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# NY Appeals Court Adopts Delaware Standard for Determining the Difference Between Direct and Derivative Claims

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In a case of first impression in New York, the Appellate Division, First Department, has adopted the test the Delaware Supreme Court developed in *Tooley v. Donaldson, Lufkin & Jenrette, Inc*., 845 A.2d 1031, 1039 (Del 2004) for determining the difference between a “derivative” claim and a “direct” claim in shareholder derivative lawsuits.

In *Yudell v. Gilbert*, --- N.Y.S.2d ----, 2012 N.Y. Slip Op. 05896, 2012 WL 3166788 (1st Dept. Aug. 7, 2012), plaintiff asserted a derivative claim, seeking to recover for injury to the business entity in which he is a shareholder.

In many such cases, the court is faced with determining whether the claim asserted is a direct claim for injury suffered by the plaintiff, or whether it is a derivative claim to redress an injury suffered by the corporation. Often, whether the nature of the claim is direct or derivative is not readily apparent.

New York has historically approached the issue on a case-by-case basis. As the *Yudell* court observed, the case-by-case approach has made it difficult to apply to new fact patterns. The difference, of course, has significant procedural implications for litigants, since derivative claims, in order to survive judicial scrutiny, must be shown to have satisfied the demand requirements for derivative actions, i.e., the plaintiff must plead that making demand upon the corporate board to take the action plaintiff is taking would have been futile.

*Yudell* involved claims by trustees of a member of a joint venture against the managing agent and other members of the venture (whose sole asset was a shopping center), including claims for waste, negligence, breach of fiduciary duty, breach of management agreement. The lower court found these were derivative claims, and because the plaintiff had not adequately alleged demand futility, the complaint was dismissed. On appeal, plaintiff argued that not all the claims were derivative. In particular, plaintiff argued that the breach of duty claim was a direct claim.

In deciding to adopt the *Tooley* test, the court concluded that the Delaware standard “is consistent with New York law and has the added advantage of providing a clear and simple framework to determine whether a claim is direct or derivative.” 2012 WL 3166788, at *1.

The Delaware standard articulated in *Tooley* requires a court to look to the nature of the wrong and to whom the relief should go. A stockholder's claim of direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation. 2012 WL 3166788, at *4 (citing Tooley, 845 A.2d at 1039). Accordingly, the New York court held that "a court should consider "(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)" *Id*. (citing *Tooley*, 845 A.2d at 1035).

Applying this "common sense approach," the court agreed with the lower court that plaintiffs' claims for breach of fiduciary duty were derivative in nature because any pecuniary loss plaintiffs suffered derived from a breach of duty and harm to the business entity (BHA). Plaintiffs' allegations of breach of fiduciary duty involved failure to collect rent, back taxes and common charges that tenants would have owed to the entity. "Although plaintiffs may own a minority interest in the joint venture, all members suffer losses from the failure to collect rents and other obligations owed the joint venture." 2012 WL 3166788, at *4.

Moreover, said the court, "*Tooley* suggests that we consider looking at who would receive the benefit of any recovery or other remedy, the joint venture or the members individually. Accordingly, here, any recovery would represent the value of lost rent, [common] charges and the like that inure to the benefit of the joint venture. Only if and when the joint venture receives this compensation would plaintiffs then be entitled to receive their proportionate share. Thus plaintiffs claims are derivative." 2012 WL 3166788, at *4.