

“Derivative action.” Merriam-Webster.com Legal Dictionary, Merriam-Webster, <https://www.merriam-webster.com/legal/derivative%20action>. Accessed 12 May. 2025.

What Is a Derivative Action for Corporations or LLCs?

Litico Law Group

June 22, 2023

Directors and officers of a corporation, as well as managers and members of an LLC, must always act in the best interests of the company. A derivative lawsuit is a mechanism that can be used to protect shareholders from abuse by a corporation’s officers and directors by ensuring accountability when those in control fail to pursue legal action. Similarly, these types of actions can also be used when an LLC has been wronged by a manager or member. If you’re a corporate shareholder or LLC member, it’s important to understand what a derivative action is — and when it is necessary to bring one.

What Is a Derivative Action?

A derivative action allows a shareholder to bring a lawsuit on behalf of the corporation or LLC when the company itself has been harmed. Not to be confused with direct claims, these types of lawsuits are typically brought by a minority shareholder or LLC member to address the misconduct of a director, officer, or LLC manager who is not acting in the best interests of the company. They can also be brought by a minority shareholder, or a group of minority shareholders, against a majority shareholder.

A derivative action can be used to address a wide range of wrongdoing, including the following:

- Breach of fiduciary duty
- Allegations of **fraudulent activity**
- Unjust enrichment
- Corporate waste and abuse of company assets
- Self-dealing and conflicts of interest
- Insider trading

Derivative actions can be crucial for safeguarding the interests of shareholders and LLC members. These lawsuits help to ensure that the company enforces its rights and can recover the damages to which it is legally entitled. In addition to an award of monetary damages and [**equitable relief**](#), a prevailing plaintiff in a derivative suit may also be awarded their [**attorneys' fees**](#).

Requirements for a Derivative Action

Derivative actions are complex, and it is essential to have a skilled business law attorney by your side to help you navigate the legal process. We welcome you to schedule a consultation to learn how our business lawyer can help.

When a company has suffered damages, the board of directors (or managers in an LLC that is manager-managed) typically make the decision regarding whether to file a lawsuit. A derivative suit can be brought when those who control the company fail to act. However, certain criteria must be satisfied before a legal action can be commenced.

One of the requirements that must be met before a derivative action can be filed is that a demand must first be made on the corporation's board of directors, or managers/members of the LLC. This requirement may be waived if it can be shown that the demand would be futile — making a demand is usually not necessary in matters where the directors would be defendants in the case. In some instances, a lawsuit can be avoided if the board is able to resolve the issue after the demand has been made.

In addition, the shareholder bringing the suit must have been a shareholder of the company at the time the harm occurred, although there are specific exceptions to this rule. For example, a shareholder may have standing to bring a derivative suit if they acquired their shares by operation of law from a person who was a shareholder at the time the misconduct took place. A shareholder may also proceed with a derivative suit at the court's discretion, if they acquired their shares prior to disclosure of the wrongdoing that is the basis of the action.

How Is It Determined Whether a Claim Is Direct or Derivative?

Sometimes, it can be difficult to determine whether a claim should be brought as a direct or derivative action. However, the legal processes and requirements for each type of lawsuit are different. If a shareholder is seeking a legal remedy which would benefit themselves, such as in cases involving a freeze-out, the suit would be brought as a direct action. If the company would benefit from the outcome of the action, the lawsuit would be a derivative action. Simply put, an action would be considered a derivative suit if the funds to be recovered belong to the company.

Some types of claims can only be brought as a derivative action. Others can be brought as either a direct claim or derivative claim, such as those involving conspiracy or a breach of confidential relationship, depending upon whether the injuries were suffered by the shareholder in their individual capacity or the corporation. Importantly, a demand to the board of directors must only be made in a derivative action — this requirement does not apply if the lawsuit is a direct action.

A shareholder (stockholder) derivative suit is a [lawsuit](#) brought by a [shareholder](#) or group of shareholders on behalf of the [corporation](#) against the corporation's directors, officers, or other third parties who breach their duties. The claim of the suit is not personal but belongs to the corporation. A shareholder can only sue when the corporation has a valid [cause of action](#) but has refused to use it, and the damage awards of the suit come to the corporation instead of the shareholder. The shareholder may ask for a reasonable cost paid for [litigation](#).

A shareholder derivative suit is different from a direct suit:

- Direct suit: A shareholder can bring a direct suit against a director or officer if the corporation breached its duty and caused their actual [injury](#). Once the damage is awarded, it will be paid to the shareholder.
- Derivative suit: The suit could have been brought by the corporation, but it failed to do so, so the shareholders have the right to sue to protect the interest of the corporation. There should be real harm to the corporation. For instance, the corporation suffered share value loss due to the board of directors' [false statements](#).

As a [plaintiff](#) of a derivative suit, a shareholder is required to:

- Be the corporation's shareholder or member at the time of the act or omission that the suit complained about, or become a shareholder or member by [operation of law](#)
- Keep shareholder status during the entire judgment
- Be fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the rights of the corporation, and
- Make a demand in writing requiring the corporation to take suitable action before the action (Generally, a derivative suit can only be filed 90 days after written demand. But it may be initiated ahead of time if a) the corporation rejects the demand, or b) the corporation will suffer irreparable harm if they wait).

A suit should:

- Not be a collusive one to confer jurisdiction on a court of the U.S. which it would not otherwise have, and
- Have a complaint that alleges with particularity any efforts made by the plaintiff to obtain the desired action from the directors or members and give reasons for “the plaintiff's failure to obtain the action or for not making the effort.” See [Federal Rules of Civil Procedure Rule 23.1](#).

For LLC, all [elements](#) required are the same as above, but;

- The action may be brought within a reasonable time after the demand instead of 90 days, and
- The demand requirement may be waived if the demand is deemed futile.
 - The demand should be made on the other members in a member-managed LLC. If it's a manager-managed LLC, the demand is made to managers.

[Dismissal](#) or compromise of derivative proceeding:

A derivative proceeding should be dismissed if most of the qualified directors, who do not have material interests in the derivative suit, have determined in good faith after conducting a reasonable inquiry that the derivative proceeding is not in the best interests of the corporation. The dismissal is made by the court on motion by the corporation. Without the approval of the court, the suit will not be compromised or dismissed. Once dismissed or compromised, a notice should be given to shareholders as the court directs.

[Last reviewed in January of 2025 by the [Wex Definitions Team](#)]

Rule 23.1. Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable

authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

(As added Feb. 28, 1966, eff. July 1, 1966; amended Mar. 2, 1987, eff. Aug. 1, 1987.)

Notes of Advisory Committee on Rules-1966

A derivative action by a shareholder of a corporation or by a member of an unincorporated association has distinctive aspects which require the special provisions set forth in the new rule. The next-to-the-last sentence recognizes that the question of adequacy of representation may arise when the plaintiff is one of a group of shareholders or members. *Cf. 3 Moore's Federal Practice*, par. 23.08 (2d ed. 1963).

The court has inherent power to provide for the conduct of the proceedings in a derivative action, including the power to determine the course of the proceedings and require that any appropriate notice be given to shareholders or members.

Notes of Advisory Committee on Rules-1987 Amendment

The amendments are technical. No substantive change is intended.