NOTE

AVOIDING A LITIGATION FREE-FOR-ALL: CLARIFYING LLC MEMBERS' STANDING TO SUE AFTER *MARX V. MORRIS*

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When a business owner or manager does something that harms the business or the other owners, who can sue that person? Corporate shareholders may bring direct actions to redress harm to themselves but must bring derivative actions to redress harm to the corporation. But how does the direct-derivative distinction translate, if at all, to limited liability companies (LLCs), a relatively new, flexible business form? In its 2019 decision in *Marx v. Morris*, the Wisconsin Supreme Court held that the owners ("members") of an LLC may bring direct claims against managers or other members for harm to the member *or to the LLC*. However, letting members sue directly for harm to the LLC permits them to improperly assert the LLC's legal rights; obtain preemptive, duplicate, or excessive recoveries; and invoke judicial power to resolve mere disputes over business judgment.

This Note argues that Wisconsin (and other states with ambiguous LLC standing statutes) should adopt LLC statutes that clearly distinguish direct from derivative actions, such as the Revised Uniform Limited Liability Company Act (RULLCA). It also argues that courts should employ the "direct harm" rule to determine when each type of action is proper. By clearly distinguishing direct from derivative claims, statutes and courts can preclude parties from unjustly asserting the legal rights of others.

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INTRODUCTION

Standing to sue is a foundational issue of justice. Far from being simply a matter of judicial administration and efficiency, the "doctrine of standing prohibits a litigant from raising another's legal rights."[1] However, the relatively recent advent of the limited liability company (LLC) raises new challenges in determining who has standing to sue for harm to the business or its owners. These challenges stem from one of the LLC's greatest advantages: its flexibility as a business form allows wide variation in organizational structure and operations.[2]

The Wisconsin Supreme Court's 2019 decision in *Marx v. Morris*[3] illustrates some of the injustices that can result when courts mistakenly engraft the flexibility of LLCs onto determinations about standing. On the last day of 2013, the six managers of North Star Sand, LLC, a silica sand mining business, met by phone.[4] Each manager—Marx, Murray, Morris, and three others who were not involved in the litigation—was the sole owner ("member," in LLC terminology) of his own LLC, and the managers' six LLCs were, in turn, the members of North Star.[5] At the meeting, Morris, who was also allegedly North Star's attorney, purportedly strong-armed the sale of a subsidiary for inadequate consideration to another business in which he had an interest.[6]

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1. *Foley-Ciccantelli v. Bishop's Grove Condo. Ass'n*, 797 N.W.2d 789, 804–05 (Wis. 2011) (quoting *Haberman v. Wash. Pub. Power Supply Sys.*, 744 P.2d 1032, 1055 (Wash. 1987)).

2. *See* JOSEPH W. BOUCHER ET AL., LLCS AND LLPS: A WISCONSIN HANDBOOK § 1.4 (6th ed. 2020).

3. 925 N.W.2d 112 (Wis. 2019).

4. *Id.* at 117–18, 121 n.18. See *infra* Figure 1 for an illustration of North Star's ownership and management structure.

5. *Marx*, 925 N.W.2d at 117.

6. *Id.* at 117–18, 128.

Marx, Murray, and their respective LLCs sued Morris and his LLC, but North Star itself was not a party to the litigation.[7] The majority let all four plaintiffs sue without indicating which could bring each of the five disparate claims.[8] With one narrow exception, the dissent would not have let any of the plaintiffs bring any of the claims.[9]

The flexibility of LLCs should not enable litigation for harm to an LLC or its members to turn into a free-for-all. The *Marx* decision wrongly allowed suit by nonmembers (Marx and Murray), and it did not clarify who could sue—the aggrieved members or the LLC—for which claims. By making causes of action for harm to an LLC or its members open to all, the decision results in confusion and injustice. It lets members improperly assert the LLC's legal rights; obtain preemptive, duplicate, or excessive recoveries; and invoke judicial power to resolve mere disputes over business judgment. The dissent's[10] approach likewise engenders confusion and injustice but by using the wrong rule to determine who can sue and when. Enacting the Revised Uniform Limited Liability Company Act (RULLCA),[11] which the Wisconsin legislature is considering adopting[12] and which many other states have adopted,[13] may succeed in rendering moot much of *Marx*'s erroneous holding and analysis regarding standing.[14] But even when statutes are clear, *Marx* also serves as a caution to courts against muddying the direct-derivative distinction.

This Note argues that Wisconsin (and other states with similarly ambiguous statutes) should adopt LLC statutes that clearly distinguish direct from derivative actions, such as RULLCA, and that courts should employ the "direct harm" rule to determine when each type of action is proper. Part I surveys the LLC's characteristics and origins, the purposes and uses of derivative claims, and standing to sue. Part II uses the *Marx*

7. *Id.* at 116.

8. *Id.* at 130–31.

9. *Id.* at 142–43, 142 n.9 (Kelly, J., concurring in part and dissenting in part).

10. For ease of reference, this Note calls Justice Kelly's separate opinion in *Marx*, which concurred in part and dissented in part, the *Marx* "dissent."

11. UNIF. LTD. LIAB. CO. ACT (2006) (UNIF. L. COMM'N, amended 2013). All citations relating to RULLCA are to RULLCA rather than the bills proposing to adopt it that have been introduced in Wisconsin. Except where indicated, there are no substantive differences between RULLCA and the Wisconsin bills for the sections cited in this Note.

12. *See* Assemb. B. 566, 2021–22 Leg., Reg. Sess. (Wis. 2021); S. B. 566, 2021–22 Leg., Reg. Sess. (Wis. 2021).

13. *See Limited Liability Company Act, Revised*, UNIF. L. COMM'N, https://www.uniformlaws.org/committees/community-home?CommunityKey=bbea059c-6853-4f45-b69b-7ca2e49cf740 [https://perma.cc/8DSG-5FAF] (last visited Aug. 5, 2021) (showing that twenty-one states, plus the District of Columbia, have enacted RULLCA).

14. *See* LTD. LIAB. CO. COMM., STATE BAR OF WIS., WISCONSIN UNIFORM LIMITED LIABILITY COMPANY LAW 17, https://docs.legis.wisconsin.gov/misc/lc/hearing_testimony_and_materials/2019/ab854/ab0854_2020_02_06.pdf [https://perma.cc/4UX6-PL2S].

decision to illustrate the pitfalls in analyzing standing in LLCs and describes how courts should proceed in the future. Specifically, statutes and courts should let formal LLC members bring either derivative claims for harm to the LLC or direct claims for harm to themselves, but not individual claims for harm to the LLC. In doing so, courts should use the direct harm approach to distinguish direct from derivative claims. To demonstrate the application of these principles, Part III classifies each of the *Marx* claims as direct or derivative using the direct harm approach.

I. THE LLC: NEW BUSINESS FORM, NEW CHALLENGES IN ADDRESSING STANDING

The relatively recent advent of the LLC raises new challenges in determining who has standing to sue, as this Part illustrates. Simple to use yet allowing for wide variation in organizational structure and operations, LLCs are now by far the most popular entity type for new businesses in Wisconsin. But when an LLC manager or member does something that harms the LLC or its members, who may sue? In corporate law, individual shareholders may bring direct actions to assert their own rights or derivative actions to assert the rights of the corporation. Although some LLC statutory schemes, such as RULLCA, similarly distinguish direct from derivative actions, Wisconsin's LLC statutes are ambiguous on this point. However, statutory clarity and judicial rigor in distinguishing direct from derivative actions are critical to ensuring justice.

A. A Simple yet Flexible Business Form

In Wisconsin, LLCs are by far the most common form for new businesses. In 2019, LLCs accounted for ninety percent of all new domestic business entities and sixty-three percent of all new out-of-state business entities in Wisconsin.[15] One reason for the LLC's popularity is that it can be a very easy business form to use. In Wisconsin, the state's receipt of the articles of organization marks the formation of the LLC.[16] The articles need include only a few pieces of basic information,[17] and the

15. *See* WIS. DEP'T OF FIN. INSTS., COMPILATION OF FILINGS (2020), https://www.wdfi.org/_resources/indexed/site/corporations/HistoricalStatistics/CompilationOfFilings/CompilationOfFilings20191231.pdf [https://perma.cc/V8LQ-2JLE].

16. *See* WIS. STAT. § 183.0204(1)(a) (2019–20); *id.* § 183.0111(1)(a).

17. The only information required is an indication that the LLC is organized under Chapter 183 of the Wisconsin Statutes; the LLC's name; the registered agent and their street address; the names and addresses of all the LLC's organizers; the effective date and time (if it will be delayed); and, if the LLC will be manager-managed, an indication to that effect. *Id.* § 183.0202.

fee for filing a new domestic LLC's articles online is a mere $130.[18] Chapter 183 provides a wealth of default statutory rules that members can rely on if they choose.[19]

Despite this simplicity, LLCs remain flexible, another factor contributing to their popularity. In Wisconsin, this business form can be organized "for any lawful purpose."[20] The business's "members" (those who own an interest in an LLC)[21] can include individuals, businesses, or other entities.[22] Although Chapter 183 provides default rules, members also have wide latitude to determine among themselves how the business will be structured and run, which can be memorialized in an operating agreement.[23]

The simplicity and flexibility of Wisconsin LLCs are not a happenstance result. These were two of the primary goals of Chapter 183's drafters, along with promoting freedom of contract.[24] The combination of these three goals allows for wide variation in how LLCs are owned, managed, and operated.

B. Governance, Liability, and Sources of Law for Wisconsin LLCs

LLCs have inherited many advantages from their main progenitors: partnerships and corporations.[25] LLCs feature several desirable characteristics of partnerships: the potential for direct member involvement in the business, organizational and operational flexibility and informality, contract-based internal governance, and no entity-level taxation.[26] Unlike partners in general partnerships, however, LLC members are not liable to third parties, and they lack indemnification and contribution requirements.[27] LLCs combine these advantages with some

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18. *Wisconsin Limited Liability Company—Directions*, WIS. DEP'T OF FIN. INSTS., https://wdfi.org/apps/CorpFormation/directions.aspx?type=12 [https://perma.cc/4X78-EC48] (last visited Oct. 25, 2020).

19. *See infra* Section I.B.

20. § 183.0106(1).

21. *See id.* § 183.0801(1).

22. *See id.* § 183.0102(15) ("'Member' means a person who has been admitted to membership in a limited liability company . . . and who has not dissociated from the limited liability company."); *id.* § 183.0102(18) ("'Person' includes an individual, a partnership, a domestic or foreign limited liability company, a trust, an estate, an association, a corporation or any other legal or commercial entity.").

23. *See infra* Section I.B.

24. BOUCHER ET AL., *supra* note 2, §§ 1.4, 1.6. Because Wisconsin's LLC act was drafted when taxation of LLCs was based on how many corporation-like characteristics the LLC had, the drafters also sought to ensure partnership-type taxation. *See id.* § 1.5.

25. *See id.* § 1.4.

26. *Id.*

27. *Id.*

of the desirable characteristics of corporations. Like corporate shareholders, all LLC members benefit from a liability shield; their personal liability is generally limited to the amount they have invested.[28]

Generally, management is more like that of a partnership in member-managed LLCs and more akin to corporate governance in manager-managed LLCs.[29] In Wisconsin, member management, in which members have management authority, is the default, but the operating agreement can limit or broaden any member's rights and duties.[30] The LLC is manager-managed only if the articles of organization so indicate, but again, the operating agreement can limit or broaden any manager's rights and duties.[31] The opportunity to vest management in members or managers, with potentially varying rights and duties even within those categories, offers tremendous flexibility in organizational structure and operations.[32]

Several sources of law govern Wisconsin LLCs: statutes, operating agreements, and judicially created law. Although Chapter 183 does contain some mandatory statutory provisions, most of its provisions are default rules that may be modified by an operating agreement.[33] The drafters intended these statutory default provisions to reflect what reasonable businesspeople would likely want.[34] Thus, for many aspects of how the business will be conducted and the relationships among the members, operating agreements are the prime source of law for Wisconsin LLCs.[35] In LLCs, operating agreements combine provisions akin to those that would appear in a corporation's bylaws and in its shareholder

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28. *Id.*

29. *Id.*

30. WIS. STAT. § 183.0401(1) (2019–20).

31. *Id.* § 183.0401(2).

32. As for other states, LLC acts vary regarding precisely which rights, duties, and other matters the operating agreement can modify and to what degree, but some freedom of contract typically remains available. For example, RULLCA provides that authority to manage and conduct the business lies with members in a member-managed LLC and with managers in a manager-managed LLC. UNIF. LTD. LIAB. CO. ACT § 407(b)(1), (c)(1) (2006) (UNIF. L. COMM'N, amended 2013). However, RULLCA also states that an LLC's operating agreement generally governs issues including relationships among members and between members and the LLC, managers' rights and duties, and the conduct of the business's affairs and activities. *See id.* § 105(a).

33. *See* JEFFREY J. STORCH & PATRICK P. NEUMAN, WISCONSIN LIMITED LIABILITY COMPANY: FORMS AND PRACTICE MANUAL 1-40 (2d ed. 2013 & Supp. 2020).

34. BOUCHER ET AL., *supra* note 2, § 1.6.

35. *See* § 183.0102(16) (broadly defining an operating agreement as a written agreement among all members of the LLC regarding "the conduct of the business of [the LLC] and its relationships with its members").

agreement.[36] Chapter 183 does not require LLCs to have operating agreements, but if any are used, they must be in writing.[37]

C. The Birth of the LLC

Because the LLC is a relatively young business form, the law surrounding it is still evolving. The first LLC statute in the United States was passed in 1977 in Wyoming.[38] Initially, uptake of LLCs was slow because whether the Internal Revenue Service (IRS) would tax LLCs as partnerships or as corporations was unclear.[39]

Beginning in 1960, the *Kintner* regulations—so called because they responded to the Ninth Circuit's decision in *United States v. Kintner*[40]—determined whether a business entity was taxable as a corporation or as a partnership.[41] The *Kintner* regulations listed six characteristics of corporations, two of which were common to partnerships as well: objective to do business and divide the gains from it and the presence of associates.[42] The other four characteristics were (1) centralized management, (2) continuity of life, (3) free transferability of ownership interests, and (4) limited liability.[43] If an entity lacked at least two of these other four corporation-like characteristics, it was taxable as a partnership.[44]

In 1988, the IRS ruled that a Wyoming LLC would be taxed as a partnership because it did not have a "preponderance" of the four other corporation-like characteristics.[45] Because LLCs were by definition limited-liability vehicles, they could have only one other corporate

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36. BOUCHER ET AL., *supra* note 2, § 3.80. In Wisconsin LLCs, operating agreements include not only any primary agreement that comprehensively addresses the LLC's operations but also any other agreements among all members concerning the business's operations. *Id.* § 3.60.

37. *See* § 183.0102(16) (defining the operating agreement as "an agreement in writing, if any").

38. *See* 1977 Wyo. Sess. Laws 537–49; *see also* Dale W. Cottam, Thomas N. Long, Scott W. Meier, Timothy O. Beppler & Whitney M. Agopian, *The 2010 Wyoming Limited Liability Company Act: A Uniform Recipe with Wyoming "Home Cooking,"* 11 WYO. L. REV. 49, 51 (2011).

39. STORCH & NEUMAN, *supra* note 33, at 1-5.

40. 216 F.2d 418 (9th Cir. 1954).

41. STAFF OF J. COMM. ON TAX'N, 105TH CONG., REV. OF SELECTED ENTITY CLASSIFICATION AND P'SHIP TAX ISSUES 7 (Comm. Print 1997).

42. Treas. Reg. §§ 301.7701-2 to -3 (as amended in 1993); STAFF OF J. COMM. ON TAX'N, 105TH CONG., *supra* note 41, at 7–8.

43. § 301.7701-2.

44. *Id.*; STAFF OF J. COMM. ON TAX'N, 105TH CONG., *supra* note 41, at 8.

45. Rev. Rul. 88-76, 1988-2 C.B. 360.

characteristic if they wanted to avoid double taxation.[46] Wisconsin's LLC act was passed during this period, in 1993.[47] Today, under the IRS's "check the box" regulations, which became effective in 1997,[48] an LLC is taxed as a partnership unless it elects to be taxed as a corporation.[49]

D. The Purposes and Uses of Derivative Claims

When an LLC manager or member does something actionable that harms the interests of the LLC or its members, who may sue? In corporations (one of the LLC's progenitors), the distinction between direct and derivative claims helps answer this question. A derivative action redresses harm to the corporation, and an aggrieved shareholder brings the claim in the corporation's name to assert the corporation's legal rights.[50] By contrast, a direct action redresses harm to the shareholder who brings the claim.[51] To give only a few examples, claims that are usually derivative include those alleging diminution in value of the business's stock stemming from mismanagement and those alleging self-dealing, waste, unjust enrichment, or excessive compensation.[52] Claims that are usually direct include those alleging breach of a duty to provide information, infringement of voting rights, and controlling shareholder dilution of a minority shareholder's equity.[53]

46. *See* STORCH & NEUMAN, *supra* note 33, at 1-8. The phrase "double taxation" refers to the fact that C corporations are generally taxed on their income at the entity level, *see* I.R.C. § 11(a), and the corporation's shareholders are then also taxed on the dividends, *see id.* § 61(a)(7).

47. Assemb. B. 820, 1993–94 Leg., Reg. Sess. (Wis. 1993).

48. *See* T.D. 8697, 1997-1 C.B. 215–17.

49. Treas. Reg. § 301.770l-3(a) (as amended in 2020).

50. *See* Judith Schemel Suelzle, *Trust Beneficiary Standing in Shareholder Derivative Actions*, 39 STAN. L. REV. 267, 267–68 (1986) ("A shareholder derivative action is a lawsuit brought by a corporate shareholder, in the name of the corporation, to redress a wrong done to the corporation."). *See also* 4 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE AS ADMINISTERED IN THE UNITED STATES OF AMERICA § 1095, at 278 (Spencer W. Symons ed., 5th ed. 1941) ("The stockholder does not bring [a derivative] suit because *his* rights have been *directly* violated, or because the cause of action is *his*, or because *he* is entitled to the relief sought; he is permitted to sue in this manner *simply in order to set in motion the judicial machinery of the court*. . . . In fact, the plaintiff has no such *direct* interest; the defendant corporation alone has a direct interest; the plaintiff is permitted, notwithstanding his want of interest, to maintain the action solely to prevent an otherwise complete failure of justice.").

51. *See Direct Action*, BLACK'S LAW DICTIONARY (11th ed. 2019) (defining a direct action, in relevant part, as a "lawsuit to enforce a shareholder's rights against a corporation").

52. *See* 2 JOSEPH M. MCLAUGHLIN, MCLAUGHLIN ON CLASS ACTIONS: LAW AND PRACTICE § 9:1 (17th ed. 2020).

53. *See id.*

The derivative claim evolved in corporate law to address the plight of corporate shareholders. In corporations, there is a separation between ownership and control.[54] Unless corporate shareholders are controlling shareholders or are also directors or managers, they cannot act on the corporation's behalf because they have no agency authority.[55] They cannot elect a new board absent the requisite votes.[56] Shareholders might not even be able to exit because they are not always able to sell their shares.[57] Thus, aggrieved shareholders may be locked in and stuck with the decisions of the board and management.

The derivative claim arose to address such problems. In both the United States and England, the derivative action grew from its roots in equity over the course of the 1800s.[58] As more people became able to invest, the ability to participate in managing the business could not, for practical reasons, also expand.[59] A concentration of management power resulted, and managers could abuse that power by shirking their responsibilities.[60] The derivative suit made managers answerable to shareholders for such lapses.[61]

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54. *See generally* Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503 (2006) (tracing the history of discussions about corporate shareholder participation, including the separation of ownership and control).

55. *Compare* WIS. STAT. §§ 180.0701–.0746 (2019–20) (addressing shareholder participation in annual meetings, special meetings, court-ordered meetings, derivative actions, and actions without meetings but describing no shareholder duties), *with* § 180.0801 ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation."), *and* § 180.0841 ("Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent not inconsistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the bylaws or by the board of directors to prescribe the duties of other officers.").

56. *See id.* § 180.0728 (stating that unless the articles of incorporation say otherwise, a plurality of votes cast by voting shares elects the directors, assuming a quorum is present at the election meeting).

57. Sometimes, there is no market for the shares. Other times, a shareholder agreement might prevent the shareholder from selling under certain circumstances. *See id.* § 180.0627 (permitting a corporation's articles of incorporation, its bylaws, or shareholder agreements to include share transfer restrictions, including, for example, restrictions that require the shareholder to first offer the shares to the corporation or others or that bar the transfer of shares to "designated persons or classes of persons, if the prohibition is not manifestly unreasonable").

58. *See generally* Bert S. Prunty, Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 980–89 (1957) (tracing early development of the derivative action in both the United States and England).

59. *Id.* at 992.

60. *Id.*

61. *See id.* at 992–93 ("The evolution of the derivative suit is the record of the efforts of judges and lawyers to enforce that responsibility without destroying the right of

However, some disputes are essentially disagreements over business judgment. In these situations, courts should not substitute their judgment for the legitimate business decisions of the managers.[62] As a result, the business judgment rule developed to shield managers' business decisions from judicial second guessing.[63] In Wisconsin, the business judgment rule requires courts to defer considerably to the board in its decision-making.[64] Procedural requirements also help safeguard the legitimate exercise of business judgment.[65] For example, the Wisconsin corporate statutes addressing derivative actions require shareholders to make "[a] written demand . . . upon the corporation to take suitable action" before bringing a derivative action.[66] This prompts the directors and managers to consider and perhaps reaffirm their exercise of business judgment before the claim can proceed.[67]

The direct-derivative distinction also helps ensure that remedies go to the correct party. For example, derivative actions redress harm to the business, and damages for such harm should go to the business entity rather than individual owners.[68] With equitable remedies, such as injunctions, accounting of profits, and contract-based equitable remedies (e.g., specific performance, rescission, reformation), it matters less whether the business entity or an owner is the one to sue.[69] Although this

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a majority of the members of a corporate body to govern the affairs of that body and without assuming the burden of all intracorporate conflict.").

62. *See Steven v. Hale-Haas Corp.*, 23 N.W.2d 620, 628 (Wis. 1946) ("[T]his court will not substitute its judgment for that of the board of directors and assume to appraise the wisdom of any corporate action. The business of a corporation is committed to its officers and directors, and if their actions are consistent with the exercise of honest discretion, the management of the corporation cannot be assumed by the court.").

63. *See Reget v. Paige*, 626 N.W.2d 302, 310 (Wis. Ct. App. 2001) (stating that the business judgment rule provides liability protections to directors and "protects the board's actions from undue scrutiny by the courts").

64. *See* Kenneth B. Davis, Jr., *The Business Judgment Rule in Wisconsin*, 2015 WIS. L. REV. 475, 477.

65. *See id.* at 476.

66. WIS. STAT. § 180.0742(1) (2019–20).

67. *See* Julian Velasco, *The Diminishing Duty of Loyalty*, 75 WASH. & LEE L. REV. 1035, 1060–61 (2018) ("Theoretically, [the demand requirement] enables directors to pursue the matter in an appropriate way. However, in practice it enables directors to decide that the matter is not worth pursuing.").

68. *See, e.g.*, *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) ("Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation.").

69. Unlike the award of money to individual shareholders, such remedies tend to necessarily affect all shareholders. In closely held corporations, statutes may even enumerate the right of individual shareholders to ask the court for such remedies without bringing a derivative action. *See, e.g.*, § 180.1833 (requiring courts to "grant appropriate relief," such as enjoining or canceling acts of the corporation or ordering an accounting, if a shareholder of a statutory close corporation shows that the directors or others in control

Note focuses on the use of derivative claims to sue an LLC manager (or, hypothetically, another member), derivative claims might also be used to sue third parties.[70]

Compared with corporations, partnerships (the other major progenitor of LLCs) have less need for derivative suits. In a partnership, all partners have apparent agency authority,[71] and they have equal management rights.[72] In addition, partners can sue each other directly.[73] Thus, aggrieved partners have less need for derivative actions because they can simply sue one another at will.

Conceptually, derivative suits might be less necessary in member-managed LLCs because they more closely resemble partnerships than corporations. In a manager-managed LLC, derivative suits make sense because the members generally lack agency authority and thus cannot sue individually without a special mechanism.[74] In a member-managed LLC, derivative litigation is theoretically less necessary because the more partnership-like structure might suggest that members could sue other members at will.[75] In other words, in a partnership, it would not make sense to let partners use agency authority to sue each other on behalf of the partnership when they can simply sue each other directly anyway.[76]

However, modern LLC laws and commentary do not necessarily limit derivative actions to manager-managed LLCs.[77] Even Wisconsin's LLC

are deadlocked or have acted or will act illegally, fraudulently, oppressively, or prejudicially toward the shareholder).

70. *See, e.g.*, *Krier v. Vilione*, 766 N.W.2d 517, 521, 528 (Wis. 2009) (indicating that the plaintiff might have been able to bring a derivative suit on behalf of two businesses of which he was a shareholder against accountants who were not directors, managers, or employees of either business).

71. *See* UNIF. P'SHIP ACT § 301 (1997) (UNIF. L. COMM'N, amended 2013); WIS. STAT. § 178.0301(1).

72. UNIF. P'SHIP ACT § 401(h); WIS. STAT. § 178.0401(8).

73. *See* UNIF. P'SHIP ACT § 410(b) ("A partner may maintain an action against the partnership or another partner . . . to enforce the partner's rights and protect the partner's interests . . . ."); WIS. STAT. § 178.0410(2) (using identical language). Partnerships also may sue individual partners. UNIF. P'SHIP ACT § 410(a); WIS. STAT. § 178.0410(1).

74. *See* UNIF. LTD. LIAB. CO. ACT § 301(a) (2006) (UNIF. L. COMM'N, amended 2013) ("A member is not an agent of a limited liability company solely by reason of being a member."); WIS. STAT. § 183.0301(2)(a) (providing that in manager-managed LLCs, members are not agents of the LLC "solely by being a member").

75. *See* § 183.0301(1)(a) (providing that in member-managed LLCs, members are agents of the LLC "for the purpose of its business").

76. *See* UNIF. P'SHIP ACT § 410(b); WIS. STAT. § 178.0410(2).

77. *See* UNIF. LTD. LIAB. CO. ACT § 802 (providing that LLC members may bring derivative suits to enforce the LLC's rights, distinguishing derivative suits on behalf of member- versus manager-managed LLCs only in regard to demand procedures). *See also* Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed Versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY. L.J. 737, 758–62 (2004–05) (arguing

act, which is an older LLC statutory scheme, requires individual members in member-managed LLCs to follow certain procedures before suing other members in the LLC's name.[78] Thus, the characterization of LLCs as hybrids of corporations and partnerships is often instructive but not controlling, including in regard to the direct-derivative distinction.[79]

E. Standing to Sue in LLCs

Standing is not simply a matter of judicial administration and efficiency but a foundational issue of justice. As the Wisconsin Supreme Court has emphasized, the "doctrine of standing prohibits a litigant from raising another's legal rights."[80] Erroneous decisions about standing may allow recovery by those who should not have standing, preclude recovery by those who should have standing, or permit duplicate recoveries, resulting in injustice for defendants and for others who truly should have standing to sue.[81] Such decisions may also infringe on a business's right to control litigation involving its interests.[82]

Although the Wisconsin Supreme Court generally construes standing "liberally," the caselaw articulates "[n]o single longstanding or uniform test for standing."[83] Instead, the Wisconsin Supreme Court has described "three aspects of standing," which address whether (1) the challenged party has a personal stake in the dispute, (2) their interests will suffer an adverse effect, and (3) judicial policy supports safeguarding the party's interests.[84] In cases in which statutory or constitutional provisions govern standing, Wisconsin courts often refer to the standing analysis as one of

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generally for elimination of distinction between member-managed and manager-managed LLCs).

78. *See* WIS. STAT. § 183.1101(1) (stating that unless the operating agreement provides otherwise, and regardless of whether the LLC is member-managed or manager-managed, an LLC member may sue on the LLC's behalf if authorized by a vote among members with no interest adverse to the LLC in the suit's outcome).

79. *See* STORCH & NEUMAN, *supra* note 33, at 1-3 to -4 (noting similarities between LLCs and other business entities, including corporations and partnerships, but adding that LLCs are "best viewed as a modern invention, designed to satisfy current tax and operating objectives"); *see also* UNIF. LTD. LIAB. CO. ACT § 802 (authorizing LLC members to sue derivatively regardless of whether the LLC is manager-managed, and thus more akin to a corporation, or member-managed, and thus more akin to a partnership, distinguishing between the two LLC types only in regard to demand procedures).

80. *Foley-Ciccantelli v. Bishop's Grove Condo. Ass'n*, 797 N.W.2d 789, 804–05 (Wis. 2011) (quoting *Haberman v. Wash. Pub. Power Supply Sys.*, 744 P.2d 1032, 1055 (Wash. 1987)).

81. *See Marx v. Morris*, 925 N.W.2d 112, 136–37 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part).

82. *See id.* (Kelly, J., concurring in part and dissenting in part).

83. *Foley-Ciccantelli*, 797 N.W.2d at 798.

84. *Id.* at 798–99.

determining whether the party asserts a "legally protectable interest."[85] In cases in which no constitutional or statutory provision directly governs standing, courts consider "the facts and relevant legal principles" in determining whether to recognize the party's interest.[86]

Wisconsin has statutes addressing derivative actions by corporate shareholders[87] and statutes addressing actions by a partnership against a partner and actions by partners against the partnership or another partner.[88] However, Wisconsin's LLC statutes only partially address who may sue on whose behalf, and even then, they do so ambiguously. Section 183.1101 addresses an LLC member's authority to sue on behalf of the LLC.[89] Unless the operating agreement provides otherwise, and regardless of whether the LLC is member-managed or manager-managed, an LLC member may sue on behalf of the LLC if authorized by a vote among members with no interest adverse to the LLC in the suit's outcome.[90] The exclusion of interested managers and members helps, but the majority vote requirement makes this provision look less like a corporate derivative suit (which any shareholder can bring) and more like the usual decision-making process for LLCs.[91] In addition, Chapter 183 itself is silent regarding whether and when a member may sue a manager or another member on their own behalf.[92]

A more comprehensive and explicit scheme appears in RULLCA.[93] Under RULLCA, an LLC "has the capacity to sue and be sued in its own name."[94] In addition, Article 8 describes two types of actions that members may bring.[95] One, a "Direct action by member," lets members sue the LLC, a manager, or another member "to enforce the member's rights and protect the member's interests."[96] The other, a "Derivative action," lets members sue "to enforce a right of a limited liability company" after first unsuccessfully demanding that the managers (if the LLC is manager-managed) or the other members (if the LLC is member-managed) make

85. *Id.* at 803–04.

86. *Id.*

87. *See* WIS. STAT. § 180.0740–.0747 (2019–20).

88. *See id.* § 178.0410.

89. *See id.* § 183.1101(1).

90. *Id.*

91. *Compare id.* § 180.0741 (stating that a corporate shareholder has standing to sue derivatively if individual was a shareholder at time of conduct and "[f]airly and adequately represents" corporation's interests), *with id.* § 183.0404(1) (requiring a fifty percent vote or approval among members in a member-managed LLC or managers in a manager-managed LLC "to decide any matter connected with the business" of the LLC).

92. *See Marx v. Morris*, 925 N.W.2d 112, 124 (Wis. 2019).

93. *See* UNIF. LTD. LIAB. CO. ACT §§ 109, 801–03 (2006) (UNIF. L. COMM'N, amended 2013).

94. *Id.* § 109.

95. *Id.* art. 8.

96. *Id.* § 801(a).

the LLC sue to enforce that right, unless such a demand would be futile.[97] Only those who are members when the action commences and who were also members when the conduct at issue occurred or whose member status has devolved can bring derivative actions.[98] Compared with the Section 183.1101 mechanism, RULLCA's derivative action provisions are more stringent and more like the requirements for bringing corporate derivative actions.[99]

II. THE *MARX* DECISION: PITFALLS IN ANALYZING STANDING IN LLCS

When courts fail to analyze standing in LLCs in a methodical way or use the incorrect rule to distinguish direct from derivative claims, the analysis becomes muddled and the outcomes potentially unjust. By allowing nonmembers to sue and otherwise failing to properly identify who could sue—the aggrieved members or the LLC—for which claims, the *Marx* decision produced confusion and injustice. Although the dissent made many analytically correct observations, it nonetheless would have barred some claims that should have been allowed to proceed, in large part because it used the wrong rule to distinguish direct from derivative claims.

This Part summarizes key aspects of the *Marx* decision that relate to standing and then makes several arguments to correct the court's mistakes and provide clarity for the future. First, plaintiffs must have formal membership in the LLC to have standing to sue for harm to the LLC or to themselves. Second, if the LLC itself does not sue, derivative actions are the only means by which members may redress harm to the LLC. Third, it is critical to distinguish direct claims from derivative claims. Fourth, the proper method of distinguishing direct from derivative claims is the direct harm rule rather than the special injury rule. Throughout, this Part discusses the potential impact of adopting RULLCA, concluding that although it would help clarify many of these issues, courts still must remain vigilant to avoid the problems that arose in *Marx*.

97. *Id.* § 802.
98. *Id.* § 803.
99. *See* LTD. LIAB. CO. COMM., STATE BAR OF WIS., *supra* note 14, at 17.

A. The Marx *Opinion*

North Star Sand, LLC, sought to own land and mine silica sand for use in fracking.[100] North Star had six members, all of which were other LLCs, each owned by six respective individuals.[101] North Star was manager-managed, with the six individuals serving as managers.[102] By the time the litigation reached the Wisconsin Supreme Court, it embroiled three of these managers and their respective LLCs: Marx and Fracsand, LLC; Murray and R&R Management Funds, LLC; and Morris (who was also allegedly North Star's attorney) and R.L. Co., LLC.[103] Figure 1 illustrates North Star's ownership and management structure.

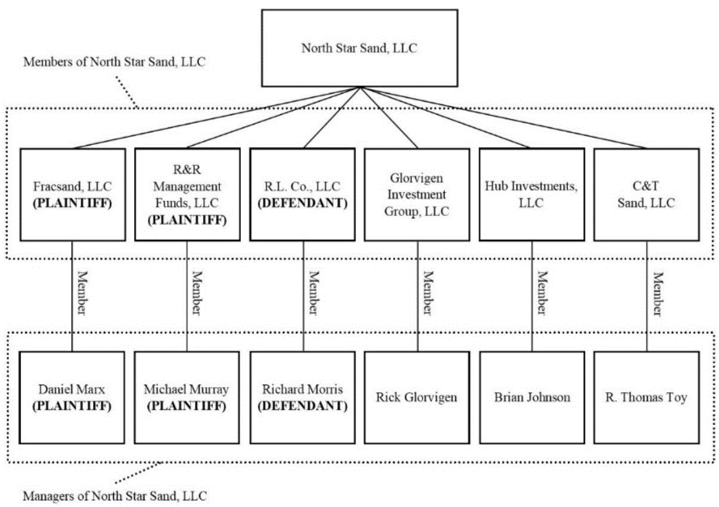

Figure 1. Ownership and Management Structure of North Star Sand, LLC, the Business at Issue in Marx v. Morris. The plaintiffs and defendants are indicated in bold; none of the other individuals or business entities shown in the illustration were parties to the litigation by the time it reached the Wisconsin Supreme Court.

North Star created a wholly owned subsidiary, Westar Proppants, LLC, to control purchase options for a group of properties that contained silica sand.[104] As many of Westar's purchase options neared expiration, concerns arose about the amount of land North Star and Westar held under

100. *Marx v. Morris*, 925 N.W.2d 112, 117 (Wis. 2019).
101. *Id.*
102. *See id.* at 121 n.18.
103. *Id.* at 117.
104. *Id.* at 118.

option contracts.[105] The day the Westar purchase options were to expire, the six managers met by phone to decide Westar's fate.[106]

At the meeting, Morris told the others that DSJ Holdings, LLC, an entity that he had formed with two other individuals (named Green and Wesch), was willing to buy Westar for $70,000.[107] On a motion to keep Westar, brought by a manager who was not a party to the litigation, four managers—including Marx and Murray—voted to keep Westar.[108] Two managers—including Morris—voted against keeping Westar.[109] According to Marx and Murray, Morris immediately became "very aggressive" and, after a brief discussion, moved for North Star to sell Westar to DSJ Holdings for $70,000.[110] Murray objected, noting that Morris had a conflict of interest, the vote had already been held, and the managers had not received notice as required by North Star's operating agreement.[111] But on a second vote, Morris and the three nonparty managers voted to sell Westar, while Marx and Murray voted against selling.[112] After the sale, DSJ assigned Westar's membership units to Morris's LLC and Wesch.[113] Westar was later sold, along with another LLC that Morris and Green had formed, for a "substantial" but confidential amount.[114]

Four plaintiffs—Marx, Murray, and their respective LLCs (Fracsand and Management Funds)—sued, and by the time the litigation reached the Wisconsin Supreme Court, two defendants remained—Morris and his LLC (R.L. Co.).[115] The plaintiffs brought five causes of action: violation of Wisconsin Statute Section 183.0402, breach of fiduciary duty, breach of the implied covenant of good faith and fair dealing, unjust enrichment, and breach of fiduciary duty as North Star's counsel.[116] The trial court denied the defendants' motion for summary judgment on all the claims, and the court of appeals certified the appeal to the Wisconsin Supreme Court.[117]

105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.* at 118 & n.10.
115. *Id.* at 112, 116.
116. *Id.* at 119.
117. *Id.*

The majority in *Marx* produced two general holdings, one addressing standing.[118] On that issue, the court held that LLC members have standing to bring individual claims against managers or other members based on harm to the member or to the LLC.[119] Concluding that genuine issues of material fact remained, the court affirmed denial of Morris and R.L. Co.'s motion for summary judgment.[120] Joined by Justices Abrahamson and Grassl Bradley, Justice Kelly disagreed with the majority, with one exception: he agreed that Fracsand and Management Funds hypothetically could recover for lack of notice of the vote to sell Westar—but only to the extent that they suffered injuries distinct from the other members.[121]

B. Formal Membership Required for Standing

In a claim alleging harm to an LLC or its members that is not brought by the LLC itself, only formal LLC members should have standing to sue. In *Marx*, the court erred in finding that all four plaintiffs had standing.[122] Marx and Murray did not have standing because they were not members of North Star.[123] However, their LLCs, Fracsand and Management Funds, may have had standing as members of North Star, depending on the claim and whether they followed any required procedures.[124] Statutes and courts should permit only formal LLC members to bring derivative or direct claims.

The *Marx* dissent concluded, correctly, that neither Marx nor Murray had standing to pursue any of their claims.[125] As the dissent noted, neither Marx nor Murray were members; the majority conflated the members of North Star with the individuals who owned those members.[126] Thus, Justice Kelly wrote, neither Marx nor Murray could assert claims for violation of Wisconsin Statute Section 183.0402, which concerns injuries to an LLC and its members.[127] Even if LLC members did owe each other fiduciary duties (which the dissent disputed), Marx and Murray could not

118. *Id.* at 130–31. The court also held that Chapter 183 does not displace common-law claims for breach of fiduciary duty. *Id.* at 126–27.

119. *Id.* at 130.

120. *Id.* at 119, 131.

121. *Id.* at 142 & n.9 (Kelly, J., concurring in part and dissenting in part).

122. *See id.* at 117 n.4 (acknowledging that North Star's members were LLCs owned by six individuals but stating that the court would refer to the named individuals "for the sake of simplicity" when discussing the members); *see also id.* at 126 ("Marx and Murray have standing to assert individual member claims against Morris.").

123. *See id.* at 117.

124. *See id.*

125. *Id.* at 142 (Kelly, J., concurring in part and dissenting in part).

126. *Id.* at 131–32 (Kelly, J., concurring in part and dissenting in part).

127. *Id.* at 138 (Kelly, J., concurring in part and dissenting in part).

bring a claim for breach of fiduciary duties because they were not members of North Star.[128]

Given the close business and financial connection between the members of North Star (the single-member LLCs) and the individuals who owned them, why not let Marx and Murray sue? After introducing the parties, the *Marx* majority consistently referred to the four plaintiffs as simply "Marx" and "Murray."[129] It gave no reasons for this conflation beyond saying that it did so "for the sake of simplicity."[130]

But this conflation created anything but simplicity for future decisions. Certainly, as sole owners of two members of North Star, Fracsand and Management Funds, Marx and Murray would feel the brunt of any financial harm to those member LLCs.[131] But parties cannot sue for just any kind of harm that befalls them, even if it is someone else's fault.[132] Rather, when analyzing standing, Wisconsin courts consider whether (1) the challenged party has a personal stake in the dispute, (2) their interests will suffer an adverse effect, and (3) judicial policy supports safeguarding the party's interests.[133] If statutory or constitutional provisions govern standing, the court determines whether the party asserts a "legally protectable interest."[134] Otherwise, the court considers "the facts and relevant legal principles" in determining whether to recognize the party's interest.[135]

The laws and doctrines at issue in *Marx* are meant to safeguard the interests of a narrower group of people than those who own an LLC's members. For example, Section 183.0402's default rule prohibits members and managers from taking several actions that can harm an LLC or its members but lets members modify such duties through the operating agreement.[136] The vesting of this power in the members, and only the members, indicates that the statute is intended to protect members' interests. As for fiduciary duties, one modern, functionalist approach suggests that "fiduciary relationships form when one party (the

128. *Id.* at 140 (Kelly, J., concurring in part and dissenting in part).

129. *See id.* at 117 n.4.

130. *Id.*

131. In Wisconsin, the default rule is that profits and losses are allocated based on the value of the contributions each member has made. WIS. STAT. § 183.0503 (2019–20).

132. For example, outside of derivative actions, corporate shareholders typically cannot sue for harm to a corporation because "the corporation is a separate entity: the shareholder's interest is viewed as too removed to meet the standing requirements." *Sabey v. Howard Johnson & Co.*, 5 P.3d 730, 735 (Wash. Ct. App. 2000).

133. *Foley-Ciccantelli v. Bishop's Grove Condo. Ass'n*, 797 N.W.2d 789, 798–99 (Wis. 2011).

134. *Id.* at 803–04.

135. *Id.* at 804.

136. *See* § 183.0402.

'fiduciary') acts on behalf of another party (the 'beneficiary') while exercising discretion with respect to a critical resource belonging to the beneficiary."[137] In LLCs, the critical resource that belongs to the beneficiary is the member's interest in the LLC, while those who own the member have a different interest—their interest in the member.[138] This melding of different interests also creates practical difficulties, such as questions about who should recover and in what proportions.[139] Thus, once someone passes beyond the boundary of formal membership, their connection to the LLC becomes too remote to support a claim.

Adopting RULLCA should help prevent courts from inappropriately letting a nonmember sue. The RULLCA provision addressing proper plaintiffs in derivative actions clarifies that the only parties who can bring derivative actions are those (1) who are members when the action commences and (2) who were also members when the conduct at issue occurred *or* whose member status has devolved.[140] The section on direct actions is titled "Direct action by member" and states that "a member may maintain a direct action against another member, a manager, or the limited liability company" to enforce their rights and protect their interests.[141] This indicates that direct actions alleging harm within the LLC belong to members alone. However, a court that might be tempted to allow a nonmember to sue directly for harm to the LLC or its members, as the majority did in *Marx*, could circumvent this otherwise clear rule by finding RULLCA Section 801 inapplicable precisely because it does *not* involve a member. Therefore, although RULLCA provides some clarity about proper plaintiffs, courts nevertheless must recognize standing only for members in disputes alleging harm to the LLC or its members.

C. Derivative Actions: The Proper Way for Members to Redress Harm to the LLC

When the *Marx* majority concluded that LLC members have standing to bring individual claims for harm to the member *or* to the LLC,[142] it was

137. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002) (emphasis omitted).

138. *See* § 183.0102(11) ("'Limited liability company interest', 'interest in the limited liability company' or 'member's interest' means a member's rights in the limited liability company, including the member's share of the profits and losses of the limited liability company, the member's right to receive distributions of limited liability company assets, and the member's right to vote or participate in management of the limited liability company.").

139. *See Marx v. Morris*, 925 N.W.2d 112, 136 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part).

140. UNIF. LTD. LIAB. CO. ACT § 803 (2006) (UNIF. L. COMM'N, amended 2013).

141. *Id.* § 801.

142. *Marx*, 925 N.W.2d at 130.

only partially correct. LLC members should have standing to bring direct claims for harm to themselves, as will be discussed later.[143] But for harm to the LLC, members should not be able to bring individual claims. Instead, they should sue derivatively using the mechanism outlined in the statute (or the operating agreement, if it permissibly deviates from the statutory mechanism).[144] Contrary to what the *Marx* majority concluded, current Wisconsin law ought to be interpreted to bar member suits to enforce the LLC's rights if the member suits are not brought via the statutory mechanism (or as the operating agreement otherwise provides).[145] RULLCA more clearly prohibits members from suing to enforce the LLC's rights except through a derivative action.[146] Although RULLCA does not make this prohibition explicit, courts should interpret it as absolute.

For harm to an LLC, one option is for the LLC to sue. Under RULLCA, an LLC "has the capacity to sue and be sued in its own name."[147] Although Chapter 183 does not explicitly state that an LLC may itself sue or be sued, Wisconsin LLCs generally are assumed to be able to bring or defend against actions because they are legal entities.[148] But in *Marx*, the LLC did not sue.[149] Instead, two members and two nonmembers sued.[150] When a member seeks to bring an action for harm to the LLC, as opposed to the LLC itself suing, the analysis becomes more complex.

In *Marx*, although Morris urged the court to apply corporate principles of derivative standing and hold that only North Star could bring the claims at issue, the majority held that "[c]orporate principles of derivative standing do not apply to the distinct business form of an LLC."[151] The majority noted the Wisconsin corporation statutes lay out requirements for derivative actions, including shareholder standing and detailed procedures.[152] Corporate shareholders cannot themselves sue the directors and officers when the corporation itself suffers the "primary injury," the court wrote; instead, the shareholders must bring a derivative

143. *See infra* Section II.D.

144. WIS. STAT. § 183.1101(1) (2019–20).

145. *See id.* §§ 183.0305(2), 183.1101(1).

146. *See* UNIF. LTD. LIAB. CO. ACT § 802 (2006) (UNIF. L. COMM'N, amended 2013).

147. *Id.* § 109.

148. BOUCHER ET AL., *supra* note 2, § 4.95.

149. *See Marx v. Morris*, 925 N.W.2d 112, 116 (Wis. 2019).

150. *Id.* at 116–17, 121 n.18.

151. *Id.* at 116, 119.

152. *Id.* at 123.

action.[153] The majority stated that Chapter 183, by contrast, lacks similar procedures limiting actions for harm to the LLC.[154]

The majority's reliance on the lack of explicit statutory language limiting member-brought actions to derivative actions is misguided. In *Tzolis v. Wolff*,[155] New York's highest court held that LLC members can bring derivative actions on behalf of an LLC even though the state LLC act did not mention derivative suits.[156] In facts similar to those in *Marx*, the plaintiff LLC members alleged that "those in control of the LLC" first leased and then sold an apartment building, the LLC's main asset, for below fair market value, personally benefiting company fiduciaries.[157]

The *Tzolis* court cited two primary reasons for its decision.[158] First, the legislative history revealed no evidence that the legislature intended to prohibit derivative suits in LLCs.[159] Second, the court cited "the long-recognized importance of the derivative suit in corporate law."[160] Because the legislature drafted provisions explicitly authorizing derivative actions that ultimately were omitted from the state LLC act, a dissenting opinion concluded that LLC members did not have the right to sue derivatively.[161] The majority, however, did not consider statutory authorization necessary. The majority noted that in New York, caselaw, and not a statute, initially created the derivative action as an equitable means of recourse for shareholders harmed by management betrayal.[162] Today, as then, "[w]hen fiduciaries are faithless to their trust, the victims must not be left wholly without a remedy," the court wrote.[163] Thus, because derivative actions are equitable, courts need not locate explicit statutory authorization to allow them.

Even if statutory authority were necessary to permit derivative actions for harm to an LLC, Chapter 183 provides such authority,[164]

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153. *Id.* at 123–24 (citing *Rose v. Schantz*, 201 N.W.2d 593, 597–98 (Wis. 1972); *Notz v. Everett Smith Grp., Ltd.*, 764 N.W.2d 904, 910 (Wis. 2009)).

154. *Marx*, 925 N.W.2d at 124. This is apparently an about-face. Fourteen years earlier, Justice Roggensack, author of the majority opinion in *Marx*, wrote in a concurrence that "[n]ot every member of a limited liability company has the right to bring an action in the name of the limited liability company," citing Wisconsin Statute Section 183.0305 and the requirements of Section 183.1101, and that "[t]he concept of derivative claims has been engrafted into the law of limited liability companies," citing Section 183.1101. *Gottsacker v. Monnier*, 697 N.W.2d 436, 447–48, 448 n.4 (2005) (Roggensack, J., concurring).

155. 884 N.E.2d 1005 (N.Y. 2008).

156. *Id.* at 1005.

157. *Id.* at 1006.

158. *Id.*

159. *Id.* at 1008–10.

160. *Id.* at 1006.

161. *Id.* at 1011–13, 1019 (Read, J., dissenting).

162. *Id.* at 1006.

163. *Id.* at 1007.

164. *See* WIS. STAT. § 183.1101(1) (2019–20).

contrary to the *Marx* majority's conclusion that derivative principles do not apply to this business form.[165] According to Wisconsin Statute Section 183.0305, an LLC member "is not a proper party to a proceeding by" an LLC except, in relevant part, if the member brings an action under Section 183.1101.[166] Under Section 183.1101, the default rule is that LLC members can bring "an action on behalf of a limited liability company . . . in the name of the limited liability company," regardless of whether the LLC is member-managed or manager-managed, if authorized by a majority vote of disinterested members.[167] If the action is successful, the LLC recovers, but the member bringing suit may be awarded expenses such as attorney fees.[168] Because Section 183.1101 presents a default rule, members may agree to a different mechanism for authorizing derivative actions or, theoretically at least, prohibit derivative actions entirely.[169]

The *Marx* dissent correctly pointed to these provisions as expressing principles of derivative standing.[170] By contrast, the *Marx* majority made no mention of Section 183.0305 and opined that Section 183.1101 simply outlines the default rule for what must occur if any lawsuit will be brought in the LLC's name.[171] But that is inaccurate. Rather, Section 183.1101 applies only to actions members bring on the LLC's behalf. Section 183.1101 is titled, "Authority to sue *on behalf of* limited liability company"[172] and pertains only to actions brought in the LLC's name "by one or more members."[173] And as previously noted, a Wisconsin LLC generally is assumed to be able to sue and be sued; thus, the LLC itself can sue without resorting to the member-driven Section 183.1101 mechanism.[174] Thus, Section 183.1101 applies specifically to actions that members bring on the LLC's behalf.

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165. *See Marx v. Morris*, 925 N.W.2d 112, 116 (Wis. 2019).

166. § 183.0305(2). Another exception provides that members are proper parties to litigation brought by or against the LLC to enforce their rights against it or their liability to it. *Id.* § 183.0305(1). Although this particular exception may affect who is a proper defendant, it does not address a plaintiff member's standing to sue on the LLC's behalf. *See Marx*, 925 N.W.2d at 134 (Kelly, J., concurring in part and dissenting in part).

167. § 183.1101(1); *see also id.* § 183.0404(1)(a).

168. *See id.* § 183.1101(4) ("[T]he court may award the member bringing the action reasonable expenses, including reasonable attorney fees, from any recovery in the action or from the limited liability company.").

169. *See id.* § 183.1101 (authorizing LLC members to bring actions on behalf of a limited liability company, if authorized by a majority vote of disinterested members, "[u]nless otherwise provided in an operating agreement").

170. *Marx*, 925 N.W.2d at 134–35 (Kelly, J., concurring in part and dissenting in part).

171. *Id.* at 124.

172. § 183.1101 (emphasis added).

173. *Id.* § 183.1101(1).

174. BOUCHER ET AL., *supra* note 2, § 4.95.

Absent a different mechanism in an operating agreement, this statutory mechanism provides the only way for members to bring an action to redress harm to the LLC, assuming the LLC itself does not sue. For manager-managed LLCs, the Section 183.1101 mechanism functions like a corporate derivative action, as it gives members—who, like corporate shareholders, do not have agency authority when the LLC is manager-managed[175]—a way to sue on the LLC's behalf without the managers' authorization.[176] Chapter 183's provision for recovery by the LLC when a member uses the Section 183.1101 mechanism likewise makes the mechanism look like a derivative action.[177] For member-managed LLCs, the Section 183.1101 mechanism operates like a usual majority member vote to approve an action by the LLC but with the exclusion of conflicted members, because members in member-managed LLCs do have agency authority.[178] Thus, to redress harm to the LLC, there are only two options: either the LLC itself sues or the disgruntled member uses the Section 183.1101 mechanism.

Adopting RULLCA would help clarify that members can bring derivative actions, but courts must recognize that this is the only pathway by which members can sue for harm to the LLC if the LLC itself does not sue. The simple fact that RULLCA calls these "derivative actions" helps.[179] In *Marx*, the majority and dissent disputed whether Chapter 183 contained principles of derivative standing.[180] Chapter 183 does not use the word "derivative" at all, contributing to this confusion.[181] In addition, while current Section 183.1101 is a default provision that members can contract around,[182] RULLCA provides that an LLC operating agreement

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175. § 183.0301(2)(a) (providing that in manager-managed LLCs, members are not agents of the LLC).

176. *Compare id.* § 183.1101(1) (permitting LLC members to sue on the LLC's behalf if authorized by a majority vote of disinterested members), *with id.* § 180.0742 (permitting corporate shareholders to sue derivatively if the corporation rejects or does not timely respond to the shareholder's written demand that the corporation take action).

177. *See id.* § 183.1101(4) ("[T]he court may award the member bringing the action reasonable expenses, including reasonable attorney fees, from any recovery in the action or from the limited liability company.").

178. *See id.* § 183.0301(1)(a) (providing that in member-managed LLCs, members are agents of the LLC).

179. UNIF. LTD. LIAB. CO. ACT § 802 (2006) (UNIF. L. COMM'N, amended 2013).

180. *Compare Marx v. Morris*, 925 N.W.2d 112, 124 (Wis. 2019) ("We will not judicially import ch. 180's corporate derivative standing provisions into the LLC context where the legislature has not done so."), *with id.* at 137 (Kelly, J., concurring in part and dissenting in part) ("[T]he court erred when it refused to inquire into who owns which claims out of a fear it would be judicially importing the derivative standing concept. The concept is already there, and not by our hand.").

181. *See* WIS. STAT. ch. 183.

182. *See id.* § 183.1101(1) (providing that LLC members may bring an action on behalf of the LLC, if approved by a majority vote of disinterested members, "[u]nless otherwise provided in an operating agreement").

must not "unreasonably restrict the right of a member to maintain an action under [Article] 8."[183]

However, RULLCA's prohibition on members pursuing methods other than derivative actions to redress harm to the LLC is implied rather than explicit, which could tempt courts to inappropriately permit members to bring individual claims for harm to the LLC, as the *Marx* majority did. Article 8, "Actions by Members," describes only two types of actions by members.[184] One, a "Direct action by member," is the means by which members may sue the LLC, a manager, or another member "to enforce the member's rights and protect the member's interests."[185] The other, a "Derivative action," is the means by which members may sue "to enforce a right of a limited liability company."[186] Between the two, they encompass the entire universe of harm to the LLC that a member may redress—harm to the member (direct action) and harm to the LLC (derivative action). Thus, the implication is that members may not bring individual claims to redress harm to the LLC; they must sue derivatively and follow the required procedures.[187]

Although it seems clear that Article 8 describes the two exclusive types of actions that members can bring to redress harm to the LLC or its members, courts must recognize that these are the only pathways by which members may sue to redress such harm. Like RULLCA, the Wisconsin corporation statutes addressing derivative actions do not explicitly prohibit shareholders from bringing other actions to redress internal harm to the corporation.[188] Instead, it took court decisions to clarify that point.[189] Therefore, although RULLCA does not make explicit its prohibition against members suing to enforce the LLC's rights except through a derivative action,[190] courts should interpret this prohibition as absolute.

183. UNIF. LTD. LIAB. CO. ACT § 105(c)(11). *See also* LTD. LIAB. CO. COMM., STATE BAR OF WIS., *supra* note 14, at 17 ("[U]nder the proposed bill, there is less flexibility in terms of limiting a member's right to bring a derivative action.").

184. UNIF. LTD. LIAB. CO. ACT art. 8.

185. *Id.* § 801(a).

186. *Id.* § 802.

187. *See id.* (specifying that the member must first demand that the managers, if the LLC is manager-managed, or the other members, if the LLC is member-managed, make the LLC sue to enforce that right unless such a demand would be futile).

188. *See* WIS. STAT. §§ 180.0740–.0747 (2019–20).

189. *See Marx v. Morris*, 925 N.W.2d 112, 123–24 (Wis. 2019) (citing *Rose v. Schantz*, 201 N.W.2d 593, 597–98 (Wis. 1972); *Notz v. Everett Smith Grp., Ltd.*, 764 N.W.2d 904, 910 (Wis. 2009)).

190. *See* UNIF. LTD. LIAB. CO. ACT § 802.

D. Why Distinguish Direct from Derivative Claims?

Given the close connection between the fortunes of the LLC and its members, why is it necessary to distinguish direct from derivative claims? The *Marx* majority's failure to distinguish between claims for harm to the LLC and harm to the members leads to inaccurate and potentially unjust results, confusion, and practical problems. The dissent recognized the importance of making this distinction but used the wrong rule, also leading to incorrect and potentially unjust conclusions. Distinguishing between direct and derivative claims is important because the type of claim determines who can sue, which procedures the parties must follow, who can recover, and whether the member may be awarded costs.[191]

The *Marx* majority did not distinguish between claims for harm to the LLC and claims for harm to the members, instead concluding that LLC members have standing to bring individual claims for "harm to the members *or* harm to the LLC."[192] The majority emphasized that injuries to an LLC and injuries to members are not "mutually exclusive."[193] In corporations, gains and losses do not flow through to the shareholders.[194] But in LLCs, which are usually subject to pass-through taxation, gains and losses flow through to the members, affecting their capital accounts and tax returns.[195] Thus, the court wrote, "there is generally a much closer financial connection between harm to an LLC and harm to its members than between harm to a corporation and harm to its shareholders."[196] To have standing to sue, plaintiffs need allege only "an injury to an interest that is legally protectable."[197] Finding that the plaintiffs alleged such an injury, the court held that they had standing, regardless of whether North Star also was injured.[198]

The majority's failure to distinguish between claims for harm to the LLC and claims for harm to the members is problematic for three reasons. First, profit distribution and taxation election should not determine standing in LLCs, as the dissent correctly opined.[199] Despite being subject to pass-through taxation by default, LLCs can elect entity-level taxation.[200] Thus, as Justice Kelly wrote, "the manner in which a member experiences harm to his LLC is not cognizably different from the manner in which a

191. *See* Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 70–71 (2006).

192. *Marx*, 925 N.W.2d at 116 (emphasis added).

193. *Id.* at 125.

194. *Id.*

195. *Id.* at 125–26.

196. *Id.* at 126.

197. *Id.* (quoting *Krier v. Vilione*, 766 N.W.2d 517, 524 (Wis. 2009)).

198. *Id.* at 126.

199. *Id.* at 136 (Kelly, J., concurring in part and dissenting in part).

200. Treas. Reg. § 301.7701-3(a) (2020).

shareholder experiences harm to his corporation, so long as they make the same tax election."[201] In addition, under the majority's reasoning, what could stop a member's spouse from suing if the LLC is taxed as a pass-through entity and the member and their spouse file a joint tax return?[202] The majority's emphasis on taxation status was so misguided, the Wisconsin bills proposing to adopt RULLCA added a provision that does not appear in the model code: Section 183.0104(2m) would clarify that an LLC's taxation status has no impact on the governing law that applies to an LLC's internal affairs or its members' liability.[203]

Second, by allowing members to sue directly for harm to the LLC, the decision raises questions about who can recover in such cases—the aggrieved members or the LLC.[204] As the dissent noted, if the plaintiffs were to obtain damages representing the difference between Westar's fair market value and the price DSJ Holdings paid for it, it would seem unfair to the other members to let Fracsand and Management Funds (and Marx and Murray, under the court's incorrect holding that they had standing) be the only ones to recover.[205] This misdistribution would cause injustice for the LLC and other potential plaintiffs (i.e., the other members).

In addition, duplicate recoveries could result if North Star also sued, causing injustice to the defendants. Other doctrines exist to prevent duplicate recoveries, but they are insufficient by themselves to address these problems in LLCs. For example, claim preclusion (formerly called res judicata) has three elements: (1) the identities of the parties, or those in privity with them, must be the same in the earlier and the current suit; (2) the causes of action must be the same in both suits; and (3) the judgment must be final.[206] This invites judicial inquiry into who the parties were in each suit, whether they were in privity, and whether the causes of action were the same, among other matters. Issue preclusion, formerly called collateral estoppel, has cast off "[f]ormalistic requirements . . . in favor of a looser, equities-based interpretation of the doctrine."[207] This invites judicial exercise of equitable discretion. Claim preclusion and issue preclusion are important backstops, but it is far preferable to ensure that the correct parties bring their claims in the proper manner the first time.

201. *Marx*, 925 N.W.2d at 136 (Kelly, J., concurring in part and dissenting in part).

202. *See* I.R.C. § 6013(a) (providing that with some exceptions, spouses "may make a single return jointly of income taxes").

203. *See* Assemb. B. 566, 2021–22 Leg., Reg. Sess. (Wis. 2021); S. B. 566, 2021–22 Leg., Reg. Sess. (Wis. 2021); *see also* LTD. LIAB. CO. COMM., STATE BAR OF WIS., *supra* note 14, at 4.

204. *See Marx*, 925 N.W.2d at 136 (Kelly, J., concurring in part and dissenting in part).

205. *Id.* at 136 (Kelly, J., concurring in part and dissenting in part).

206. *N. States Power Co. v. Bugher*, 525 N.W.2d 723, 727–28 (Wis. 1995).

207. *Sumpter ex rel. Michelle T. v. Crozier*, 495 N.W.2d 327, 330 (Wis. 1993).

Thus, the *Marx* majority's holding opens the door to unjust and impractical recoveries.

Third, by allowing members to sue for harm to North Star without joining it or otherwise giving North Star a say in whether and how litigation to redress harm to it should proceed, the majority's decision also eviscerated the LLC's right to control such litigation, Justice Kelly added.[208] He continued, "[u]nder the court's new paradigm, a cause of action belongs to the first person to grab it."[209] The majority did not explain how courts should resolve questions of recovery or the LLC's right to participate in litigation to redress harm to it in this case or in future cases. In addition, distinguishing claims for harm to the LLC from claims for harm to the members would have revealed that some claims were for harm to the LLC and thus could not be brought directly by the members, much less those members' owners.[210] As a result, the decision allowed Fracsand and Management Funds (as well as Marx and Murray) to unjustly assert legal rights belonging to another—namely, North Star.[211]

E. Direct Harm: The Proper Method of Distinguishing Direct from Derivative Claims

Given the importance of distinguishing direct from derivative claims, how can courts sort one from the other? Although the special injury rule reflects one approach, the proper method is the direct harm approach.[212] Although RULLCA's provision on this point reflects the direct harm approach, an easier way to think about it is in terms of which injury occurs first—the injury to the member or the injury to the LLC?[213] Thus, to distinguish direct from derivative claims, courts should determine who was injured first.[214]

The direct harm approach more accurately reflects whose rights, those of the LLC or the member, the defendants infringed. Under the direct harm approach, "[a]n individual cause of action exists only if damages to the shareholders were not incidental to damages to the corporation."[215]

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208. *See Marx*, 925 N.W.2d at 136–37 (Kelly, J., concurring in part and dissenting in part).

209. *Id.* at 137 (Kelly, J., concurring in part and dissenting in part).

210. *See infra* Part III.

211. *See Foley-Ciccantelli v. Bishop's Grove Condo. Ass'n*, 797 N.W.2d 789, 804–05 (Wis. 2011) (quoting *Haberman v. Wash. Pub. Power Supply Sys.*, 744 P.2d 1032, 1055 (Wash. 1987)) (explaining that standing doctrine precludes parties from "raising another's legal rights").

212. *See* Kleinberger, *supra* note 191, at 65, 88.

213. *See Agostino v. Hicks*, 845 A.2d 1110, 1121–22 (Del. Ch. 2004); *see also* Kleinberger, *supra* note 191, at 88.

214. *See* Kleinberger, *supra* note 191, at 88.

215. *Schuster v. Gardner*, 25 Cal. Rptr. 3d 468, 474 (Ct. App. 2005).

Thus, if the injury the owner suffered depends on a "prior injury" to the business entity, the claim is derivative; if it does not, the claim is direct.[216] In other words, the direct harm approach "asks: who got hurt first—the entity or its owner(s)?"[217] For example, under a direct harm analysis, claims for diminution in value because of mismanagement are derivative because the owner's diminution in value stems from a prior injury to the business entity.[218] By contrast, infringement of owners' voting rights, whether it affects one owner or all of them, is a direct claim because harm to the voting rights occurs before any resulting harm to the business entity.[219]

Under the special injury rule, an aggrieved owner may bring a direct claim instead of a derivative claim only if they have experienced an "injury distinct from that suffered by other shareholders"; absent such a showing, the claim must be brought derivatively.[220] In 2004, Delaware, initially an adherent of the special injury rule, discarded it in favor of the direct harm rule.[221] The special injury rule, the Delaware Supreme Court opined, "is not helpful to a proper analytical distinction between direct and derivative actions."[222] The special injury rule is inferior because when applying it strictly, courts may require owners to sue derivatively when they allege injuries that clearly harmed them first, such as infringement of voting rights, improper dilution, and failure to provide required information, merely because others shared the same fate.[223] Professor Kleinberger attributes this confusion to a logical error: although it may be true that indirect injuries to owners are necessarily shared by all owners, that does not mean that the reverse is true—that if all owners experienced the same injury, it must have been indirect.[224]

As previously discussed, the *Marx* majority did not distinguish direct from derivative claims because it conflated claims for harm to the LLC with claims for harm to members.[225] Having concluded that Chapter 183 already contains principles of derivative standing, Justice Kelly wrote that the court should have determined who—the LLC or its members—owned which claims.[226] To solve this puzzle, he advocated applying the special

216. *See Agostino*, 845 A.2d at 1121–22.
217. Kleinberger, *supra* note 191, at 88.
218. *See id.* at 89.
219. *See id.* at 98.
220. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1069–70 (Del. Ch. 1985).
221. *See Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1038–39 (Del. 2004).
222. *Id.* at 1035.
223. *See* Kleinberger, *supra* note 191, at 99–100.
224. *Id.* at 103.
225. *See supra* Section II.D.
226. *Marx v. Morris*, 925 N.W.2d 112, 137 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part).

injury rule[227] and ultimately arrived at some incorrect conclusions. For each of the five claims brought in *Marx*, Part III contrasts the dissent's approach with the direct harm approach.

Although RULLCA's provisions on this point reflect the direct harm approach, an easier way of thinking about the issue (but one that is still analytically correct) is to ask which injury occurred first, the injury to the member or the injury to the LLC.[228] The provision addressing derivative actions states that members may bring such actions "to enforce a right of a limited liability company."[229] By contrast, the provision addressing direct actions by members states that members bringing such actions "must 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."[230] Thus, RULLCA focuses on the line between harm to the LLC and independent harm to the member, as the direct harm approach does,[231] rather than the line between harm to the plaintiffs and harm to the other members, as the special injury rule does.[232] However, thinking about who suffers the prior injury makes the direct harm approach easier to conceptualize and apply. In other words, if the injury the owner suffered depends on a "prior injury" to the business entity, the claim is derivative; if it does not, the claim is direct.[233] Thus, when distinguishing direct from derivative claims, courts should determine who was injured first.[234]

227. Although the dissent refers to the "primary injury" rule, the dissent's characterization of it is essentially the special injury rule: "The cause of action belongs to the company's owner, as opposed to the company itself, if the injury is 'primarily . . . to an individual shareholder [or member] . . . .' And the injury is primarily to the individual if it 'affects a shareholder's [or member's] rights in a manner distinct from the effect upon other shareholders [or members] . . . .'" *Id.* at 133 (Kelly, J., concurring in part and dissenting in part) (quoting *Notz v. Everett Smith Grp., Ltd.*, 764 N.W.2d 904, 911 (Wis. 2009) (quoting *Jorgensen v. Water Works, Inc.*, 630 N.W.2d 230, 235 (Wis. Ct. App. 2001)) (citation omitted).

228. *See Agostino v. Hicks*, 845 A.2d 1110, 1121–22 (Del. Ch. 2004); Kleinberger, *supra* note 191, at 88.

229. UNIF. LTD. LIAB. CO. ACT § 802 (2006) (UNIF. L. COMM'N, amended 2013).

230. *Id.* § 801(b).

231. *Schuster v. Gardner*, 25 Cal. Rptr. 3d 468, 474 (Ct. App. 2005) ("An individual cause of action exists only if damages to the shareholders were not *incidental* to damages to the corporation.").

232. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985) (providing that an aggrieved owner may bring a direct claim only if they have experienced "an injury which is separate and distinct from that suffered by other shareholders").

233. *See Agostino*, 845 A.2d at 1121–22.

234. *See* Kleinberger, *supra* note 191, at 88.

III. THE *MARX* CLAIMS: DIRECT OR DERIVATIVE?

To determine whether Fracsand and Management Funds had standing to bring their five claims, the *Marx* court first should have decided whether each claim was direct or derivative, as the dissent did.[235] However, many of the dissenting opinion's conclusions were incorrect because the dissent employed the special injury rule.[236] This Part classifies each of the *Marx* claims as direct or derivative using the direct harm rule, proceeding claim by claim.

Under the direct harm approach, the plaintiffs' claims for violation of Wisconsin Statute Section 183.0402 and breach of fiduciary duties were derivative to the extent that they alleged diminution in value but direct to the extent that they alleged infringement of voting rights. Their claims for unjust enrichment and breach of fiduciary duty as North Star's counsel were derivative. More information would be necessary to determine whether Fracsand and Management Funds could bring the claim for breach of the implied covenant of good faith and fair dealing as a direct claim. After making these determinations, the court should have allowed Fracsand and Management Funds to pursue the direct claims but barred them from bringing the derivative claims because they did not follow the proper procedural mechanisms.

A. Violation of Wisconsin Statute Section 183.0402 and Breach of Fiduciary Duties

The claims for violation of Wisconsin Statute Section 183.0402 and breach of fiduciary duties were derivative to the extent that they alleged diminution in value. Accordingly, the plaintiffs could not bring them without using the Section 183.1101 mechanism. But the claims for violation of Wisconsin Statute Section 183.0402 and breach of fiduciary duties were direct to the extent that they alleged infringement of voting rights, enabling Fracsand and Management Funds to pursue them. However, the record before the court did not illuminate to what extent, if any, the claims for breach of common-law fiduciary duties simply reiterated the Section 183.0402 claims or alleged anything beyond what the statute covers.[237] Thus, although many claims for breach of fiduciary

235. *See Marx v. Morris*, 925 N.W.2d 112, 137–39, 141–42 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part). Although the dissenting opinion frequently characterized this analytical step as "determining who owns the causes of action," it recognized that the question was one of distinguishing direct from derivative claims. *See id.* at 132, 134–35 (Kelly, J., concurring in part and dissenting in part).

236. *See id.* at 133 (Kelly, J., concurring in part and dissenting in part).

237. *Id.* at 127.

duties are derivative, courts should consider to what extent such allegations raise the potential for a direct claim.

Regarding the alleged violation of Wisconsin Statute Section 183.0402, the *Marx* dissent concluded that this claim was derivative, with the exception that Fracsand and Management Funds could recover for lack of notice of the vote to sell Westar, but only to the extent that they suffered injuries distinct from the other members.[238] The dissent addressed aspects of this claim alleging diminution in value and aspects alleging infringement of voting rights. First, to the extent that the plaintiffs alleged a claim for diminution in an LLC's value stemming from a conflicted sale, such a claim was derivative, the dissent concluded.[239] Such a claim "describes a classic derivative injury," the dissent reasoned, because the injury does not affect the complaining members any differently from the other members.[240]

The dissent was correct that claims for diminution in value are derivative, but for the wrong reasons. Under the proper approach (a direct harm approach), a claim for diminution in value because of poor management decisions is a derivative claim because the business entity experiences the prior injury.[241] In LLCs, this is because the LLC first experiences profit or loss, which is then allocated to the members.[242] The dissent's special injury approach simply aligned with the *accurate* half of the logical error that Professor Kleinberger noted: it is true that indirect injuries to owners are necessarily shared by all owners.[243]

Second, noting that Wisconsin courts previously had determined that plaintiffs can bring direct claims for infringement of an individual right of a shareholder—including voting rights specifically—the dissent determined that Fracsand and Management Funds could bring a direct claim for infringement of their voting rights.[244] However, employing the special injury rule, the dissent concluded that these two plaintiffs could recover for infringement of their voting rights only to the extent that the injuries they experienced from that lack of notice fell differently on them than on the other members.[245]

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238. *Id.* at 142 (Kelly, J., concurring in part and dissenting in part).

239. *Id.* at 138 (Kelly, J., concurring in part and dissenting in part).

240. *Id.* (Kelly, J., concurring in part and dissenting in part).

241. *See* Kleinberger, *supra* note 191, at 89.

242. *See* WIS. STAT. § 183.0503 (2019–20) ("The profits and losses of a limited liability company shall be allocated among the members in the manner provided in an operating agreement.").

243. Kleinberger, *supra* note 191, at 103.

244. *Marx*, 925 N.W.2d at 138–39, 142 (Kelly, J., concurring in part and dissenting in part) (citing *Rose v. Schantz*, 201 N.W.2d 593, 597 (Wis. 1972); *Ewer v. Lake Arrowhead Ass'n*, 817 N.W.2d 465, 475 (Wis. Ct. App. 2012)).

245. *Id.* at 138–39, 142 (Kelly, J., concurring in part and dissenting in part).

The dissent was correct that a claim for infringement of voting rights is a direct claim, but the plaintiffs did not have to show that they suffered harm different from the harm to the other members. Under a direct harm approach, infringement of owners' voting rights, whether it affects only some owners or all of them, is a direct claim because harm to the voting rights occurs before any resulting harm to the business entity.[246] The dissent's special injury approach illustrates the *inaccurate* half of the logical error that Professor Kleinberger noted: the fact that indirect injuries to owners are shared by all owners does not mean that if all owners experienced the same injury, it must have been indirect.[247] Under the special injury rule, Fracsand and Management Funds thus would have essentially been barred from bringing direct claims to vindicate their voting rights simply because *all* the members experienced harm in the same way.[248] Had one of the other members received proper notice, could Fracsand and Management Funds have brought a direct claim? Why should that make any difference?

Such a result is nonsensical and unjust. Tellingly, several courts that otherwise use the special injury rule have developed a "work around" for claims of infringement of voting rights.[249] By classifying voting rights as contractual instead of as aspects of the owner's interest in the business entity, the "work around" lets owners bring direct claims for infringement of voting rights.[250] These courts often view violation of contractual rights as an alternative to the usual special injury standard for bringing direct claims.[251]

But if violation of a contractual right is "direct" enough to warrant a carve-out from the usual rule, why not instead use a rule that better gets at the underlying rationale for distinguishing direct from derivative claims? The direct harm approach does this not by considering differences among the harms that the owners suffered but by considering differences between the harm that the member suffered and the harm that the entity suffered.[252] The latter is, essentially, the distinction between a direct and a derivative

246. *See* Kleinberger, *supra* note 191, at 98.

247. *See id.* at 103.

248. *See Marx*, 925 N.W.2d at 138 (Kelly, J., concurring in part and dissenting in part).

249. Kleinberger, *supra* note 191, at 98.

250. *Id.*

251. *See, e.g.*, *In re Tri-Star Pictures, Inc.*, 634 A.2d 319, 330 (Del. 1993) ("A special injury is established where there is a wrong suffered by plaintiff that was not suffered by all stockholders generally *or where the wrong involves a contractual right of the stockholders, such as the right to vote*.") (emphasis added).

252. *Compare id.* ("A special injury is established where there is a wrong suffered by plaintiff that was not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote."), *with Agostino v. Hicks*, 845 A.2d 1110, 1122 (Del. Ch. 2004) ("[T]he inquiry should focus on whether an injury is suffered by the shareholder that is not dependent on a prior injury to the corporation.").

action.[253] The voting rights issue in *Marx* illustrates how a direct harm approach would avoid injustice and ease application by better reflecting this distinction. The question of whether the voting rights infringement harmed the members or the LLC first is much more germane to whether the members are asserting their own or the LLC's rights than is the question of whether all members suffered the same harm to their voting rights.

B. Unjust Enrichment

The plaintiffs' claim for unjust enrichment was derivative. In Wisconsin, a plaintiff has a potential claim for unjust enrichment when the plaintiff confers a benefit on the defendant and the defendant knowingly accepts or retains the benefit but does so "under circumstances making it inequitable to do so."[254] In *Marx*, the plaintiffs alleged that the defendants knowingly obtained a benefit (Westar) from some potential plaintiff (arguably Fracsand and Management Funds, but more likely North Star) that the defendants then inequitably retained.[255]

The *Marx* dissent correctly concluded that this claim was derivative.[256] However, the dissent again erred by invoking the special injury rule. The dissent opined that "[i]f the enrichment was unjust, then it was an unjustness suffered in like kind by all of North Star's members."[257] Any ill-gotten funds were rightfully North Star's, Justice Kelly wrote, so letting only Fracsand and Management Funds recover would enrich them at the other members' expense.[258] The dissent again had it backward: just because indirect injuries to owners are shared by all owners does not mean that if all owners experienced the same injury, it must have been indirect.[259]

The dissenting opinion's emphasis on funds gets closer to the heart of the issue than its focus on the uniformity of harm to the members. Westar belonged to North Star, so the economic harm from losing Westar first occurred to North Star, which the members then experienced as a

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253. *Compare* UNIF. LTD. LIAB. CO. ACT § 801(a) (2006) (UNIF. L. COMM'N, amended 2013) (providing that a member may bring a direct action "to enforce the member's rights and protect the member's interests"), *with id.* § 802 (providing that a member may bring a derivative action "to enforce a right of a limited liability company").

254. *Sands v. Menard*, 904 N.W.2d 789, 798 (Wis. 2017).

255. *Marx v. Morris*, 925 N.W.2d 112, 139 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part).

256. *Id.* at 139 (Kelly, J., concurring in part and dissenting in part).

257. *Id.* (Kelly, J., concurring in part and dissenting in part).

258. *Id.* (Kelly, J., concurring in part and dissenting in part).

259. *See* Kleinberger, *supra* note 191, at 103.

loss.[260] The order in which the harms occurred pertains more to whether the action seeks to "enforce the member's rights and protect the member's interests"[261] or "enforce a right of a limited liability company"[262] than does the uniformity of harm to the members. Thus, the unjust enrichment claim was derivative, and Fracsand and Management Funds could not bring the claim without using the Section 183.1101 mechanism. Although this claim was derivative under either analysis, the direct harm approach arrives at the correct conclusion in a way that is more logically sound.

C. Breach of the Implied Covenant of Good Faith and Fair Dealing

More information would have been necessary to determine whether Fracsand and Management Funds could bring the claim for breach of the implied covenant of good faith and fair dealing as a direct claim. Such claims are contract-based, and the operating agreement in *Marx* was a contract among North Star's members.[263] However, plaintiffs might or might not be able to bring a claim for breach of an LLC operating agreement as a direct claim, depending on the facts.

The implied covenant of good faith and fair dealing attaches to every contract.[264] As an agreement among the members of an LLC, an operating agreement is a contract.[265] A claim for breach of agreement among the owners of a business entity is direct when the breach directly causes injury to an owner, such as when the agreement guarantees a particular owner a certain percentage of the distributions but that owner does not receive the agreed-to percentage. However, the claim is derivative when the prior harm is to the business and the value of the ownership interest simply decreases as a result.[266]

In *Marx*, the majority did not elucidate the allegations underlying this claim. The dissent briefly stated that the plaintiffs argued that the law implies the covenant of good faith and fair dealing into North Star's operating agreement and that the defendants breached this covenant by selling Westar for inadequate consideration.[267] Noting that this was the same injury as in the claims for violation of Wisconsin Statute Section

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260. *See* WIS. STAT. § 183.0503 (2019–20) ("The profits and losses of a limited liability company shall be allocated among the members in the manner provided in an operating agreement.").

261. UNIF. LTD. LIAB. CO. ACT § 801(a) (2006) (UNIF. L. COMM'N, amended 2013).

262. *Id.* § 802.

263. *See* WIS. STAT. § 183.0102(16) (2019–20) (defining "operating agreement").

264. *See Chayka v. Santini*, 176 N.W.2d 561, 564 n.7 (Wis. 1970).

265. *See* § 183.0102(16).

266. *See id.*

267. *Marx v. Morris*, 925 N.W.2d 112, 139 (Wis. 2019) (Kelly, J., concurring in part and dissenting in part).

183.0402 and unjust enrichment, the dissent concluded, without further analysis, that the claim was derivative.[268]

More analysis of the allegations may have yielded the same result or perhaps a different one. If the alleged manner of the breach was simply the sale of Westar for inadequate consideration, Fracsand and Management Funds could not have sued directly because the prior harm was to the business. But if Fracsand and Management Funds alleged that they suffered any direct injury from a breach of the implied covenant of good faith and fair dealing, they could have sued directly. The dissent's disregard of the latter possibility again shows the injustice of the special injury rule, especially when unmodified by the "contractual rights" work-around.[269] The direct harm approach, by contrast, more effectively distinguishes between direct actions, which safeguard the member's rights and interests,[270] and derivative actions, which enforce the LLC's rights.[271]

D. Breach of Fiduciary Duty as North Star's Counsel

The plaintiffs claimed that Morris breached his fiduciary duties as North Star's counsel. But instead of alleging that Morris breached his fiduciary duties as counsel to North Star, they alleged that Morris breached his fiduciary duties—in his capacity as North Star's counsel—to *them*.[272] But if Morris breached any of his duties as an attorney, he breached his duties to North Star.[273] No one could have brought a claim for breach of Morris's lawyerly fiduciary duties to North Star's members because he did not owe them any such duties. To bring a claim against Morris as counsel for breach of fiduciary duties, Fracsand and Management Funds should have had to characterize the claim as a breach of fiduciary duties to North Star and sue derivatively.

In this claim, the plaintiffs alleged that because Morris was also North Star's counsel, he owed fiduciary duties to the LLC's members.[274] Here, the dissent did not invoke the special injury rule. Instead, the dissent focused on the exclusive nature of the lawyer-client relationship and the

268. *See id.* (Kelly, J., concurring in part and dissenting in part).

269. *See, e.g.*, *In re Tri-Star Pictures, Inc.*, 634 A.2d 319, 330 (Del. 1993) ("A special injury is established where there is a wrong suffered by plaintiff that was not suffered by all stockholders generally *or where the wrong involves a contractual right of the stockholders, such as the right to vote*.") (emphasis added).

270. *See* UNIF. LTD. LIAB. CO. ACT § 801(a) (2006) (UNIF. L. COMM'N, amended 2013).

271. *See id.* § 802.

272. *Marx*, 925 N.W.2d at 141 (Kelly, J., concurring in part and dissenting in part).

273. *See id.* at 141–42 (Kelly, J., concurring in part and dissenting in part).

274. *Id.* at 141 (Kelly, J., concurring in part and dissenting in part).

fiduciary duties that attend it.[275] The dissent noted that Morris owed North Star fiduciary duties because the lawyer-client relationship is a fiduciary relationship.[276] However, a lawyer who performs legal services for a business entity represents the entity, not its owners, the dissent observed.[277] Therefore, the dissent concluded Morris owed lawyerly fiduciary duties only to North Star and not to its members.[278]

The dissent's analysis is correct. However, the direct harm approach is again instructive—this time not in distinguishing whether a particular, potentially valid claim is direct or derivative but in revealing why this claim, as the plaintiffs characterized it, is totally impermissible. The plaintiffs tried to avoid their claim being characterized as obviously belonging to North Star by inventing a new type of claim altogether.[279] And they succeeded, at least at the Wisconsin Supreme Court.[280]

If Morris breached any of his duties as an attorney, he breached his duties to North Star for the reasons the dissent discussed.[281] Under the direct harm approach, a claim for breach of a lawyer's fiduciary duties to their client business entity is clearly a derivative claim because the breach first harms the business.[282] Any repercussions for the owners flow from that breach.[283] By characterizing their claim as they did, the plaintiffs produced from their imaginations a separate set of fiduciary duties flowing from Morris to *them*.[284] They did this so that they could sue directly. But ultimately, the harm that they suffered occurred after and as a result of the breach to the client, North Star. As it is, no one could have brought a claim for breach of Morris's lawyerly fiduciary duties to North Star's *members* because he did not owe them any such duties. To bring a claim against Morris as counsel for breach of fiduciary duties, Fracsand and

275. *Id.* at 141–42 (Kelly, J., concurring in part and dissenting in part).

276. *Id.* at 142 (Kelly, J., concurring in part and dissenting in part) (citing *In re Bd. of L. Exam'rs*, 210 N.W. 710, 711 (Wis. 1926)).

277. *Id.* (Kelly, J., concurring in part and dissenting in part) (citing Wis. SCR 20:1.13(a)).

278. *Id.* (Kelly, J., concurring in part and dissenting in part).

279. *See id.* at 141 (Kelly, J., concurring in part and dissenting in part) ("[T]he plaintiffs claim that Mr. Morris's service as North Star's counsel imposed on him fiduciary obligations to North Star's members.").

280. *See id.* at 130–31.

281. *See id.* at 141–42 (Kelly, J., concurring in part and dissenting in part).

282. *See In re Bd. of L. Exam'rs*, 210 N.W. 710, 711 (Wis. 1926) ("An attorney occupies a fiduciary relationship towards his client."); Wis. SCR 20:1.13(a) ("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.").

283. *See, e.g.*, WIS. STAT. § 183.0503 (2019–20) ("The profits and losses of a limited liability company shall be allocated among the members in the manner provided in an operating agreement.").

284. *See Marx*, 925 N.W.2d at 141 (Kelly, J., concurring in part and dissenting in part).

Management Funds should have had to characterize the claim as a breach of fiduciary duties to North Star and sue derivatively.

CONCLUSION

LLCs' flexibility and variability may tempt courts to blur boundaries in determining who can sue for harm to an LLC or its members. However, a litigation free-for-all can breed preemptive, duplicate, or excessive recoveries. Instead, statutes and courts should permit LLC members to bring *either* derivative claims for harm to the LLC *or* direct claims for harm to themselves as members. Claims for harm to the LLC must be brought by the LLC itself or as a derivative action; statutes and courts should prohibit LLC members from bringing individual claims for harm to the LLC. In addition, formal membership should be required.

Wisconsin (and other states with similarly ambiguous statutes) should adopt an LLC statutory scheme that provides clearly distinguished mechanisms for members to sue directly versus derivatively, such as RULLCA. To rigorously differentiate direct from derivative claims in LLCs, courts should use the direct harm approach rather than the special injury rule because the direct harm approach more accurately identifies whose rights—those of the LLC or the member—were infringed. By clearly distinguishing direct from derivative claims, statutes and courts can preclude parties from unjustly asserting the legal rights of others.