Who Will Watch the Watchers?:
Derivative Actions in Nonprofit Corporations

Thomas E. Rutledge

Quis custodiet ipso custodes?
- Juvenal, Satire VI, lines 347–8
("Who will watch the watchers?")

Unlike the Kentucky statutes governing business corporations, limited partnerships and statutory trusts, both the Kentucky Limited Liability Company Act and the Kentucky Nonprofit Corporation Acts are silent as to the requirements for “derivative actions” brought on behalf of the LLC or corporation by a member or other constituent thereof. Some have suggested that this absence indicates that derivative actions do not exist in those organizational forms, positing, it would seem, that it is the statute governing derivative actions that gives rise to the actions. This assessment is incorrect, and, presumably, arises out of a misunderstanding of the basis for derivative actions. In fact, the derivative action is a question of equitable standing that was later, in certain contexts, reduced to

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3 Id. §§ 273.161–.390 (West, Westlaw through 2014 Legislation).

4 A “derivative action” is subject to at least two definitions. The first is that it is an action brought in the name and for the benefit of a business entity, other than by the business entity, to enforce its rights. The second, that it is an action brought in the name and for the benefit of a business entity against the wishes of those otherwise in control of the entity, in the name and for the benefit of the entity to enforce its rights.

5 Derivative actions are provided for in KY. REV. STAT. ANN. § 271B.7–400 (West, Westlaw through 2014 Legislation) (relating to business corporations); id. §§ 362.511 to .517, 362.2-932 to .935 (relating to limited partnerships); KY. REV. STAT. ANN. § 386A.6-110(2) (relating to statutory trusts). See also id. §§ 272A.13-010 to .050 (relating to derivative actions in limited cooperative associations). The first Kentucky statute recognizing the right to bring some form of derivative action was not adopted until 1946, significantly subsequent to the clear appearance of the “derivative action” in Kentucky law. See Act of March 21, 1946, ch. 141 §§ 381, 425, 1946 Ky. Acts, repeated by Act of March 17, 1972, ch. 274 §§ 1195, 1308, 1972 Ky. Acts.
It does not follow, therefore, that there are not derivative actions in LLCs and nonprofit corporations consequent to the failure of the statute to provide for them. Rather, equity will provide the rules applicable when the organizational statute does not specify the rules governing derivative actions.

While the analysis here explicated is equally applicable in the context of any business entity organizational statute lacking an express derivative action enabling statute, this presentation will focus upon the nonprofit corporation. That said, there appears to be implicit acceptance in Kentucky of LLC derivative actions.

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4 KY. REV. STAT. ANN. §§ 275.001–540 (West, Westlaw through 2014 Legislation); id. §§ 273.161–390. The statement that the Kentucky Nonprofit Corporation Acts is silent as to “derivative actions” should be clarified. While the label “derivative” is not therein employed, and while the statute does not have a detailed procedural provision equivalent to that found in other acts, see, e.g., id. §§ 272A.13-010 to -050, suits on behalf of the entity initiated by other than the board of directors are clearly contemplated. In response to actions that may be ultra vires, the statute contemplates “a proceeding by a member or a director against the corporation to enjoin” the improper action. Id. § 273.173(1). Further, the statute contemplates a “proceeding by the corporation” acting “through members in a representative suit, against the officers or directors of the corporation for exceeding their authority.” Id. § 273.173(2). Working from the supposition that actions of the board of directors that do not satisfy the aspirational standard of conduct fall within “exceeding their authority,” then the Kentucky Nonprofit Corporation Acts does by statute authorize derivative actions on behalf of a nonprofit corporation. Furthermore, KY. REV. STAT. ANN. § 273.215(6) refers to a “person bringing an action for monetary damages” based upon a director’s failure to discharge their fiduciary obligations. Accord id. § 273.229(6) (detailing an equivalent provision as to officers of a nonprofit corporation). In neither instance is “the person” bringing an action to vindicate the rights of the corporation (and bearing the defined burden of proof) restricted to the corporate entity itself. See also id. § 273.161(14) (defining a person as including an individual and an entity). Further, it is provided that each director consents to the jurisdiction of the Kentucky courts with respect to “any action by, in the name of, or on behalf of the corporation.” Id. § 273.211(5). A suit “in the name” of “on behalf” of the corporation in which a director is named as a defendant is clearly derivative in nature. See also Thomas E. Rutledge, The 2012 Amendments to Kentucky’s Business Entity Statutes, 101 KY. L.J. ONLINE 1, 7 (2012) (describing the provision as applying “when a derivative action is filed against [a director].”).

5 See also KY. REV. STAT. ANN. § 275.003(1) (West, Westlaw through 2014 Legislation).

6 See, e.g., Pixler v. Huff, No. 3:11-CF-00207-JHM, 2012 WL 3109492, *3 (W.D. Ky. July 31, 2012) (applying in the context of an LLC the test traditionally applied in corporations as to the direct versus derivative distinction and determined whether certain claims brought by a member could be brought only on a derivative basis); id. (“Therefore, Plaintiff may maintain her claims against the Defendants only where she has suffered an injury that is separate and distinct from that which would be suffered by other members or the LLC as an entity.”); R.C. Tway Co. v. High Tech Performance Trailers, LLC, No. 3:12-CV-122, 2013 WL 842577, *3 (W.D. Ky. Mar. 6, 2013) (“Each of the claims identified above clearly alleges that High Tech or Hanusosky violated some duty it owed directly to [Performance Trailers], thus causing [Performance Trailers] injury. As [Performance Trailers] is the allegedly injured party for each of these claims, it is the one that is entitled to enforce the rights granted by substantive law. Accordingly, [Performance Trailers] is not a nominal party, but instead is a real party in interest as to those claims.”); Chou v. Chilton, Nos. 2009-CA-002198-MR, 2009-CA-002284-MR, 2014 WL 2154087, *4 (Ky. Ct. App. May 23, 2014) (“[The LLC] and not Chou himself would benefit from any recovery for the misappropriation of funds and opportunities. . . . While Chou may or may not receive funds from [the LLC] on dissolution of that company, any wrongs for misappropriation perpetrated by any of the [defendants] would be wrongs against [the LLC] and not Chou individually.”); Turner v. Andrews, 413 S.W.3d 272, 277–78 (Ky. 2013) (rejecting effort by the sole member of an LLC to bring a claim for lost profits on his own behalf rather than on behalf of the LLC.). See also CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 10.07[2] (2012 and 2014–2 cum. supp.) (“Many LLC statutes express
This article will begin by reviewing a New York Court of Appeals case which held that derivative actions exist with respect to LLCs organized in New York notwithstanding the silence of the state’s LLC Act as to derivative actions. This article will then turn to a series of Kentucky decisions as to derivative actions in corporations at a time when the related corporate statutes were silent as to derivative actions. Collectively, these decisions stand for the proposition that derivative actions both pre-exist and exist independently of a statute authorizing derivative actions. From there, the article will discuss a pair of issues as to the necessity of affording derivative actions even where statutes are silent. The first of these is the necessity of a mechanism by which the venture’s rights may be enforced over the contrary actions of those then exercising control over it. Second, as a federal court in diversity may entertain a derivative action pursuant to its equitable jurisdiction, the point is made that it would be curious to deprive those who cannot act on a derivative basis the same rights. The next portion of the article will review a number of decisions of foreign courts that have considered the question of derivative actions in nonprofit corporations absent a statute thereon. The discussion will then review seriatim various aspects of derivative actions as they now exist in statute and ascertain whether or not similar requirements exist under Kentucky’s equity-based derivative action precedents. Last, this article considers who may exercise equitable standing in nonprofit corporations to initiate a derivative action.

THE EQUITY BASIS OF THE "DERIVATIVE ACTION"

The ability to enforce fiduciary obligations (and to recover damages for failure in their discharge) has its roots in trust law and the later treatment of the assets of a venture as a cestui que trust for the benefit of the owners. As such, the ability to authorize derivative actions, but some do not. This distinction should make little difference. Derivative litigation began in the corporate context over 150 years ago without the benefit of statutes, and remains essentially equitable in nature.” (citation omitted).  

 See James B. Ames, The Origin of Uses and Trusts, 21 HARV. L. REV. 261, 265 (1908). While the trust, the separation of legal and beneficial title, may have had its structural genesis in German law, the advance of the English courts of equity was to convert the “trustee’s obligations from those based upon honor to those enforceable in equity.” See generally Joseph Willard, Illustrations on the Origin of Cy Pres, 8 HARV. L. REV. 10 (1894). As to the treatment under Kentucky law of the assets of a firm as a “trust fund to be used for the benefit of creditors and shareholders,” see Metropolitan Fire Ins. Co. v. Middendorf, 188 S.W. 790, 794 (Ky. 1916) (citation omitted). The first recognition of the derivative action in American law has been traced to the decision rendered by Chancellor Kent in Attorney General v. Utica Ins. Co., 2 Johns. Ch. *371, *389–90 (N.Y. Ch. 1817), namely:

[b]ut, at the same time, I admit, that the persons who, from time to time, exercise the corporate powers, may, in their character of trustees, be accountable to this Court for a fraudulent breach of trust; and to this plain and ordinary head of equity, the jurisdiction of this Court over corporations ought to be confined.

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Nor does the case, as charged, amount to a breach of trust, of which I am to take notice.

There is no complaint, on the part of the stockholders, of misconduct, nor is the information
enforce fiduciary obligations has its basis in equity rather than in positive statutory law. A derivative action recognizes that persons other than the entity have standing to initiate an investigation of management and the propriety of its actions, an important mechanism of enforcement of fiduciary duties. The Connecticut Supreme Court described this mechanism, stating that:

If the duties of care and loyalty which directors owe to their corporations could be enforced only in suits by the corporation, many wrongs done by directors would never be remedied.

As such, the derivative action serves an important policing function in providing a mechanism by which those charged with management and control of a venture may be called upon to demonstrate that they are in fact discharging the obligations they have voluntarily undertaken. Ergo, in response to Juvenal’s famous query, “Who will watch the watchers?”, it will be the court acting at the instigation of those with a relationship with the venture other than through control.

The New York Court of Appeals decision in Tzolis v. Wolff, before considering whether a derivative action may be brought in a New York organized LLC notwithstanding that a derivative action provision had been deleted from that state’s draft LLC Act, addressed the history of the derivative action:

The derivative suit has been part of the general corporate law of this state at least since 1832. It was not created by statute, but by case law. Chancellor Walworth recognized the remedy in Robinson v Smith, because he thought it essential for shareholders to have recourse when those in control of a corporation betrayed their duty. Chancellor Walworth applied to a joint stock corporation — then a fairly new kind of entity — a familiar principle of the law of trusts: that a beneficiary (or “cestui que trust”) could bring suit on behalf of a trust when a faithless trustee refused to do so. Ruling that shareholders could sue on behalf of a corporation under similar circumstances, the Chancellor explained:

“The directors are the trustees or managing partners, and the stockholders are the cestui que trusts, and have a joint interest in all the property and effects of the corporation. . . . And no injury the stockholders may sustain by a fraudulent breach of trust, can, upon the general principles of equity, be suffered to pass without a remedy. In the language of Lord Hardwicke, in a similar case [Charitable Corp. v. Sutton], I will never determine that a court of equity cannot

See also Bert S. Prunty, Jr., The Shareholders’ Derivative Suit: Notes on its Derivation, 32 N.Y.U. L. Rev. 980, 987 (1957).

See, e.g., Tzolis v. Wolff, 884 N.E.2d 1005, 1006 (2008) (“[The derivative action] was not created by statute, but by case law.”); Ross v. Bernhard, 396 U.S. 531, 534 (1970) (“The remedy made available in equity was the derivative suit, viewed in this country as a suit to enforce a corporate cause of action against officers, directors, and third parties.”) (emphasis in original). See Prunty, supra note 9, for a further review of the parallel development of the derivative action in English and American law.


lay hold of every such breach of trust. I will never determine that frauds of this kind are out of the reach of courts of law or equity; for an intolerable grievance would follow from such a determination."

Eventually, the rule that derivative suits could be brought on behalf of ordinary business corporations was codified by statute. But until relatively recently, no similar statutory provision was made for another kind of entity, the limited partnership; again, the absence of a statute did not prevent courts from recognizing the remedy. In Klebanow v. New York Produce Exch., the Second Circuit Court of Appeals held that limited partners could sue on a partnership’s behalf. For the Second Circuit, the absence of a statutory provision was not decisive because the court found no “clear mandate against limited partners’ capacity to bring an action like this.” We agreed with the holding of Klebanow in Riviera Congress Assoc. v. Yassky, relying, as had Chancellor Walworth long before, on an analogy with the law of trusts:

“There can be no question that a managing or general partner of a limited partnership is bound in a fiduciary relationship with the limited partners . . . and the latter are, therefore, cestuis que trustent . . . It is fundamental to the law of trusts that cestui[s] have the right, ‘upon the general principles of equity’ and ‘independently of [statutory] provisions,’ to sue for the benefit of the trust on a cause of action which belongs to the trust if ‘the trustees refuse to perform their duty in that respect.’”

After Klebanow and Riviera were decided, the Partnership Law was amended to provide for derivative actions by limited partners (see Partnership Law § 115-a [1]).

From this foundation, the Court of Appeals found that derivative actions exist in New York LLCs notwithstanding the deletion of the derivative action provisions from the draft New York LLC Act.

A similar basis for the derivative action, although sadly not so direct, can be found in Kentucky law. At least a quartet of cases, all decided when there was no “derivative action” statute in the law of corporations, demonstrate that the courts of equity would entertain such an action. In Jones v. Johnson, responding to an effort by certain shareholders, in their individual capacity, to bring suit against corporate officers for malfeasance, the court rejected those actions, requiring rather that the shareholders proceed in equity on the corporation’s behalf, stating that:

The error in this view consists, as we think, in regarding the injuries complained of as done to the shareholders and not to the corporation. The funds lost did not belong to the shareholders, but to the ideal person called “The Traders’ Bank and Warehouse Company.” It was the sufferer of the losses sustained; and as every actionable wrong gives to the person injured a cause of action, the right to sue these officers was primarily in the corporation. If the corporation or its assignee had sued, the shareholders could not have maintained either a joint or separate
action; but the corporation being still under the control of the alleged unfaithful officers, it would be unreasonable to expect them to sue themselves; and the trustee who might have sued them as the representative of the corporation having refused to do so, the shareholders, as the beneficiaries of the assets of the company, have a right in equity to sue in its name and stead. And we here remark that, suing as they do as a substitute for the injured corporation, they can only sue in equity, because their rights are in this respect equitable only. It does not matter if the action be founded upon a tort; the shareholders, not having a legal right to sue, must either come into equity or they will be without remedy.16

In Collier v. Deering Camp Ground Ass’n, addressing an effort by a shareholder to recover rents on lands owned by the corporation, the court wrote:

The pleadings admit that the title to the land was in the Washington Mining and Manufacturing Company, and never in the appellant. The interest of appellant in the land was only that of a stockholder in the corporation. He had no right or title in the land of that he could sell or convey. Nor was he entitled to rents for its use. Under the facts stated, recovery for rents would be by the Washington Company; and if that company, after proper demand refuses to sue, appellant might maintain an action for the benefit of the corporation.17

Next in this quartet of cases is Pittsburg, C., C. & St. L. Ry. Co. v. Dodd, in which the court addressed contracts between corporations with overlapping directors but dissimilar shareholders:

It will not be questioned that if the bridge company directors, through a fraudulent purpose, refused to bring the suit against the Louisville & Nashville Railroad Company to enforce its liability under the contract, the minority stockholders of the bridge company might maintain the suit on its behalf, although the Louisville & Nashville Railroad Company was not a part to the fraud.18

Expanding, so it would seem, on Collier’s requirement that suit on the cooperation’s behalf is predicated on a demand upon the corporation to so act, in Reinecke v. Bailey the court directed: “[t]here being no averment that the corporation declined to institute the action, the right to institute it was in the corporations, and not appellant, who was merely a stockholder.”19

16 Jones v. Johnson, 73 Ky. (10 Bush) 649, 660 (Ky. 1874).
17 Collier v. Deering Camp Ground Ass’n., 66 S.W. 183, 183 (Ky. 1902); see also Gregory v. Bryan-Hunt Co., 174 S.W.2d 510, 512–13 (Ky. 1943) (holding that a 50% shareholder could not for himself bring an action based upon injury to corporation and its property).
18 Pittsburg, C., & St. L. Ry. Co. v. Dodd, 72 S.W. 822, 828 (Ky. 1903) (citation omitted).
19 Reinecke v. Bailey, 112 S.W. 569, 570 (Ky. 1908). The court went on to state that:

It is well settled that an action to recover corporate property must be brought in the name of the corporation, and such an action cannot be maintained by one or more stockholders unless it should be shown that the corporation or its directors declined to bring the action, and that the interests of the stockholders may it necessary that one should be instituted. When this state of case is presented, and action to recover corporate property or to protect the interests of the corporation may be brought by the stockholders,
Clearly the shareholders of a corporation have long enjoyed, even absent a statute, the capacity, on the corporation’s behalf, to initiate a derivative action. It follows that a member, even in the absence of a statute to that effect, on behalf and in the name of an LLC, has the capacity, after demand is made on management, to initiate an action to address an injury to the LLC.

Likewise, a member (and perhaps other constituents) of a nonprofit corporation has the capacity, after demand, to initiate a derivative action by which there may be addressed a potential injury to the corporation. This right, arising out of equity, exists independently of any statutory authorization to do so. Therefore:

- statutes such KRS §§ 271B.7-400 and 362.511 et seq., while serving to both confirm and supplement the equitable right to bring derivative action, cannot be identified as the basis of the right to bring a derivative action;
- with respect to those organizational forms that do not provide by statute for derivative actions, the right to bring such action exists in equity.

Id. at 571 (citation omitted). See also Shawhan v. Zinn, 79 Ky. 300, 304 (Ky. 1881); Gilman v. German Lithographic Stone Co., 153 S.W. 996, 997 (Ky. 1913) (setting forth the demand requirement). The futility defense to not having made a demand was seen as early as 1913. See Chilton v. Bell County Coke & Improvement Co., 156 S.W. 889, 890 (Ky. 1913); Lebus v. Stansifer, 157 S.W. 727, 729 (Ky. 1913). In Butler Tobacco Co. v. Vest, the court stated:

The demand may be dispensed with, if the officers have such relations to the acts complained of, or bear such relations to the adversary party, as to show their interests to be antagonistic to the corporation, or that it would be improper for the action to proceed in the name of the corporation while it should remain under their control, in which state of circumstances an action may be maintained or a defense made for the corporation by a stockholder.

178 S.W. 1102, 1105 (Ky. 1915).

Butler Tobacco Co., 178 S.W. at 1104; Lebus, 157 S.W. at 729; Chilton, 156 S.W. at 890; Gilman, 153 S.W. at 997 (demonstrating the requirement in equity to have made demand or be able to plead the futility hereof).

See KY. REV. STAT. ANN. § 273.187(2) (West, Westlaw through 2014 Legislation); id. § 273.150(1); id. § 273.240(1) (showing that both the LLC and the nonprofit corporation utilize the same rules of affirmative and negative asset partitioning as does the business corporation, rules that create the cestui que trust equivalency that initially gave rise to the derivative action.).


Examples include LLCs, nonprofit corporations, limited partnerships governed by the pre-1970 law, and limited partnerships governed by the 1970 limited partnership act. See Act of March 20, 1970, ch. 97 §§ 1-27, 1970 Ky. Acts. While it is entirely accurate that much of the law of corporations and other business organizations has been reduced to statute, and for that reason the first reference needs to be to the organizational act, see Pannell v. Shannon, 56 S.W.3d 58, 79 (Ky. 2014), it remains true that not every rule governing business organizations has been reduced to statute. For example, while it is uncontroversial that corporate directors may not vote by proxy, that rule is not set forth in the Kentucky statutes governing corporations. See, e.g., Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917); 2 ARTHUR W. MACHEN, JR., A TREATISE ON THE MODERN LAW OF CORPORATIONS §§ 1455, 1458 (Little, Brown & Co. 1908).
A principal of equity is that for every wrong there is a provided remedy. The Kentucky Nonprofit Corporation Acts specifies in great detail the fiduciary obligations of corporate directors and officers. The Act specifies to whom these obligations are owed, namely the corporation. When these obligations are violated, the entity has a claim for damages to remedy the injury it has suffered. The corporation may, through its board of directors, determine to bring suit to seek recompense for the injury suffered. At times, however, due to any number of factors, the board may elect to not pursue redress for the injury suffered by the corporation. In that situation the corporation has been doubly injured in that it has suffered both the initial injury and the failure of the board to protect its legal rights.

A derivative action protects the corporation from this latter circumstance, namely not being able to pursue recourse for its injury. For example, while claims against the directors for breach of duty may be tolled while those directors remain in control of the corporation, claims against non-directors (e.g. the embezzling bookkeeper) may be lost if not promptly brought. Even as to claims that are not time barred until a new majority of the board is seated and able to make, on the corporation’s behalf, a disinterested judgment, by then evidence may be stale or lost. There is even the possibility the culpable parties will be deceased. Absent the ability of someone other than those in control of the corporation to initiate an

24 See, e.g., Marbury v. Madison, 5 U.S. 137, 163 (1803); Leo Feist, Inc. v. Young, 138 F.2d 972, 974 (7th Cir. 1943); see also 1 FRED E. LAWRENCE, A TREATISE AS TO THE SUBSTANTIVE LAW OF EQUITY JURISPRUDENCE § 38 (1929).

25 See KY. REV. STAT. ANN. § 273.215 (West, Westlaw through 2014 legislation) (regarding directors); id. § 273.227 (regarding officers). Of themselves these standards are the same as those applied to directors and officers of business corporations. See id. §§ 271B.8-300, -420. All of those provisions were adopted in 1988. See Act of April 15, 1988, ch. 23 §§ 85, 89–90, 133, 149, 1988 Ky. Acts. Likewise the LLC Act specifies the fiduciary obligation of the members, if the LLC is member managed, and of the managers, if the LLC is manager managed. See KY. REV. STAT. ANN. §§ 273.170(1)(a)-(b).

26 KY. REV. STAT. ANN. § 273.215(1)(c) (West, Westlaw through 2014 legislation); Ballard v. 1400 Willow Council of Co-Owners, Inc., 430 S.W.3d 229, 241 (Ky. 2013) (stating that fiduciary duties of directors are owed to the corporation and not to the individual members thereof). In the context of the LLC the duty of care is owed to the LLC and the other members while the duty of loyalty is owed only to the LLC. See KY. REV. STAT. ANN. § 275.170(1)(a)-(b). See also Thomas E. Rule, Limited Liability Company Operations, LIMITED LIABILITY COMPANIES IN KENTUCKY 1, 48–67 (2014-1 Supp.), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=212920. [hereinafter Limited Liability Company Operations].


28 See id. § 273.207 (West, Westlaw through 2014 legislation) (“The affairs of a corporation shall be managed by a board of directors.”). The management structure of an LLC is determined by private ordering in the operating agreement. Even where the LLC is managed by managers, there is a statutory option by which the members may cause the LLC to initiate a legal action, including against a manager. See id. § 275.335(1). Such a suit is not, however, a derivative action. Limited Liability Company Operations, supra note 26, at 109.

action to vindicate its rights, the express fiduciary duties undertaken by the
directors are a toothless tiger that are in effect only aspirational and lack the
likelihood of effective enforcement. Furthermore, it would indeed be curious that
the members of a nonprofit corporation are afforded a nearly unlimited right to
inspect the corporation’s books and records but then may not use that information
to vindicate the corporation’s rights nor seek remedy for the wrongs it has
suffered.30

THE FEDERAL LOOPHOLE

As a practical matter, if derivate actions may not be brought absent an
affirmative statute to that effect, that limitation would apply only in suits brought
in state court; they could still be brought in federal court. Under Federal Rule of
Civil Procedure 23.1, a derivative action may be entertained in federal court on the
basis of diversity jurisdiction.31 A constituent of a nonprofit corporation who is not
a citizen of the state where the corporation has its principal place of business or
where the corporation is incorporated may initiate the action.32 The federal court’s
jurisdiction over the matter is not subject to the substantive law of the jurisdiction
of organization.33 As observed in Berg, in reviewing a derivative action brought in
federal court on the basis of diversity jurisdiction, “a Federal District Court may,
under its general equity powers independently of state statute, entertain a bill of a
stockholder for the appointment of at least a temporary receiver to prevent
diversion or loss of assets through gross fraud and mismanagement of its officers.”34
If a derivative action may not be initiated by a corporate constituent in the
jurisdiction of organization because of the view that the organic organizational law
does not authorize such a suit (for reasons already reviewed as false conclusion), it
could be brought by a constituent domiciled in a foreign jurisdiction pursuant to
the federal court’s diversity jurisdiction.35 It would indeed be a strange circumstance
if a constituent domiciled in the jurisdiction of organization did not have the
capacity to bring a derivative action by which to protect the corporation from
potentially disloyal directors even as a constituent domiciled in a foreign
jurisdiction could do so.

30 See KY. REV. STAT. ANN. § 273.233 (West, Westlaw through 2014 Legislation) (“All books and
records of a corporation may be inspected and copied by any member . . . for any proper purpose at any
reasonable time.”). In American Saddlebred Horse Association, Inc. v. Bennett, No. 09-CI-5292, at
*5–7 (Ky. Cir. Ct. Dec. 2, 2010), Judge Ishmael of the Fayette Circuit Court held that this statute
should be read broadly, and that the “All books and records” would not be limited to the list enumerated
in the preceding sentence of the statute.
32 28 U.S.C. § 1332(c)(1) (West, Westlaw through 2014 Legislation) (stating that a corporation is a
citizen of its jurisdiction of incorporation and that in which it maintains its principal place of business).
1944).
34 Id. at 846–47.
The suggestion that there are not derivative actions in either LLC’s or nonprofit corporations on the basis that neither has “shareholders” is, for all intents and purposes, an infantile position. This argument proceeds from the flawed syllogism that derivative actions are brought by shareholders, nonprofit corporations and LLCs do not have shareholders, and therefore there cannot be derivative actions in either nonprofit corporations or LLCs. In the business corporation context, “shareholders” are specifically authorized to bring derivative actions.36 This does not define, however, the maximum reach of the universe of persons enabled to bring derivative actions. For example, limited partners, who clearly are not “shareholders,” may bring derivative actions.37 To provide another example, members, who are clearly not “shareholders,” in a limited cooperative association may bring derivative actions.38 Likewise, in a statutory trust, a beneficial owner, who is not a “shareholder,” may bring a derivative action.39 Although not yet clearly addressed in Kentucky law, it has been recognized that a creditor may bring a derivative action with respect to a corporation, a capacity that exists irrespective of the fact that the creditor is not a “shareholder.”40 In Bernfield v. Kurilenko, the widow and heir of a shareholder in a professional corporation in which she could not be a shareholder41 was permitted to maintain a derivative action on behalf of the corporation in which her husband had been a shareholder.42 Partners in a general partnership have been permitted to bring a derivative action.43 The assertion that only “shareholders” may bring derivative actions does not stand up to even minimal scrutiny.

41 See N.Y. BUS. CORP. LAW § 1507 (McKinney 2014).
43 See, e.g., George Wasserman & Janice Wasserman Goldsten Family L.L.C. v. Kay, 14 A.3d 1197, 1215–16 (Md. Ct. Spec. App. 2011) (stating the partner’s “ability to act on behalf of the partnership” may be ineffective when those with the controlling interests are unwilling to cause the partnership to sue those in control for alleged misconduct, in which case the “partnership claim may be enforced by all of the disinterested partners.”) (emphasis supplied); Cates v. Int’l Tel. & Tel. Corp., 756 F.2d 1161, 1179 (5th Cir. 1985) (“[w]here the controlling partners, for improper, ulterior motives and not because of what they in good faith believe to be the best interests of the partnership, decline to sue on a valid, valuable partnership cause of action which it is advantageous to the partnership to pursue,” the minority partners must have a right to initiate the action).
Slightly (but only barely so) more sophisticated is the assertion that shareholder or similar “ownership” status, i.e., the capacity to receive interim or liquidating distributions, is a necessary precondition to the capacity to bring a derivative action as only a person with such an interest has an interest to protect through the derivative action. This assertion fails on its own terms. A derivative action exists not to enforce a right of a shareholder or other potential participant in the economics of the venture, but rather to protect the venture’s interest in its own assets. For this reason various actions seeking only injunctive (and no monetary) relief are structured as derivative actions. For example, an action to compel the corporation to produce records or hold a meeting is derivative in nature. Regardless, “shareholder” status is not a *sine qua non* to bringing a derivative action.

Numerous courts that have expressly considered the question have found there to be derivative actions absent a statute.

In addition to the decision rendered by the New York Court of Appeals in *Tzolis v. Wolff*, although decided in the context of an LLC, numerous courts have squarely addressed the question of whether, *ab initio*, derivative actions exist in a nonprofit corporation absent a statute to the effect.

Addressing who should have standing to bring a derivative action in a nonprofit organization, the Arkansas Court of Appeals, in *Morgan v. Robertson*, observed:

> It should be recognized, however, that Morgan’s standing to bring this suit need not rest alone on his status as a member of the Foundation, as he professes to be an officer and a director of the Foundation and assuming that to be so, he has the necessary standing to complain against the sort of acts charged in the complaint. We believe an officer, director and a member of a non-profit corporation is not without standing to question the management and conduct of other officers and directors which are alleged to be in violation of the By-Laws and Articles and against the purposes of the corporation. If such an individual lacks standing, who would have it? We regard the public as having a clear interest in non-profit corporations from the standpoint of the faithful administration of the affairs of the corporation. The standing of one or more directors of non-profit corporations to act derivatively in behalf of the corporation does not seem open to question.

In *Kirtley v. McClelland*, the court addressed the question of whether, in the context of a nonprofit corporation organized under a statute that did not address derivative actions, could such an action be brought. The court held that it could:

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44 See supra notes 10–12 and accompanying text.
47 *Kirtley v. McClelland*, 562 N.E.2d 27, 29 (Ind. Ct. App. 1990) (identifying the issue raised on appeal as “[w]ether the court erred in denying defendant’s motion to dismiss the second amended complaint where no Indiana statutory or common law authority exists for a shareholder’s derivative suit against a non-profit corporation.”). See also id. (“The directors emphasize the absence of express
Nonetheless, we are convinced that equitable redress would have been available at common law for members of a nonprofit corporation or an incorporated voluntary association had such plaintiffs sought to utilize it.

First, there is nothing about the remedy itself which warrants distinctive treatment based upon corporate purpose, for a derivative action by nature has as its aim the non-pecuniary benefit of the corporation, not the individual stockholder or member. A stockholder is permitted to sue on behalf of the corporation, not because his rights have been violated, but simply as a means of setting in motion the judicial machinery of the court. The stockholder commences the action and prosecutes it, but in every other respect the action is brought by the corporation; it is maintained directly for the benefit of the corporation and final relief when obtained belongs to the corporation.

The absence of a statutory procedure for initiating a derivative action by a non-profit corporation when one has been affirmatively provided for for-profit corporations does not require the conclusion that statutory authorization is a necessity either. A court of general jurisdiction has inherent equitable power unless a statute either explicitly or by necessary implication provides otherwise. The Not-for-Profit Corporation Act does not expressly bar derivative actions by members of a nonprofit corporation.

In the Tennessee case of Bourne v. Williams, it was held that a derivative action could be brought on behalf of a nonprofit corporation notwithstanding statutory language that could be read to restrict derivative actions to for-profit ventures. In the course of its decision, the Bourne Court cited with approval Fletcher's Cyclopedia for the proposition: “[t]he right of a stockholder to sue is not affected by the nature or kind of the corporation, and the law pertaining to derivative suits applies to a non-profit corporation exactly the same as if it were a business corporation.”

Explaining the need for derivative actions in nonprofit corporations, the court wrote:

statutory authorization in the Indiana Not-for-Profit Corporation Act of 1971 . . . and case law addressing use of the derivative remedy by members of nonprofit corporation.”).

48 Id. at 30-31 (citation omitted); see also Brenner v. Powers, 584 N.E.2d 569, 574 (Ind. Ct. App. 1992).


50 Id. at 472 (citation omitted). Since then, the source the court relied on has been rewritten and now provides: “[t]he preconditions for a derivative proceeding may not be affected by the kind of corporation; the procedural requirements governing such actions may apply to a nonprofit corporation exactly as if it were a business corporation.” 13 William Meade Fletcher, et al., Fletcher's Cyclopaedia of the Law of Private Corporations § 5972.60 (2004) (citation omitted). In Leeds v. Harrison, the court stated that:

[u]nlike most corporations for profit, a corporation not for pecuniary profit normally has no stockholders, but in place thereof it has members. The same rights and liabilities exist between the trustees of a non-profit corporation and the members as exist between the directors and stockholders of a corporation for profit. The suit here brought may be likened to a derivative or representative suit brought in connection with a stock corporation. The law applicable to such suits is, so far as is here pertinent, applicable to this suit.

It would be unconscionable for this Court to say, that in a case such as this, simply because the corporate entity was organized as a corporation not for profit as opposed to a corporation for profit, that there would be no forum available to members of the corporation who believe that the Corporation was being harmed and damaged by alleged illegal and unauthorized acts by its officers and/or directors.

But for being members of a corporation not for profit, as opposed to being stockholders of a corporation for profit, the plaintiffs have stated a cause of action in their complaint.51

A decision of a Florida intermediate appellate court, Fox v. Professional Wrecker Operators of Florida, Inc., addressed the question of derivative actions in a nonprofit corporation where the statute was silent as to the issue.52 Prior to 1993 the Florida Nonprofit Corporation Act incorporated by reference the Florida Business Corporation Act, the latter providing for derivative actions, but in a 1993 amendment that linkage was eliminated.53 In this decision the court determined that notwithstanding the severing of the linkage to the business corporation act and its provisions on derivative actions, there is no basis for depriving members in a nonprofit corporation of standing to protect its rights through a derivative action.54

A similar ruling was issued in Larsen v. Island Developers, Ltd., where the court noted that the derivative action exists "as relief from 'faithless directors and managers,'" that arose in equity "long before the legislature countenanced such suits by inclusion of statutory references to derivative actions."55

The only contrary holding in Kentucky is that rendered in Porter v. Shelbyville Cemetery Co., wherein a former trustee was denied the right, as a trustee, to on behalf of a de facto (but not de jure) corporation, bring a derivative action challenging certain actions alleged to be ultra vires.56 For a variety of reasons this decision should not be followed. Initially, it is unpublished and therefore by its terms without precedential value. Second, it deals with a former corporation that had forfeited its charter for failure to satisfy express legal requirements imposed at

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51 Bourne, 633 S.W.2d at 473.
53 Id. at 180.
54 Larsen v. Island Developers, Ltd., 769 So. 2d 1071, 1072 (Fla. Dist. Ct. App. 2000) (citation omitted); see also Nonprofit Corporation Act Task Force, Official Commentary to the Revised Oregon Nonprofit Corporation Act, 71 OR. L. REV. (SPECIAL ISSUE) 1, 69 (1992) ("While Oregon has no general statutory provision for members' derivative actions in a nonprofit corporation, a court would likely recognize such an action."). Further, the article stated that:

[c]ommentators recommend extending the remedy of a derivative action to members of nonprofit corporations. They indicate that while statutes may regulate and occasionally preempt the common law action, a statute has never been thought necessary in order to authorize a derivative action. Indeed, the derivative suit predated derivative suit statutes.

55 Id. at 70.
the time the new constitution was adopted, rather than with a nonprofit corporation incorporated under KRS chapter 273. 57 Third, the de facto trustee (i.e., director) who sought to bring the action had been removed from that office prior to bringing the action, eliminating application of the rule that directors are at times permitted to initiate derivative actions. 58 Fourth and most telling, notwithstanding excellent briefing to the court, neither side identified to it the express provisions of the Nonprofit Corporation Acts to the effect that any other variety of persons affiliated with a nonprofit corporation may bring an action to preclude from engaging in ultra vires conduct. 59 Fifth, the Kentucky Court of Appeals, in Fenley v. Kamp Kaintuck, Inc., clearly thought the questions of derivative actions in nonprofit corporations to be open even as it applied derivative action rules. 60 Simply put, the Porter v. Shelbyville Cemetery decision is in conflict with the current statute governing nonprofit corporations. Alternatively, if Shelbyville Cemetery was at most a de facto corporation or some other extra-statutory form, then the decision is not about nonprofit corporations. Either way, this decision does not merit being afforded precedential value.

THE EQUITY REQUIREMENTS OF THE DEMAND AND CONTEMPORANEOUS OWNERSHIP REQUIREMENTS

In Hawes v. City of Oakland, the U.S. Supreme Court required that the plaintiff in a derivative action have sought redress through direct action by the corporation (the “demand requirement”) and have owned the shares in the corporation at the time of the asserted injury (“or that [the] shares had since devolved [to him or her] since by operation of law”). 61 This contemporaneous

57 Id. at *1 (“Grove Hill failed to comply with any of the requirements of Chapter 32 and accordingly suffered the revocation of its corporate charter in 1897.”).
58 Id. at * 2–3.
61 Hawes v. City of Oakland, 104 U.S. 450, 460–61 (1882). The court describes this procedure in the following passage:

[H]e [the shareholder] should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court. If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

The efforts to induce such action as complainant desires on the part of the directors, and of the shareholders when that is necessary, and the cause of failure in these efforts should be stated with particularity, and an allegation that complainant was a shareholder at the time of
ownership requirement has been repeated in Kentucky, both in statutory and case law, but the existence of the requirement long predated its reduction to statute. It has well been applied in the context of Kentucky nonprofit corporations. In *Fernley v. Kamp Kaintuck, Inc.*, a derivative complaint brought by former members of a nonprofit corporation was dismissed on the basis that the plaintiffs were not current members.

In a derivative action brought on behalf of a nonprofit corporation, the plaintiff must be expected to either make a demand or plead futility. If it is a membership organization, the plaintiff must also plead that they are a member and are able to represent the interests of similarity situated members in representing the interests of the corporation. Other possible positions granting appropriate standing are discussed below.

**THE DIRECT VS. DERIVATIVE DISTINCTION**

Kentucky courts are vigilant in preserving the direct versus derivative distinction, thereby preserving for the corporation any damages that flow from the breach of duty to the corporation and precluding an individual shareholder from directly receiving that recovery. In doing so, the courts have shown no inclination

\[\text{Id.}\]

\[\text{See, e.g., KY. REV. STAT. ANN. § 271B.7-400(1) (West, Westlaw through 2014 Legislation); id. § 362.513 (West 2007); id. § 362.2-933; id. § 386A.6-110(3); Bacigalupe v. Kohlhopp, 240 S.W.3d 155, 157 (Ky. Ct. App. 2007).}\]

\[\text{See, e.g., Collier v. Deering Camp Ground Ass’n, 66 S.W. 183, 183 (Ky. 1902) (“and if the company, after proper demand refuses to sue, appellant might maintain an action for the benefit of the corporation.”); Reinecke v. Bailey, 112 S.W. 569, 571 (Ky. 1908). See also Flint v. Jackson, No. 2014-CA-000426-MR, 2014 WL 7206835, at *1, *4 (Ky. App. Dec. 19, 2014) (derivative action dismissed on the basis that shareholder had not plead demand made upon the board and failure to adequately represent the “interests of the similarly situated shareholders in representing the rights of the corporation. . .”).}\]

\[\text{See infra text accompanying notes 109–112.}\]
to adopt the rule set forth in section 7.01(d) of the ALI Principles of Corporate Governance. 66

To place a pair of bookends on a consistent string of rulings, begin with the 1908 decision rendered in *Reinecke v. Bailey*. 67 In that case, one of the company’s three shareholders embezzled a significant amount of money. 68 The majority shareholder sought to settle the claim on terms that included the embezzling shareholder transferring to the majority shareholder his shares in the corporation. 69

In response to the argument that due to the few number of shareholders it should be permissible to settle the matter between them, the court wrote:

But this argument is not sound, nor is it supported by any authority. There is no escape from the proposition that the wrong, if any, committed by appellee, was against the corporations; that the money he embezzled, if any, was the property of the corporation. This seems conclusive of the question that any settlement concerning the wrongful acts of appellee upon which an action could be maintained must have been made by and with the corporations, and that a suit to enforce the settlement must be in the name of the corporations. No matter how many shares of stock Reinecke and Bailey owned, they were merely shareholders in the corporation. . .

This controversy is not an individual matter between Reinecke and Bailey. Nor does the fact that Reinecke owns the principal interest in the stock of the corporations confer upon him the right to make the corporate business a personal matter. . .

It is well settled that an action to recover corporate property must be brought in the name of the corporation, and that such an action cannot be maintained by one or more stockholders unless it . . .70

Thus there is a dual nature of the stockholder’s action: first the plaintiff’s right to sue on behalf of the corporation and, second, the merits of the corporation’s claim itself.71

Of more recent vintage is *Sahni v. Hock*, a 2010 decision of the Court of Appeals. 72 That dispute involved allegations by a minority shareholder that the majority shareholder, through his domination of the Board of Directors, caused the company to engage in certain transactions that had the net effect of reducing the value of her shares. 73 Ultimately, even if true, the effect of the allegedly improper

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66 See Snyder v. Baumgardner, No. 09-9-04445, at *3 (Ky. Cir. Ct. Aug. 15, 2010) (rejecting the suggestion that pursuant to Section 7.01(d) of the *Principles of Corporate Governance*, the plaintiffs be permitted to proceed on an individual, rather than a derivative basis, writing that the *Principles* had not been adopted by Kentucky courts).
67 Reinecke v. Bailey, 112 S.W. 569 (Ky. 1908).
68 Id. at 570.
69 Id.
70 Id. at 570–71.
71 See id. at 571.
73 See id. at 42–44.
conduct was to divert funds from the corporation, only indirectly reducing the value of each shareholder’s stock. Since the corporation was the only entity to suffer direct injury, the claim was derivative, and therefore the plaintiff’s efforts to bring the claim individually were rejected.\(^7\)

Typically, the direct versus derivative distinction will not be as complicated an issue in the nonprofit realm as it is in the for-profit ventures. That is not to say, however, that it will be absent. While in a traditional charity there is no expectation of personal inurement, many organizations do not have such strict limits. A person who purchases a membership in a country club has obvious (and entirely proper) expectations as to the use of the facilities; deprivation of that use may raise mixed direct and derivative claims.

**ALIGNMENT**

Any recovery in a derivative action will be for the benefit of the venture on whose behalf the action is brought; it is its rights that are being vindicated. Even so, as the action is brought against the wishes of those with management control of the venture, typically it will be aligned as a defendant in the action.\(^7\) As observed by the U.S. Supreme Court in *Ross v. Bernhard*, “[t]he corporation is a necessary party to the action; without it the case cannot proceed. Although named a defendant, it is the real party in interest, the stockholder being at best the nominal plaintiff.”\(^7\)

**A JURY TRIAL FOR DERIVATIVE ACTIONS**

Notwithstanding that the derivative action arose in equity, the Supreme Court has held that derivative actions may be tried by a jury.\(^7\) While the ability of the shareholder to initiate the action on the corporation’s behalf may have arisen in equity, the corporation’s claim for redress is legal in nature – hence, a jury trial.

**SETTLEMENT REQUIRES COURT APPROVAL**

Settlement of a derivative action requires court approval, even if not mandated by statute.\(^7\) For example, in *Denicke v. Anglo California Nat. Bank of San Francisco*, it was observed that the task of the shareholder initiating a derivative


\(^7\) See, e.g., KY. REV. STAT. ANN. § 271B.7-400(3) (West, Westlaw through 2014 Legislation); id. § 386A.6-110(6); id. § 272A.13-040.
action is to “set in motion the judicial machinery of the court”\textsuperscript{79} to the effect that: “his position in the litigation is assimilated to that of a guardian ad litem with power in the court, not in the stockholder, to compromise the rights of the real party in interest, which is the corporation itself.”\textsuperscript{80}

Predating this decision by almost forty years is a Kentucky decision utilizing similar language. In \textit{Louisville Bridge Co. v. Dodd},\textsuperscript{81} the court addressed the respective roles of the plaintiff minority shareholders and the court:

\begin{quote}
[The plaintiff shareholders are] always subject to the control of the court. It is at last the judgment of the latter, in the application of principles of equity, that obtains in lieu of the discretion of the board of directors. The minority stockholder merely sets in motion the action, and presents the facts upon which the court can act.\textsuperscript{82}
\end{quote}

\textbf{RECOVERY OF ATTORNEY FEES BY A SUCCESSFUL PLAINTIFF}

As noted above, \textit{Louisville Bridge Co.} was decided at a time when Kentucky’s corporate law did not address or authorize derivative actions. As such, statutes were silent concerning the ability of the shareholder plaintiff to recover attorney fees. With respect to that capacity, the \textit{Louisville Bridge} Court wrote: “[a] necessary incident of the power and right to maintain such an action is the power to employ counsel to prosecute it, and to incur other necessary expenses in the litigation.”\textsuperscript{83}

From there, the court explained that plaintiff’s counsel’s fee should be paid by the corporation: “[s]o far as the causes of action set up in this suit have succeeded, counsel representing the plaintiffs are to be deemed as representing the corporation, upon like principles as the plaintiffs themselves are deemed its representatives.”\textsuperscript{84}

Consequently, while the right of a plaintiff to recover attorney fees expended on behalf of the corporation has in Kentucky been often reduced to statute,\textsuperscript{85} the right exists even absent a statute.\textsuperscript{86}

\textsuperscript{79} Denicke v. Anglo California Nat. Bank of San Francisco, 141 F.2d 285, 288 (9th Cir. 1944) (quoting Whitten v. Dabney, 154 P. 312, 316 (Cal. 1915)) (citation omitted).

\textsuperscript{80} Id. at 288 (citations omitted). See also Morgan v. Robertson, 609 S.W.2d 662, 663 (Tenn. Ct. App. 1980) (“in derivative suits the corporation is the real party in interest, although the real parties in litigation were the stockholders.”) (citing Breswick & Co. v. O Henry Briggs, 135 F. Supp. 397 (S.D.N.Y. 1955)).

\textsuperscript{81} Louisville Bridge Co. v. Dodd, 85 S.W. 683 (Ky. 1905).

\textsuperscript{82} Id. at 684; see also Burley Tobacco Co. v. Vest, 178 S.W. 1102, 1105 (Ky. 1915).

\textsuperscript{83} Louisville Bridge Co., 85 S.W. at 684.

\textsuperscript{84} Id.

\textsuperscript{85} See, e.g., KY. REV. STAT. ANN. §§ 362.517 & 362.2-935 (West, Westlaw through 2014 Legislation); id. § 386A.6-110(9)(6); id. § 272A.13-050(2)(6). No equivalent provision exists in the Business Corporation Act, although the ability of the prevailing plaintiff to recover attorney fees is not contested.

RECOVERY OF ATTORNEY FEES FROM AN UNSUCCESSFUL PLAINTIFF

It does not appear, based upon a review of Kentucky law, that the entity and other defendants have a right in common law to seek recovery of attorney fees from a plaintiff whose claim is unsuccessful. As such, while the directors named as defendants may have rights of advancement and indemnification from the corporation’s assets, the corporation appears to lack a basis for making a claim against the persons that on the corporation’s basis initiated the suit.

SPECIAL LITIGATION COMMITTEE

It does not appear, based upon a review of Kentucky law, that the entity and the other defendants have the right in common law to appoint a special litigation committee and to thereby effect a dismissal of the action. Therefore, a special litigation committee may not be available unless provided for by statute or in the organic documents such as the Articles of Incorporation and Bylaws.

NON-PROFIT STATUS IS NOT A BAR TO DERIVATIVE ACTIONS, BUT IT RAISES QUESTIONS OF STANDING

Some may assert that non-profit status should preclude derivative actions as there is no pecuniary interest to protect. There are at least two failures in this proposition. First, it fails to account for the broad range of activities undertaken by nonprofit organizations. Second, it ignores the fact that a derivative action exists not to protect the plaintiff’s interest in the organization, but rather the organization’s interest in the proper application of its assets.

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87 Compare KY. REV. STAT. ANN. § 271B.7–400(4) (West, Westlaw through 2014 Legislation) (subjecting plaintiff to liability for defendant’s attorney fees if the “proceeding was commenced without reasonable cause”), with id. § 386A.6–110(9)(a) (subjecting plaintiff to liability for defendant’s expense and reasonable attorney fees if the “proceeding or any portion thereof was commenced without reasonable cause or for an improper purpose.”). See also id. § 272A.13–050(2)(a). The limited partnership acts are silent as to fee-shifting against the plaintiff.

88 See KY. REV. STAT. ANN. § 273.171(14) (West, Westlaw through 2014 Legislation) (power to indemnify directors and officers). Often corporations will purchase directors and officers insurance as a mechanism of satisfying these obligations. Care needs to be taken to ensure that the coverage is effective. See, e.g., Lake Cumberland Resort Cmty. Ass’n, Inc. v. Auto Owners Ins. Co., No. 2010-CA-001725-MR, 2012 WL 1758108, at *3 (Ky. Ct. App. May 18, 2012) (finding that coverage should be denied on the basis that the corporation had agreed to indemnify directors from claims asserted).


90 But see Janssen v. Best & Flanigan, 662 N.W.2d 876, 887–88 (Minn. 2003) (allowing use of special litigation committee in context of derivative action brought on behalf of nonprofit corporation). In an LLC, it should be possible to provide for a special litigation committee in the operating agreement.
The range of activities undertaken in nonprofit organizations91 is broad and includes charitable ventures such as the United Way,92 the American Red Cross93 and USA Harvest,94 benevolent organizations such as the Elks,95 religious organizations such as the Little Sisters of the Poor96 and the Abbey of Gethsemani,97 athletic organizations,98 residential condominium associations,99 and

92 See Deborah A. DeMott, Self-Dealing Transactions in Nonprofit Corporations, 59 BROOK. L. REV. 131, 133 (1993) (“Highly-publicized incidents of self-dealing by directors and executive officers have afflicted several well-known nonprofits in recent years. In the most visible incident, the United Way of America lent $2.1 million in 1990 to a for-profit spinoff headed by the son of United Way’s executive director. With the board’s support, the executive director, who received $463,000 annually in compensation, had previously created three for-profit spinoffs that performed services for the United Way and staffed them with friends and family members.”) (citation omitted).
private country clubs.\textsuperscript{100} It is beyond contravention that each of these classes of organizations serves different constituencies and none of these classes of organizations are exempt from the ravages of poor management. It is likewise true that some or all of these organizations are subject to pressures that may limit or preclude the bringing of suit in order to make the corporation whole for losses suffered at the hands of those in management.\textsuperscript{101} While some may lament and caterwaul that bringing to light breakdowns in oversight in nonprofit organizations will reduce if not eliminate the likelihood of further support,\textsuperscript{102} it must be acknowledged that such organizations should not be supported and that the public who invests in nonprofit organizations through the contribution of time and money (irrespective of charitable status) should be made aware that those particular bodies are not good stewards. Furthermore, publication of failures serves to advise other organizations of the need to police their inner workings as a means of protecting their respective reputational bonds.\textsuperscript{103}

While federal tax law may impose limitations that address certain violations of fiduciary duties,\textsuperscript{104} these penalties cannot be seen as the exclusive means of policing fiduciary conduct in the nonprofit realm. First, many nonprofit organizations, such as benevolent and athletic organizations, are not within the scope of Code section 501(c)(3) and are therefore not subject to those limitations. Second, the limitations imposed by the federal tax law are not co-extensive with the fiduciary obligations imposed by state law upon those who agree to manage nonprofit organizations. For example, while it may be questioned whether the board of a corporation that has suffered systematic embezzlement has satisfied its duty to act in good faith as

\begin{footnotes}
\footnote{101}{See, e.g., Paul L. Davies, The Board of Directors: Composition, Structure, Duties and Powers, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, at *6 (Dec. 7–8, 2000), http://www.oecd.org/corporate/ca/corporategovernanceprinciples/1857291.pdf (pointing out that in the absence of strong shareholders, boards are likely to be “captured” by management and become “expressions” of their will even as they are unaccountable to shareholders); see also Richard P. Chait, William P. Ryan & Barbara E. Taylor, GOVERNANCE AS LEADERSHIP: REFRAMING THE WORK OF NONPROFIT BOARDS 3 (2005) (discussing capture of management by CEO with board abdication of oversight).}
\footnote{103}{See, e.g., Evelyn Brody, Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms, 40 N.Y.L. SCH. L. REV. 457, 461 (1996) (“In the end, the same economic force motivates nonprofit firms as for-profit firms: the desire for a reputation as a worthy recipient of future trade, be it donations, purchase of services, government contracts, or labor.”).}
\end{footnotes}
exemplified by the Caremark decision, limitations imposed by the federal tax law on self-dealing, excess personal benefit and similar transactions do not address or provide a means of remedying that failure.

All of which explain why derivative actions are necessary in nonprofit corporations, but without addressing who should have the capacity to initiate such an action. In light of the many ways in which a nonprofit corporation may be structured, courts should be afforded significant leeway in determining that particular actors have a sufficient interest in the venture to initiate the court’s investigation of management’s discharge of its obligations. Clearly, ab initio members of a membership corporation should be afforded the capacity to initiate a derivative action. As observed by leading commentators in the field of corporate governance:

Nonprofits do not have shareholders, but there may still be constituencies who arguably should be able to bring derivative suits. For example, in a membership nonprofit, the ability to bring a derivative suit could be conferred on members. Directors, as members of the governing board, could also be given the ability to sue derivatively on the organization’s behalf.

Also, irrespective of whether the corporation has members, individual directors should be able to initiate a derivative action. Often directors will have the most immediate knowledge of the need to bring a derivative action and they are therefore in the best position to protect the corporation’s interest. The ability of a director to initiate a derivative action on the corporation’s behalf has precedent in the law of trusts wherein a co-trustee may bring suit against another trustee to challenge the latter’s conduct violating the trust’s terms.

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106 Under current Kentucky law, the default is that a nonprofit corporation has members; the absence of members requires an affirmative statement in the articles of incorporation or the bylaws. See KY. REV. STAT. ANN. § 273.187(1) (West, Westlaw through 2014 Legislation).

107 Thomas Lee Hazen & Lisa Love Hazen, Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors’ Fiduciary Duties, 14 U. PA. J. BUS. L. 347, 411 (2012); see generally HOWARD L. OLECK & MARTHA E. STEWART, Derivative Actions and Class Actions, in NONPROFIT CORPORATIONS, ORGANIZATIONS, & ASSOCIATIONS 1364, 1364–67 (6th ed. 1994) (discussing derivative actions in nonprofit corporations, including standing, and offering no suggestion that such actions are improper).

108 See FLETCHER, supra note 50, § 5972.60 (2004) (“Members or directors of nonprofit corporations may have standing to bring derivative proceedings. The plaintiff does not lose standing even though the plaintiff’s voting rights may be restricted.”).

109 See RESTATEMENT (SECOND) OF TRUSTS § 200, cmt. e (1959) (“If there are several trustees, one or more of them can maintain a suit against another to compel him to perform his duties under the trust, or to enjoin him from committing a breach of trust committed by him.”); see also Holt v. Coll. of Osteopathic Physicians and Surgeons, 394 P.2d 932, 937 (Cal. 1964); 19 AM. JUR. 2d CORPORATIONS § 2007 (“in the case of membership or nonprofit corporations, a member, may maintain a corporate derivative suit.”); accord RESTATEMENT (THIRD) OF TRUSTS § 94 (2012).
While some may lament that such an open policy to bringing derivative actions invites ill-conceived and even abusive suits, the protections of the demand rule will remain in place, as does the ability of the court to determine that a constituent seeking to initiate a suit does not adequately represent the corporation’s interests. Simply put, the absence of a significant member of nonprofit derivative actions even in those states where they are expressly recognized by statute evidence that fears of abuse are unjustified. Likewise, the rarity of nonprofit derivative suits even where they are by statute expressly allowed demonstrates the fallacy of the argument that they may limit the pool of available directors. At the same time, it should be acknowledged that the risk of enforcement of the fiduciary duties undertaken by directors of nonprofit corporations serves to focus attention and enhances the possibility of real oversight. Simply put, individuals who are not willing to become informed as to the activities of a nonprofit corporation and who are not willing to attend and actively participate in board oversight should not stand for election to boards. In that manner, fiduciary exposure is ab initio avoided.

Persons who would lament the very existence of derivative actions in a nonprofit corporation and the potential diversion of assets away from charitable purposes towards the defense of perhaps ill-conceived derivative suits should recognize the capability, by statute, of minimizing such possible disruption. As observed in *Fletcher’s Cyclopedia*:

> A nonprofit corporation statute may impose more stringent standards for bringing a derivative proceeding [in the context of a nonprofit corporation] than those imposed in the context of a for profit corporation, such as requiring the action be supported by a stated minimum percentage of the corporation’s members. The purpose of such a requirement is to prevent a nonprofit corporation from having to incur legal expenses when there is not a showing at a minimum number of members support the suit.

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111 See CHAIT, supra note 101, at 13 ("[Board members] are faulted for not knowing what is going on in their organizations and not demonstrating much desire to find out. Attendance at board meetings is often spotty and participation perfunctory.").
112 FLETCHER, supra note 50, § 5972.60 (citations omitted); see also, e.g., MINN. STAT. ANN. § 317A.467 (West, Westlaw through 2014 Legislation). The statute states that:

> If a corporation or an officer or director of the corporation violates this chapter, a court in this state, in an action brought by at least 50 members with voting rights or ten percent of the members with voting rights, whichever is less, or by the attorney general, may grant equitable relief it considers just and reasonable in the circumstances and award expenses, including attorney fees and disbursements, to the members.

*Id.; WYO. STAT. ANN. § 17-19-630 ("A proceeding may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor by: (i) Any member or members having five percent (5%) or more of the voting power or by fifty (50) members, whichever is less . . ."); MODEL NONPROFIT CORP. ACT (SECOND) § 6.3 (1997); MODEL NONPROFIT CORP. ACT (THIRD) § 13.02 (2008); accord PRINCIPLES OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS §§ 550, 560 (Tentative Draft No. 4, 2013).*
Again, these limitations must arise by affirmative statute; they do not exist at common law. At the same time, the barriers to bringing a derivative action and thereby bringing to light potential misconduct by those in control of the venture should not be set so high as to preclude the likelihood of appropriate policing of fiduciary obligations.

CONCLUSION

Derivative actions provide a powerful tool for ensuring that those charged with control of a venture properly see to its management. Answering the question of “who will watch the watchers?,” the derivative action provides a means by which the discharge of the managerial function may be policed, giving true effect to the fiduciary and other obligations imposed on (and voluntarily undertaken by) those entrusted with oversight and control of the venture.

Where the statute governing an organizational form lacks an express provision addressing derivative actions, equity will supply the rules for actions in that context. There is no justification for the view that in the absence of a statute on derivative actions they do not exist, just as there is no justification for the view that the capacity to bring a derivative action is dependent upon shareholder status.

For purposes of clarity, assuming there can be agreement as to the terms thereof, it would be of benefit that all organizational forms expressly address the requirements for derivative actions; there exists as well the question as to whether a single statutory provision common to all organizational forms would be the best means of addressing the question. Until that day, where the statute is silent, reference needs to be made to equity to ascertain the mechanism by which the watchers will be watched.