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Standing of Trust Beneficiaries in Derivative Actions

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Regular trusts practitioners see it often—settlors establish trusts to hold a certain business interest, and the appointed trustee, frequently one with whom the trust creator enjoys a position of confidence, is also put in charge of the business. The potential for a conflict of interest then turns into an actual conflict when the business manager partakes in improper conduct that damages the business, and yet the said manager, in his capacity as trustee, forgoes any action on behalf of the trust-owner to pursue accountability.

Since New York case law generally holds that a trustee is the proper party to a suit in these circumstances, the aggrieved trust beneficiary is seemingly without options. Practitioners, however, should be familiar with two exceptions to the general rule in this context—the so-called "double-derivative" standing of a trust beneficiary and the "equitable owner" approach to standing. This piece sets forth a brief basis for each theory and a few strategic considerations when bringing these types of matters.

Derivative Suits Generally

A derivative suit is instituted by the owner of the business to prosecute a claim on behalf of the company. This frequently applies when those charged with availing the business of court remedies are the alleged wrongdoers. A derivative claim belongs to the business and not the owner (*see Derivative v. Direct Claims* below).

New York statutes and decisional law impose ownership and demand prerequisites in order to bring a derivative suit, for each of, among others, business corporations (Business Corporation Law ("BCL") 626(a) and (c)), limited liability companies (*LNYC Loft, LLC v Hudson Opportunity Fund I, LLC,* 154 AD3d 109 [1st Dept 2017]), and general and limited partnerships (N.Y. Partnership Law, Article 8-A Section 115-a(1) and (2), 121-1002(b) and(c)). These requirements may be modified by agreement; thus, special attention should be paid to all corporate governance documents before a derivative suit is commenced.

Seeking Relief When the Trustee/Business Manager Refuses to Act

When a trust-owner of a business interest has the standing to bring a derivative action, it is the trustee which is the proper party to the action.

Matter of Brandt, 81 A.D.2d 268 [1st Dept 1981]. With the law separating beneficial interests and the right to bring suit, however, trust beneficiaries are sometimes left in a position where they wish for a trustee to commence an action to no avail. In many of those instances, the trustee is acting purely out of self-interest, namely the avoidance of liability, to the detriment of the beneficiaries.

The New York Court of Appeals addressed these circumstances in the latter part of the 19th century in *Western R.R. Co. v. Nolan*, where the high court set forth the initial groundwork for "double-derivative" standing. Relying on precedent in the corporate derivative context, it recognized, among the distinctions between a beneficial owner and one with the authority to sue, the related exception that a trust beneficiary may bring suit in instances where the trustee refuses to act:

The plaintiff should be regarded as a *cestui qui trust,* and interested in the said fund. The trustees are the parties in whom the fund is vested, and whose duty it is to maintain and defend it against wrongful attack or injury tending to impair its safety or amount. The title to the fund being in them, neither the *cestuis qui trust* nor the beneficiaries can maintain an action in relation to it, as against third parties, except in case the trustees refuse to perform their duty in that respect, and then the trustees should be brought before the court as parties defendant.

48 N.Y. 513 [1872]. Nearly a century later, the Court of Appeals reaffirmed these principles in the context of a partnership dispute, drawing an analogy between the relationship of general partner/limited partner to that of a trustee/beneficiary (*Riviera Congress Assoc. v. Yassky*, 18 N.Y.2d 540 [1966]).

In *Matter of Brandt*, the Appellate Division, First Department applied the reasoning set forth in *Western R.R.* and *Riviera* to hold that the beneficiary of a trust owning an interest in a limited partnership could bring a double-derivative action, in the first instance on behalf of the trust and in the second instance on behalf of the aggrieved partnership, where the trustees, alleged to be colluding with the bad actors, refused to act on behalf of the trust.

There, the partial remaindermen of two trusts, both of which owned an interest in a limited partnership, commenced a proceeding to remove the trustees of the trusts for breach of fiduciary duty, waste and diversion and on behalf of the partnership for claims of damages against the general partners.

The *Brandt* court held that "[i]ndependently of statutory provisions and upon the general principles of equity *cestuis* have the right to sue *on behalf of the trusts* for a cause of action belonging to the trust if the trustees refuse to perform their duty in that respect." (emphasis added).

Cases following *Brandt* have also referred to the beneficiary as suing "on behalf of the trust." *See Velez v. Feinstein*, 87 A.D.2d 309 [1st Dept 1982] (where trustees refuse to act, "the beneficiaries may bring a suit *on behalf of the trust*, analogous to stockholders' derivative suits on behalf of a corporation.") (emphasis added); *Matter of McKelvey*, 2023 WL 5046505 [Sur. Ct., N.Y.Cty.] ("Where, as here, the fiduciary normally charged with taking action to protect estate or trust assets cannot be expected to do so because of a conflict, beneficiaries may seek redress *on the estate's or trust's behalf*") (emphasis added).

It appears, interestingly, based upon the holdings in *Western R.R. Co.* and its progeny, including *Brandt,* that many courts hold a view of trusts as if they were akin to business entities. At common law, however, it is a well-settled principle that trusts are not legal person (Am. Jur. 2d Trusts § 3 (May 2023) ("A trust is not an entity distinct from its trustees and capable of legal action on its own behalf . . . .").

Instead, it is a legal construct that divides interests in property and power attendant to ownership between the trustee (title owner) and the beneficiary (equitable owner) *(see* 90 C.J.S. Trusts § 6). It is the well-settled law in this state that trustees are the proper parties in interest and should be the named parties in a lawsuit (*Henning v Rando Mach. Corp.*, 207 AD2d 106, 109 [4th Dept 1994]).

It is along the lines of this understanding that a second line of cases has developed espousing an alternate theory. Since the beneficiaries are equitable owners of the business interest, there is no need for "double-derivative" standing. The beneficiaries could instead bring typical derivative actions as "owners" simply because of their interest in the trust corpus and the trustee's failure to bring suit. *See Cassata on behalf of A. J. Hughes Screw Products Co. v. Cassata*, 148 A.D.2d 944 [4th Dept 1989], app. dismissed, 74 N.Y.2d 892 [1989] (*citing* BCL §626 and holding that "[p]laintiff was the beneficiary of a trust holding stock in defendant corporation and thus, was entitled to institute a shareholder derivative action."); *Schlegel v. Schlegel Mfg. Corp.*, 23 A.D.2d 808 [4th Dept 1965] ("It is familiar law that an equitable owner of shares of stock in a corporation has legal capacity to sue on behalf of the corporation."); *Sasso v. Gallucci*, 112 Misc.2d 865 [Sup. Ct., Nassau County 1982] (citing BCL §626 and holding that "[t]he equitable owner of stock who is a beneficiary of a trust is even considered as a stockholder for purposes of maintaining a derivative action."); *Braman v. Westaway*, 60 N.Y.S.2d 190, 196 [Sup. Ct., N.Y.Cnty. 1945] ["It seems clear that an equitable owner of stock who sues as a beneficiary of a trust, is to be considered a stockholder for the purpose of maintaining a derivative action.").

While the "equitable owner" approach appears to be more in line with New York's view of how a trust is structured, practitioners should be wary of ignoring the longstanding Court of Appeals precedent and should consider employing both approaches as bases for standing.

Derivative Versus Direct Claim

We conclude with an important strategic point for consideration. It is imperative to distinguish between the trust's direct claims and the trust's derivative claims on behalf of the business entity. A failure to do so may result in dismissal of the action. To determine whether a cause of action is personal (to the trust) or derivative, "the pertinent inquiry...'is whether the thrust of the plaintiff's action is to vindicate his [or her] personal rights as an individual and not as a stockholder on behalf of the corporation.'" *Bibbo v. Arvanitakis*, 145 A.D.3d 657 [2d Dept 2016]. The ultimate question, therefore, is where does the recovery go?

It has been consistently held in New York that diminution in the value of shares is "quintessentially a derivative claim." *Higgins v. N.Y. Stock Exchange, Inc.*, 806 N.Y.S.2d 339 [Sup. Ct., N.Y.Cty. 2005] ("While a decrease in share value is undoubtedly harmful to the individual shareholder, this harm is said to derive from the harm suffered principally by the corporation and only collaterally to shareholders, and thus is derivative in nature."). The courts have also held that claims alleging waste and mismanagement on the part of the board of directors, damage to a corporation's reputation and associated goodwill due to chairman misconduct, and diversions of corporate opportunities gives rise to derivative actions only.

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