

§7.03 Exhaustion of Intracorporate Remedies: The Demand Rule

(a) Before commencing a derivative action, a holder or a director should be required to make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective measures, unless demand is excused under §7.03(b). The demand should give notice to the board, with reasonable specificity, of the essential facts relied upon to support each of the claims made therein.

(b) Demand on the board should be excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result, and in such instances demand should be made promptly after commencement of the action.⁵⁶

Thus, a derivative plaintiff must first write to the board of directors demanding prosecution of the claim or other corrective action and providing reasonable specificity of the material facts supporting the claim or claims. The board of directors is permitted a “reasonable time” within which to respond to the demand, and the action is to be dismissed if brought before that “reasonable time” expires.⁵⁷ The board must provide a written response that includes specific facts supporting its decision to reject the claim.⁵⁸ There are circumstances under which this requirement may be excused.

Excusing the Demand/Refusal Requirement

Excusing the Demand/Refusal Requirement to Avoid Irreparable Injury to the Company

Prior to *Cuker*, the demand/refusal requirement would only be excused if the plaintiff could show sufficient “fraudulent collusion” on the part of the directors sufficient to render any demand futile.⁵⁹ The *Cuker*/ALI Principles changed this standard.⁶⁰ Under the *Cuker*/ALI Principles, the demand/refusal requirement is only to be waived under the following, narrower, set of circumstances:

(b) Demand on the board should be excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result, and in such instances demand should be made promptly after commencement of the action.⁶¹

Neither *Cuker* nor the ALI Principles define what would constitute “irreparable injury” to the corporation for these purposes.

Two federal decisions have addressed this “irreparable injury” basis for excusing the demand/refusal requirement. In *Warden v. McElland*,⁶² the plaintiffs were the beneficiaries of trusts the largest assets of which were shares in a family-related corporation.⁶³ The plaintiffs pleaded that: 1) their brother who controlled the corporation was diverting its assets; 2) to another entity that he controlled, and; 3) the family corporations was shortly to be liquidated. The plaintiff initiated a derivative action against their brother and other officers of the corporation and trustees of the trust without first making a demand.⁶⁴ The District Court granted the Defendants’ Motion to Dismiss on various bases, including that no pre-litigation demand was made, as required by *Cuker*. The Court of Appeals reversed the District

56. *Cuker*, 692 A.2d at 615-16 (citing, ALI Principles of Corporate Governance citing, American law Institute, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, §7.03 (1994)).

57. *Id.* at Sec. 703(d).

58. *Id.* at Sec. 704(a)(2).

59. *Garber*, 11 F.3d at 1202.

60. *Drain v. Covenant Life Ins. Co.*, 712 A.2d 273, 278 (Pa. 1998).

61. *Cuker*, 692 A.2d at 1050 (citing, ALI Principles, Sec. 703(b)).

62. *See*, n.40, *supra*.

63. *Warden*, 288 F.3d at 108-09.

64. *Warden*, 288 F.3d at 109.

Court's dismissal. The Third Court excused demand on the basis that the resulting delay would have caused irreparable injury to the corporation because it would give the defendant/brother time to dissolve the family-related corporation and so, deprive the plaintiffs of standing.⁶⁵ The irreparable injury consisted of imminent dissolution and/or the loss of the minority shareholders' ability to challenge the malefacting directors' actions. Although *Warden* is one of the few applications of this exception, this case deals with the highly deferential Rule 12(b)(6) standard, addresses a very broad statement of irreparable injury, simultaneously addresses different grounds and standards for excusing demand, and may be the result of the very extreme facts posed.

The irreparable injury standard was addressed more recently by the United States District Court for the Eastern District of Pennsylvania in *Hawaii Structural Ironworkers Pension Trust Fund v. Belda*.⁶⁶ In that case, after a criminal investigation into Alcoa's overseas actions was disclosed, certain shareholders brought a derivative action without first making a written demand on Alcoa's Board of Directors.⁶⁷ In response to Alcoa's Motion to Dismiss, the plaintiffs argued that they would irreparably be injured by being "required to sit on their hands" "while the fox guarded the hen house."⁶⁸ The District Court considered the general definition of an irreparable injury as one that "cannot be redressed by legal or equitable remedy after a trial" and is not "remote or speculative."⁶⁹ The District Court also considered the Third Circuit's decision in *Warden*, which found that irreparable injury for purposes of a derivative claim includes imminent liquidation and/or loss of standing.⁷⁰ After consideration of these factors, the Court of Appeals concluded that no such harm was threatened by the need to "sit on one's hands."

Neither of these cases provides a clear definition of what constitutes irreparable injury for purposes of a derivative action. However, they demonstrate how highly fact-driven a seemingly clear statutory issue can be. A plaintiff who wishes to avail himself of this exception must make specific, non-speculative, allegations of a loss of their remedy or standing. Otherwise, the party risks losing more time, and possible dismissal, than he would have lost to a demand.

Excusing the Demand/Refusal Requirement In Cases Involving Closely-Held Corporations

Other courts have accepted the Supreme Court's invitation to adopt other sections of the *Cuker/ALI Principles* as they may prove to be helpful.⁷¹ These courts relied on Section 7.01 of the *Cuker/ALI Principles*. This Section provides:

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 from those restrictions 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 affair distribution of the recovery among all interested persons.⁷²

65. *Warden*, 288 F.3d at 111.

66. *Hawaii Structural Ironworkers Pension Trust Fund v. Belda*, 2008 WL 2705548 (E.D. Pa. 2008).

67. *Belda*, 2008 WL 2705548 * 1.

68. *Id.*

69. *Belda*, 2008 WL 2705548 * 7.

70. *Id.*

71. See, e.g., *Warden*, 288 F.3d at 112 (applying Section 7.01(d) of *Cuker/ALI Principles* to excuse demand requirements in a case involving a closely-held corporation); *Nedler v. Vaisberg*, 427 F.Supp.2d 563, 570-71 (same); *Liss v. Liss*, 2002 WL 576510 (Phila. Cty. C.C.P. 2002) (same).

72. *Liss*, 2002 WL 576510 at *9 (citing *Cuker/ALI Principle 7.01*) (emphasis added).

In summary, this section allows a court to excuse a plaintiff from undertaking any of the derivative threshold requirements, and treat the claim like a direct claim when the corporation is closely held and excusing the derivative requirements would not expose the defendants to a “multitude of actions”.

This exception may not be as broad as some may hope. In *Liss v. Liss*, the plaintiff and defendant were brothers and 50%/50% shareholders in a corporation.⁷³ Therefore, because the two parties to the *Liss* action were the only possible two parties, excusing the derivative requirements posed no threat of a multiplicity of actions. In fact, virtually every Pennsylvania case that relies on this exception for closely-held corporations where excusing the demand and other derivative requirements would not expose the defendants to a “multiplicity of actions” involved cases in which the defendants were not exposed to any other actions.⁷⁴ The authors of the ALI Principles appear to have used “closely held corporation” as a term of art that can be subject to interpretation and application. It would seem imprudent to suggest that Section 7.01 of the ALI Principles should be construed with Pennsylvania’s statutory definition of a close corporation as one with fewer than 30 shareholders because 28 separate lawsuits could certainly constitute a “multiplicity of actions” that would require application of derivative rules even though the corporation or entity was closely held.⁷⁵ Therefore, this exception also should be applied with caution because a court could exercise broad discretion when determining how many other possible actions could constitute a multiplicity.

Pleading and Challenging the Pleading of Exhaustion of Intra-Corporate Remedies

Pleadings Must Be Drafted and Analyzed in Accordance With Substantive Corporate Law As Well As, Procedural Pleading Requirements

Having addressed the substantive law governing derivative claims brought against entities governed by Pennsylvania law, the next question is how one would plead or challenge a derivative claim. Both Fed.R.Civ.P. 23.1 and Pa.R.C.P. 1506 requires that a derivative plaintiff allege ownership and plead particular facts identifying the efforts made by the plaintiff to obtain the desired action from “directors or comparable authority” or the reasons for not doing so.⁷⁶ These necessary facts

73. *Liss*, 2002 WL 576510 at *1.

74. See, e.g., *White v. George*, 66 Pa.D.&C.4th 129, 135 (Mercer Cty. C.C.P. 2004) (excusing derivative plaintiff from ALI requirements because corporation has only 2 shareholders of which plaintiff was one and defendant was the other); *Top Quality Mfgng., Inc. v. Sinkow*, 2004 WL 2554615 (Phila. Cty. C.C.P. 2004) (excusing ALI demand requirements in derivative action between two 50%/50% shareholders of a closely held corporation); *Levin v. Schiffman*, 54 Pa.D.&C.4t 152, 168 (Phila. Cty. C.C.P. 2001) (excusing derivative standing requirements of ALI Principles where derivative action was between two 50%/50% shareholders of a closely-held corporation); *Pritzker v. Baron*, 2001 WL 1855054 (Phila. Cty. C.C.P. 2001) (same); *Warden v. McLelland*, 288 F.3d 105, 112 (3d Cir. 2002) (applying Pennsylvania law and excusing ALI requirements because there was no danger of multiplicity of actions because the plaintiff was the sole minority shareholder who might assert a claim); *Nedler v. Vaisberg*, 427 F.Supp. 2d 563, 572 (E.D. Pa. 2006) (applying Pennsylvania law to determine that failure to comply with ALI requirements for derivative actions could be excused because there was no danger of multiplicity of actions insofar as all non-party shareholders had executed releases); *Cooper v. Rucci*, 2008 WL 942710 * 7 (W.D. Pa. 2008) (excusing plaintiff from ALI demand requirements because the plaintiff and the defendant were 50%/50% shareholders in the corporation). Thus, although trial courts have excused certain derivative plaintiffs from the *Cuker* requirements, it has only been in cases in which there was no danger of a “multiplicity of actions” and particularly in cases of 50/50 shareholders.

75. See, 15 Pa.C.S.A. Sec. 1103 (defining a closely held corporation as one with fewer than 30 shareholders).

76. Fed.R.Civ.P. 23.1(b)(3); Pa.R.C.P. 1506 (set forth at length above).

must be pleaded with particularity and should not be pleaded generally or on information and belief.⁷⁷

Alleging these facts with particularity is not a question of complying with a procedural pleading rule. Rather, it is a question of establishing subject matter jurisdiction.⁷⁸ This is so because, as discussed above, when a cause of action is created by statute, one must allege all elements of that cause of action to establish subject matter jurisdiction.⁷⁹ Although the differences may be slight, litigators should be mindful of the difference between the pleading rules and the substantive law when pleading or challenging a derivative cause of action asserted against a Pennsylvania corporation.⁸⁰

The next question, then, is how one is to challenge a derivative claim. Keeping in mind that when one challenges derivative standing, it is a challenge to subject matter jurisdiction, the obvious assumption is that the challenge would be a preliminary objection pursuant to Pa.R.C.P. 1028(a)(1)⁸¹ or a motion to dismiss pursuant to Fed.R.Civ.P. 12(b).⁸² Both of these rules are subject to a standard that is highly deferential to plaintiffs.⁸³ Both of these rules can also permit either a “facial” challenge to the allegations of the complaint or a more substantive “factual” challenge that permits the taking of discovery on the plaintiff’s allegations in support of subject

77. See, *Shenango Inc. v. American Coal Sales Co.*, 2007 WL 2310869 * 3 (E.D. Pa. 2007) (where federal rules required pleading with particularity, allegations made on information and belief were not sufficient to withstand a motion to dismiss unless accompanied by specific allegations of facts supporting the allegations); *First Realvest, Inc. v. Avery Builders, Inc.*, 600 A.2d 601, 603-04 (Pa. Super. 1991) (general allegations of necessary elements of a disfavored claim without allegations of specific supporting facts were not sufficient to withstand demurrer).

78. *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 96 (U.S. 1991) (Fed.R.Civ.P. 23.1 establishes only a pleading requirement; to determine whether demand was undertaken sufficiently, one must look to underlying state corporation law and the statute creating the claim).

79. See, *Grom v. Burgoon*, 672 A.2d 823, 824 (Pa. Super. 1996) (where cause of action is created by a statute, all of the statutory elements of that cause of action, particularly those regarding standing, must be sufficiently alleged to establish the court’s subject matter jurisdiction over the claim); see also, *Wheeler*, 22 F.3d at 537 (because federal courts are courts of limited jurisdiction, questions of standing implicate questions of subject matter jurisdiction); *In re Total Containment, Inc.*, 2008 WL 682455 *9 n.11 (Bankr. E.D. Pa. 2008) (reviewing *Cuker*/ALI Principles to determine whether federal bankruptcy court had subject matter jurisdiction over derivative claim).

80. For example, although Rule 1506 and 23.1 contemplate a futility exception to the demand requirement, the underlying substantive law permits a futility exception under only very circumscribed conditions. Compare, *Drain*, 712 A.2d at 278 (after *Cuker* decision, failure to make demand on corporate directors was no longer excused by futility); 15 Pa.C.S.A. Sec. 8591 (specifically permitting limited partner asserting derivative claim to be excused from demand in instances of futility).

81. This Rule provides:

(a) Preliminary objections may be filed by any party to any pleading and are limited to the following grounds:

(1) lack of jurisdiction over the subject matter of the action or the person of the defendant, improper venue or improper form or service of a writ of summons or a complaint;

Pa.R.C.P. 1028(a)(1).

82. This Rule provides:

Every defense to a claim for relief in any pleading must be asserted in the responsive pleading if one is required. But a party may assert the following defenses by motion:

(1) lack of subject-matter jurisdiction;

A motion asserting any of these defenses must be made before pleading if a responsive pleading is allowed. If a pleading sets out a claim for relief that does not require a responsive pleading, an opposing party may assert at trial any defense to that claim. No defense or objection is waived by joining it with one or more other defenses or objections in a responsive pleading or in a motion.

Fed.R.Civ.P.(12)(b).

83. See, *Stilp v. Cappy*, 931 A.2d 108, 110 (Pa. Cmwlth. 2007) (court ruling on preliminary objections must accept all allegations of the complaint as true); *Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406, 1409 (3d Cir. 1991) (upon facial challenge to subject matter jurisdiction, plaintiff bears a light burden of persuasion).

matter jurisdiction. based on jurisdictional discovery.⁸⁴ A defendant's advantage, and a plaintiff's disadvantage, with the factual challenge, is that it shifts the burden of proof from the plaintiff to the defendant and deprives the allegations of the Complaint of any presumption of truthfulness that it would otherwise have.⁸⁵

The Application of These Procedural and Substantive Requirements in *Lemenstrel v. Warden*

Many of these issues were addressed in *Lemenstrel v. Warden*.⁸⁶ In that case, the Superior Court affirmed a decision to dismiss a group of minority shareholders' derivative claims because a committee of uninterested directors determined that the action was not in the corporation's best interests.⁸⁷ A group of dissenting shareholders, acting through counsel, sent written notice of their objections to certain management decisions and payments that were anticipated to be made as part of a compensation program related to the liquidation of the company.⁸⁸ These objections led to an examination of the corporate records, as permitted by statute.⁸⁹ This examination led to a longer, written demand for action that included claims dating back over a decade.⁹⁰ Upon receipt of the demand, the Board of Directors, acting on guidance from counsel relying in the *Coker/ALI* Principles, convened a special litigation committee of uninterested directors,⁹¹ who were provided with independent counsel, to investigate.⁹² The independent counsel undertook a six-month investigation that involved the interview of 9 witnesses who had personal knowledge of the challenged transactions and the review of numerous other witnesses from related litigation. Memoranda were kept of all interviews and the committee had access to these memoranda because counsel did not assert work product privilege over them.⁹³ After meeting with the disaffected shareholders' counsel to define the scope of the inquiry and conducting frequent meetings with the committee, the independent counsel prepared a 106-page report concluding that pursuit of the claims was not in the best interest of the company.⁹⁴ The filing of a derivative action followed shortly thereafter.⁹⁵

84. See, Pa.R.C.P. 1028(c)(2) ("If an issue of fact is raised [by a preliminary objection], the court shall consider evidence by deposition or otherwise.") The Explanatory Note continues to identify objections raised to subject matter jurisdiction among those that may raise an issue of fact requiring discovery. In federal courts, facial attacks on subject matter jurisdiction, i.e., attacks limited to the allegations on the face of the complaint, are distinguished from factual challenges that raise issues of fact by affidavit, initially, and by other forms of discovery. *Gould Electronics v. United States of America*, 220 F.3d 169, 176 (3d Cir. 2000).

85. When preliminary objections raise issues of fact, the court must review the elicited discovery and the complaint loses the presumption of truthfulness generally accorded a complaint subject to preliminary objections. *Telstar Corp. v. Berman*, 422 A.2d 551, 555 (Pa. Super. 1980). Similarly, when federal courts address a factual attack on a plaintiff's claim of subject matter jurisdiction, the pleading are not accorded a presumption of truthfulness. *Mortensen v. First Fed. Savings Bank & Loan Assoc.*, 549 F.2d 884, 891 (3d Cir. 1977). Moreover, the plaintiff bears the burden of proof of establishing jurisdiction. *Id.* (citing, 5 C. Wright and A. Miller, FEDERAL PRACTICE AND PROCEDURE Sec. 1350 (1969)).

86. *Lemenstrel v. Warden*, 964 A.2d 902 (Pa. Super. 2009).

87. *Lemenstrel*, 964 A.2d at 904.

88. *Lemenstrel*, 964 A.2d at 906.

89. *Lemenstrel*, 964 A.2d at 904 (citing, 15 Pa.C.S.A. Sec. 1508(b)).

90. *Lemenstrel*, 964 A.2d at 907.

91. For purposes of forming such a committee, an uninterested director is one who is a party to the transaction at issue, has a familial relationship with a party to the transaction, has a material pecuniary interest in the transaction such that his judgment would be affected, or is subject to a controlling influence by an interested director. *Lemenstrel*, 964 A.2d at 918-19.

92. *Lemenstrel*, 964 A.2d at 909.

93. *Lemenstrel*, 964 A.2d at 909; 917.

94. *Lemenstrel*, 964 A.2d at 910.

95. *Id.*

Initially, the Board of Directors responded with preliminary objections asserting a facial challenge to the derivative claims. The Judge overruled these objections.⁹⁶ However, he also entered an Order requiring that discovery be taken only on the threshold issues on the issues of whether: 1) the special litigation committee was properly established in accordance with ALI Principles; 2) the members of the special litigation committee were uninterested, and; 3) the special litigation committee members were adequately informed to arrive a rational decision regarding the pursuit of this litigation.⁹⁷ After reviewing briefs and conducting 6 days of hearings, the Court of Common Pleas found that the ALI Principles were followed when the special litigation committee was formed with 2 or more directors who were uninterested and assisted by counsel of their choice.⁹⁸ The special litigation committee was also not unduly dominated by counsel because his investigatory materials, the depositions and interview, were available for the committee's review and consideration.⁹⁹ More-over, the scope of the inquiry was sufficient to adequately inform the special litigation not only because of its breadth, but because plaintiff's counsel was involved in the definition of its scope.¹⁰⁰ Various other attacks on the uninterested nature of the members of the special litigation committee were also disposed of.¹⁰¹

Although the Court's decision in *Lemenstrel* is very detailed, it shows two important aspects of an appropriate response to a derivative claim. The first, specifically, is to remain aware of the substantive state law regarding intra-corporate (or intra-LLC or intra-limited partnership) remedies. The second, more general issue relates as much to human nature as to legal procedure: when accused of mis- or malfeasance, a director's first obligation is not to defend himself but to investigate the demand or claim objectively. Many of the case cited herein show that courts will overlook various procedural or substantive requirements so long as it appears that the officer, directors, managers or partners are acting properly and the plaintiffs are not being unfairly victimized. Courts will not look past a refusal to consider one's own conduct objectively.

CONCLUSION

The successful assertion of or challenge to a derivative claim asserted or behalf of the shareholders, members of LLC or limited partners of a Pennsylvania entity relies on an appreciation of the relationship between substantive statutory law and procedural pleading rules. Because derivative claims are creatures of statute, the internal affairs doctrine requires that all statutory remedies and requirements be exhausted before a court's subject matter jurisdiction over the claim can be established. Even though a Plaintiff may claim to assert a common law breach of fiduciary claim, that duty is defined by the same statutes that define the statutory claim. Parties should be mindful of both these statutory requirements and the related procedural pleading rules so they can be aware of the possibilities of discovery, burden-shifting and dismissal that they implicate. The preceding article may provide some guidance about these requirements and the cases applying them.

96. *Lemenstrel*, 964 A.2d at 922.

97. *Lemenstrel*, 964 A.2d at 910.

98. *Lemenstrel*, 964 A.2d at 913.

99. *Lemenstrel*, 964 A.2d at 916. The trial court and appellate courts both noted, however, that if the attorney's work product was not made available to the committee, counsel could be found to have unduly dominated the committee's investigation.

100. *Id.*

101. *Lemenstrel*, 964 A.2d at 916.