The Unfortunate Role of Special Litigation Committees in LLCs

*By Donald J. Weidner**

Recent LLC acts adopt the rule developed for public corporations that most owner claims against managers or other owners are merely "derivative" rather than "direct" and give the firm the right to appoint special litigation committees ("SLCs") to decide how to dispose of derivative claims. The imposition of the complexities of derivative litigation upon closely held LLCs imposes significant transaction costs that cannot be spread and that typically serve no purpose. It is also contrary to the presumptive intent of members, who presumably expect to be treated as contracting parties with the normal remedies for breach, as in the case of partners. Legislatures should permit LLCs to "opt in" to the complexities of derivative litigation rather than force them to "opt out" of it when the claim is made against an insider. Short of that, legislatures should amend the rule that permits a majority of derivative defendants to appoint the SLC that resolves the claims against them. Even in the absence of legislative change, courts should adopt the Delaware approach that offers the possibility that the composition, work, and recommendations of SLCs may receive enhanced scrutiny in equity.

Introduction

Limited liability companies ("LLCs") have largely displaced corporations as the form of choice for closely held businesses. Although LLC acts have always reflected a blend of partnership law and corporate law, recent acts embrace many more features of corporate law. Nowhere has the shift to the corporate model been more dramatic, or more unfortunate, than in access to judicial remedies. Earlier LLC acts mirrored partnership law by giving members a direct action against one another or the firm for breach of either contractual or statutory duties. In a dramatic reversal, more recent LLC acts, of which the Revised Uniform Limited Liability Company Act[1] ("RULLCA") is an exemplar, have severely restricted the rights of members to bring a direct action, while locking in their economic interests. As in the case of a publicly held corporation, members are

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1. Unif. Ltd. Liab. Co. Act (Unif. L. Comm'n 2013) [hereinafter R.U.L.L.C.A.].

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now denied "standing" to bring a direct action unless they can show that their injury is not solely the result of an injury to the LLC.[2] Claims that fail the test are deemed to be merely "derivative" of the firm's claim and, therefore, can only be brought on the firm's behalf in a derivative action. If a member brings a derivative action,[3] the LLC has the right to respond by appointing a special litigation committee ("SLC") to decide how to dispose of the matter.[4] Although RULLCA formally requires that members of the SLC be disinterested and independent, the act nonetheless permits, in many situations, the SLC to be appointed by a majority of the defendants in the derivative action.

The derivative action, and the firm's right to respond with an SLC, are largely creatures of public corporation law with roots that can be traced back to the nineteenth century.[5] It was not until the 1970s, however, that corporate managers widely used SLCs to defend themselves and their decisions.[6] To the present day, if a shareholder properly commences a derivative action, the board of directors typically appoints an SLC of supposedly "disinterested and independent" directors and delegates to them the board's authority to determine what to do with the claim. Often, the directors appointed to the SLC are people newly appointed to the board to make them eligible to serve on the SLC.

As courts began to process shareholder challenges to the composition, work, and determinations of SLCs, they struggled to find an appropriate standard of review. By 1981, two divergent standards had emerged. The landmark New York case of *Auerbach v. Bennett*[7] is the archetype of a more lenient standard of review, which essentially treats the SLC as exercising the business judgment

2. *Id.* §§ 801, 802.

3. *Id.* § 802. Unless excused, the member must first demand the firm to pursue its claim. *Id.* § 802(a). If the managers ignore or oppose a member's concerns, the member does not have the authority to sue on the firm's behalf until there has been a finding either that the managers wrongfully refused a demand to sue or that a demand is excused because the managers are incapable of making an impartial decision regarding the litigation. *See id.* § 802. *See generally* Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993) (discussing the requirements for demand excusal). The demand requirement exists to ensure that a member exhausts intrafirm remedies and to prevent strike suits. If management appoints a special litigation committee that takes no position on claims asserted derivatively, demand may be excused. *In re* Am. Int'l Grp., Inc., 965 A.2d 763, 808–11 (Del. Ch. 2009).

4. R.U.L.L.C.A., *supra* note 1, § 805.

5. The stockholder's derivative suit was an early nineteenth century creature of equity. *See* Dodge v. Woolsey, 59 U.S. 331, 341–43 (1855). Its initial purpose was to give shareholders a right to call their directors to account for their management. *Id.* at 344. The analogy was to the right of a trust beneficiary to call a trustee to account. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549–50 (1949). Although the right to sue was individual, the interest to be protected was that of the corporation, and only indirectly, or derivatively, the shareholders. *See id.* During the last half of the nineteenth century, it was expanded to give shareholders the right to sue parties the directors refused to sue. *See* Bert S. Prunty, Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. Rev. 980, 990–92 (1957).

6. In 1980, the appointment of SLCs was described as "a fairly new defensive strategy in response to shareholders' derivative suits against corporate directors." Marc I. Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. Miami L. Rev. 1, 2 (1980).

7. 393 N.E.2d 994 (N.Y. 1979).

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of the full board and defers to it.[8] By contrast, the Delaware case of *Zapata Corp. v. Maldonado*[9] is the archetype of a stricter standard of review, which offers the possibility of closer scrutiny of the SLC if the claims concern the wrongdoing of insiders. *Auerbach* and *Zapata* remain the two contrasting paradigms, although courts in some other jurisdictions have fashioned other standards of review that fall at or somewhere between New York and Delaware.[10]

Empirical studies have confirmed what many had only assumed: the standard of review applied to SLCs has practical consequences. A recent large empirical study found that SLCs tend to favor fellow directors and officers.[11] SLCs and their counsel "appear to underestimate the likelihood that cases will settle and overestimate the chances that cases will be dismissed."[12] In states "applying the lowest level of judicial review, SLCs are more likely to recommend dismissal of a case, are more likely to have a case dismissed as opposed to settled, and are less likely to have a settlement resulting in a high settlement value."[13] By contrast, under the closer review of Delaware law, SLCs "are less likely to move to dismiss derivative suits and courts overall are less deferential to committee determinations and recommendations."[14]

Part I of this article examines *Auerbach* and *Zapata* for the lessons they hold for reviewing the work of SLCs in LLCs. The RULLCA Official Comments declare the drafters' intent to "follow" the limited judicial review set out in *Auerbach* "rather than" the closer standard of review set out in *Zapata*.[15] Part I also discusses the 2003 landmark Delaware decision of *In re Oracle Corp. Derivative Litigation*,[16] which states a more demanding requirement for SLC independence that requires neutrality with respect to a wide variety of personal and social factors in addition to economic factors.

Part II addresses LLCs. It first considers statutory provisions that apply corporate derivative litigation concepts to LLCs and their SLCs. RULLCA's provisions are much more detailed than those in many corporate statutes, particularly when it comes to the qualifications and procedures for appointment to SLCs. Part II then explains that, as courts have begun to review the use of SLCs in LLCs, Delaware has again taken the lead in setting a higher standard of review. In 2016, *Obeid v. Hogan* offered a thirty-five-year retrospective on *Zapata* and explained

8. It was not considered problematic to defer to the business judgment of SLCs that decline to bring, or seek to dismiss, suits against unrelated third parties. The controversy arose when courts applied the business judgment rule to situations in which directors were implicated in alleged wrongdoing. *See* Steinberg, *supra* note 6, at 5.

9. 430 A.2d 779 (Del. 1981).

10. For the range of judicial standards of review, see Deborah A. DeMott, Shareholder Derivative Actions: Law & Practice § 5.16 (2020).

11. C.N.V. Krishnan, Stephen Davidoff Solomon & Randall S. Thomas, *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. Corp. Fin. 1 (2020).

12. DeMott, *supra* note 10, § 5.18.

13. Krishnan, Davidoff Solomon & Thomas, *supra* note 11, at 2.

14. DeMott, *supra* note 10, § 5.18.

15. R.U.L.L.C.A., *supra* note 1, § 805 cmt. (e).

16. 824 A.2d 917 (Del. Ch. 2003).

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how it applies to LLCs.[17] The basic lesson of *Obeid* is that courts should be guided by the presumptive intent of the parties, which can be inferred from how they have structured their LLC. The more a particular LLC resembles a corporation, the more corporate law will inform the review of its SLC. On the other hand, the more the LLC in question resembles a partnership, the more partnership law will inform the review of the SLC and its recommendations.

Part III concludes that the machinery of corporate-style derivative litigation, including the SLC mechanism, is excessively clumsy and costly in the case of most LLCs, which have relatively few members and are member-managed. In many, if not most, situations, entrepreneurs forming LLCs likely do not intend to impose upon themselves the machinery of derivative litigation used in publicly held corporations. Members should be permitted to "opt in" to the machinery of corporate derivative litigation, not required to "opt out" of it. This would avoid excessive litigation costs by providing members with easier access to judicial remedies for internal claims, reflecting their presumptive intent, on which *Obeid* instructs us to focus. A small minority of states already exempts LLCs with fewer than thirty-five members from the imposition of the derivative action rules.

RULLCA's implementation of the derivative model is also outdated and flawed. By adopting provisions that attempt to "follow" the "standard stated for judicial review" in *Auerbach* "rather than *Zapata*," and by ignoring or failing to anticipate developments such as *Oracle* and *Obeid*, RULLCA attempts to roll back the law almost forty years to an extremely pro-management, minority-insensitive position. Its worst provisions are those that permit a majority of defendants to appoint the SLC to resolve the claims against them. Although Official Comments refer to the SLC as a dispute resolution mechanism, RULLCA does not offer plaintiffs the independent tribunal they would have in arbitration. At a minimum, legislatures should repeal the RULLCA rule that a majority of defendants can select the SLC. Even without statutory change, courts should follow Delaware and require SLCs to be truly independent and closely scrutinize their work and recommendations when the claims are against insiders. Until SLCs are carefully reviewed for personal, social, and economic independence, they will not be considered an appropriate dispute resolution mechanism for LLCs.

I. Divergent Approaches to Reviewing Corporate SLCs

It was not until the 1970s that corporations commonly used SLCs to respond to derivative litigation. As a result, it is not surprising that it was 1981 before two significant courts of last resort announced their standards for reviewing the appointment and work of SLCs. New York was the first, declaring a more limited judicial review, followed shortly by Delaware, declaring a more careful review.

17. No. 11900, 2016 WL 3356851 (Del. Ch. June 10, 2016).

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A. *Auerbach* Announced New York's More Deferential Review

1. *Auerbach* Facts and SLC

In 1979, *Auerbach v. Bennett*[18] became the first decision by a state's highest court to review a corporation's use of an SLC. The audit committee of the board of directors of General Telephone & Electronics Corporation, with the assistance of its outside auditor Arthur Andersen & Co., and with a prominent outside law firm retained to serve as special counsel, investigated the firm's worldwide operations. It concluded that the firm and its subsidiaries had paid millions of dollars of bribes and kickbacks both abroad and in the United States, and that four of the thirteen board members "had been personally involved in certain of the transactions."[19] Nevertheless, there were no allegations or findings that these board members had profited personally from the challenged transactions. When the audit committee released its report, Auerbach, a shareholder, immediately filed a derivative action on behalf of the corporation against Arthur Andersen, the four personally involved directors,[20] and the corporation itself. Auerbach alleged that the directors had violated their duties and sought to hold them to account for the inappropriate payments.

The board of directors responded to the derivative action by appointing an SLC, to which it delegated all its authority to deal with the claims raised in the derivative litigation. It appointed to the committee "three disinterested directors" who were disinterested in two ways.[21] First, they were not appointed to the board until after the challenged transactions had occurred.[22] Second, they had no prior affiliation with the corporation.[23]

The SLC retained its own "eminent special counsel" and began by reviewing the prior work of the audit committee.[24] It examined its "completeness, accuracy and thoroughness" by interviewing representatives of the audit committee's outside counsel, reviewing the transcripts of testimony of ten corporate officers and employees before the Securities and Exchange Commission, and studying documents collected by and the work papers of outside counsel.[25] The SLC also conducted individual interviews with the directors found to have personally participated in the questioned payments and with representatives of the outside auditor. It also sent questionnaires to each of the non-management directors. At the

18. 393 N.E.2d 994 (N.Y. 1979).
19. *Id.* at 997.
20. "It appears that only 4 of the 13 named individual defendants, all present directors, [were] served." *Id.* at 997 n.2.
21. *Id.* at 997.
22. *Id.* The court apparently assumed they were "disinterested" because they were not on the board when the disputed transactions occurred. Even if they had been on the board when the contested decisions were made, that alone might not have made them interested. *See* Braun v. Herbert, 180 A.3d 482, 489 (Pa. Super. Ct. 2018) (concluding that mere service on a corporate board or audit committee does not rise to the level of an "interest" that renders the business judgment rule inapplicable).
23. *Auerbach*, 393 N.E.2d at 1001.
24. *Id.* at 1003.
25. *Id.*

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conclusion of its investigation, the SLC solicited legal advice from its own special counsel.

The SLC reported that the defendant Arthur Andersen had conducted its examination of the corporate affairs in good faith and in accordance with generally accepted auditing standards. It concluded that no corporate or shareholder interest would be served by the continued assertion of a claim against Arthur Andersen. It also concluded that none of the individual defendants had violated New York's statutory standard of care, noting that none of them "had profited personally or gained in any way."[26] It concluded that the claims asserted in the derivative action were without merit, that "if the action were allowed to proceed, the time and talents of the corporation's senior management would be wasted on lengthy pretrial and trial proceedings, that litigation costs would be inordinately high in view of the unlikelihood of success, and that the continuing publicity could be damaging to the corporation's business."[27] The SLC ultimately concluded that it would not be in the best interests of the corporation for the derivative action to proceed, and it directed the corporation's general counsel to take that position.

2. Deferring to the Business Judgment of the SLC

The New York Court of Appeals held that the disposition of the case on the merits "turns on the proper application of the business judgment doctrine, in particular to the decision of a specially appointed committee of disinterested directors acting on behalf of the board to terminate a shareholders' derivative action."[28] The rule is based, at least in part, on "the prudent recognition that courts are ill-equipped and infrequently called on to evaluate what are and must be essentially business judgments."[29] The authority and responsibilities vested in corporate directors, both by statute and decisional law, "proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision can be measured, by the courts or otherwise."[30] Even if that were not the case, "by definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility."[31] As with other policy and management decisions, the decision whether and to what extent to explore and prosecute derivative claims "must be predicated on the weighing and balancing of a variety of disparate considerations" to determine "what course of action or inaction is best calculated to protect and advance the interests of the corporation."[32] This is the province of the board, not of the courts. As a result, "absent bad faith or fraud (of which there is none here) the courts must

26. *Id.* at 997.
27. *Id.*
28. *Id.* at 1000.
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at 1000–01.

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and properly should respect their determinations,"[33] even if the results show that the decision "was unwise or inexpedient."[34]

The SLC merely presents a "special instance" of the application of the business judgment rule, which "applies in its full vigor to shield from judicial scrutiny the decision of a three-person minority committee of the board acting on behalf of the full board not to prosecute a shareholder's derivative action."[35] Because the substantive decision reached by the SLC falls "squarely within the embrace of the business judgment doctrine," the courts "cannot inquire as to which factors were considered . . . or the relative weight accorded them."[36] Accordingly, summary judgment for the defendants was appropriate because "the determination of the special litigation committee forecloses further judicial inquiry in this case."[37]

3. The Prerequisite "Disinterested Independence" of the SLC

Auerbach made clear that the application of the business judgment rule to SLCs is conditional, although only the dissent used that precise word.[38] The rule shields "the deliberations and conclusions" of the SLC "only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudicial exercise of business judgment."[39] The SLC had the requisite "disinterested independence"[40] because its three members were neither on the

33. *Id.* at 1000.
34. *Id.* (quoting Pollitz v. Wabash R.R. Co., 100 N.E. 721, 724 (N.Y. 1912)).
35. *Id.* at 1001.
36. *Id.* at 1002.
37. *Id.* at 1000.
38. *Id.* at 1005 (Cooke, C.J., dissenting).
39. *Id.* at 1001. "Unprejudicial" arguably extends beyond disinterested independence to a broader impartiality, although the inference is weak because the prejudice apparently must stem from a "dual relation."
40. *Id.* Although the requirements of "disinterest" and "independence" have a long history in corporate law, the line between the two concepts is not always clear. The essence of disinterest seems to be a freedom from a financial stake in the outcome of a proceeding greater than that of any other shareholder. Independence, on the other hand, seems to embrace a multi-faceted freedom from financial, social, or personal involvement in the outcome. The Model Business Corporation Act provides an explanation:

> The judicial decisions . . . have generally required that directors be both *disinterested*, in the sense of not having exposure to an actual or potential benefit or detriment arising out of the action being taken (as opposed to an actual or potential benefit or detriment to the corporation or all shareholders generally), and *independent*, in the sense of having no personal or other relationship with an interested director (*e.g.*, a director who is a party to a transaction with the corporation) that presents a reasonable likelihood that the director's objectivity will be impaired.

Model Bus. Corp. Act § 1.43 cmt. (Am. B. Ass'n 2020). As a matter of semantics, "independence" seems the broader concept, and may explain why *Auerbach* spoke of "disinterested independence." Cases on the requisite neutrality for SLC membership typically focus on "independence," rather than "disinterest," perhaps because financial disinterest is assumed to be a minimum requirement, with the question phrased in terms of how "independent" an SLC member must be in other respects. *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 929–48 (Del. Ch. 2003) (addressing independence). By contrast, arbitration rules emphasize "independence and impartiality," which seems to include both disinterest and independence with an additional hint of philosophical neutrality. *See* Non-Administered Arb. Rules § 7.1 (Int'l Inst. for Conflict Prevention & Resol. 2018) [hereinafter CPR Rules] ("Each arbitrator shall be independent and impartial.").

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board at the time of the challenged transactions nor had any prior affiliation with the corporation. Nor were there other factual allegations that the SLC members were personally related to other board members, either defendant or non-defendant directors.[41] Auerbach argued, and the dissent agreed, that facts about personal relationships were peculiarly within the knowledge of the defendants and the SLC, and might be revealed if the motion to dismiss were denied and the case were permitted to proceed to pre-trial discovery.[42] Nevertheless, the court granted the motion to dismiss, stating that, "[n]otwithstanding the vigorous and imaginative hypothesizing and innuendo of counsel there is nothing in the record to raise a triable issue of fact as to the independence and disinterested status of these three directors."[43]

4. Even Imperfect Boards Have Appointment Power

An important question is whether the "disinterest" or "independence" of the SLC is compromised by interest or dependence on the board that appoints them. Auerbach[44] argued that "any committee authorized by the board of which the defendant directors were members must be . . . legally infirm and may not be delegated power to terminate a derivative action."[45] The court rejected this argument, stating that, in the very nature of a corporation, only the board of directors has the authority, "on behalf of the corporation, to direct the investigation and to assure the cooperation of corporate employees, and it is only that same board . . . which had the authority to decide whether to prosecute the claims against defendant directors."[46] Here, the board properly

41. *See Auerbach*, 393 N.E.2d at 997, 1001. *See generally* Einhorn v. Culea, 612 N.W.2d 78, 89 (Wis. 2000) ("[T]he test is whether a member of a committee has a relationship with an individual defendant or the corporation that would reasonably be expected to affect the member's judgment with respect to the litigation in issue."); *id.* at 89–90 (listing several factors, including prior financial and social relationships and the number of SLC members).

42. *Auerbach*, 393 N.E.2d at 1004; *id.* at 1004–05 (Cooke, C.J., dissenting). In dissent, Chief Judge Cooke wrote that it was inappropriate to grant summary judgment to the defendants prior to disclosure proceedings: "It is precisely because certain defendants and the members of the committee are possessed of exclusive knowledge of the facts that [Auerbach] is now unable to suggest the possible avenues which might be successfully pursued upon pretrial disclosure." *Id.* at 1004 (Cooke, C.J., dissenting). The decision to dismiss should be informed by the fact that the business judgment rule was "only conditionally applicable" in that case. *Id.* at 1005 (Cooke, C.J., dissenting). The grant of summary judgment and resulting lack of discovery on independence "not only effectively dilutes the substantive rule of law at issue, but may also render corporate directors largely unaccountable to the shareholders whose business they are elected to govern." *Id.* at 1005 (Cooke, C.J., dissenting). Independent of the standard of review, states can choose to allow discovery on the "disinterested independence" issue. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.456(a) (West, Westlaw through 2021 Reg. Sess.) (providing for limited discovery if an LLC proposes to dismiss a derivative action).

43. *Auerbach*, 393 N.E.2d at 1001.

44. The argument was made by another shareholder who pursued the derivative action after Auerbach left it. *Id.* at 1003 (focusing on shareholder intervenor because of the absence of submissions by Auerbach).

45. *Id.* at 1001.

46. *Id.*

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delegated its authority to the SLC. To make the appointment, it followed "prudent practice in observing the general policy" that when individual board members "prove to have personal interests which may conflict with the interests of the corporation, such interested directors must be excluded while the remaining board proceed to consideration and action."[47]

Because management is vested in the board, it may appoint the SLC from its own ranks even "where some directors are charged with wrongdoing, so long as the remaining directors making the decision are disinterested and independent."[48] To disqualify the entire board would "render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action."[49] The "possible risk of hesitancy" of board members to investigate the activity of fellow board members "where personal liability is at stake" is an "inherent, inescapable, given aspect" of the corporate form.[50] Indeed, a board's attempt to delegate the authority to resolve derivative claims to an SLC "wholly separate and apart from the board would, except in the most extraordinary circumstances, itself be an act of default and breach of the nondelegable fiduciary duty owed by the members of the board to the corporation and to its shareholders, employees and creditors."[51] A judicial attempt to do the same thing "would similarly work an ouster of the board's fundamental responsibility and authority for corporate management."[52]

5. Important Judicial Role Under *Auerbach*

Even under *Auerbach*'s limited standard of review, courts have an important role in assessing the composition and work of SLCs. First, they must address claims that SLC members are not "disinterested and independent." Second, they must address claims that the SLC has not made a proper investigation of facts or law. Unlike the lack of judicial standards or competence to second guess an SLC's business judgment, courts are generally "better qualified" than directors to make determinations about the "methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability."[53] These determinations do not "partake of the nuances or special perceptions or comprehensions of business judgment or corporate activities or interests. The question is solely how appropriately to set about to gather the pertinent data."[54] The SLC "may reasonably be required to show that they have pursued their chosen investigative methods in good faith."[55] Questions of good

47. *Id.*
48. *Id.* at 1002.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* As Professor DeMott has summarized, the SLC's "recommendation may be treated as an exercise of nonreviewable 'business judgment' even if the derivative claims alleged that defendants received personal financial benefits from the transactions challenged in the suit." DEMOTT, *supra* note 10, § 5.15.
53. *Auerbach*, 393 N.E.2d at 1002.
54. *Id.*
55. *Id.* at 1003.

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faith, or even fraud, may be raised by proof "that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half-hearted as to constitute a pretext or sham."[56]

B. *Zapata* Announced Delaware Goes Beyond the Business Judgment Rule

In 1981, just two years after *Auerbach*, the Delaware Supreme Court, in *Zapata Corp. v. Maldonado*,[57] called for a more careful review of SLCs than *Auerbach.* Like *Auerbach*, *Zapata* held that courts will not automatically defer to the decision of an SLC to wrest control of a derivative suit that alleges a breach of fiduciary duties by directors. Unlike *Auerbach*, *Zapata* said that courts may exercise their own "business judgment" to determine whether to permit the derivative proceeding to remain in shareholder hands.[58]

1. Facts and Chancery Finding of a Vested Right to Bring a Derivate Action

In June 1975, William Maldonado, a stockholder of Zapata Corporation, whose shares were traded on the New York Stock Exchange, instituted a derivative action on behalf of Zapata against ten of its officers and/or directors, alleging breaches of fiduciary duty by engaging in self-dealing. Without first demanding that the board pursue these claims, Maldonado filed suit, alleging that a demand would be futile because all the directors participated in the acts complained of and were named as defendants.[59] Initially, Zapata neither sued to pursue Maldonado's claims[60] nor moved to dismiss his derivative suit.[61] However, four years later, after four of the defendant-directors left the board, the remaining directors appointed two new "outside directors" and appointed them to serve as an SLC to investigate Maldonado's claims.[62] The board delegated to the SLC its full authority to take any action it deemed appropriate, explicitly providing that the SLC's determination would bind the corporation without further review. The SLC investigated, concluded that the claims were "inimical to the Company's best

56. *Id.* The court found nothing in the record suggesting that the SLC chose insufficient or inappropriate procedures or failed to pursue its inquiries in good faith. *See id.*

57. 430 A.2d 779 (Del. 1981).

58. *Id.* at 787–89.

59. *Id.* at 780.

60. *See* Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980) ("Zapata has refused to bring suit . . . ."), *rev'd*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

61. *See Zapata*, 430 A.2d at 780–81 (noting that suit was filed in 1975 but motion to dismiss was not filed until 1979). In *Zapata*, the stockholder "had gained the power to sue, both because the corporation had not moved to dismiss and because it appeared that the directors . . . [were] interested for purposes of demand futility analysis." Obeid v. Hogan, No. 11900, 2016 WL 3356851, at *10 (Del. Ch. June 10, 2016).

62. *Zapata*, 430 A.2d at 781. The SLC was also tasked with addressing Maldonado's federal action on the same claims and a similar derivative action in Texas. *Id.*

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interests,"[63] and caused Zapata to move in the alternative to dismiss the complaint or for summary judgment.

"The Court of Chancery denied the motions, holding that once the stockholder had gained authority to sue in a representative capacity, the board lacked the power to divest the stockholder of control over the litigation."[64] The derivative suit was created in equity, in the first half of the nineteenth century, "to provide the stockholder a right to call to account his directors for their management of the corporation, analogous to the right of a trust beneficiary to call his trustee to account for the management of the trust corpus."[65] It has a "dual nature," in which the "stockholder asserts in the suit not only a right belonging to the corporation but also a right individual to himself,"[66] although "the interest he sought to protect was primarily that of the corporation and only indirectly his own."[67] The stockholder's individual right to assert the corporate claim "ripens" or "vests" when "he has made a demand on the corporation which has been met with a refusal by the corporation to assert its cause of action or unless he can show a demand to be futile."[68] Once the shareholder's right vests, the corporation "no longer controls the corporate right to which the plaintiff's individual right attaches."[69] Because the corporation "refused to bring suit against its directors for an apparent breach of fiduciary duty to it, it can no longer control the destiny of this suit and cannot compel the dismissal of this action at this stage of the proceedings."[70]

2. Delaware Supreme Court Rejects a Vested Right to Maintain Derivative Action

On an interlocutory appeal, the Delaware Supreme Court "addressed a question of first impression: whether a board of directors could assert control over a derivative action *after a stockholder had obtained the right to represent the corporation and proceed beyond the pleading stage*."[71] The court reversed the Chancery Court's holding that the derivative plaintiff acquired a vested right to maintain the action after establishing that making a demand on the corporation would have been futile.[72] The broader question was "the power of the corporation by motion to terminate a lawsuit properly commenced by a stockholder without

63. *Id*. The SLC made the same determination with respect to Maldonado's federal action and with respect to the Texas litigation. *See id*.

64. Charles R. O'Kelley, Robert B. Thompson & Dorothy S. Lund, Corporations and Other Business Associations 587 (9th ed. 2022).

65. *Maldonado*, 413 A.2d at 1261. The derivative action ultimately was expanded beyond the trust analogy to include the right to assert corporate claims against third parties. *Id*.

66. *Id*. at 1262.

67. *Id.* at 1261.

68. *Id*. at 1262.

69. *Id*.

70. *Id*.

71. Obeid v. Hogan, No. 11900, 2016 WL 3356851, at *8 (Del. Ch. June 10, 2016) (emphasis added).

72. *Maldonado*, 413 A.2d at 1262; *see* DeMott, *supra* note 10, § 5.16.

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prior demand."[73] The specific question was whether the SLC had the "power to speak for the corporation as to whether the lawsuit should be continued or terminated."[74]

Echoing *Auerbach,* the Delaware Supreme Court began with the proposition that the corporate statute "is the fount of directorial powers"[75] that gives the directors, not the shareholders, the power to manage the corporation, including the power to make decisions concerning whether to litigate. It rejected as "erroneous" the Court of Chancery's "absolute rule" that "a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation."[76] Disputes pertaining to control of the suit generally arise in one of two contexts, which "can overlap in practice."[77] First, a shareholder can sue the board after it has refused the shareholder's demand to sue. A board's decision "to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected *unless it was wrongful*."[78] Stated differently, "when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected *if the requirements of the rule are met*."[79] "Absent a wrongful refusal, the stockholder . . . simply lacks legal managerial power."[80] Second, even without a prior demand, a stockholder may acquire an individual right to initiate an action if "it is apparent that a demand would be futile [because] the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation."[81]

3. Even in Demand Excused Situations, Imperfect Boards Have Appointment Power

Even in demand futility situations, there must be a "permissible procedure" by which a corporation "can rid itself of detrimental litigation."[82] If not, "a single stockholder in an extreme case might control the destiny of the entire corporation."[83] "To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident

73. Zapata Corp. v. Maldonado, 430 A.2d 779, 783 (Del. 1981).

74. *Id.* at 782.

75. *Id.* (quoting Del. Code Ann. tit. 8, § 141(a) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) ("[T]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .")).

76. *Id.*

77. *Id.* at 784 n.10.

78. *Id.* at 784 (emphasis added).

79. *Id.* at 784 n.10 (emphasis added). "In order to overcome this presumption and successfully assail the directors' decision, the derivative plaintiff must first show facts which, if true, would remove the directors' decision from the protection of the rule, such as self-dealing, lack of good faith, failure to exercise due care, or the like." *Maldonado*, 413 A.2d 1255.

80. *Zapata*, 430 A.2d at 784.

81. *Id.* (quoting McKee v. Rogers, 156 A. 191, 193 (Del. Ch. 1931)).

82. *Id.* at 785.

83. *Id.*

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shareholders."[84] At the same time, when examining the means of preventing shareholder abuse, one of which is an SLC, "potentials for abuse must be recognized."[85]

A board, "tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors."[86] First, the statute expressly provides that a committee can exercise the full authority of the board if the board so provides.[87] Second, "at least by analogy to our statutory section on interested directors, it seems clear that the Delaware statute is designed to permit disinterested directors to act for the board."[88] That statute provides that a contract or transaction between the corporation and one or more directors or officers is neither void nor voidable solely because the director or officer is present at the meeting authorizing it, if a majority of disinterested directors authorizes it in good faith after disclosure.[89] Nor is it void or voidable if it is fair to the corporation when they approve or ratify it.[90] The Delaware Supreme Court does "not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members."[91] Therefore, even an SLC appointed by a tainted board can properly act for the corporation "to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest."[92] The question is, what standard should the court use to review the motion.

4. An Equitable Standard of Review in Demand Excused Situations

The standard of review should include the "equitable considerations" concerning the use of an SLC that qualify its statutory power to act on behalf of the corporation.[93] Two competing concerns must be balanced. On the one hand,

84. *Id.* (quoting Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979)).

85. *Id.*

86. *Id.* at 786; *see* DeMott, *supra* note 10, § 5:16 ("*Zapata Corp.* presupposes that directors are capable of delegating to a committee power to determine the corporation's position in derivative litigation, even in circumstances that would excuse the plaintiff from making a demand on the directors. Indeed, *Zapata Corp.* explicitly confines the scope of its two-step judicial review to cases in which demand would be excused.").

87. *See* Del. Code Ann. tit. 8, § 141(c) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.).

88. *Zapata*, 430 A.2d at 786 (citing Del. Code Ann. tit. 8, § 144 (West, Westlaw through ch. 265 of the 151st Gen. Assemb.)).

89. Del. Code Ann. tit. 8, § 144(a)(1) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.)).

90. *Id.* § 144(a)(3).

91. *Zapata*, 430 A.2d at 786. The court did not address how the taint could be cured if the entire board is tainted, a situation likely to present itself in the case of many closely held corporations and LLCs.

92. *Id.*

93. *Id.* at 785. As a technical matter, the board has the statutory power to delegate its full authority to a committee of the board, including the power to seek termination of a derivative suit. *See* Del. Code Ann. tit. 8, § 141(c) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.). The board's

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if corporations can use SLCs to "consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs," the derivative suit "will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors."[94] On the other hand, if "corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result."[95] The task is to "find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled upon by the board of directors, but the corporation can rid itself of detrimental litigation."[96]

Zapata said that *Auerbach* does not reflect the proper balance. Under the *Auerbach* view that defers to the business judgment of the SLC, the issues are simply whether the committee has been independent, acted in good faith, and conducted a reasonable investigation. "The ultimate conclusion of the committee, under that view, is not subject to judicial review."[97] However, a proper balance permits review even in situations in which the SLC had been independent, acted in good faith, and conducted a reasonable investigation. When a derivative plaintiff has been excused from making a demand on the corporation,[98] there is "sufficient risk in the realities of [the] situation . . . to justify caution beyond adherence to the theory of business judgment."[99]

Unlike *Auerbach, Zapata* was not willing to accept the "possible risk of hesitance" of one board member to investigate another as an "inherent, inescapable, given aspect" of the corporate form.[100] Instead, concern for that risk animated *Zapata*'s stricter standard of review:

> [W]e must be mindful that *directors are passing judgment on fellow directors* in the same corporation and fellow directors, in this instance, *who designated them to serve both as directors and committee members*. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.[101]

statutory power to decide about corporate litigation continues even after a shareholder acquires a right to bring a derivative action. "The problem is one of member disqualification, not the absence of power in the board." *Zapata*, 430 A.2d at 786.

94. *Zapata*, 430 A.2d at 786.

95. *Id.* at 786–87.

96. *Id.* at 787.

97. *Id.*

98. *Id.* ("We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case.").

99. *Id.*

100. Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979); *cf. Zapata*, 430 A.2d at 787 ("The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role."). The court was also concerned that the corporation did not create an SLC until four years after Maldonado filed his claim: "Situations could develop where such motions could be filed after years of vigorous litigation for reasons unconnected with the merits of the lawsuit." *Id.*

101. *Zapata*, 430 A.2d at 787 (emphases added).

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An SLC's neutrality was of particular concern in *Zapata* because, if the corporation's motion were granted, the merits of the shareholder's underlying claim would never be reached, even though he had already been excused from making demand on the board.

The court struggled for an appropriate analogy. The nature of the corporation's motion "finds no ready pigeonhole, as perhaps illustrated by its being set forth in the alternative"[102] as a motion to dismiss or a motion for summary judgment.[103] "It is perhaps best considered as a hybrid summary judgment motion for dismissal because the stockholder plaintiff's *standing to maintain the suit has been lost*."[104] However, it is not strictly either "since the question of genuine issues of fact on the merits of the stockholder's claims are not reached."[105] It is analogous to a settlement, in which the same is true. In determining whether to approve a proposed settlement of a derivative action when directors are on both sides of the transaction, the court "is called upon to exercise its own business judgment."[106] In this case, "the litigating stockholder plaintiff facing dismissal of a lawsuit properly commenced ought . . . to have sufficient status for strict Court review."[107]

Zapata announced its now-famous and oft-criticized two-step review of motions to dismiss in demand excused situations. First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. The corporation has the "burden of proving independence, good faith and a reasonable investigation, with no presumption of independence, good faith and reasonableness."[108] Second, even if the corporation meets its burden and establishes that the "committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step."[109]

102. *Id.*

103. Both are dispositive pre-trial motions. A motion to dismiss is generally filed by a defendant shortly after a complaint is filed. A motion for summary judgment can be made by either party and is generally filed after discovery.

104. *Zapata*, 430 A.2d at 787 (emphasis added).

105. *Id.* When an SLC causes the corporation to file a pretrial motion to dismiss, each party should have an opportunity to make a record on the motion. "As to the limited issues presented by the motion . . . , the moving party should be prepared to meet the normal burden . . . that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law." *Id.* at 788.

106. *Id.* at 787 (quoting Neponsit Inv. Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979)).

107. *Id.* at 788. The court also analogized to Chancery Rule 41(a)(2). If a plaintiff seeks a dismissal after an answer, the Chancery Court has the power to condition the dismissal as it deems proper. *See* Del. Ch. R. 41(a)(2).

108. *Zapata*, 430 A.2d at 788. "Our approach here is analogous to and consistent with the Delaware approach to 'interested director' transactions, where the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny." *Id.* at 788 n.17.

109. *Id.* at 789. "This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied." *Id.*; *see also* Kaplan v. Wyatt, 499 A.2d 1184, 1191–92 (Del. 1985) (emphasizing that the second step was discretionary, not mandatory).

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> The second step provides, we believe, the *essential key* in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. . . . The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."[110]

In taking this next step, a court "must carefully consider and weigh how compelling the *corporate interest in dismissal* is when faced with *a non-frivolous lawsuit*."[111] A court also "should, when appropriate, *give special consideration to matters of law and public policy* in addition to the corporation's best interests."[112] If the court's "independent business judgment" is satisfied, it may grant the motion to dismiss, "subject, of course, to any equitable terms or conditions the Court finds necessary or desirable."[113]

Zapata acknowledged that stricter review presents "a danger of judicial overreaching," but concluded that the alternatives are "outweighed by the fresh view of a judicial outsider."[114] The final judgment whether to maintain a particular lawsuit "requires a balance of many factors—ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal."[115] These factors are within the reach of the Court of Chancery, "which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems."[116]

5. *Zapata* in Perspective

Zapata was criticized both for undermining the business judgment rule[117] and for the way it described each of its two steps of review.[118] It has generally been confined to cases in which demand is excused, which are relatively few because of the high bar to establish that demand would have been futile and is therefore excused.[119] If a plaintiff makes a pre-suit demand, the demand is deemed a tacit

110. *Zapata*, 430 A.2d at 789 (emphasis added).
111. *Id.* (emphases added).
112. *Id.* (emphasis added).
113. *Id.*
114. *Id.* at 788.
115. *Id.* (quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980), *rev'd on other grounds*, 671 F.2d 729 (2d Cir. 1982)).
116. *Id.*
117. *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (referencing the "numerous" derivative suits filed without prior demand after *Zapata*). For an extensively annotated discussion of the "furor" over *Zapata*, see *In re* EZCORP Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *26 n.18 (Del. Ch. Jan. 25, 2016).
118. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 939 (Del. Ch. 2003); *infra* Part I.C.2.
119. In *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the court stated that, to excuse a demand on the basis of futility, a shareholder must allege particularized facts under which "a reasonable doubt is created that: (1) the directors are disinterested and independent; and (2) the challenged transaction was

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concession "that the board was able to properly consider that demand."[120] Accordingly, the more deferential business judgment rule applies to the denial of the demand, and the plaintiff challenging the denial "must allege with particularity 'facts that give rise to a reasonable doubt as to the good faith or reasonableness of [the Board's] investigation' and deliberations."[121]

Even though *Zapata*'s two-step review is generally limited to situations in which demand has already been excused, it may be particularly instructive for LLCs. It is significant that, even in the context of a publicly held corporation, it applied the broader principle that equity may disregard something even if it is technically legal.[122] Its call for more careful review of SLCs may have even greater vitality for LLCs. First, LLCs do not present the foundational rule that management is centralized in a board of directors.[123] Second, LLC law has developed primarily in the context of closely held firms rather than in the context of publicly held firms.[124] As discussed below, *Obeid v. Hogan*[125] recently applied *Zapata* to LLCs and characterized it as an early example of a broader shift to a more careful review of the work of insiders. It treated the presumptive intent of the owners as paramount, an inquiry much more feasible in closely held firms than in public companies. According to *Obeid*, *Zapata* subjects SLCs in

otherwise the product of a valid exercise of business judgment." *Id.* at 814. Absent a particularly egregious transaction, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors." *Id.* at 815; *see* Busch *ex rel.* Richardson Elecs., Ltd. v. Richardson, No. 2017-0868, 2018 WL 5970776, at *15 (Del. Ch. Nov. 14, 2018) ("Simply saying that demand is futile because directors would have to sue themselves is insufficient."). On September 23, 2021, without overruling *Aronson*, the Delaware Supreme Court refined the *Aronson* inquiry. *See* United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg, No. 404, 2021 WL 4344361, at *17 (Del. Sept. 23, 2021) (en banc) ("[C]ourts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility: (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.").

120. Solak *ex rel.* Ultragenyx Pharm. Inc. v. Welch, No. 2018-0810, 2019 WL 5588877, at *3–8 (Del. Ch. Oct. 30, 2019) (holding that a letter disclaiming an intent to make a demand nevertheless constituted a demand, with the result that the business judgment rule, rather than *Zapata*'s two-step review, applied), *aff'd*, 228 A.3d 690 (Del. 2020).

121. *Id.* at *8 (quoting Espinoza *ex rel.* JPMorgan Chase & Co. v. Dimon, 124 A.3d 33, 36 n.10 (Del. 2015) (en banc)).

122. *See* Coster v. UIP Cos., 255 A.3d 952, 953 (Del. 2021) (en banc) (concluding that, even if a transaction passes muster under the entire fairness standard, it will not be permitted if it is inequitable, because "inequitable action does not become permissible simply because it is legally possible" (quoting Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971))).

123. *See* Del. Code Ann. tit. 6, § 18-402 (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) ("Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members.").

124. *See* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. Corp. L. 555, 557 (2012) (emphasizing that "publicly traded LLCs and LPs . . . represent only a small portion of the broader Delaware alternative entity landscape").

125. No. 11900, 2016 WL 3356851 (Del. Ch. June 10, 2016).

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LLCs to a standard of review that represents a middle ground between the "maximal deference" of the business judgment rule and the strictest review of the entire fairness standard.[126]

C. *ORACLE* REQUIRES CLOSE SCRUTINY OF SLC INDEPENDENCE

Zapata's two-tier review addressed the risk of insiders investigating one another in the important but narrow context of a motion to dismiss a properly commenced derivative proceeding. The broader question is what constitutes independence for an SLC member. Here, again, the Delaware courts have taken the lead in setting a higher bar for SLC independence. Delaware's high watermark for the independence requirement is *In re Oracle Corp. Derivative Litigation*,[127] which explicitly followed *Zapata* while criticizing its doctrinal formulation. Because *Oracle* also involved a publicly held corporation, its stricter approach to independence may be especially meaningful for SLCs in closely held LLCs without the inhibiting formalities of boards of directors.

1. Basic Facts

Shareholders of Oracle Corporation brought a derivative action in Delaware against certain Oracle directors and officers for insider trading. In December 2000, Oracle issued public guidance about projected earnings for the third quarter of the 2001 fiscal year ("3Q FY 2001"), which ran from December 1, 2000, to February 28, 2001. The plaintiffs alleged that this guidance was a "rosy" projection that was materially misleading when it was issued and became more so as time passed. In January 2001, four directors (the "Trading Directors"), including Lawrence Ellison, Oracle's Board Chairman, CEO, and largest stockholder, sold almost $1 billion of their Oracle stock for $30 or more per share. On March 1, 2001, the company announced that both earnings and growth would be significantly lower than the earlier guidance. The stock market reacted swiftly and negatively to the news, and the price of the stock dropped by 21 percent in a single day and closed at $16.88, an amount significantly lower than $30-plus prices at which the Trading Directors had sold. The plaintiffs alleged that the Trading Directors had inappropriately engaged in insider trading because they had material, non-public information showing that Oracle would not meet the earnings

126. *Id.* at *13 n.16 (quoting *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 597 (Del. Ch. 2010) (referencing "two starkly divergent categories—business judgment rule review reflecting a policy of maximal deference . . . and entire fairness review reflecting a policy of extreme skepticism")); *see infra* Part II.B.3 (discussing this middle ground). Entire fairness review, which is itself nuanced and controversial, was summarized in the LLC context in *Solar Cells, Inc. v. True North Partners, LLC*:

> The party with the burden of establishing entire fairness must establish that the challenged transaction was the result of fair dealing and offered a fair price. Fair dealing pertains to the process by which the transaction was approved and looks at the terms, structure, and timing of the transaction. Fair price includes all relevant factors. . . .

No. 19477, 2002 WL 749163, at *5 (Del. Ch. Apr. 25, 2002).

127. 824 A.2d 917 (Del. Ch. 2003).

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guidance it had disclosed to the public. The plaintiffs also sued the members of the board during 3Q FY 2001 who did not trade (the "Non-Trading Directors") on the ground that their "indifference to the deviation between the company's December guidance and reality was so extreme as to constitute subjective bad faith."[128]

In summer 2001, two Stanford professors were recruited to the board to enable them to serve as SLC members. One was Hector Garcia-Molina, a distinguished professor of computer science, and the other was Joseph Grundfest, a distinguished law professor and expert on corporate governance who had previously served as a Commissioner of the Securities and Exchange Commission. They were recruited primarily by two of the Trading Directors, one of whom, Michael Boskin, was himself a distinguished professor in Stanford's economics department and who had previously served as chairman of the President's Council of Economic Advisers. While they were "wooing" him to join the board, Grundfest performed his own "due diligence."[129] Among other things, he met with the other two Trading Directors, including Mr. Ellison, and questioned them about other recently filed litigation based on the same events. Their responses gave him sufficient "confidence" to join the board.[130] He testified that this did not mean that he had concluded that the class action had no merit. On the other hand, he did conclude "that these were reputable businessmen with whom he felt comfortable serving as a fellow director," and that he had received "very impressive answers to difficult questions regarding the way Oracle conducted its financial reporting operations."[131] Both professors joined the board on October 15, 2001, which was after the allegedly misleading guidance, after the stock sales in question, after a correcting press release, and more than six months after the books had been closed on the quarter in question.

The following February, Oracle formed an SLC, consisting solely of the two professors newly appointed as directors, to investigate the Delaware derivative action and to determine "whether Oracle should press the claims raised by the plaintiffs, settle the case, or terminate it."[132] For their service on the SLC, they were compensated at an hourly rate that was below their normal consulting rates.[133] The SLC retained a number of advisors, the most important of which was a major national law firm that had not before performed any material amounts of work, either for Oracle or for any of the individual defendants.

128. *Id*. at 923. The court referred to this as an allegation of a *Caremark* violation. *Id*. (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)).

129. *Id*. at 924.

130. *Id*.

131. *Id*.

132. *Id*. at 923. Related litigation was stayed in deference to the work of the SLC and the Delaware court's review of it. *Id*.

133. *Id*. at 924. At some point, the professors became concerned that their compensation might be so high as to present an argument against their independence. *Id*. They offered to give up their SLC-related compensation if the court found it unfair. *Id*.

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"The SLC's investigation was, by any objective measure, extensive."[134] It resulted in a report of over 1,100 pages that considered the situation of each of the Trading Directors and concluded that none of them had possessed material, non-public information. It also concluded that they had not acted with *scienter* in making their January trades. In short, it concluded that there was no merit to the "allegations that the Trading [Directors] had breached their fiduciary duty of loyalty by using inside information about Oracle to reap illicit trading gains."[135] Consistent with this determination, the report also concluded there was no reason to sue the Non-Trading Directors. Accordingly, the SLC filed a motion to end the Delaware derivative suit, which the plaintiffs resisted.

2. Vice Chancellor Strine Invokes *Zapata* but Avoids Its "Oxymoronic" Second Step

Vice Chancellor Strine said he was bound to decide the case under *Zapata*'s two-step analysis, although he was critical of the way *Zapata* explained each step. Under the first step, in order to prevail on its motion to "terminate" the derivative action, the SLC must persuade him that its members were independent, that they acted in good faith, and that they had reasonable bases for their recommendations.[136] Under the second step, even if the SLC met its first-step burden, Vice Chancellor Strine had the discretion to "undertake my own examination of whether Oracle should terminate and permit the suit to proceed if I, in my *oxymoronic judicial 'business judgment,'* conclude that procession is in the best interests of the company."[137]

He never got to step two because he held that the SLC failed to meet its step-one burden. *Zapata* "instructed" him to "apply a procedural standard akin to a summary judgment inquiry" when ruling on the SLC's motion to "terminate."[138] The SLC must show that "there is no genuine issue as to any material fact and that [it] is entitled to dismiss as a matter of law."[139]

> Candidly, this articulation of a special litigation committee's burden is an odd one, insofar as it applies a procedural standard designed for a particular purpose—the

134. *Id*. at 925. The SLC reviewed "an enormous amount" of paper and electronic records. *Id*. SLC counsel interviewed seventy witnesses, and the SLC members participated in several of the key interviews, including the interviews of the Trading Directors. *Id*. The interviewees included all the senior members of Oracle's management team most involved in monitoring and projecting financial performance. *Id*. The interviewees also included those identified by the plaintiffs in various actions, although the plaintiffs in the Delaware derivative suit declined to suggest witnesses to the SLC or to meet with it. *Id*. The SLC met with its counsel thirty-five times and ultimately produced a report that totaled 1,110 pages (excluding appendices and exhibits). *Id*.

135. *Id*. at 928.

136. *Id*. Vice Chancellor Strine allowed the plaintiffs discovery on these three issues. *See id*. at 929 (referencing facts that emerged during discovery). The plaintiffs also received the materials that the SLC relied upon in preparing its report.

137. *Id*. at 928 (emphasis added).

138. *Id*.

139. *Id*. (quoting Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981)).

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> substantive dismissal of a case—with a standard centered on the determination of when a corporate committee's business decision about claims belonging to the corporation should be accepted by the court.[140]

In this "first-step stage of proceedings," the SLC itself is under examination, "not the merits of the plaintiffs' cause of action."[141] If there is a material fact question about the SLC's independence, good faith, or reasonable basis for its recommendation, its motion to terminate would be denied. Because he found that the SLC failed the step-one independence inquiry, he denied its motion to dismiss without ever reaching the questions of good faith or reasonable basis.[142]

3. Failing the Independence Test

Oracle is fascinating because some of the nation's most prominent and most respected lawyers and professors, working for one of the world's richest and most respected corporations, run by some of the world's most successful entrepreneurs, failed the independence test they knew they had to pass. They failed in large part because Vice Chancellor Strine appears to have raised the bar for independence. At the very least, he probed more carefully for independence than the *Zapata* court had occasion to.

a. *"Indeterminate" Contextual Approach*. Vice Chancellor Strine said that the Delaware Supreme Court's test for independence could be summarized as turning "on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind."[143] The problem, he said, was that the test had not been applied consistently.[144] In order to be "faithful" to the "essential spirit" of the Delaware Supreme Court's decisions, it is necessary to take a "contextual" approach that considers the function of SLCs.[145] The contextual approach "undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue."[146]

At the outset, Vice Chancellor Strine rejected the SLC's argument that its members are independent if they are free from "the domination and control"

140. *Id*. at 928.

141. *Id*. at 929 n.20 (quoting Kaplan v. Wyatt, 484 A.2d 501, 519 (Del. Ch. 1984)).

142. *Id*. at 948. Vice Chancellor Strine said that independence was a "more difficult" question than whether the SLC acted in good faith or had a reasonable basis for its decision. *Id*. at 929.

143. *Id*. at 938 (quoting Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002)).

144. *Id*. at 939 ("Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees of consanguinity. Likewise, there is admittedly case law that gives little weight to ties of friendship in the independence inquiry." (footnote omitted)).

145. *Id*.

146. *Id.* at 941. Vice Chancellor Strine cited recent reforms adopted by Congress and the stock exchanges defining more narrowly who can be an independent director. *Id*. at 941 n.62 (collecting sources).

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of the interested parties.[147] Under the domination and control test, Oracle's SLC would win. To apply this test "would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity."[148] He refused to consider independence solely through the lens of economically consequential relationships.[149]

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus.* We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.[150]

The law should also consider "the social nature of humans."[151] Directors are generally people "deeply enmeshed in social institutions" that have norms and expectations "that, explicitly and implicitly, influence and channel the behavior of those who participate" in them.[152]

The law should recognize that trust plays an important role in the success of many business firms[153] and that many transactions within a firm are largely protected by a "governance mechanism . . . that is almost entirely not legally enforceable."[154] Inside a particular firm, "[s]ome things are 'just not done,' or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution."[155] The law cannot assume that corporate directors serving on SLCs "are, as a general matter, persons of unusual social

147. *Id.* at 937 (citing *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 355 (Del. Ch. 1998)).
148. *Id.*
149. *Id.* at 937–38. The SLC had argued that much of the Delaware "jurisprudence on independence focuses on economically consequential relationships between the allegedly interested party and the directors who allegedly cannot act independently of that director." *Id.* at 936. Much of it focuses on "treating the possible effect on one's personal wealth as the key to the independence inquiry." *Id.* The SLC cited decisions "concluding that directors who are personal friends of an interested party were not, by virtue of those personal ties, to be labeled non-independent." *Id.* (citing Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 980–81 (Del. Ch. 2000) (stating that an allegation of a fifteen-year personal and professional relationship between a CEO and a director does not, in itself, raise a reasonable doubt about the director's independence); *In re Walt Disney*, 731 A.2d at 354 n.18 ("Demand is not excused, however, just because directors would have to sue 'friends, family and business associates.'" (quoting Abrams v. Koether, 766 F. Supp. 237, 256 (D.N.J. 1991))).
150. *Id.* at 938 (citing Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 677–78 (2002) (arguing that corporate directors are likely to be motivated by altruistic concerns and not merely by their own monetary interests)).
151. *Id.*
152. *Id.*
153. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law,* 149 U. PA. L. REV. 1735, 1780 (2001).
154. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1640 (2001).
155. *Oracle*, 824 A.2d at 938.

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bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk."[156]

If a majority of the directors cannot impartially consider a demand to proceed against insiders,[157] an SLC is "a last chance for a corporation to control a derivative claim."[158] To evaluate an SLC's independence, "a court must take into account the extraordinary importance and difficulty of such a committee's responsibility."[159] It is much more difficult to cause a corporation to sue a friend, relative, colleague, or boss, than it is to disapprove an act that has not yet occurred. In the case of an SLC, only a subset of the board bears the weight of the moral judgment "that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him."[160] "A small number of directors feels the moral gravity—and social pressures—of this duty alone."[161] It is "critically important" that the SLC's "fairness and objectivity cannot be reasonably questioned."[162] Both the court and the shareholders must have "confidence in the integrity of corporate decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an independent group of directors."[163]

The question in *Oracle* was "whether the SLC "can independently make the difficult decision . . . whether the [T]rading [Directors] should face suit for insider trading-based allegations of breach of fiduciary duty."[164] A decision to sue "would have potentially huge negative consequences for the Trading [Directors], not only by exposing them to the possibility of a large damage award but also by subjecting them to great reputational harm."[165] A decision to sue would likely be "accompanied by a recommendation that they step down as fiduciaries until their ultimate culpability was decided."[166] The "mindset and talent" of the SLC members "influence, for good or ill, the course of the investigation. Just as there are obvious dangers from investigators suffering from too much zeal, so too are dangers posed by investigators who harbor reasons not to pursue the investigation's targets with full vigor."[167] The nature of the investigation is also important. Oracle's SLC "could not avoid a consideration of the

156. *Id*.

157. *Id*. at 939. "One way for a plaintiff to impugn the impartiality of the board is to plead particularized facts creating a reasonable doubt that the board complied with its fiduciary duties." *Id.* at 938 n.58.

158. *Id*. at 939.

159. *Id*. at 940.

160. *Id*.

161. *Id*.

162. *Id*. (quoting, in the second instance, Biondi v. Scrushy, 820 A.2d 1148, 1156 (Del. Ch. 2003)).

163. *Id.* (quoting *Biondi*, 820 A.2d at 1156).

164. *Id*.

165. *Id*. at 940–41.

166. *Id*. at 941.

167. *Id*.

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subjective state of mind of the Trading [Directors]."[168] The SLC would make judgments about culpability, no matter how objective the criteria they attempted to use.[169]

b. *Facts Indicating Failure to Satisfy Independence Test*. Vice Chancellor Strine found the lengthy SLC Report shockingly insufficient on the independence issue. On the one hand, it disclosed that one of the Trading Directors was a professor at Stanford and that another of the Trading Directors was a donor to Stanford. It also disclosed that the latter made a $50,000 donation to Stanford Law School after Grundfest delivered a speech at the request of a venture capital firm in which that defendant's son was a partner, and that half of the donation was allocated for Grundfest's use in his research. Nevertheless, in view of the "modesty of these disclosed ties, it was with some shock that a series of other ties among Stanford, Oracle, and the Trading [Directors] emerged during discovery."[170] "Noticeably absent from the SLC Report was any disclosure of several significant ties between Oracle or the Trading [Directors] and Stanford University, the university that employs both members of the SLC."[171] The "plain facts are a striking departure from the picture presented in the Report."[172]

A brief review of these "plain facts," which Vice Chancellor Strine discussed at greater length, is sufficient for purposes of this article. In short, Trading Director Boskin, who was a Stanford professor, was a former teacher of Grundfest, and both were senior fellows and steering committee members at the Stanford Institute for Economic Policy and Research ("SIEPR"). The two published working papers under the SIEPR rubric, and SIEPR helped to publicize their research. In the month in which the SLC was formed, Grundfest addressed a meeting of some of SIEPR's largest benefactors.[173] Trading Director Lucas's ties to Stanford were "far, far richer" than the SLC Report had indicated.[174] Among other things, Lucas was the chairman of a foundation, established by his brother's will, which had given $11.7 million to Stanford, and which was used in part to establish a center at Stanford Medical School in the Lucas name and for which Lucas served as lead director. Lucas also contributed $4.1 million of his personal funds, and more specifically had been a "generous contributor to not one, but two, parts

168. *Id.*

169. Delaware law requires courts to consider the independence of directors based on facts known about them specifically, the so-called "subjective 'actual person' standard." *Id.* at 942 (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995)). Nevertheless, given "the limited ability of a judge to look into a particular director's heart and mind," the court must "often apply to the known facts about a specific director a consideration of how a reasonable person similarly situated to that director would behave." *Id.* Vice Chancellor Strine said this is especially true when the SLC chooses, as occurred in *Oracle*, to eschew live witness testimony. *Id.*

170. *Id.* at 929.

171. *Id.*

172. *Id.* at 930.

173. *Id.* at 931. The SLC argued, among other things, that Grundfest was largely "MIA" as SIEPR steering committee member and that it basked in the glow of the two professors, not the reverse. *Id.*

174. *Id.*

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of Stanford important to Grundfest: the Law School and SIEPR."[175] Trading Director Ellison was "a major figure in the community in which Stanford is located," and one of "the wealthiest men in America."[176] Stanford had been a beneficiary of almost $10 million in grants from an Ellison Foundation that Ellison served as sole director.[177] While Ellison was its CEO, Oracle made more than $300,000 in donations to Stanford. In addition, Stanford made a proposal to Ellison for a $170 million gift to create a Stanford program analogous to Oxford's Rhodes Scholarship, and three of the four Trading Directors were proposed members of the program board. There had also been reports discussing Ellison's intent to donate his $100 million home to Stanford, about which he later changed his mind. Even after one of his children was denied admission, Ellison was publicly considering creating further endowments at Stanford.

Vice Chancellor Strine said that the "question is whether these ties . . . would be of a material concern to two distinguished, tenured faculty members whose current jobs would not be threatened by whatever good faith decisions they made as SLC members."[178] His conclusion was that the Stanford connections "would be on the mind of the SLC members in a way that generates an unacceptable risk of bias."[179] Therefore, the SLC failed to meet its "burden to show the absence of a material factual question about its independence."[180]

The "ties among the SLC, the Trading Defendants, and Stanford are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face suit."[181] As SLC members, Grundfest and Garcia-Molina were already being asked to consider whether the firm should level extremely serious allegations against a fellow board member. As to Boskin, both SLC members were being asked to press insider trading claims against a fellow professor. Grundfest had "an even more complex challenge than Garcia-Molina [because] Boskin was a professor who had taught him and with whom he had maintained contact over the years."[182] Given his

175. *Id.* at 932.

176. *Id.*

177. *Id.* The SLC had argued that the grants were awarded to specific researchers and portable if they moved. *Id.*

178. *Id.* at 930. Vice Chancellor Strine was "not faced with the relatively easier call of considering whether these ties would call into question the impartiality of an SLC member who was a key fundraiser at Stanford or who was an untenured faculty member subject to removal without cause." *Id.* (footnote omitted) (citing *In re* Limited, Inc. S'holders Litig., No. 17148, 2002 WL 537692, at *6–7 (Del. Ch. Mar. 27, 2002) (concluding that a university president who had solicited a $25 million contribution from a corporation's president, chairman, and CEO was not independent of that corporate official in light of the sense of "owingness" that the university president might harbor with respect to the corporate official); Lewis v. Fuqua, 502 A.2d 962, 966–67 (Del. Ch. 1985) (finding that an SLC member was not independent where that member was also the president of a university that received a $10 million charitable pledge from the corporation's CEO and the CEO was a trustee of the university)).

179. *Id.* at 947. The court found for the plaintiffs on the independence issue even though they had pressed their case "with less nuance than was helpful." *Id.* at 936.

180. *Id.* at 942.

181. *Id.*

182. *Id.*

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extraordinary ties to Boskin, Grundfest "would have more difficulty objectively determining whether Boskin engaged in improper trading than would a person" without those ties.[183]

The SLC did not provide evidence that Grundfest was a "very special person who is capable of putting these kinds of things totally aside."[184] Vice Chancellor Strine did "not infer that Grundfest would be less likely to recommend suit against Boskin than someone without these ties."[185]

> The inference I draw is subtly, but importantly, different. What I infer is that a person in Grundfest's position would find it difficult to assess Boskin's conduct without pondering his own association with Boskin and their mutual affiliations. Although these connections might produce bias in either a tougher or laxer direction, the key inference is that these connections would be on the mind of a person in Grundfest's position . . . .[186]

Grundfest would be put in the position of choosing between causing serious legal harm to a person with whom he shares several connections or being suspected of favoritism. Grundfest also presented the "same concerns" with respect to Trading Director Lucas, who was SIEPR's Advisory Board Chair and a major benefactor, and who also made a significant contribution to the law school after Grundfest made a speech at his request.[187]

As for both Grundfest and Garcia-Molina, "service on the SLC demanded that they consider whether an extremely generous and influential Stanford alumnus should be sued by Oracle for insider trading."[188] "A reasonable professor . . . would obviously consider the effect his decision might have on the University's relationship with Lucas, it being (one hopes) sensible to infer that a professor of reasonable collegiality and loyalty cares about the well-being of the institution he serves."[189] Vice Chancellor Strine distinguished between Grundfest and Garcia-Molina, saying that "Grundfest would have had to be extremely insensitive to his own working environment not to have considered Lucas an extremely generous alumni benefactor of Stanford, and at SIEPR and the Law School in particular."[190] Even as to Garcia-Molina, there was little doubt he knew of the relative magnitude of Lucas's generosity to Stanford. "Furthermore, Grundfest comprised half of the SLC and was its most active member. His non-independence is

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183. *Id.* at 943.
184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.* Vice Chancellor Strine gave "little weight to the SLC's argument that it was unaware of just how substantial Lucas's beneficence to Stanford had been." *Id.* First, it undermined confidence in the SLC that it did not examine the Trading Directors' ties to Stanford in preparing its report. *Id.* It was the SLC's burden to show independence. *Id.* Second, in forming the SLC, "the Oracle board should have undertaken a thorough consideration of the facts bearing on the independence of the proposed SLC members from the key objects of the investigation." *Id.* "[T]here were too many visible manifestations of Lucas's status as a major contributor . . . to conclude that Grundfest, at the very least, did not understand Lucas to be an extremely generous benefactor to Stanford." *Id.* at 944.
190. *Id.* at 944.

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sufficient alone to require a denial of the SLC's motion."[191] "In view of the ties involving Boskin and Lucas alone, I would conclude that the SLC has failed to meet its burden on the independence question. The tangible facts about Ellison merely reinforce this conclusion."[192]

In summary, "two Stanford professors were recruited to the Oracle board in summer 2001 and soon asked to investigate a fellow professor and two benefactors of the University."[193] The connections "would weigh on the mind of a reasonable [SLC] member deciding to level the serious charge of insider trading against the Trading [Directors]."[194]

> [T]his does not mean that the SLC would be less inclined to find such charges meritorious, only that *the connections identified would be on the mind of the SLC members in a way that generates an unacceptable risk of bias*. That is, these connections generate a *reasonable doubt about the SLC's impartiality* because they *suggest that material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments*.[195]

To emphasize, to fail the independence test does not require either a showing of bad faith on the part of SLC members or a finding that their connections make them less inclined to find the derivative action meritorious. It requires only the lesser showing that the connections would be "on the mind" of the SLC members in a way that generates an "unacceptable risk" of bias. It is not necessary that the direction of the bias be established. The bias might be one way or the other, or, as Vice Chancellor Strine said in *Oracle*, unknowable. It is sufficient to show that the connections "generate a reasonable doubt about impartiality" because they "suggest that material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments."[196] Even if the SLC members are "persons of good faith and moral probity," they may nevertheless not be "situated to act with the required degree of impartiality."[197] Stockholders

191. *Id*. (citing, among other cases, *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 354 (Del. Ch. 1998) ("[U]nder *Aronson*'s first prong—director independence—for demand to be futile, the Plaintiffs must show a reasonable doubt as to the disinterest of at least half of the directors."), *rev'd on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (en banc)).

192. *Id.* at 945. "An inquiry into Ellison's connections with Stanford should have been conducted before the SLC was finally formed and, at the very least, should have been undertaken in connection with the Report." *Id.* at 946.

193. *Id.* at 947.

194. *Id*.

195. *Id*. (emphases added).

196. Because Vice Chancellor Strine found that there was "too much doubt about the SLC's independence" for it to meet its *Zapata* burden, he made "no finding about the subjective good faith of the SLC members." *Id*.; *see also* Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985) ("Although not necessary to do so in view of my holding that there is a question of fact as to whether the Special Litigation Committee was independent, I will also consider the issue of the reasonableness of the investigation by the Sanford Committee, and the reasonableness of the basis for the findings and recommendations of the Committee.").

197. *Oracle*, 824 A.2d at 947; *id*. ("[The independence] inquiry recognizes that persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations. To conclude that the Oracle SLC was not independent is not a conclusion that the two accomplished professors who comprise it are

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should not be forced to rely on SLC members "who must put aside *personal considerations that are ordinarily influential in daily behavior* in making the already difficult decision to accuse fellow directors of serious wrongdoing."[198]

4. Summary and Impact of *Oracle*

Although Vice Chancellor Strine said that he was bound to apply *Zapata*, he criticized its formulation and avoided its controversial second step by deciding there was insufficient independence. Cases before and after *Oracle* have mentioned the importance of social relationships to independence.[199] *Oracle*'s essential contribution is that, for social relationships to be disqualifying, they need not create a bias one way or the other, only a hesitancy. The test is whether, taking into account the totality of economic and social considerations, the SLC member is in a position that requires him or her to "put aside personal considerations that are ordinarily influential in daily behavior" when making decisions about accusing fellow directors of serious wrongdoing.[200] If the answer is yes, the SLC's subjective good faith and the reasonableness of its conclusions are not sufficient to justify terminating the derivative proceeding.[201] In short, *Oracle* seems to require the neutrality of SLC members, not merely their independence as it had been defined previously.

As mentioned earlier, empirical studies have indicated that the standard of review for the work of an SLC matters in the real world.[202] It is still not clear how much *Oracle* has influenced legal doctrine, even in Delaware. The Delaware Supreme Court has neither repudiated *Oracle* nor given it a full-throated endorsement.[203] However, *Oracle* appears to have influenced business practice. The fact that the nation's best and brightest failed the independence test when the stakes were so high has apparently captured the attention of many boards and the

not persons of good faith and moral probity, it is solely to conclude that they were not situated to act with the required degree of impartiality.").

198. *Id.* (emphases added).

199. *See* London v. Tyrrell, No. 3321, 2010 WL 877528, at *12 (Del. Ch. Mar. 11, 2010) (referring to a "sense of obligation [that] need not be of a financial nature"); Einhorn v. Culea, 612 N.W.2d 78, 89–90 (Wis. 2000) (referring to a committee member's "past or present personal, family, or social relations with individual defendants," as well as the "number of members" on an SLC).

200. *Oracle*, 824 A.2d at 974. Vice Chancellor Strine said it was "overwrought" to argue that his ruling would "chill the ability of corporations to locate qualified independent directors in the academy." *Id.*

201. *Id.* at 948.

202. *See* Krishnan, Davidoff Solomon & Thomas, *supra* note 11, at 1–2.

203. The Delaware Supreme Court briefly discussed *Oracle* in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054–55 (Del. 2004) (en banc). *Beam*, unlike *Oracle*, considered the independence of board members in the demand requirement context, not in the context of measuring the independence of SLC members. *Id. Beam* explicitly declined to decide whether the same test applies in both contexts, and this appears to be an open question. *Id.*; DeMott, *supra* note 10, § 5:19. Nevertheless, there are two aspects of *Beam* that suggest the Delaware Supreme Court might not be as strict as the Chancery Court in *Oracle*. First, it said, "a relationship must be of a bias-producing nature" and that "mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence." *Beam*, 845 A.2d at 1050. Second, it suggested that financial relationships were more critical disqualifiers than personal relationships by factually distinguishing *Beam* from *Oracle* based on "the financial support of Stanford by [Oracle] and its management." *Id.* at 1055.

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lawyers who represent them. Not surprisingly, they prudently consider *Oracle* as tightening the requirements for SLC independence when insiders are accused of serious wrongdoing. After *Oracle*, once derivative suits are properly commenced, boards have much greater incentive to settle with the shareholders who bring them.[204] *Oracle* also suggests a stricter independence test that can be applied more broadly to SLCs in both corporations and LLCs.

II. SLCs in LLCs: Recent LLC Acts and *Obeid*

A. Recent Uniform LLC Acts Adopt the Large Corporation Model of Derivative Litigation

The Uniform Law Commission ("ULC") has been extremely influential in the areas of partnership and LLC law, much more so than in the area of corporate law. In 1996, the ULC finalized the Uniform Limited Liability Company Act ("1996 Act"),[205] which embodied a blend of features taken from partnership law and from corporate law. It included the partnership rule that members could sue one another or the firm at any time. Ten years later, RULLCA made LLCs more closely resemble corporations and, in particular, imposed the machinery of derivative litigation on all LLCs as a default rule.

1. The Target Group of the 1996 Act and Easy Access to Member Remedies

The 1996 Act reflected a "a single policy vision—to draft a flexible act with a comprehensive set of default rules designed to substitute as the essence of the bargain for small entrepreneurs."[206] The drafters "recognized that small entrepreneurs without the benefit of counsel should . . . have access to the Act."[207] Accordingly, the "great bulk" of the 1996 Act "sets forth default rules designed to operate a[n LLC] without sophisticated agreements and to recognize that members may also modify the default rules by oral agreements defined in part by their own conduct."[208]

Consistent with the vision that the target group for the 1996 Act was small groups of entrepreneurs operating informally without the benefit of sophisticated counsel, the default rule was that members would have the same easy access to judicial remedies as partners. They would be able to sue one another, or the firm, for any breach of the operating agreement or the LLC act.[209] Therefore,

204. DeMott, *supra* note 10, § 5:18 ("Within cases applying Delaware law, the arguable tightening of standards for director independence articulated in 2003 in the *Oracle* case appears to have made it harder for litigation committees to obtain dismissal. Following *Oracle*, a committee report recommending dismissal is significantly and positively associated with the probability of settlement, compared with pre-*Oracle* cases alleging breaches of the duty of loyalty and options backdating." (footnotes omitted)).

205. Unif. Ltd. Liab. Co. Act (Unif. L. Comm'n 1996).

206. *Id.* at 2.

207. *Id.*

208. *Id.* at 2–3.

209. *Id.* § 410(a).

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the 1996 Act did not deny members standing to assert any direct claims or otherwise divert any member claims to a derivative track, although it did provide members the option to bring a derivative action.[210] It made no mention of SLCs.

The 1996 Act reflected the policy judgment set forth in the 1994 Revised Uniform Partnership Act ("RUPA") that "[n]o purpose of justice is served by delaying the resolution [of partner claims] on empty procedural grounds."[211] RUPA intended to eliminate "present procedural barriers to suits between partners," and explicitly provided for "direct actions" against other partners or the partnership "for almost any cause of action arising out of . . . the partnership business."[212] Although the ULC considered easy access to judicial remedies a major step forward in the partnership area,[213] it withdrew that approach from its LLC act in just ten years when it replaced the 1996 Act with RULLCA.

2. RULLCA Eliminated Easy Access to Direct Remedies by Imposing the Machinery of Derivative Litigation

a. RULLCA Made LLCs More Like Corporations. As the 1996 Act was being finalized, the Internal Revenue Service issued its long-awaited and now famous "check the box" regulations, which gave LLCs unprecedented freedom to be taxed as partnerships, even if they had a preponderance of corporate characteristics.[214] There was, of course, no tax requirement to make LLCs more like corporations. Nevertheless, it was clear that RULLCA was drafted to take advantage of the new tax classification freedom.

RULLCA makes LLCs more like corporations in several important ways. First, it declares LLCs to be "perpetual" entities, like corporations.[215] Consistent with the "perpetual entity" concept, RULLCA completely removes the term "at will." Second, it provides that members, like shareholders, no longer have a right to liquidate or be bought out, even if the LLC is at will. The intent behind this

210. *Id.* §§ 1101–1104 ("Derivative Actions").

211. UNIF. P'SHIP ACT § 405 cmt. 2 (UNIF. L. COMM'N 1994) [hereinafter 1994 R.U.P.A.] (quoting Auld v. Estridge, 382 N.Y.S.2d 897, 901 (Sup. Ct. 1976)). *See generally* ROBERT W. HILLMAN, DONALD J. WEIDNER & ALLAN J. DONN, THE REVISED UNIFORM PARTNERSHIP ACT 445–50 (2020) (addressing section 405 of RUPA and the availability of remedies).

212. 1994 R.U.P.A., *supra* note 211, § 405 cmt. 2.

213. *See generally* Donald J. Weidner, *LLC Default Rules Are Hazardous to Member Liquidity*, 76 BUS. LAW. 151, 169 (2020) ("RUPA section 405 went 'far beyond' the UPA rule and provided that a partner may sue the partnership or another partner at any time, for legal or equitable relief, to enforce the partner's rights under the partnership agreement or under RUPA. Section 405 'reflects a new policy choice that partners should have access to the courts during the term of the partnership to resolve claims against the partnership and the other partners, leaving broad judicial discretion to fashion appropriate remedies.'" (footnotes omitted) (quoting 1994 R.U.P.A., *supra* note 211, § 405 cmt. 2)).

214. Treas. Reg. §§ 301.7701-1 to -3 (1996).

215. R.U.L.L.C.A., *supra* note 1, § 108(c) ("A limited liability company has perpetual duration."); *see, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(5) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) (permitting inclusion of a charter "provision limiting the duration of the corporation's existence to a specified date; otherwise, the corporation shall have perpetual existence").

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rule was to facilitate lower valuations for estate tax purposes. The tax law had changed such that liquidity restrictions in statutory default rules could result in valuation discounts whereas restrictions in operating agreements could not.[216] Finally, and most importantly for our purposes, RULLCA imposes the general default rule that the remedies of members in LLCs are limited to the remedies they would have if they were shareholders in a public corporation.

b. RULLCA Denies Members Standing to Bring Many Claims. RULLCA reverses the 1996 Act rules offering members easy access to judicial remedies by subjecting member claims to the direct *versus* derivative distinction of corporate law.[217] It declares many if not most member claims to be derivative, rather than direct. A direct action may be maintained only by alleging and proving an injury that is not solely the result of an injury to the firm.[218] In generally accepted parlance, a member does not have "standing" to pursue a direct claim unless this test is met. A member denied standing to bring a direct claim is only able to pursue a derivative claim on behalf of the firm. As under corporate law, a member seeking to bring a derivative claim on behalf of the LLC must first make demand on the firm, unless demand is excused.[219]

216. Weidner, *supra* note 213, at 164–65.

217. *See, e.g.*, Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004) (en banc) (holding that, when distinguishing between a direct claim and a derivative claim, "analysis must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?").

218. *See* R.U.L.L.C.A., *supra* note 1, § 801(a) ("Subject to subsection (b), a member may maintain a direct action against another member, a manager, or the limited liability company to enforce the member's rights and protect the member's interests, including rights and interests under the operating agreement or this [act] or arising independently of the membership relationship."). The rub, of course, is the reference to subsection (b), which is extremely limiting language that guts most of the provision's broad declaration of the right to maintain a direct action. Subsection (b) requires a member bringing a direct action to "plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company." *Id.* § 801(b). This language diverts a member's claim to the derivative track if the injury is "solely" the result of an injury to the LLC. Curiously, the RULLCA Official Comment uses a different standard from the "not solely the result of" language of the statute itself: "To have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the [LLC]." *Id.* § 801 cmt. (b). As if to underscore the importance of the "independen[ce] of the harm . . . to the LLC" test, the Official Comment quoted, among other cases, the famous opinion in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, which used "independent of any injury to the corporation" language to direct courts to look to "the nature of the wrong and to whom the relief should go." *Id.* (quoting *Tooley*, 845 A.2d at 1039). Despite the slippage between the statutory "not solely the result of" test and the "independent harm" test in the Official Comments, the basic approach is clear: a derivative claim is the firm's claim, not the member's claim, and the firm can decide what to do with it. *Id.* § 802.

219. *See* Del. Ch. R. 23.1(a) ("In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the . . . complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or . . . the reasons for the plaintiff's failure to obtain the action or for not making the effort."); R.U.L.L.C.A., *supra* note 1, § 802 ("A member may maintain a derivative action to enforce a right of a limited liability company [*only*] if: (1) *the member first makes a demand* on the other members in a member-managed limited liability company, or the managers of a manager-managed limited liability company, requesting that they cause the company to bring an action to enforce the right, and the managers or

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RULLCA's denial of standing is a default rule, rather than a mandatory rule. Members are free to "opt out" of the denial of standing and "opt in" to easy access to direct actions against the firm and its managers. Stated differently, members may contract for the same access to judicial remedies that they would have if they were partners, which is the same access to judicial remedies they would have had under the first generation of LLC acts. The Official Comment to the "denial of standing" rule states that it is "subject to reasonable alterations by the operating agreement,"[220] citing the mandatory rule that the operating agreement may not "unreasonably restrict the right of a member to maintain an action under [Article] 8."[221] Article 8 refers to both direct and derivative actions, and the Official Comment indicates that the operating agreement may not unreasonably limit the right to bring member claims.[222] Thus, access to remedies may be expanded but not contracted unreasonably. As in other areas, the operating agreement may limit access to courts by providing "for arbitration of both direct and derivative claims."[223]

c. RULLCA's Offsetting Cause of Action for Oppression. When RULLCA gave LLCs additional corporate features to take advantage of liberalized tax classification rules and facilitate lower estate tax valuations, it created additional tension with its historic mission to serve closely held, member-managed LLCs. Perhaps RULLCA's most important concession to the need to serve small business is its cause of action for dissolution in the event those in control of the LLC have acted "oppressively" in a harmful way.[224] The Prefatory Note states that, because RULLCA denies members the right to be bought out from entities it deems "perpetual," it is "necessary" to give them a right to seek judicial dissolution in the event of oppressive conduct.[225] Although some states adopted RULLCA without

other members do bring the action within a reasonable time; *or* (2) a *demand under paragraph (1) would be futile*." (emphases added)). Neither dissociated members nor certain other transferees have standing to bring a derivative action. *Id.* § 803. The "demand futility" concept, borrowed from corporate law, recognizes that "presumptively at least, the decision to cause a[n LLC] to bring suit is a business decision, to be made by those who manage the business." *Id.* § 802 cmt. (citing DeMott, *supra* note 10, § 5.9).

220. R.U.L.L.C.A., *supra* note 1, § 801 cmt. (b).

221. *Id.* § 105(c)(11).

222. *Id.* § 105(c)(11) cmt. ("Article 8 delineates a member's rights to bring direct and derivative actions. It would be unreasonable to frustrate these rights but not unreasonable to channel their exercise. For example, the operating agreement might select a forum, require pre-suit mediation, provide for arbitration of both direct and derivative claims, or override Section 802 and require 'universal demand' in all derivative cases. Similarly, it is not unreasonable to provide for liquidated damages consonant with the law of contracts. In contrast, it would be unreasonable for an operating agreement to both: (i) require a would-be derivative plaintiff to make demand regardless of futility; and (b) bar taking the claim to court no matter how long the management group ponders the demand.").

223. *Id.*

224. *Id.* § 701(a)(4)(C).

225. *Id.* prefatory note at 5. RULLCA narrowed the dissolution remedy as it existed under the 1996 Act because it made it unavailable to a transferee. *Id.*

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this "necessary" protective provision,[226] most retained it intact. RULLCA leaves it to the courts to decide when it will be available.[227]

d. Reasons for Eliminating Easy Access to Member Remedies. It is not completely clear why RULLCA eliminated a member's easy access to judicial remedies. There was no indication that the target group had changed from small groups of entrepreneurs who presumptively intend to operate as partners but with a liability shield. The basic explanation appears to be that, from the outset, the RULLCA drafters used as their starting point the corporate-style derivative rules that had been adopted in the case of limited partnerships.[228] It does not appear to have been a matter of concern that LLCs, unlike limited partnerships and publicly held corporations, do not generally involve passive investors.

In short, from the beginning, the RULLCA drafters assumed a conception of the business entity that characterized the public corporation. The Official Comment declares that "a[n LLC] is emphatically an entity, and the members lack the power to alter that characteristic."[229] RULLCA Co-Reporter Daniel Kleinberger stated his belief that the "distinction between direct and derivative claims follows necessarily from the concept of a legal person being separate and distinct from its owners."[230] However, there are many developments before and since RULLCA that indicate to the contrary, including developments in corporate law.

To begin with, as the 1996 Act illustrates, early LLC law did not see the direct/derivative distinction as following ineluctably, or at all, from an entity model. Nor does partnership law, which has, since RUPA's adoption in 1994, declared partnerships as entities distinct from their partners.[231] Indeed, partners have easy access to judicial remedies even if they become shielded by qualifying as

226. *See, e.g.*, FLA. STAT. ANN. § 605.0702(b)(3) (West, Westlaw through the 2021 1st Reg. Sess.) (adopting R.U.L.L.C.A., *supra* note 1, § 701(a)(4), including the right to dissolution if the managers or controlling members have acted "in a manner that is illegal or fraudulent," but deviating from R.U.L.L.C.A. by excluding "oppressive" conduct as grounds for dissolution).

227. R.U.L.L.C.A., *supra* note 1, § 701(a)(4)(C) cmt. ("The act does not define 'oppressively,' but 'oppression' is a concept well-grounded in the law of close corporations."). Relying primarily on the Official Comment, *Manere v. Collins* concluded that the "reasonable expectations" standard determines oppression under RULLCA, rather than the less generous "fair dealing" standard. 241 A.3d 133, 150–59 (Conn. App. Ct. 2020) (citing, among other sources, F. HODGE O'NEAL & ROBERT B. THOMPSON, OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS (rev. 2d ed. 2021); Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883 (2005)).

228. According to Co-Reporter Daniel Kleinberger, "[f]rom the very first tentative draft, the new Act [took] seriously the direct/derivative distinction and embraced the direct harm rule. Borrowing from ULPA (2001) § 1001(b), the April 2004 draft of [the updated] RULLCA provided that: 'A member commencing a direct action . . . is required to plead and prove an . . . injury that is not solely the result of an injury . . . [to] the LLC.'" Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 136 (2006) (footnote omitted).

229. R.U.L.L.C.A., *supra* note 1, § 105(c)(2) cmt.

230. Daniel S. Kleinberger, *How Can I Be a Party to a Contract and Yet Lack Standing to Sue Another Party for Breach?*, BUS. L. TODAY, July 2018, at 1.

231. 1994 R.U.P.A., *supra* note 211, § 201(a) ("A partnership is an entity distinct from its partners.").

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a limited liability partnership.[232] The RUPA drafters concluded that they could expand remedies among partners, and between partners and the partnership, *precisely because* they had declared the partnership to be an entity and made concomitant changes that protected the stability for which partners and their firms had contracted. Accordingly, RUPA's adoption of the entity theory included a provision that a partner may sue the partnership or another partner at any time, for legal or equitable relief, to enforce the partner's rights under the partnership agreement or under RUPA.[233] To this extent, RUPA's adoption of the entity theory was qualified by recognizing the direct rights of partners. At the same time, RUPA made partnership entities more stable by providing that a partner's suit does not cause either a dissociation[234] or a dissolution.[235] These new provisions reflected "a new policy choice that partners should have access to the courts during the term of the partnership to resolve claims against the partnership and the other partners, leaving broad judicial discretion to fashion appropriate remedies."[236]

Other developments in corporate and LLC law, both before and after RULLCA, confirm that it is excessively formalistic, historically incomplete (if not inaccurate), and reflective of a poor policy choice to conclude that derivative litigation "follows necessarily" from the entity theory. Several states have enacted closely held business statutes that exempt both corporate[237] and LLC entities[238] from the burdensome formalities of derivative litigation. The American Law Institute ("ALI") has long stated that a court should free a shareholder from the restrictions on derivative claims if to do so "will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of the creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all the interested persons."[239] A significant number of courts have applied the ALI approach both to corporations[240]

232. The ULC retained partners' easy access to remedies even after it added the LLP provisions to RUPA in 1997. UNIF. P'SHIP ACT §§ 405, 1001(a) (UNIF. L. COMM'N 1997).

233. 1994 R.U.P.A., *supra* note 211, § 405.

234. *Id.* § 601.

235. *Id.* § 801.

236. *Id.* § 405 cmt. 2.

237. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 21.563(a), (b) (West, Westlaw through the 2021 Reg. Sess.) (exempting corporations with fewer than thirty-five shareholders from most of the restrictive provisions on derivative litigation, provided no shares are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association).

238. *See, e.g.*, *id.* § 101.463(a), (b) (exempting LLCs with fewer than thirty-five members from most of the restrictive provisions on derivative litigation, provided no membership interests are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or members of a national securities association); ME. REV. STAT. ANN. tit. 31, § 1637 (West, Westlaw through the 2021 1st Reg. Sess. & 1st Spec. Sess.) (same).

239. PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(d) (AM. LAW INST. 1994) [hereinafter ALI CORP. GOV.].

240. *See, e.g.*, Wichansky v. Zowine, 150 F. Supp. 3d 1055, 1067 n.12 (D. Ariz. 2015) (noting that where a "corporation was closely held by the plaintiffs and the defendants, who 'operated more as partners than in strict compliance with the corporate form,' plaintiffs had standing to initiate direct action seeking individual recovery" (quoting Johnson v. Gilbert, 621 P.2d 916, 918 (Ariz. Ct.

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and LLCs,[241] some specifically noting that the ALI approach exempts the plaintiff from the rule that permits an SLC to recommend the dismissal of the suit.[242] Similarly, the Alabama legislature specifically cited the ALI approach when it enacted statutory language providing that a "member may maintain a direct action to enforce a right of a[n LLC] if all members at the time of suit are parties to the action."[243] In sum, a significant number of legislatures, courts, and commentators have concluded that the important question is what characteristics a

App. 1980), *overruled on other grounds by* Turley v. Ethington, 146 P.2d 1282 (Ariz. Ct. App. 2006) (citing ALI Corp. Gov., *supra* note 239, § 7.01(d)); *see also* Durham v. Durham, 871 A.2d 41, 46 (N.H. 2005) ("While we agree that consistency in the law is important, we also recognize that the derivative proceeding involves burdensome, and often futile, procedural requirements when a minority shareholder seeks to redress wrongful behavior by the majority shareholders. . . . A direct action may be appropriate in this case because all of the corporation's shareholders are before the court either as the plaintiff or as defendants; thus, there is no risk that a direct suit would expose the corporation to a multiplicity of actions. Furthermore, it appears that the corporation does not have a disinterested board of directors that could evaluate whether a derivative proceeding is in the best interest of the corporation." (citing ALI Corp. Gov., *supra* note 239, § 7.01(d))); Simon v. Mann, 373 F. Supp. 2d 1196, 1199 (D. Nev. 2005) (noting that, "in a closely-held corporation, the relatively few shareholders are generally also parties to the suit, and thus the attendant remedies and policy concerns are distinct from those arising in derivative suits for publicly-held corporations" (citing ALI Corp. Gov., *supra* note 239, § 7.01(d))); Trieweiler v. Sears, 689 N.W.2d 807, 837 (Neb. 2004) ("[A] closely held corporation may be treated, in effect, as an incorporated partnership, and a significant difference in legal treatment is unwarranted, as the concept of a corporate injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders." (citing ALI Corp. Gov., *supra* note 239, § 7.01(d))); Mynatt v. Collis, 57 P.3d 513, 529–30 (Kan. 2002) (citing ALI Corp. Gov., *supra* note 239, § 7.01(d), but emphasizing that the rule explicitly entrusts the trial court with discretion to determine whether a derivative claim may be pursued directly); Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280–81 (Utah 1998) ("[A] court may allow a minority shareholder in a closely held corporation to proceed directly against corporate officers." (citing ALI Corp. Gov., *supra* note 239, § 7.01(d))); Barth v. Barth, 659 N.E.2d 559, 562 (Ind. 1995) ("[The ALI's rule] represents a fair and workable approach for balancing the relative interests in closely-held corporation shareholder litigation." (citing ALI Corp. Gov., *supra* note 239, § 7.01(d))); Derouen v. Murray, 604 So. 2d 1086, 1091 n.2 (Miss. 1992) (citing with approval ALI Corp. Gov., *supra* note 239, § 7.01(d), but noting that the trial court did not address the issue).

241. Saunders v. Briner, 221 A.3d 1, 28 (Conn. 2019) (permitting the member of a single-member LLC to bring derivative claims as a direct action and receive individual recovery because to prohibit the direct action "would 'exalt form over substance' [because] . . . none of the reasons underlying the [distinct and separate injury] requirement [is] present" (quoting *Barth*, 659 N.E.2d at 560 (citing ALI Corp. Gov., *supra* note 239, § 7.01(d)))); BioConvergence, LLC v. Menefee, 103 N.E.3d 1141, 1166 (Ind. Ct. App. 2018) (citing ALI Corp. Gov., *supra* note 239, § 7.01(d)); Banyan Inv. Co. v. Evans, 292 P.3d 698, 702–05 (Utah Ct. App. 2012) (holding that a member of an LLC was entitled to bring a derivative action as a direct action, extending the ALI's exception for closely held corporations to LLCs).

242. *See, e.g.*, *BioConvergence, LLC*, 103 N.E.3d at 1166 (stating that the ALI approach exempts the plaintiffs from the rules that permit an SLC to recommend dismissal of the lawsuit, thus, "the court in making its decision should consider whether the corporation has a disinterested board that should be permitted to consider the lawsuit's impact on the corporation"); *Durham*, 871 A.2d at 46 (emphasizing the absence of a disinterested board).

243. Ala. Code § 10A-5A-9.01(c)(1) (West, Westlaw through 2021 Reg. Sess. & 1st Spec. Sess.); *id.* cmt. ("Subsection (c) is a modification of the [ALI] provision that allows the court to treat an action raising derivative claims as a direct action under certain circumstances. . . . Having all the members before the court, without the other qualifications, should be a sufficient safeguard against multiple actions. Creditor protection, which is required to be considered by a court in allowing a direct suit under the [ALI] provision, is inconsistent with the function of litigation by [LLC] members, whether this litigation is 'direct' or 'derivative' in nature.").

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particular entity should have as a matter of pragmatic policy, not what is logically compelled by the abstract notion that the business is an entity.

The related major reason the RULLCA drafters gave for curtailing direct actions by members is to protect the integrity of the shield limiting the vicarious liability of members for their involvement in the firm. It perhaps goes without saying that members forming LLCs want the liability shield. However, the LLC shield is virtually identical to the limited liability partnership shield, which never has and does not cause partners to be denied standing to bring any of their claims. Nor is it necessary to curtail direct remedies to protect partners from vicarious liability for money damages. A member's vicarious liability for breach of the agreement or statute can be made nonrecourse without withholding other direct remedies, such as an injunction.

The RULLCA Official Comment states that operating agreements are not to be treated as normal commercial contracts, while acknowledging that, "in ordinary contractual situations, it is axiomatic that each party to a contract has standing to sue for breach of that contract."[244] Without explaining why or how, the Official Comment declared that "different circumstances typically exist" within an LLC.[245] It concluded that the "distinction between direct and derivative claims protects the operating agreement."[246]

It is unclear how an agreement is "protected" by raising procedural barriers to its enforcement. The Official Comment states that, if "any member can sue directly over any management issue, the mere threat of suit can interfere with the members' agreed-upon arrangement."[247] First, this is the opposite policy choice that was made in RUPA and in the 1996 Act, which was that modern business acts result in business entities that are sufficiently stable legally and contractually to withstand internal litigation. Second, it suggests that imposing the procedural obstacles of derivative litigation will reduce or minimize internal disharmony. The "threat" of suit remains, nonetheless. It is doubtful that harmony is enhanced by imposing the complexities and costs of derivative litigation. Nor is it clear how harmony among all members, and not just harmony among the majority, will be enhanced by allocating the resolution of derivative claims to SLCs, which are likely to favor the majority unless they are subjected to careful judicial review.

e. SLC Is the Default "Dispute Resolution" Mechanism for Derivative Claims. Once the ULC decided to extend the direct/derivative distinction from public corporate law to LLCs, the natural next step would be to provide the SLC as the default dispute resolution mechanism for resolving the derivative claims. RULLCA section 805 contains the rules concerning SLCs in LLCs. It begins by giving an LLC

244. R.U.L.L.C.A., *supra* note 1, § 801 cmt. b.

245. *Id.* ("A member does not have a direct claim against a manager or another member merely because the manager or other member has breached the operating agreement. Likewise, a member's violation of the act does not automatically create a direct claim for every other member. To be able to have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to a[n LLC].").

246. *Id.*

247. *Id.*

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that is named or made a party in a derivative proceeding the right to appoint an SLC "to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests" of the LLC.[248] The remainder of section 805 contains three different types of rules. First, it contains the basic requirement that an SLC "must be composed of one or more disinterested and independent individuals, who may be members."[249] Second, it provides for the ways in which an SLC may be appointed, depending upon the situation.[250] Third, it contains judicial mandates. The section requires the court, absent "good cause shown," to "stay discovery for the time reasonably necessary to permit the committee to make its investigation."[251] It concludes, most importantly, by requiring the court to enforce the determination of the SLC, if it finds "that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care."[252]

Section 805 is a mixture of mandatory rules and default rules. Section 105(c)(12) provides that the operating agreement may not "vary the provisions of Section 805, but the operating agreement may provide that the company may not have a special litigation committee."[253] One fundamental point, for our purposes, is that the parties may completely opt out of the use of an SLC. Another fundamental point is that, if there is no opt out in the operating agreement, section 105(c)(12) suggests that the operating agreement may not alter either the rules governing the SLC itself or the rules directed to the court. By contrast, the Official Comment states that, unless the operating agreement "preclude[s] entirely" the use of an SLC, it "may not alter the act's rules for a special litigation committee,"[254] raising the question whether the only mandatory rules are those directed at the SLC itself, rather than those directed to the court. However, the statute itself suggests that the provisions of section 805 must be opted out as a complete package. The parties may not customize their SLC in a way that "varies" the rules of section 805. Nor is there any reason the parties should be able to vary the legislature's directives to the courts on how to treat LLCs.

It is understandable that the drafters intended a court to give a qualified and properly appointed SLC a chance to work and to defer to its properly produced recommendation. It also makes sense to require the SLC to be composed of "disinterested and independent individuals," because that is the same fairness requirement in corporate law, although, as we have seen, imposed with varying levels of scrutiny. It also makes sense that the parties can opt out of using an SLC and choose instead arbitration or other dispute resolution mechanism. On the other hand, it is not at all clear why the parties may not opt for a middle ground by tailoring the processes for appointing an SLC. Arbitration agreements,

248. *Id.* § 805(a).
249. *Id.* § 805(b).
250. *Id.* § 805(c).
251. *Id.* § 805(a).
252. *Id.* § 805(e).
253. *Id.* § 105(c)(12).
254. *Id.* § 105 cmt. (c)(12).

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for example, are likely to address arbitrator qualifications, whether there is a single arbitrator or a panel, rules governing arbitration, and how arbitrators are selected if the parties cannot agree. It is not clear why parties who do not opt for arbitration cannot include in their operating agreement similar rules on the qualifications and appointment of SLCs, especially if they intend to provide for greater protections for minority interests than those embodied in RULLCA.

f. RULLCA's Weak Protections on Appointment and Review of SLCs. RULLCA does relatively little to protect minority owners in closely held LLCs against abuses of SLCs. Some protection follows from the statutory requirement that members of the SLC be "disinterested and independent," although, as we have seen, the level of protection depends upon the jurisdiction. The critical question is how the courts will apply those two requirements, which in turn depends upon what guidance they draw from the statute. As mentioned earlier, significant practical consequences flow from choice of standard of review.[255] SLCs that face meaningful scrutiny are likely to be more receptive to claims by minority interests. RULLCA's Official Comments set forth the basic declaration of intent the RULLCA drafters made to the courts: they are to "follow" *Auerbach*'s more deferential approach rather than *Zapata*'s more careful review.[256] Consistent with this approach, section 805(e) requires the court to enforce the determination of the SLC if the members were disinterested and independent and if it "acted in good faith, independently, and with reasonable care."[257] By contrast, some states have modified this provision and stated that courts have the discretion whether to accept, modify, or reject the resolution of the SLC.[258] The statutory grant of judicial discretion brings those states closer to *Zapata* without adopting *Zapata*'s controversial formulation.

Neither the text of RULLCA nor the Official Comments make any mention of a requirement that those appointing the SLC be disinterested and independent. Indeed, they state the opposite by providing that, in certain situations likely to arise quite often, the SLC can be appointed by a majority of those named as defendants. In the case of a member-managed LLC, the SLC may be appointed "by the affirmative vote or consent of a majority of the members not named as parties in the proceeding."[259] However, if all members are named as parties to the proceeding, as is likely to be the case in closely held LLCs, "a majority of the members named as defendants" may appoint the SLC.[260] In the case of a

255. Krishnan, Davidoff Solomon & Thomas, *supra* note 11, at 1–2; DeMott, *supra* note 10, § 5.18.

256. R.U.L.L.C.A., *supra* note 1, § 805 cmt. (e).

257. *Id.* § 805(e).

258. *See, e.g.*, Fla. Stat. Ann. § 605.0804(5) (West, Westlaw through the 2021 1st Reg. Sess.) ("If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court *may* enforce the determination of the committee. Otherwise, the court shall dissolve any stay of derivative action entered under subsection (1) and allow the derivative action to continue under the control of the plaintiff." (emphasis added)).

259. R.U.L.L.C.A., *supra* note 1, § 805(c)(1)(A).

260. *Id.* § 805(c)(1)(B).

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manager-managed LLC, the SLC may be appointed by a majority of the managers not named as parties.[261] Once again, however, if all the managers are named as parties in the proceeding, "a majority of the managers named as defendants" may appoint the SLC.[262] As mentioned earlier, if an LLC uses an SLC, the operating agreement may not "vary" RULLCA's SLC rules.[263] This apparently includes the rules authorizing majorities of defendants to appoint the SLC. Unfortunately, a significant number of states enacting RULLCA have included these rules without modification.[264]

The grant of authority to a majority of defendants to appoint the SLC seems inconsistent with corporate law requiring the appointers themselves to be disinterested and independent wherever possible. It is true that many corporate statutes have no such requirement, and it also is true that other statutes provide that a defendant is not automatically disqualified from being a part of the appointment process.[265] It is also true that *Zapata* states that tainted boards may make legitimate appointments. However, *Zapata* and *Oracle* also suggest that fresh appointments to the board can and should minimize or eliminate taint, and that tainted appointment may cause the resulting SLCs to be held to a higher standard of review, a stricter independence requirement, or both. In most closely held LLCs, there is no board to which new blood can be appointed to minimize or eliminate taint. The law of these LLCs should not be constrained, directly or indirectly, by appointment rules premised on the existence of a board. When there is an internal dispute in a closely held LLC with no board and in which all members are parties, there is an inherent conflict between the requirement that SLC members be "disinterested and independent" and the rule that they may be appointed by majorities of defendants. This inherent conflict has been

261. *Id.* § 805(c)(2)(A).

262. *Id.* § 805(c)(2)(B).

263. *See id.* § 105(c)(12).

264. *See* CONN. GEN. STAT. ANN. § 34-271d (West, Westlaw through the 2021 Reg. Sess.); D.C. CODE ANN. § 29-808.05 (West, Westlaw through Sept. 22, 2021); IDAHO CODE ANN. § 30-25-805 (West, Westlaw through ch. 364 of the 2021 1st Reg. Sess.); MINN. STAT. ANN. § 322C.0905 (West, Westlaw through the 2021 Reg. Sess. & 1st Spec. Sess.); NEB. REV. STAT. ANN. § 21-168 (West, Westlaw through the 1st Reg. Sess. & 1st Spec. Sess. of the 107th Leg.); N.J. STAT. ANN. § 42:2C-71 (West, Westlaw through L.2021, c. 221); N.D. CENT. CODE ANN. § 10-32.1-37 (West, Westlaw through the 2021 Reg. Sess.); 15 PA. STAT. AND CONS. STAT. § 8884 (West, Westlaw through the 2021 Reg. Sess. Act 83); S.D. CODIFIED LAWS § 47-34A-1105 (West, Westlaw through the 2021 Reg. Sess.); UTAH CODE ANN. § 48-3a-805 (West, Westlaw through the 2021 1st Spec. Sess.); VT. STAT. ANN. tit. 11, § 4135 (West, Westlaw through Act 76 & M-6 of the Reg. Sess. of the 2021–22 Gen. Assemb.); WYO. STAT. ANN. § 17-29-905 (West, Westlaw through the 2021 Gen. Sess.). Other states have adopted RULLCA but do not have a statutory provision for setting up an SLC. *See* ALA. CODE § 10A-5A-9.01 to .09 (West, Westlaw through the 2021 2d Spec. Sess.); CAL. CORP. CODE § 17709.01–.02 (West, Westlaw through ch. 770 of the 2021 Reg. Sess.); 805 ILL. COMP. STAT. ANN. 180/40-1 to -15 (West, Westlaw through P.A. 102-334 of the 2021 Reg. Sess.); IOWA CODE § 489.901 to .1000 (West, Westlaw through the 2021 Reg. Sess.); WASH. CODE ANN. § 25.15.386 to .401 (West, Westlaw through the 2021 Reg. Sess.).

265. *See* GA. CODE ANN. § 14-2-744 (West, Westlaw through the 2021 Reg. Sess.); N.C. GEN. STAT. ANN. § 55-7-44 (West, Westlaw through S.L. 2021-117 of the 2021 Reg. Sess.); N.J. STAT. ANN. § 14a:3-6.5 (West, Westlaw through L.2021, c. 221 & J.R. No. 3); VA. CODE ANN. §§ 13.1-603, 13.1-672.4 (West, Westlaw through the 2021 Reg. Sess. & 2021 Spec Sess. I); WIS. STAT. ANN. § 180.0744 (West, Westlaw through the 2021 Act 59-79).

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recognized in the law of arbitration and in state enactment of RULLCA that modifies its appointment provisions.

In the analogous dispute resolution mechanism of arbitration, arbitrators, like SLC members, must be "independent and impartial."[266] In addition to this requirement, courts have placed limitations on who may appoint the arbitrators. The unilateral appointment of arbitrators by defendants has been rejected for a variety of reasons. For example, provisions that allow a business entity to select all the arbitrators have been voided as "so wholly one-sided as to present a stacked deck"[267] and substantively and procedurally unconscionable.[268]

The inherent conflict in RULLCA's rules allowing only defendants to appoint an SLC that must be "disinterested and independent" explains why a state like Florida, which generally adheres closely to major uniform acts, modified RULLCA by including non-uniform provisions that unqualifiedly require the appointing members or managers to be "disinterested and independent."[269] Continuing that example, under Florida law, if no such member or manager exists, the court will appoint the SLC, "consisting of a panel of one or more disinterested and independent persons," who need not be members or managers.[270] RULLCA would be improved by adopting this simple rule that those who appoint the SLC must themselves be disinterested and independent. In making this modification, the ULC or adopting states can be guided by uniform rules on the judicial appointment of arbitrators when normal methods fail.[271] Under the Revised Uniform Arbitration Act, for example, if the economics of the situation warrant it, a court may appoint a panel of arbitrators, with the plaintiff(s) selecting one, the defendant(s) selecting one, and those two panelists selecting a third.[272]

266. *See* CPR Rules, *supra* note 40, § 7.1; *see also* Am. Arb. Ass'n, Commercial Arbitration & Mediation Procedures § R-18(a) (2013) ("impartial and independent"). The use of the term "impartiality" in arbitration, rather than disinterest, presumably derives from the use of the term "evident partiality" in the Federal Arbitration Act as one of the few grounds for overturning an arbitral award. 9 U.S.C. § 10(a)(2) (2018).

267. Hooters of Am., Inc. v. Phillips, 173 F.3d 933, 940 (4th Cir. 1999).

268. Chavarria v. Ralphs Grocery Co., 733 F.3d 916, 927 (9th Cir. 2013) (declaring an arbitration agreement substantively and procedurally unconscionable because it would always result in an arbitrator proposed by the employer in employee-initiated arbitration proceedings).

269. Fla. Stat. Ann. § 605.0804(3) (West, Westlaw through the 2021 1st Reg. Sess.).

270. *Id.* § 605.0804(3)(c).

271. The ULC should modify RULLCA by borrowing language from the Uniform Arbitration Act. *See* Unif. Arb. Act § 11(a) (Unif. L. Comm'n 2000) ("If the parties to an agreement to arbitrate agree on a method for appointing an arbitrator, that method must be followed, unless the method fails. If the parties have not agreed on a method, the agreed method fails, or an arbitrator appointed fails or is unable to act and a successor has not been appointed, the court, on [motion] of a party to the arbitration proceeding, shall appoint the arbitrator . . . .").

272. *See id.* § 12 cmt. 5 ("Special problems are presented by tripartite panels involving non-neutral Arbitrators—that is, in situations such as where each of the arbitrating parties selects an arbitrator and a third, neutral arbitrator is jointly selected by the arbitrators chosen by the parties."). This is said to be a situation involving "party appointed" arbitrators. There is a lesser impartiality requirement for the party-appointed arbitrators. *See generally* Elkouri & Elkouri, How Arbitration Works § 2.2.B.ii, at 2-56 (8th ed. 2016) (noting that "some statutes expressly limit the impartiality requirement to the neutral arbitrators serving on tripartite boards"). "While courts are required to overturn arbitration awards if they find that there has been evident partiality, two of the arbitrators of a tripartite panel are, by

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g. RULLCA's Fundamental Error Imposing Derivative Litigation. A significant mixture of commentators, law reform organizations, and state legislatures have taken the position that the machinery of derivative litigation, concededly appropriate in large corporations, should not be imposed upon closely held businesses. The basic reason is that it imposes heavy litigation costs.[273] Indeed, one of the most frequently litigated areas of LLC law is whether a member's claim is direct as opposed to derivative. Unfortunately, even two- to four-person LLCs get ensnared in litigating this issue,[274] possibly entailing separate proceedings if some of a member's claims are direct and some of them derivative.[275] The smaller the firm, the more costly the issue per member. Similarly, it is easy to imagine the many hours incurred trying to sort through how the selection of SLC members can be accomplished in closely held LLCs.[276]

RULLCA made the dramatic shift to limiting member access to direct remedies with no indication that the statute's target group had shifted away from small groups of entrepreneurs operating informally and without the benefit of sophisticated counsel. Instead, the Official Comment says simply that the imposition of derivative action rules is consistent with the entity theory.[277] However, partnerships are also statutory entities, yet offer their members easy access to direct actions. The question is not the abstract nature of a business entity. Rather, the question is what characteristics you want a particular entity to have. Numerous authorities have said that, even assuming a business is a legal entity, one size need not fit all. For example, as we have seen, some state statutes authorize direct actions in closely held businesses, whether they be in the corporate form or

their very nature, biased . . . ." *Id.* § 4.5.B, at 4-21–22; *see* Deseriee A. Kennedy, *Predisposed with Integrity: The Elusive Quest for Justice in Tripartite Arbitration*, 8 GEO. J. LEGAL ETHICS 749, 750 (1995) ("In tripartite panel arbitrations, under the rules of the American Arbitration Association (AAA), party-appointed arbitrators are permitted and even encouraged to be predisposed toward the position of their nominating party.").

273. *See* Larry E. Ribstein, *Litigating in LLCs*, 64 BUS. LAW. 739, 740–41 (2009); *see also* Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 453 (2001) ("A direct action should not be barred in an LLC, particularly where it would be the most efficient manner of resolving the dispute.").

274. *See* 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 9:26 (rev. 3d ed. 2021) ("The derivative/direct distinction makes little sense when the only interested parties are two individuals or sets of shareholders, one who is in control and the other who is not. In this context, the debate over derivative status can become 'purely technical.'" (footnotes omitted) (quoting Funk v. Spalding, 246 P.2d 184, 188 (Ariz. 1952))).

275. *See* Passarella v. Klein, No. 652904/2017, 2020 N.Y. Slip Op. 31527(U) (Sup. Ct. N.Y. Cnty. May 21, 2020) (illustrating the absurdity of applying the direct/derivative distinction to a closely held LLC). In that case, the court denied a direct claim to a plaintiff who was 50 percent owner of a two-member, member-managed LLC who argued that the only other member had violated his fiduciary duties by diverting firm funds for his personal use and to form a new business. *Id*. at *1–5. It is not clear what policy goal, if any, the court thought it was serving by denying the direct claim. For a discussion of Florida cases addressing the direct/derivative distinction in small LLCs, see Donald J. Weidner, *Dissatisfied Members in Florida LLCs: Remedies*, 18 FLA. ST. U. BUS. REV. 1 (2019).

276. Einhorn v. Culea, 612 N.W.2d 78, 93 n.49 (Wis. 2000) (acknowledging that "it may be difficult for closely held corporations to assemble special litigation committees," and noting the corporate statute providing for court appointment in that event (citing WIS. STAT. ANN. § 180.0744(6))).

277. *See* R.U.L.L.C.A., *supra* note 1, § 801 cmt. (b) ("This subsection codifies the role of standing that predominates in entity law.").

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in the LLC form.[278] Similarly, numerous courts have adopted the American Law Institute's recommendation that direct actions should be permitted in closely held firms unless there is a policy reason to withhold them.[279]

Therefore, to avoid high litigation costs, effect the presumptive intent of the members, and afford access to the courts unless reason suggests otherwise, legislatures should allow people forming LLCs to opt in to the machinery of derivative litigation rather than force them to opt out of it. Texas offers a good example of one way to proceed slightly more narrowly. It permits much greater access to judicial remedies in the case of closely held firms, defined as corporations or LLCs with fewer than thirty-five shareholders[280] or members.[281] In the case of a closely held LLC, the derivative action rules "do not apply to a claim or a derivative proceeding by a member of a closely held [LLC] against a governing person, member, or officer of the [LLC]."[282] This means that the derivative action rules do not apply to internal disputes within the LLC, but continue to apply to claims against third parties. Any internal derivative action brought by a "member . . . may be treated . . . as a direct action brought by a member for the member's own benefit.[283] However, any recovery in a direct or derivative proceeding may be paid to the LLC "if necessary to protect the interests of creditors or other members" of the LLC.[284]

B. *Obeid* Applies *Zapata* to Judicial Review of SLCs in LLCs

Thirty-five years after *Zapata* and a dozen years after *Oracle*, *Obeid v. Hogan*[285] gave a retrospective on *Zapata* and explained how it applies to the appointment and review of SLCs in LLCs with different structures. Although the Delaware legislature quickly reversed a key aspect of *Obeid*'s holding,[286] it remains an important discussion of how corporate precedent applies to SLCs in LLCs.

278. *See supra* notes 237–38 and accompanying text.
279. *See supra* notes 239–43 and accompanying text.
280. Tex. Bus. Orgs. Code § 21.563(a), (b) (West, Westlaw through the 2021 Reg. Sess.).
281. *Id.* § 101.463(a), (b).
282. *Id.* § 101.463(b).
283. *Id.* § 101.463(c)(1).
284. *Id.* § 101.463(c)(2).
285. No. 11900, 2016 WL 3356851 (Del. Ch. June 10, 2016).
286. *Compare id.* at *16–17 (suggesting limits on delegation under Del. Code Ann. tit. 6, § 18-407), *with* S. 72, 149th Gen. Assemb. § 11 (Del. 2017) (amending Del. Code Ann. tit. 6, § 18-407 ("Unless otherwise provided in the [LLC] agreement, a member or manager of a[n LLC] has the power and authority to delegate to 1 or more other persons any or all of the member's or manager's, as the case may be, rights, powers and duties to manage and control the business and affairs of the [LLC]. Any such delegation may be to agents, officers and employees of a member or manager or the [LLC], and by a management agreement or another agreement with, or otherwise to, other persons. . . . No other provision of this chapter shall be construed to restrict a member's or manager's power and authority to delegate any or all of its rights, powers and duties to manage and control the business and affairs of the [LLC]."), *amended by* S. 114, 151st Gen. Assemb. § 4 (Del. 2021)).

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1. *Obeid* Facts and Basic Holding

Obeid involved three natural persons who were equal members of two manager-managed Delaware LLCs that owned and "jointly manage[d]" over $1 billion in real estate assets, including hotels and other commercial properties.[287] Initially, Obeid managed the day-to-day operations of the hospitality division and his two fellow members, La Mack and Massaro, managed the operations of the commercial division. One LLC, which the court referred to as the Corporate LLC, was managed by a Board of Directors to which all three members were initially named.[288] The second LLC, which the court referred to as the Manager-Managed LLC, was managed by the three members, not in their capacity as members but in their capacity as the persons designated as "managers" under the LLC agreement.[289] Obeid was also the President and Operating Manager of the Manager-Managed LLC.[290]

On July 1, 2014, La Mack and Massaro voted to remove Obeid as President and Operating Manager of the Manager-Managed LLC and to install Massaro in his place. Consistent with their agreement that entitled each of them to be a manager for so long as he is a member, they did not attempt to remove him as a manager. Instead, they sued him and voted to remove him as a director of the Corporate LLC.

The next month, Obeid asserted derivative claims on behalf of both LLCs in New York federal district court.[291] He claimed that La Mack and Massaro had inappropriately used the assets of both LLCs to start competing companies. He argued that it was futile to make a demand on the LLCs because La Mack and Massaro "suffer from conflicts of interest and divided loyalties that preclude them from exercising their independent business judgment on this matter."[292] The derivative suit subsequently "progressed well beyond the stage where La Mack and Massaro could contest Obeid's authority to assert derivative claims . . . on

287. *Obeid*, 2016 WL 3356851, at *1.

288. *Id.*

289. *Id.* at *1–2.

290. *Id.* at *2.

291. *Id.* Contemporaneous with their vote to remove Obeid as president and operating manager of the manager-managed LLC, La Mack and Massaro filed an action in North Carolina state court against Obeid relating to his tenure as operating manager. *Id.* In August, Obeid filed an action against them in New York federal court, alleging they were using assets belonging to the two LLCs. *Id.* This New York federal action asserted both direct and derivative claims. *Id.* The following March, the North Carolina court stayed its action in deference to the New York action. *Id.* Later that month, Obeid filed a second action in New York, in state court, against a third party that competed with the two LLCs, alleging that La Mack and Massaro were improperly selling properties of the LLCs in return for side benefits. *Id.* In July 2015, La Mack and Massaro counterclaimed against Obeid in the New York federal action, alleging, among other things, fraud and breach of the LLC agreements. *Id.* In September of 2015, La Mack and Massaro caused the subsidiaries of the LLCs, through which the LLCs held the properties that were the subject of the New York state action, to file for bankruptcy. *See id.* The bankruptcy court later lifted the automatic stay to allow both the state and federal actions in New York to proceed. *Id.* In January 2016, the claims asserted in the state action were brought into the federal action. *Id.* The numerous counts in the enlarged federal action against La Mack, Massaro, and their affiliates included derivative claims on behalf of the two LLCs. *Id.*

292. *Id.*

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the theory that demand should have been made."[293] Indeed, discovery had been completed.

The story of the appointment of an SLC for each LLC is a bit untidy, as fallings out often are. At the end of July 2015, there was a joint special meeting of the board of directors of the Corporate LLC and the managers of the Manager-Managed LLC. During the meeting, the Brewer Firm, retained by La Mack and Massaro to represent both LLCs, proposed that a retired federal judge be hired to serve as the SLC for each entity, to investigate and recommend whether to pursue the derivative claims, including the claims asserted against La Mack and Massaro. La Mack and Massaro voted in favor of "the concept" of forming an SLC whereas Obeid voted against it.[294] One month later, La Mack and Massaro executed an engagement letter, naming Judge Hogan, one of two retired federal judges mentioned at the joint meeting, to serve as a one-person SLC for each LLC.[295] Unlike the typical practice in corporations, Judge Hogan was not first appointed as a director of the Corporate LLC. Nor was he appointed as a member or manager of the Manager-Managed LLC.[296]

Obeid sued for a declaratory judgment that Judge Hogan had no authority to act as a one-person SLC for either LLC, and hence had no authority over any of the derivative claims.[297] The court, in an opinion by Vice Chancellor Laster that emphasized the extraordinary nature of an attempt to wrest control over a validly commenced derivative action, granted Obeid summary judgment with respect to both SLCs.

The court held that both SLCs were improperly constituted, although for slightly different reasons. Because the Corporate LLC adopted "a governance structure paralleling that of a Delaware corporation," *Zapata* applied to prevent Judge Hogan, as a non-director, from serving "as a one-man [SLC]."[298] Because the "Manager-Managed LLC also exhibits corporate features, albeit not so pervasively as the Corporate LLC, [i]t . . . seems likely that the reasoning applicable to the Corporate LLC compels the same result for the Manager-Managed LLC."[299] However, Vice Chancellor Laster said it was not necessary to decide whether *Zapata* prevented Judge Hogan, as a non-manager, from serving as the sole member of the Manager-Managed LLC's SLC. He avoided resolving the issue as a matter of law by interpreting the LLC agreement as preventing a non-manager from serving as a single-person SLC.

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293. *Id.*

294. *Id.* at *3. "No formal resolutions creating parallel [SLCs] were either presented or adopted. The idea was considered, and a vote was held, but only as a concept." *Id.*

295. *Id.* at *3–4. La Mack and Massaro each signed the letter as a "member-manager" of the Corporate LLC and the Member-Managed SLC. *Id.* at *4.

296. *Id.* at *4. A month later, La Mack and Massaro voted to remove Obeid as a director of the Corporate LLC. *Id.*

297. *Id.* Obeid also argued that he had not properly been removed from the board of the Corporate LLC, a claim the court rejected. *Id.*

298. *Id.* at *5.

299. *Id.* at *17.

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2. Presumptive Intent of Members Is Inferred from the Structure of Their LLC

Obeid's most important lesson is that courts will fill gaps in the statute or operating agreement according to the presumptive intent of the members, which in turn will be inferred from the structure they have chosen for their LLC. Part of the "freedom" of the LLC form is that members get to define the "character" of their firm and "their own approach to common business 'relationship' problems."[300] Accordingly, when filling a statutory or contractual gap, the court will analogize to business forms that most resemble the way the members have structured their relationship. For example, analogies to corporate law are most appropriate if the members have contracted for all the formalities normally associated with the corporate form. By contrast, analogies to partnership law are more appropriate if the members eschewed corporate formalities and all act informally as managers. The appropriate analogy can also vary depending upon the issue.

In the case of derivative suits, the analogy to corporate law is particularly strong because the "derivative suit is a corporate concept grafted onto the [LLC] form."[301] Given the corporate origins of derivative suits, "[a]bsent other convincing considerations, case law governing corporate derivative suits is generally applicable to suits on behalf of an LLC."[302] However, the analogy could vary based on the choices members make when structuring their LLCs. Those "choices . . . have consequences."[303]

If the members[304] "have embraced the statutory default rule of a member-managed governance arrangement . . . , then *the parties should expect a court to draw on analogies to partnership law*."[305] The "member-managed governance arrangement . . . has strong functional and historical ties to the general partnership (albeit with limited liability for the members)."[306] As in the case of partnership law,[307] the LLC act's "default framework generally contemplates a unity of

300. *Id.* at *5 (first quoting Del. Code Ann. tit. 6, § 18-1101(b) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.); then quoting Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 880 (Del. Ch. 2009); and then quoting Haley v. Talcott, 864 A.2d 86, 88 (Del. Ch. 2004)).

301. *Id.* at *7 (quoting Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 293 (Del. 1999) (citing Del. Code Ann. tit. 6, § 18-1001, which addresses derivative actions)).

302. *Id.*

303. *Id.* at *6.

304. Vice Chancellor Laster discussed "drafters" and not "members." *See id.* However, there is no need for a "drafter" for the default rule to apply. Also, a drafter, under normal agency principles, is to effect the intent of the principal, which would be the members under an aggregate theory, the LLC itself under an entity theory, or both under a blended theory. In short, the decisions of the "drafters" are presumptively imputed to the members and the firm.

305. *Id.* (emphasis added).

306. *Id.*

307. The default rules vary for the allocation of management authority among the owners. Management of an LLC is vested, by default, in the members in proportion to their interest in profits owned by the members, whereas in a partnership it is, by default, shared equally. *See* Del. Code Ann. tit. 6, § 15-401(f) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) ("Each partner has equal rights in the management and conduct of the partnership business and affairs."); *id.* § 18-402 ("Unless otherwise provided in a[n LLC] agreement, the management of a[n LLC] shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the [LLC] owned by all of the members . . . ."). In both forms, the majority controls management

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membership and management control."[308] "If, on the other hand, the drafters have opted for a single managing member with other generally passive, non-managing members," they have created "a structure closely resembling and often used as an alternative to a limited partnership, then *the parties should expect a court to draw on analogies to limited partnership law*."[309] "The field of limited partnership law is particularly fertile" because the LLC act was modeled on the limited partnership act, with almost identical architecture and wording.[310] In addition, as a practical matter, the passive members of a manager-managed entity are often treated like limited partners.[311] If, on the other hand, the members "have opted for a manager-managed entity, created a board of directors, and adopted other corporate features, then *the parties to the agreement should expect a court to draw on analogies to corporate law*."[312] This is true even if the board is called a "board of managers" rather than a board of directors.[313] Finally, depending upon the terms of the operating agreement, "analogies to other legal relationships may also be informative."[314]

The court cautioned against embracing "analogies to other entities or legal structures too broadly or without close analysis," given the great flexibility inherent in the LLC form.[315] The drafters of an LLC agreement may have adopted partnership-like features for some aspects of the relationship and corporate-like features for others.[316] For example, corporate features are lacking if the member has no economic interest or if the interest of the member is not as alienable as corporate shares or involves no right to vote. Analogies to the law of different forms may therefore be appropriate within the same LLC, depending upon the issue.

The facts of the Corporate LLC in *Obeid* did not involve any "other convincing considerations" that would render corporate case law inapplicable to the review of the SLC.[317] To the contrary, "the Corporate LLC agreement substantially re-creates the governance structure of a Delaware corporation using language drawn from the corporate domain."[318] It provided for a member-managed

decisions. *See id.* § 15-401(j) ("A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners."); *id.* § 18-402 ("[T]he decision of members owning more than 50 percent of the said percentage or other interest in the profits [shall be] controlling . . . .").

308. *Obeid*, 2016 WL 3356851, at *6 n.3 (quoting Robert L. Symonds, Jr. & Matthew J. O'Toole, Delaware Limited Liability Companies § 9.01[A][1], at 9-5 (2015)).

309. *Id.* at *6 (emphasis added).

310. *Id.* at *6 n.4 (citing Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999)).

311. *Id.* (citing *Elf Atochem N. Am., Inc.*, 727 A.2d at 290).

312. *Id.* at *6 (emphasis added).

313. *Id.* at *6 n.5 (collecting cases involving agreements that provided that the board was to be treated in all respects like a corporate board or that the LLC was to be governed in all respects like a corporation).

314. *Id.* at *6 (citing JAKKS Pac., Inc. v. THQ/JAKKS Pac., LLC, No. 4295, 2009 WL 1228706, at *2 (Del. Ch. May 6, 2009) (stating that a party to an LLC agreement, while "technically a member," had an economic interest that was "less . . . of an equity owner and more akin to a licensor with rights to royalties based on sales").

315. *Id.*

316. *Id.*

317. *Id.* at *7.

318. *Id.*

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LLC in which "the business and affairs" of the LLC "shall be managed by or under the direction of a Board of one or more Directors designated by the Members."[319] A director "need not be a Member."[320] The members could increase or decrease the number of directors at any time. The court concluded that this provision alone "establishe[d] a board-centric governance model tracking that of a corporation."[321] Equally important was the fact that the agreement tracked the corporate statute when defining the board's ability to delegate authority to committees.[322] It provided that the board could designate committees, consisting of one or more directors, to whom it could delegate all its authority to manage the firm. "The presence of these corporate traits in the Corporate LLC Agreement calls for applying corporate precedents to derivative claims involving the entity."[323] In particular, "corporate analogies should guide whether the Corporate Board can empower a[n SLC] comprising a single non-director."[324]

3. The Reformulation of *Zapata* as Enhanced Scrutiny

The second most important lesson of *Obeid* is that judicial review of the composition, work, and recommendations of SLCs is better understood in terms of enhanced scrutiny than in terms of a second step of review in which courts apply their own "business judgment."[325] *Obeid* located the then-thirty-five-year-old *Zapata* opinion among the three standards of judicial review that had come to be recognized in Delaware, depending upon the nature of the case. First, there is the "maximal deference" characterized by the business judgment rule, which applies to decisions by a disinterested board.[326] Second, at the other extreme, is "entire fairness review, reflecting a policy of extreme skepticism toward self-dealing decisions."[327] Third, and in between the two, is the "intermediate" standard of review, which requires enhanced scrutiny but not extreme skepticism.[328]

Obeid concluded that, "[w]ith the benefit of hindsight, one can discern in *Zapata* the foundational concepts that animate enhanced scrutiny, the more intermediate standard of review the Supreme Court introduced openly some four years later."[329]

319. *Id.*; *cf*. DEL. CODE ANN. tit. 8, § 141(a) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

320. *Obeid*, 2016 WL 3356851, at *7; *cf*. DEL. CODE ANN. tit. 8, § 141(a) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) ("Directors need not be stockholders . . . .").

321. *Obeid*, 2016 WL 3356851, at *7.

322. *Id.*; *cf*. DEL. CODE ANN. tit. 8, § 141(c) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.).

323. *Obeid*, 2016 WL 3356851, at *8.

324. *Id.*

325. Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

326. *Obeid*, 2016 WL 3356851, at *13 n.16 (quoting *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 597 (Del. Ch. 2010)).

327. *Id.* (quoting *Dollar Thrifty*, 14 A.3d at 597).

328. *Id.* at *13 (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)).

329. *Id.* (citing *Unocal*). "The *Zapata* test thus can be properly regarded as a nascent form of enhanced scrutiny and integrated within the larger body of case law applying the intermediate standard." *Id.*

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> First, there is a specific and recurring decision-making context where the realities of the situation "can subtly undermine the decisions of even independent and disinterested directors." Second, there is a need for an intermediate position which recognizes that "[i]nherent in these situations are subtle structural and situational conflicts that do not arise to a level sufficient to trigger entire fairness review, but also do not comfortably permit expansive judicial deference."[330]

Although *Obeid* did not directly address the independence test, Vice Chancellor Laster's concern for "subtle structural and situational conflicts" echoed the concerns that Vice Chancellor Strine expressed in *Oracle*. Although he did not cite *Oracle*, Vice Chancellor Laster cited a subsequent opinion by Vice Chancellor Strine stating that, when heightened or enhanced scrutiny comes into play, the "predicate question" is the board's motivation.[331] In such a situation, the court "must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board to block a bid or steer a deal to one bidder rather than another."[332]

4. Summary and Impact of *Obeid*

The Delaware legislature rejected *Obeid*'s suggestion that SLC members must have a certain status within the LLC. It specifically authorized an LLC's members or managers to delegate "any or all" of their authority to non-members,[333] and made conforming changes to the partnership and limited partnership acts.[334] The basic instruction the legislature had for courts reviewing SLCs in unincorporated entities was to avoid requiring corporate formalities.[335] There is no reason to require an SLC to be cleansed by washing one or more of its appointees through membership or management status, much less board membership. This

330. *Id.* (footnotes omitted) (first quoting *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013); and then quoting *In re* Rural Metro Corp. S'holder Litig., 88 A.3d 54, 81 (Del. Ch. 2014), *aff'd sub nom*. RBC Cap. Mkts., LLC v. Jervis, 129 A.3d 816 (Del. 2015) (en banc)).

331. *Id.* at *13 n.5 (quoting *Dollar Thrifty*, 14 A.3d at 598).

332. *Id.* (quoting *Dollar Thrifty*, 14 A.3d at 598). The intermediate standard of review of enhanced scrutiny was first announced in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), which Professor Gilson criticized as choosing "the middle ground that had been championed by no one." Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 496 (2001).

333. DEL. CODE ANN. tit. 6, § 18-407 (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) (stating that, unless otherwise provided in the LLC agreement, "a member or manager [of an LLC] has the power and authority to delegate to 1 or more other persons any or all of the member's or manager's . . . rights, powers and duties to manage and control the business and affairs of the [LLC and that n]o other provision of this chapter shall be construed to restrict a member's or manager's power and authority to delegate any or all of its rights, powers and duties to manage and control the business and affairs of the [LLC]").

334. *See id.* § 17-403(c) (addressing limited partnership); *id.* § 15-401(*l*) (addressing partnership). *See generally* Louis T.M. Conti, *Recent Changes to Delaware's Alternative Entity Acts as a Result of* Obeid v. Hogan, HOLLAND & KNIGHT (Aug. 25, 2017) (discussing those amendments).

335. *See* DEL. CODE ANN. tit. 8, § 141(c) (West, Westlaw through ch. 265 of the 151st Gen. Assemb.) (permitting the board to create committees but requiring that such committees be comprised of directors); Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981) (specifically permitting a "delegation of the board's power to an independent committee composed of disinterested board members").

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is consistent with the widespread modern practice of resolving key disputes through arbitrators who are not required, or even permitted, to have member or manager status. In short, the Delaware legislation leaves only two basic requirements for the composition of SLCs in LLCs. First, the SLC must be invested with the authority to decide the claims. The authority could either be delegated by those within the firm or granted by a court. Second, the SLC members must be independent of the disputants.

Despite being reversed by the legislature on internal status requirements for SLC membership, *Obeid* remains the most important judicial opinion explaining how and why *Zapata* applies to LLCs with widely divergent structures. Its search for the presumptive intent of the members is foundational and its use of enhanced scrutiny to determine reasonableness seems a cleaner statement of the standard of review than *Zapata*'s original suggestion that courts may apply their own business judgment to the work of SLCs.[336] In other contexts, it has been said that enhanced scrutiny to determine "reasonableness" is designed to "smoke out mere pretextual justifications for improperly motivated decisions."[337] Because *Obeid* locates *Zapata* historically as a precursor to a broader enhanced scrutiny of transactions involving insiders, it is not just concerned with the "pretextual," which is limited to an intent to cloak the true state of affairs. Rather, *Obeid* evokes the broader concerns of *Oracle*. In short, *Obeid* applies the lessons of *Zapata* and *Oracle* to LLCs, indicating that SLC members can be improperly selected if their deliberations are influenced by factors exogenous to the dispute, even if it is not clear which way those factors will influence. *Oracle* discusses those factors as bearing upon independence, whereas *Obeid* discusses them more broadly as triggering enhanced scrutiny.

III. Conclusion

Most of the law on SLCs is drawn from corporate law, developed primarily in the context of publicly held corporations. The animating conception is that management is vested in the board of directors, not in the owners. Corporate SLCs have classically been subcommittees of the board, often staffed by new board members specifically appointed to the board to qualify them to serve on the SLC. To protect the board's authority to appoint the SLC, Delaware courts avoid requiring every board member to be disinterested and independent. Instead, they protect minority interests primarily by requiring strict "disinterest and independence" of the SLC the board appoints.

336. "*Zapata*'s two-step standard . . . effectively amounts to reasonableness review and a context-specific application of enhanced scrutiny." La. Mun. Police Emps. Ret. Sys. v. Morgan Stanley & Co., No. 5682, 2011 WL 773316, at *7 (Del. Ch. Mar. 4, 2011).

337. *Dollar Thrifty*, 14 A.3d at 598–99; *see id.* at 599–600 ("[T]he reasonableness standard requires the court to consider for itself whether the board is truly well motivated (i.e., is it acting for the proper ends?) before ultimately determining whether its means were themselves a reasonable way of advancing those ends.").

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By contrast, most LLCs are closely held rather than publicly traded. They typically have no board of directors. The animating conception is that management is vested directly in the owners rather than in a board or management group, although the owners may contract otherwise. Despite these critical differences, most recent LLC acts impose upon even the smallest LLCs the complex machinery of derivative litigation that was developed in the context of public corporations. These acts adopt the default rule that most member claims are merely "derivative," rather than "direct," and give the LLC the right to respond to derivative claims by appointing an SLC.

The first problem with applying the derivative approach to LLCs is that it imposes significant dispute resolution costs that bear heavily on the relatively few owners of closely held businesses. LLCs typically do not have a large group of members to share the burden of the additional costs of resolving the myriad issues peculiar to derivative litigation. Indeed, one of the most heavily litigated issues in LLCs has become whether a member's claim is direct or derivative.[338] Sadly, even LLCs with only two or relatively few members get ensnared in litigating the distinction.[339] Added costs are also incurred to sort through the rules concerning the default dispute resolution mechanism of the SLC: who may appoint it, who may serve on it, and what standard of review shall be applied to its appointment and work. Indeed, even the jurisdiction of a validly appointed and otherwise qualified SLC can be in doubt because it only extends to derivative claims. Although it is generally accepted that these and other rules of derivative litigation, such as when demands are properly made, denied, or excused, impose costs that are appropriate for publicly held corporations, they have long been considered inappropriately burdensome for closely held firms.

The second, and related, problem with applying public corporation derivative law to LLC dispute resolution is that it runs counter to the presumptive intent of the members, which, *Obeid* reminds us, should determine statutory default rules and their application. Small firms formed without the benefit of counsel, whose members take part in management, and expect to do so informally, are unlikely to have intended to impose upon themselves the dispute resolution machinery applicable to shareholders in publicly held corporations.[340] They are more likely to view their operating agreements as normal commercial contracts that support direct remedies for breach, like partnership agreements. LLCs should be subject to the default rule of easy access to member remedies that are as inexpensive as possible, like

338. *See* Ribstein, *supra* note 273, at 743.

339. *See* Clifford Paper, Inc. v. WPP Invs., LLC, No. 2020-0448, 2021 WL 2211694 (Del. Ch. June 1, 2021) (explicitly rejecting the argument that, in a two-person LLC, the harm caused by one member directly flows to the other member); *id.* at *7 (concluding that Delaware's LLC act "does not distinguish two-member LLCs from other LLCs when addressing derivative actions—a distinction our General Assembly easily could have codified had it been so inclined"). The direct/derivative distinction has even been litigated in the context of a single-member LLC. *See* Saunders v. Briner, 221 A.3d 1 (Conn. 2019).

340. *See* Miller, *supra* note 273, at 437–38.

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limited liability and other partnerships.[341] Take away the default rule of corporate-style derivative litigation, and the problem of SLCs in LLCs largely resolves itself.

State legislatures should permit LLCs to "opt in" to the machinery of derivative litigation, rather than force them to "opt out" of it. Small groups of businesspeople should not be shunted into the derivative litigation morass simply because they selected the liability shield of an LLC. Legislatures give limited liability partnerships essentially the same shield,[342] without subjecting them to default rules that deny their partners the right to bring direct claims. Fortunately, state legislatures have begun to uncouple the adoption of a liability shield from the imposition of derivative litigation. Texas, for example, exempts both closely held corporations and closely held LLCs from the constraints of derivative litigation when the claims are against insiders, and Maine has taken a similar step.[343] At the very least, state legislatures should follow suit and exempt closely held LLCs from the imposition of the strictures of derivative litigation. Larger LLCs and those with passive investors can rely on sophisticated counsel to craft bespoke agreements that opt into derivative litigation. The rarified tail should not wag everyone's dog.

Second-best improvements are still possible if legislatures continue to impose derivative litigation on all LLCs as a default rule. Delaware courts should serve as a model for courts in other jurisdictions to check potential abuses of SLCs. Even in the context of publicly held corporations, they have been more open to ferreting out problematic relationships when managers appoint SLCs to investigate themselves or "one of their own." *Zapata*, as more recently interpreted as offering the possibility of enhanced equitable review, should be available to garden-variety LLCs, which are closely held and have no board of directors. As *Obeid* indicates, the presumptive intent of the members is the litmus test that should be applied to determine the appropriate process of dispute resolution.

Even courts that are not prepared to leave *Auerbach* and offer *Zapata*'s possibility of enhanced scrutiny should incorporate *Oracle*'s more careful review of SLC independence.[344] Closer review of independence is arguably consistent with RULLCA's intent. First, the Official Comment stating an intent to "follow" *Auerbach*, rather than *Zapata*, does not suggest that courts should ignore *Oracle*.[345] Second, RULLCA's intent for more limited judicial review is arguably reflected in and limited to its provision that courts must follow the recommendations of properly constituted and functioning SLCs.[346] Even in a RULLCA

341. *See* Weidner, *supra* note 213, passim (critiquing the "presumptive intent" of recent LLC acts).

342. 1994 R.U.P.A., *supra* note 211, § 405(b).

343. *See supra* notes 237–38.

344. *See, e.g.*, Atkins v. Topp Telecom, Inc., 874 So. 2d 626, 628 (Fla. Dist. Ct. App. 2004) (concluding that, although there was no legislative intent to adopt *Zapata*, closer review may be appropriate if the "court is concerned about the independence, neutrality, or good faith of the independent investigator or investigative committee"); Taneja v. Saraiya, 290 So. 3d 602, 604 (Fla. Dist. Ct. App. 2020) (affirming trial court's appointment of a non-member as a one-person SLC, emphasizing that he had "no financial or social ties to any of the parties or their representatives").

345. R.U.L.L.C.A., *supra* note 1, § 805 cmt. (e).

346. *Id.* § 805(e) ("If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court *shall enforce the determination of the committee*." (emphasis added)). Not every RULLCA

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jurisdiction, *Oracle* and *Obeid* can be applied to require financial and social neutrality for a properly constituted SLC.

If courts incorporated *Oracle*'s test for independence into *Auerbach* review, *Auerbach* and *Zapata* would be brought closer together as a practical matter, despite their different doctrinal formulations. There is less of a need for enhanced review if there is a high bar for SLC independence. *Oracle* raises the bar for independence by requiring SLC members to be personally, socially, and financially neutral. At the very least, *Oracle* is a significant qualification to *Auerbach*'s statement that the risk of SLC members hesitating to decide against "one of their own" is inherent in the corporate form. As the empirical work in the corporate area suggests, stricter scrutiny of SLCs in LLCs should make settlements of derivative claims more likely and more substantial. A direct application of *Oracle* to LLCs would also avoid placing excessive reliance on *Zapata*, which corporate law has limited to demand excused situations.

The worst independence rules are those in RULLCA that permit a majority of defendants in derivative actions to appoint the SLC that decides the disposition of the claims against them. These provisions, which apply whether the LLC is member- or manager-managed, seem impossible to reconcile as a practical matter with RULLCA's own requirement that the members of the SLC be "disinterested and independent."[347] They are also inconsistent with RULLCA's Official Comment that the SLC is an "ADR mechanism."[348] The use of an SLC is most like the use of an arbitrator, who must be "independent and impartial."[349] In the context of arbitration, provisions that allow a business entity to select all the dispute resolvers have been voided as "so wholly one-sided as to present a stacked deck."[350] More RULLCA states should follow Florida's lead and adopt a non-uniform provision that requires those who appoint SLCs in LLCs to be disinterested and independent. As in the case of arbitration, a court may appoint the LLC's SLC when there is no prospect of internal selection of a dispute resolver.

state requires the court to follow the SLC's determination. FLA. STAT. ANN. § 605.0804(5) (West, Westlaw through the 2021 1st Reg. Sess.) (providing only that the court "may" enforce the SLC's determination of the SLC).

347. R.U.L.L.C.A., *supra* note 1, § 805(b).

348. *Id.* § 805 cmt.

349. CPR RULES, *supra* note 40, § 7.1.

350. Hooters of Am., Inc. v. Phillips, 173 F.3d 933, 940 (4th Cir. 1999).

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