

What is a Derivative Lawsuit?

A derivative lawsuit is generally filed by shareholders or members on behalf of a corporation or association in order to defend a legal right to remedy or prevent a wrong to the corporation. In this type of lawsuit, the shareholders or members are plaintiffs and fiduciaries for the corporation, and the corporate officers or directors are defendants. Below is a brief overview explaining this type of suit and the role of a court receiver.

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A derivative lawsuit may be filed by shareholders on behalf of a corporation or by members on behalf of an association. Suits are brought by current shareholders or members under state corporate law and allege that the officers or members of the board of directors have breached their fiduciary duties. These lawsuits are referred to as “derivative” because shareholders/members do not bring the action directly on behalf of themselves as individuals. Instead, they sue on behalf of the corporation that is being injured by the action or inaction of the officers or directors. In other words, the value is derived by the shareholders/members through improvements made to the corporation as any damages recovered belong to the corporation or association, not to the representative plaintiffs.

To correct alleged wrongs, the shareholders/members step into the shoes of the corporation to compel it to correct its course. Those bringing derivative legal action do not do so for monetary gain, but as an impetus to force the company to hold its officers and directors accountable and liable for actions they have taken on the corporation’s behalf. No direct benefits accrue to the individual stakeholders/members that originally filed the lawsuit. The benefit of a derivative suit is that it results in improvements in corporate governance, policies, and financial management. (*Tenn. Code § 48-56-401, Derivative Suits*)

In most jurisdictions, shareholders/members must satisfy statutory requirements to prove that they have “standing” to bring the action. In other words, the right of a party to challenge the conduct of another party in court. Before a derivative lawsuit can proceed, the stakeholders/members are required to demonstrate that they petitioned the corporation for redress of their concerns. If the corporation refuses to comply with the request made in accordance with Tennessee law, then the lawsuit may proceed. Hence, derivative lawsuits must meet a high standard in order to proceed through the court, as the court’s permission is required to continue the claim. When courts find that directors and officers have violated their fiduciary duties, their Directors & Officers insurance will not cover the cost of their litigation or potential damages; and corporate financial resources may not be used to pay for these costs either. Board members will be held personally responsible for all costs associated with the lawsuit. (*Tenn. Code § 48-28-108, Standing to Maintain Derivative Suit*)