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New York Appellate Court Adopts *Tooley* Test to Determine Whether a Claim Is Derivative or Direct

On August 7, 2012, the Appellate Division of the New York Supreme Court, First Department, issued a unanimous opinion in *Yudell v. Gilbert*, Index No. 600404/08, explicitly adopting the analytical framework used by Delaware courts, known as the "*Tooley* test," to determine whether a claim is derivative or direct.

Different Approaches to Distinguishing Between Derivative and Direct Claims

Courts in New York and elsewhere often struggle to distinguish between derivative claims and direct claims. Derivative claims are claims brought by shareholders who seek to recover for injury to their company. Direct claims seek to recover for injury to the individual claimant. A shareholder asserting a derivative claim is required to first make a demand on the company's board of directors detailing the alleged wrongdoing and demanding that the board take action. If the shareholder fails to make a demand on the board but still seeks to pursue a claim, the shareholder must plead with particularity that a demand would be futile. A shareholder asserting a direct claim need not worry about making a demand or pleading demand futility.

The distinction between a derivative claim and a direct claim is not always easily discernible. As recognized by the *Yudell* court, New York courts have not clearly articulated a uniform approach to determining whether a claim is derivative or direct and instead analyze the issue "on a case by case basis depending upon the nature of the allegations." The Delaware Supreme Court, on the other hand, established a uniform framework for analyzing whether a claim is derivative or direct in 2004 in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004). The *Tooley* test, as it has come to be known, requires Delaware courts to ask the following two questions: "(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)." If the corporation suffered the harm and would receive the benefit of any recovery, then the claim is derivative.

The First Department of New York's Appellate Division Adopts *Tooley*

In *Yudell*, the court considered an appeal from an order of the trial court dismissing the complaint based on a finding that plaintiffs' claims were derivative and that plaintiffs had failed to plead demand futility with the requisite particularity. The action, brought by owners of a joint venture against other members of the joint venture and the joint venture's managing agent, purported to allege both derivative and direct claims. More specifically, plaintiffs alleged claims for waste and mismanagement, breach of a management agreement, breach of fiduciary duty, negligence, and breach of a joint venture agreement arising from defendants' alleged failure to collect and/or preserve the right to collect amounts owing to the joint venture.

Rather than continue to analyze this issue on a case-by-case basis, the *Yudell* court explicitly adopted the *Tooley* test. Applying *Tooley*, the court asked who suffered the alleged harm and found that "[i]t is only through loss to [the joint venture] that plaintiffs suffer a loss at all." The court then asked who would receive the benefit of any recovery and found that recovery of amounts owing would benefit the joint venture and that plaintiffs would be entitled to a proportionate share "[o]nly if and when the joint venture receives this compensation." Accordingly, the court found that plaintiffs' claims were derivative and affirmed the trial court's dismissal of the complaint for failure to plead demand futility with particularity.

The *Yudell* decision is significant for the added predictability it brings to New York shareholder litigation. While New York courts will undoubtedly struggle with interpreting and applying the *Tooley* test, they now have a framework from which to

analyze the issue. Likewise, public corporations and their attorneys now have a framework that should allow them to better assess potential liabilities and to fashion pleadings and motions in response to shareholders' complaints.