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Securities

Director Self-Interest

Director Independence under New York Law

By Mara Leventhal

While New York law outlining the contours of director independence is somewhat less robust than the precedents that inform similar analyses under Delaware law, the fact that New York statutes and case law address circumstances that a court should consider in determining a director's interest in a given issue or transaction cannot be gainsaid. The purpose of this article is to set forth a practical set of issues that a court—or any board, committee, or other person or entity—evaluating director disinterest should consider in the discharge of an independence analysis exclusively pursuant to New York authorities. A checklist of questions and an overview of New York precedents that inform such an independence analysis follow.

1. Is the director a party to the transaction? Pursuant to N.Y. Business Corporations Law (''BCL'') § 713(a) (McKinney 2012), director self-interest is expressly implicated where there is a ''contract or transaction between a corporation and one or more of its directors.'' In other words, a director who is also a counter-party to the corporation in a given transaction is, by definition, interested.[1]

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2. Is the director affiliated with party to the transaction? BCL § 713(a) also makes clear that director self-interest is in play where there is a contract or transaction ''between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest.''[2] Thus, for example, directors who control an entity receiving a corporate loan[3] or a below

[1] *See, e.g., Park River Owners Corp. v. Bangser Klein Rocca & Blum LLP*, 269 A.D.2d 313, 313, 703 N.Y.S.2d 465, 466 (1st Dep't 2000) (''Director interest, which can be either self-interest in the transaction at issue or a loss of independence because a director with no direct interest in a transaction is controlled by a self-interested director, invalidated the vote of at least two, if not all three, of the directors who voted to terminate defendant's retainer—a principal, an employee and a tenant of the sponsor.'') (citations omitted); *Rapoport v. Schneider*, 29 N.Y.2d 396, 402, 278 N.E.2d 642, 646, 328 N.Y.S.2d 431, 437 (1972) (''A director is 'interested' if he is an officer or director of another corporation apparently involved in the questioned transaction.''). *Compare Decana Inc. v. Contogouris*, No. 604247/02, 2007 BL 139442, at *3 (Sup. Ct. N.Y. Cnty. Oct. 9, 2007) (''the transaction was not 'self-dealing' as defined in BCL § 713, because Contogouris was not a director, officer, employee, or beneficiary of [the counterparty]''), *aff'd as modified*, 55 A.D.3d 325, 865 N.Y.S.2d 72 (1st Dep't 2008).

[2] *See, e.g., Ench v. Breslin*, 241 A.D.2d 475, 476, 659 N.Y.S.2d 893, 894 (2d Dep't 1997) (holding that the business judgment doctrine did not protect transaction where the director had ''substantial interests'' in the counterparty to reciprocal easement agreement with the corporation); *In re Croton River Club Inc.*, 52 F.3d 41, 44 (2d Cir. 1995) (''It is black-letter, settled law that when a corporate director or officer has an interest in a decision, the business judgment rule does not apply.'').

[3] *See In re Investors Funding Corp. of New York Securities Litigation*, No. 76 Civ. 4679 (S.D.N.Y. Jan. 12, 1982) (factual issues regarding whether the directors ''had 'substantial finan-

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market lease,[4] or merging with the corporation,[5] or to which other valuable corporate assets are assigned[6] are unlikely to be deemed independent.

3. Will the director receive a direct benefit from the transaction different from the benefit received by shareholders generally? A director's receipt of a financial benefit as a result of a transaction may also suggest self-interest,[7] unless the same financial benefit is ''received by the shareholders generally.''[8] Excessive director compensation is the quintessential example of a ''different'' benefit,[9] but self-interest may not be established if the defendant director did not participate in the challenged compensation decision.[10] Of course, potentially self-interested financial benefits can take many other forms, including receipt of backdated options,[11] an ownership interest in the corporation's merger counterparty[12] or lessee,[13] insider trading,[14] loan forgiveness[15] or any other expense reduction for the director,[16] diversion of commissions[17] or corporate funds,[18] or receipt of any other allegedly usurped corporate asset.[19] Significantly, receipt of normal directors' fees is *not* a sufficient ''financial benefit'' to show self-interest by a director.[20]

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cial interests' in the partnerships receiving [corporation's] loans'' precluded summary judgment on alleged violations of BCL § 713).

[4] *See Lewis v. S.L. & E. Inc.*, 629 F.2d 764, 768 (2d Cir. 1980) (''Because the directors of SLE were also officers, directors and/or shareholders of LGT, the burden was on the defendant directors to demonstrate that the [rental] transactions between SLE and LGT were fair and reasonable.'').

[5] *See Alpert v. 28 Williams Street Corp.*, 63 N.Y.2d 557, 570, 473 N.E.2d 19, 26, 483 N.Y.S.2d 667, 674 (1984) (finding that allegations of ''a common directorship or majority ownership'' between entities being merged demonstrated interest).

[6] *See Sardanis v. Sumitomo Corp.*, 282 A.D.2d 322, 324, 723 N.Y.S.2d 466, 469 (1st Dep't 2001) (plaintiff who caused corporation ''to assign legal claims constituting 'all or substantially' all of [corporation's] assets . . . to an entity . . . in which plaintiff and his son had a substantial financial interest'' had ''unclean hands'').

[7] *See In re Comverse Technology Inc.*, 56 A.D.3d 49, 54, 866 N.Y.S.2d 10, 15 (1st Dep't 2008) (''Directors are self-interested in a challenged transaction where they will receive a direct financial benefit from the transaction which is different from the benefit to shareholders generally.'') (citation omitted); *Board of Managers of Chelsea 19 Condominium v. v. Chelsea 19 Associates*, No. 105347/08, slip op. at 6 (Sup. Ct. N.Y. Cnty. Mar. 13, 2009) (citing *In re Comverse*).

[8] *Shapiro v. Rockville Country Club Inc.*, 22 A.D.3d 657, 659, 802 N.Y.D.2d 717, 720 (2d Dep't 2005). *See also Stein v. Immelt*, 472 F. App'x 64, 66 (2d Cir. 2012) (the ''test for self-interestedness is . . . whether [a director] will 'receive a direct financial benefit from the transaction which is different from the benefit to shareholders generally.' '') (citation omitted); *Torres v. Ubiquitous Media Inc.*, No. 116624/08, 2009 BL 235179, at *7 (Sup. Ct. N.Y. Cnty. Oct. 19, 2009) (''plaintiffs have sufficiently pled that Nicole and Robert would receive a direct financial benefit from the transaction, which was different from the benefit to the shareholders generally''); *Appell v. LAG Corp.*, No. 0602846/2005, slip op. at 25 (Sup. Ct. N.Y. Cnty. July 11, 2008) (holding business judgment rule inapplicable where the facts established that the director defendants ''received favorable treatment at Appell's expense, thereby singling out Appell for harmful treatment'').

[9] *See, e.g., Marx v. Akers*, 88 N.Y.2d 189, 202, 666 N.E.2d 1034, 1042, 644 N.Y.S.2d 121, 129 (1996) (excusing demand as to challenge to outside directors' compensation, but dismissing for failure to state a claim); *Deblinger v. Sani-Pine Products Co. Inc.*, No. 01239/11, 2012 BL 97437, at *3 (Sup. Ct. Nassau Cnty. Apr. 11, 2012) (''it would have been futile to demand that Cecile bring an action challenging her own compensation''); *Lippman v. Shaffer*, 836 N.Y.S.2d 766, 773 (Sup. Ct. Monroe Cnty. 2006) (holding business judgment rule inapplicable to directoral self-compensation decisions).

[10] *See Lockridge v. Krasnoff*, No. 7903-07, 2008 BL 105726, at *4 (Sup. Ct. Nassau Cnty. Apr. 30, 2008) (dismissing for failure to satisfy the demand requirement where, *inter alia*, challenged salary and benefit decisions were made by the compensation committee, ''none of whose members is alleged to be interested and none of whose members is a Defendant in this action'').

[11] *See In re Comverse*, 56 A.D.3d at 54, 866 N.Y.S. 3d at 15 (holding director ''recipient of backdated options worth millions of dollars'' self-interested).

[12] *See Higgins v. New York Stock Exchange Inc.*, 806 N.Y.S.2d 339, 358 (Sup. Ct. N.Y. Cnty. 2005) (finding self-interest where director held shares in the parent company of a merger counter-party and stood ''to receive a direct personal financial benefit from the unfair terms of the [m]erger'').

[13] *See Patrick v. Allen*, 355 F. Supp. 2d 704, 711 (S.D.N.Y. 2005) (allegations that defendants ''retain[ed] the Property and lease[d] it to Deepdale at below-market rent'' were sufficient to overcome business judgment protection on a motion to dismiss).

[14] *See Tsutsui v. Barasch*, 67 A.D.3d 896, 898, 892 N.Y.S.2d 400, 402 (2d Dep't 2009) (holding director interest adequately alleged to excuse demand where the chairman ''was accused of receiving a direct financial benefit by personally engaging in insider trading'' and other directors owned or had a close affiliation with the ''business entity which was alleged to have profited through the sale of Universal stock on the basis of inside information'').

[15] *See In re Perry H. Koplik & Sons Inc.*, 476 B.R. 746, 803 (S.D.N.Y. 2012) (holding business judgment protection inapplicable ''when a corporate officer or director grants ''self-determined benefits'' of loan forgiveness to himself'').

[16] *See In re Croton River Club*, 52 F.3d at 44 (holding that ''conflict of interest in the instant matter is obvious and of great magnitude'' where board members realized a savings of $2,000 annually as a result of the challenged decision).

[17] *See Segal v. Cooper*, 49 A.D.3d 467, 467-68, 856 N.Y.S.2d 12, 13 (1st Dep't 2008) (allegations that defendants ''diverted'' commissions and deprived plaintiff ''of his share'' were sufficient to establish that a majority of the controlling members of the limited liability company were interested in the challenged transactions).

[18] *See Finlayson v. Death*, No. 0807-07, 2008 BL 29118, at *1-*2 (Sup. Ct. Nassau Cnty. Jan. 22, 2008) (allegations that director defendant ''divert[ed] corporate funds to himself'' established self-interest for demand futility purposes); *Rubenstein v. Rubenstein*, 602065-2005, slip op. at 8-9 (Sup. Ct. N.Y. Cnty. Mar. 13, 2006) (allegations that defendants ''used corporate funds for his own benefit'' or received ''higher *pro rata* distributions than the other shareholders'' were sufficient to establish director self-interest).

[19] *See Owen v. Hamilton*, 44 A.D.3d 452, 454, 843 N.Y.S.2d 298, 301 (1st Dep't Oct. 16, 2007) (''the fact that the competing business undertaken presented itself in the form of a corporate opportunity which the corporation was financially unable or for other reasons unwilling to undertake should be no excuse for an officer undertaking it individually. Despite the corporation's inability or refusal to act it is entitled to the officer's undivided loyalty'').

[20] *See Alpert v. National Association of Securities Dealers LLC*, No. 600657/2004 (Sup. Ct. N.Y. Cnty. July 28, 2004) (''re-

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4. Is the director controlled by a self-interested director? A director ''with no direct interest in a transaction'' nevertheless may be deemed interested if he or she ''is controlled by a self-interested director.''[21] A plaintiff alleging such control must ''present specific and detailed allegations that the [controlling] defendant directors have coercive power over the other directors.''[22] Allegations that may demonstrate control sufficient to overcome independence include economic dependence on an interested director;[23] close business and personal relationships with an interested director;[24] membership on the board of a controlled corporation;[25] and continued support for an interested director notwithstanding strong evidence of his or her wrongdoing.[26] Factors that have been held insufficient to demonstrate control by an interested director include a casual acquaintance;[27] a regular working relationship;[28] a loan that the director is obligated to repay;[29] a share sale transaction;[30] status as an inside director;[31] a track record of casting votes consistent with another director;[32] or appointment by an allegedly controlling director.[33]

5. Is the director potentially subject to a ''substantial threat'' of personal liability? While the ''mere threat of personal liability is insufficient to challenge either the independence or disinterestedness of directors,'' ''particularized facts showing that a majority of directors face a *substantial threat* of personal liability'' may suffice to establish a disabling interest,[34] especially in the

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ceipt of directors' fees is not sufficient to show self-interest by a board member'') (citation omitted).

[21] *Park River Owners Corp.*, 269 A.D.2d at 313, 703 N.Y.S.2d at 466. *See also Malkinzon v. Kordonsky*, 56 A.D.3d 734, 735, 868 N.Y.S.2d 123, 124 (2d Dep't 2008) (rejecting board's motion to dismiss where ''plaintiffs alleged particularized facts in their amended complaint that each member of the Board either had a self-interest in the challenged transactions or had lost independence to and was controlled by a self-interested director''). *See also Higgins*, 806 N.Y.S.2d at 357 (same).

[22] *Health-Loom Corp. v. Soho Plaza Corp.*, 209 A.D.2d 197, 198, 618 N.Y.S.2d 287, 288 (1st Dep't 1994).

[23] *See Tsutsui*, 67 A.D.3d at 898, 892 N.Y.S.2d at 402 (finding director controlled where his small law firm earned substantial fees for recent services to the company).

[24] *See Venturetek LP v. Rand Publishing Co. Inc.*, No. 605046/98, slip op. at 7 (Sup. Ct. N.Y. Cnty. Jan. 7, 2003) (''Where, as here, a director has a history of deriving personal benefit from his affiliation with another director, there is clearly a reasonable doubt regarding the former's ability to act impartially in assessing whether to authorize legal action against the latter.''); *Davidowitz v. Edelman*, 583 N.Y.S.2d 340, 343-44 (Sup. Ct. Kings Cnty. 1992) (holding that ''close business and personal relations . . . preclude this court from finding that the committee possessed the required disinterested independence''), *aff'd*, 203 A.D.2d 234, 612 N.Y.S.2d 882 (2d Dep't 1994).

[25] *See Davidowitz*, 583 N.Y.S.2d at 344 (''common directorships and cross-relations create an inherent conflict of interest'').

[26] *See Bansbach v. Zinn*, 1 N.Y.3d 1, 12, 801 N.E.2d 395, 403, 769 N.Y.S.2d 175, 183 (2003) (finding board ''dominated and controlled'' by director whose legal fees continued to be advanced after he admitted in open court ''having implicated the corporation in his criminal conduct'').

[27] *See Alpert*, No. 600657/2004 (''Nor are allegations regarding Boglioli's personal relationship with Koondel sufficient to demonstrate Koondel's lack of independence.''); *Bansbach v. Zinn,* 294 A.D.2d 762, 763, 742 N.Y.S.2d 708, 710 (3d Dep't 2002) (''directors' personal relationships . . . with [defendant] were insufficient to create a question of fact regarding the directors' independence''), *aff'd as modified*, 1 N.Y.3d 1, 801 N.E.2d 395, 769 N.Y.S.2d 175 (2003); *Lichtenberg v. Zinn*, 260 A.D.2d 741, 742, 687 N.Y.S.2d 817, 819-20 (3d Dep't 1999) (finding SLC disinterest at summary judgment although certain SLC members had met an interested board member ''because their children attended the same dance class,'' or had ''an occasional tennis match'' with an interested board member).

[28] *See Lichtenberg*, 260 A.D.2d at 743, 687 N.Y.S.2d at 820 (finding disinterest notwithstanding SLC member's submission of consulting proposals that never came to fruition and/or prior business venture with interested board member); *Sanford v. Colgate University*, 36 A.D.3d 1060, 1061-62, 828 N.Y.S.2d 633, 635 (3d Dep't 2007) (fraternity board member's work with Alumni InterFraternity/Sorority Council held insufficient to establish a '' 'dual role' in this transaction''); *Bansbach*, 294 A.D.2d at 763, 742 N.Y.S.2d at 710 (''prior business dealings with [defendant] were insufficient to create a question of fact regarding the directors' independence'').

[29] *See Radwan v. Tsikasis*, No. 114783/2010, 2012 BL 200858, at *2 (Sup. Ct. N.Y. Cnty. June 4, 2012) (''a disqualifying interest . . . does not flow from the alleged assistance . . . received from another Board member in refinancing her cooperative apartment. Plaintiffs have not shown that she received financial assistance from a Board member, or, if she did, that she is not obligated to repay it[.]'').

[30] *See Gillette v. Sembler*, 21900-11, 2012 BL 28340, at *3 (Sup. Ct. Suffolk Cnty. Feb. 3, 2012) (holding allegations that one director is in the process of buying another director's shares ''are insufficient to establish domination or control'' of the selling director by the purchasing director).

[31] *See King v. Bartlett*, No. 0600991/2007, 2007 BL 182475, at *3 (Sup. Ct. N.Y. Cnty. Dec. 21, 2007) (expressly rejecting the argument that a director who served as the corporations' president and CEO was ''incapable of independently and disinterestedly considering a demand to commence this action against other Director Defendants, who control his employment and compensation'' and holding that status as an inside director does not, ''by itself,'' indicate control by other directors).

[32] *See Yudell v. Gilbert*, No. 601090/2009, 2010 BL 320816, at *4 (Sup. Ct. N.Y. Cnty. Apr. 27, 2010) (holding neither self-interest nor control were established by directors' voting record in support of allegedly controlling director's recommendation).

[33] *See Alpert*, No. 600657/2004 (''[E]ven if Hyde and Koondel were appointed as hold-over directors by Boglioli, plaintiffs fail to show that Hyde and Koondel were beholden to NASD, or controlled by Boglioli.'').

[34] *Central Laborers' Pension Fund ex rel. Goldman Sachs Group Inc. v. Blankfein*, 931 N.Y.S.2d 835, 847 (Sup. Ct. N.Y. Cnty. 2011) (citation omitted) (emphasis in original). *See also Glatzer v. Grossman*, 47 A.D.3d 676, 677, 849 N.Y.S.2d 300, 301 (2d Dep't 2008) (''To justify failure to make a demand, it is not sufficient to name a majority of the directors as defendants with conclusory allegations of wrongdoing or control by wrongdoers, as the plaintiff did here.''); *Wandel ex rel. Bed Bath & Beyond Inc. v. Eisenberg*, 60 A.D.3d 77, 80, 871 N.Y.S.2d 102, 105 (1st Dep't 2009) (''The bare claim that the directors who served on the stock option and compensation committees should be viewed as interested because they are 'substantially likely to be held liable' for their actions is not enough.''); *Kahn v. Ran*, No. 601288-11, 2012 BL 153679, at *6 (Sup. Ct. Nassau Cnty. June 12, 2012) (''allegations . . . that demand should be excused because directors are substantially likely to be held liable . . . are insufficient''); *City of Tallahassee Retirement System v. Akerson*, No. 601535/08, slip op. at 5 (Sup. Ct. N.Y. Cnty. Oct. 16, 2009) (''Risk of personal liability by the majority of a board of directors does not render a demand futile.''); *Hildene Capital Management LLC v. Friedman, Billings, Ramsey Group Inc.*, No. 11 Civ. 5832 (AJN), 2012 BL 216599, at *3 (S.D.N.Y. Aug. 15, 2012) (''Merely naming direc-

context of an assessment of a derivative demand or a special litigation committee investigation. Such a particularized showing is not satisfied by the fact that a demand was rejected[35] or that a corporation's insurance policy would exclude coverage for an indemnified director sued by the corporation,[36] particularly where the director did not non-participate in the challenged conduct.[37] However, a complaint that ''alleges acts for which a majority of the directors may be liable'' may suffice to demonstrate that ''[t]he board would not be responsive to a demand.''[38]

6. Are there any other relevant facts or circumstances? As the issues outlined above make clear, an independence analysis is highly fact intensive. It depends on an assessment of director-specific information, including any relationship between a director and the challenged action, transaction or other directors or transactional counter-parties. Accordingly, a thorough independence analysis must also search out any other potentially significant relationships between the director and the relevant parties or events—such as past dealings, family relationships, or charitable contributions to affiliated entities—and evaluate whether those contacts taint the director's motives in respect of the actions at issue. A thorough advance review of possible director self-interest is, of course, the best protection against subsequent independence attacks.

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tors (or the trustee) as defendants or alleging that they may be liable is not sufficient to render demand futile.'').

[35] *See Stoner v. Walsh*, 772 F. Supp. 790, 802 (S.D.N.Y. 1991) (holding ''the naked fact that [a plaintiff's] demand was rejected'' was ''not enough'' to establish interest).

[36] *See In re Omnicom Group Inc. Shareholder Derivative Litigation*, No. 602383/2002, 2006 BL 3606, at *5 (Sup. Ct. N.Y. Cnty. June 23, 2006) (''plaintiffs' allegation concerning the 'insured v. insured' exclusion in the corporate insurance policy fail to establish director interest'').

[37] *See Auerbach v. Bennett*, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979) (finding no triable issue of fact ''as to the independence and disinterested status'' of special litigation committee members who joined the board after the challenged transactions and had no ''prior affiliation with the corporation''); *Lichtenberg*, 260 A.D.2d at 742, 687 N.Y.S.2d at 819 (affirming application of the business judgment rule and dismissal of derivative action where special litigation committee members were not ''named as defendants in the underlying action nor implicated in the alleged wrongdoing'' and ''were not members of [the] board of directors at the time that the challenged transactions are alleged to have occurred''); *In re Merrill Lynch & Co., Inc. Securities Derivative & ERISA Litigation*, 773 F. Supp. 2d 330, 340 (S.D.N.Y. 2011) (''Plaintiff fails to explain why the [] Board would be incapable of performing a disinterested assessment of a demand'' where the majority of directors ''had no connection to this conduct and face no personal liability whatsoever with respect to these claims.''), *aff'd*, No. 11-1285 (2d Cir. Dec. 4, 2012).

[38] *Barr v. Wackman*, 36 N.Y.2d 371, 377, 329 N.E.2d 180, 185, 368 N.Y.S.2d 497, 504 (1975). *See also Curreri v. Verni*, 156 A.D.2d 420, 421, 548 N.Y.S.2d 540, 540 (2d Dep't 1989) (allegations ''that the appellants were in exclusive control of the corporation and that they were involved in a series of specific transactions which were detrimental to the corporation . . . set forth sufficient details from which it may be inferred that the making of a demand would indeed be futile.'').

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