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Does It Walk Like a Duck? New York Appellate Court Adopts Delaware "Common Sense" Standard to Distinguish Direct and Derivative Claims

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The Appellate Division, First Department of the New York Supreme Court recently adopted a test from the Delaware Supreme Court to determine whether a claim is direct or derivative. Prior to deciding the case *Yudell v. Gilbert*,[1] New York courts lacked a clear approach for assessing when a claim was direct or derivative in nature, and employed a case-by-case analysis that was not always predictable. The distinction is important because derivative claims require additional action before a party can bring such claims, such as a prior demand requirement, and allow for broader defenses including the business judgment rule.

By adopting the Delaware Supreme Court's test from *Tooley v. Donaldson, Lufkin & Jerette, Inc.*,[2] the First Department opted for what it deemed a "clear and simple" framework that focuses on who really suffers the harm of alleged wrongdoing and to whom the recovery will go as the key factors in determining whether a claim is direct or derivative. The case is significant because it will provide corporate defendants with additional defenses in certain types of cases.

Background: A Joint Venture Gone Awry

Yudell involved a dispute among the owners of a joint venture created to build and operate a shopping center. Plaintiffs, a trust with a one-third interest in the joint venture, sued the managing agent for the shopping center, alleging that he failed to timely collect rent and properly maintain the shopping center. The claims included breach of the joint venture and management agreements, breach of fiduciary duty and negligence. The managing agent's motion to dismiss included arguments that plaintiffs' claims must be dismissed because plaintiffs had failed to make a demand of the defendants or plead why a demand would be futile with the required particularity. These defenses are typically used in shareholder derivative actions, in which a shareholder generally is required to make a demand on the board of directors of the company being sued before bringing the suit, or sufficiently plead facts that show why demand would be futile. In granting the managing agent's motion to dismiss, the court held that all the claims were derivative in nature, and thus plaintiffs were required to make a demand on the board or plead futility with requisite particularity as shareholders bringing derivative claims must do. On appeal, plaintiffs maintained that the trial court erred because the breach of fiduciary duty claim was a direct claim not subject to a demand requirement.

1 *Yudell v. Gilbert*,— N.Y.S.2d—, 2012 N.Y. Slip Op. 05896, 2012 WL 3166788 (1st Dept. Aug. 7, 2012).

2 *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004).

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The First Department disagreed. In affirming the lower court's dismissal, the court held that the alleged conduct was injurious to the business as an entity and not to the joint venture members individually. The court adopted the test articulated by the Delaware Supreme Court in *Tooley*, after finding that the existing approach in New York lacked clarity. Under the *Tooley* "common sense" analysis, courts must consider (1) the nature of the harm—whether a corporation or individual suffered the alleged harm—and (2) who would receive any recovery. The court emphasized that "[a] plaintiff asserting a derivative claim seeks to recover for injury to the business entity, whereas, a plaintiff asserting a direct claim seeks redress for injury to him or herself individually." 2012 WL 3166788, at *3.

Applying the *Tooley* test, the court held that the complaint sought redress on behalf of the company. Plaintiffs were more like shareholders in a derivative action than individuals seeking direct personal compensation. The court determined that "any pecuniary loss plaintiffs suffered derives from a breach of duty and harm to the business entity" and plaintiffs' recovery was contingent on the joint venture's recovery. 2012 WL 3166788, at *4. Under the *Tooley* standard, a plaintiff's individual claim must be independent of any alleged harm to the company to be non-derivative. Accordingly, the Court concluded that the breach of fiduciary duty claim was derivative in nature and dismissed the appeal.

Implications: New Potential Defenses to Shareholder Claims

The *Yudell* decision is significant for the more predictable standard it brings to shareholder litigation. Though *Yudell* involved a joint venture, the Court's analysis suggests that the *Tooley* framework is applicable to analyzing direct and derivative claims generally. The "common sense" analysis borrowed from Delaware courts should allow litigants to better assess and evaluate shareholder complaints. In creating a uniform approach, the *Yudell* decision eliminates a degree of uncertainty for defendants and sets forth a clear-cut methodology for New York courts to apply.

The new test may also have an impact on the defenses available in shareholder litigation. Claims that previously may have been considered direct claims may now be subject to procedural requirements of derivative claims, including making a prior demand on the company or pleading demand futility with adequate particularity. Companies may also have additional defenses with respect to the business judgment rule and the formation of special committees to investigate any such allegations.

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