

# Business & Securities Litigator

An Update on Recent Developments Prepared by the  
Business & Securities Litigation Department of Weil, Gotshal & Manges LLP



## Ten Things That Every Director Should Know For 2004

By Ira M. Millstein, Holly J. Gregory and David Murgio

### 1. The Environment Has Changed.

As a result of recent scandals and reforms, every public company director is now subject to heightened scrutiny and expanding expectations. Congress, the SEC, the exchanges, the courts, the media, as well as the public at large, are focused on boards and directors to a degree that is unprecedented. (And beware the alliance that has developed between the plaintiff's bar and the union and public pension funds.) In this fishbowl, every board action – or inaction – is potential fodder for public discussion and, increasingly, shareholder litigation.

### 2. Compliance Is Necessary But Insufficient.

Compliance with SOXA and related reforms is not the same as good governance. Box ticking against the new requirements by itself won't position the board to direct the affairs of the corporation effectively. Boards should avoid the temptation to rely on narrow, technical readings of the rules. Strive to adhere to the spirit – not just the letter – of the new reforms.

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## Shareholder Derivative Litigation In New York After *Bansbach*

By Stephen A. Radin

The Court of Appeals' recent – and largely unnoticed – decision in *Bansbach v. Zinn*<sup>1</sup> re-affirms the rules governing the pre-litigation demand requirement in shareholder derivative litigation involving New York corporations established in 1996 in *Marx v. Akers*<sup>2</sup> and applies those rules in an unusual context. An important corporate governance issue is at stake: the right of directors elected by all shareholders, rather than minority shareholders acting on their own, to decide when litigation should be commenced on behalf of the corporation against directors alleged to have mismanaged corporate affairs. *Bansbach* illustrates the type of unusual facts that excuse demand.

### The Pre-Litigation Demand Requirement

Unlike a claim a plaintiff brings on his or her own behalf to enforce a claim the plaintiff personally possesses, a shareholder derivative claim is brought “to enforce a corporate cause of action.”<sup>3</sup> “The remedy sought is for wrong done to the corporation; the primary cause of action belongs to the corporation; recovery must enure to the benefit of the corporation.”<sup>4</sup>

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### 3. Increased Disclosure And CEO/CFO Certifications Only Relate To Past Events.

The new certification and disclosure requirements regarding internal controls, MD&A, off-balance sheet transactions, non-GAAP financial measures, critical accounting policies, and sales of securities by insiders add transparency for investors and also remind CEOs and CFOs of the critical stewardship they've undertaken. However, these requirements are focused retrospectively. Directors should understand that these new requirements do not necessarily ensure against problems going forward.

### 4. Structure Does Not Replace Judgment.

Increasing the number of independent directors, establishing independent committees with clearly defined responsibilities, obtaining the advice of disinterested counsel, relying on independent auditors, adopting codes of ethics, establishing internal control procedures, holding executive sessions and appointing an independent chairman or a presiding or lead director all help position the board to provide more effective oversight of the company's operations and management. However, these largely structural mechanisms do not alone translate into better board decision-making. Directors should remember that even the best governance system is no substitute for sound judgment.

### 5. The Basics Still Matter: Time, Attention, Information, Absence Of Conflicts.

Beyond compliance and structural adjustments, directors must be personally engaged and devote significant time, attention and diligence while avoiding conflicts. This requires both an understanding of best practice and a commitment to real activation and objectivity (again, not mere technical compliance). Due care, loyalty and good faith remain the standards for avoiding liability for a breach of fiduciary duty. Understand, however, that changing expectations impact how courts judge what is due care, loyalty and good faith.

### 6. Independence Paradoxically Increases Board Dependence On Management.

By definition, independent directors are outsiders who lack significant rela-

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tionships to the company. They lack the intimate knowledge of the company that comes with being an employee or having significant business contacts. As a result, boards are increasingly dependent on management to identify the critical issues and to provide them the information needed to monitor corporate and management performance and to govern effectively. Directors must remember that managers have individual perspectives that may lead them, consciously or unconsciously, to hesitate to bring certain issues to the board's attention or to omit or downplay certain information when interacting with the board.

### **7. Independent Leadership Is Needed To Manage Key Agenda, Information And Risk Assessment Functions.**

In light of their increasing dependence on management, boards need independent leadership (an independent chair, a lead director or an empowered presiding director) for critical agenda-setting and information flow functions. This leader should assist the board to organize: by creating processes that assure directors will receive the information they need when they need it; by communicating to management expectations about the types of issues that the board wants brought to its attention; by monitoring development throughout the company of procedures to automatically “flag” issues or information for board attention; and by coordinating the work of the various board committees. The board should actively participate in setting its own agenda. (And the agenda

should not be unduly cluttered but should allow time for critical issues to be discussed.) Internal controls and risk assessment need automatic links to the board – and both types of systems should look beyond financial information.

### **8. Board Materials Are Not Enough.**

Directors can no longer rely entirely on materials and presentations prepared specifically for board consumption by management. Directors should seek as much information about the company, the industry and competitors as possible, including analyst reports, media reports, and industry reports. They should keep current on legal and regulatory changes, and consult independent sources of information as necessary.

### **9. Be Sensitive To The Hot Topics.**

Every board should focus on:

- *Executive Compensation.* The level of executive compensation should be justifiable and have some relationship to performance (including performance against peer groups). Special scrutiny needs to be given to exit, retirement and “retention” packages, and grants of stock or stock options. Excessive compensation and perks can bring down the most competent executive and lead to public lack of confidence in the board.
- *Shareholder Access.* The SEC is promoting increased transparency about, and a greater role for shareholders in, the nomination of directors. Rightly or wrongly, boards are viewed as self-perpetuating bodies, often cut off from the shareholders they represent. Boards should be

mindful of these concerns and be open to suggestions from shareholders, especially as it relates to director nominees.

- *Succession Planning.* Management succession is a key board responsibility and should be a regular topic of board discussion. In addition to planning for contingencies and assuring preparedness for an orderly succession, boards should incorporate management development strategies into their succession planning to help ensure they maintain a deep bench of able managers. (Properly focusing succession planning on management development rather than potential CEO replacement makes the topic good governance, rather than threatening.)
- *Good Faith.* Directors should pay careful attention to the emerging duty of “good faith.” Recent Delaware cases, as well as speeches by noted Delaware jurists, have increasingly focused on the importance of “good faith” in addition to disinterestedness, independence and due care, when considering claims against directors. The contours of this duty are being shaped by the evolving expectations about how corporate directors should function.

### **10. Remember: It's Other People's Money.**

Directors need to remember that they are dealing with a collection of assets that represent other people's money. Shareholders have entrusted their assets to the company with the understanding that the board will act as a steward to protect those assets and, hopefully, reward the providers.

## **Shareholder Derivative Litigation In New York After *Bansbach***

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In order to have standing to commence a derivative action, a shareholder must demand that the corporation's board of directors cause the corporation to pursue the alleged claim, unless a demand would be futile. This threshold demand requirement implements what the United States Supreme Court has called “the basic principle of corporate governance that the decisions of a cor-

poration – including the decision to initiate litigation – should be made by the board of directors.”<sup>5</sup>

The Court of Appeals similarly stated a quarter of a century ago in *Barr v. Wackman*<sup>6</sup> – in a passage quoted in *Bansbach* – that the demand requirement rests on “basic principles of corporate control – that the management of the corporation is entrusted to its board of directors who have primary responsibility for acting in the name of the corporation and who are often in a position to correct alleged abuses without resort to the courts.” As stated in

*Marx* and in *Auerbach v. Bennett*<sup>7</sup>: “As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such [derivative] claims lies within the judgment and control of the corporation's board of directors.” As stated in *Auerbach*:

Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calcu-

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## Shareholder Derivative Litigation In New York After *Bansbach*

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lated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.

The court in *Marx* also noted that the demand requirement “relieve[s] courts from deciding matters of internal corporate governance by providing corporate directors with opportunities to correct alleged abuses,” “provide[s] corporate boards with reasonable protection from harassment by litigation on matters clearly within the discretion of directors,” and “discourage[s] ‘strike suits’ commenced by shareholders for personal gain rather than for the benefit of the corporation.”

Under *Marx*, demand is excused only “when a complaint alleges with particularity” one of the following: [1] “a majority of the board of directors is interested in the challenged transaction,” with interestedness including 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,” [2] “the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances,” or [3] “the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.”

### **Bansbach**

*Bansbach* involved violations by Michael Zinn, the majority shareholder, chairman and chief executive officer of Besicorp Group, Inc., of federal prohibitions on corporate campaign contributions: Zinn made, and arranged for Besicorp employees to make, campaign contributions that were reimbursed by Besicorp as raises or cash bonuses. Zinn and Besicorp were indicted and pleaded guilty, and Zinn acknowledged at sentencing that he knowingly and willfully violated the law. Zinn was sentenced to six months in prison and fined.

The board’s three outside directors, Gerald Habib, Harold Harris and Richard Rosen, determined shortly after subpoenas were issued at the start of the government’s investigation that Besicorp would advance Zinn legal fees and expenses, with Besicorp to be reimbursed if indemnification proved unwarranted. These payments continued following the indictment and guilty plea and through sentencing. As of that date, Besicorp had advanced \$273,010.99 for Zinn’s defense.

Two months later, plaintiff commenced a derivative action alleging that Besicorp’s directors breached their fiduciary duties and wasted corporate assets by authorizing the use of corporate funds to pay Zinn’s legal costs and by not seeking reimbursement. Four months after the suit was commenced, a board committee including Habib, Rosen and Zinn’s successor determined to seek partial reimbursement of the almost \$275,000 advanced to Zinn and agreed to accept a \$161,000 promissory note from Zinn.

The trial court dismissed the case due to plaintiff’s failure to make a demand. “With dismissal of the case in hand,” the board committee that had sought reimbursement met and “reviewed a report of independent counsel retained to advise whether the corporation could indemnify Zinn . . . and whether the corporation was obligated to seek reimbursement.” Zinn, who had been released from prison, “attended virtually the entire meeting.” The committee found that Zinn’s conduct was “undertaken in good faith,” that he “reasonably believed” that his conduct was “in the best interests of the Company,” and that he “had no reasonable cause to believe that his conduct was unlawful” and determined to indemnify Zinn for “all legal costs and expenses related to his defense, subsequent guilty plea, sentencing and incarceration,” including his fine and the \$141,000 balance remaining on his promissory note. The minutes of the meeting did “not reflect what consideration, if any, the board gave to Zinn’s sworn admissions to having knowingly violated the law, thus exposing the corporation to criminal penalties and other harm.”

A short time later, the Appellate Division, Third Department, reversed,

holding that a demand upon Besicorp’s board, which consisted at the time the litigation was commenced of Zinn, Habib, Harris and Rosen, was excused because Zinn “dominated and controlled” Habib, Harris and Rosen due to various personal and business relationships between Zinn and these directors.

At about the same time, the Appellate Division dismissed a separate derivative action, *Lichtenberg v. Zinn*,<sup>8</sup> brought on behalf of Besicorp challenging stock options and warrants granted to Zinn. This dismissal, the Court of Appeals noted, was based upon “a lengthy, comprehensive investigation” and recommendation by a special litigation committee consisting of Harris, Habib and Rosen, each of whom “submitted detailed affidavits . . . attesting to their independence from Zinn, their comprehensive investigation and their lengthy deliberative process.” The Appellate Division then dismissed the *Bansbach* action on the ground that plaintiff was collaterally estopped from claiming that demand was excused by the directors’ personal and business dealings with Zinn.

### **The Court of Appeals Decision**

The Court of Appeals rejected the Appellate Division’s conclusion that Harris, Habib and Rosen’s independence with respect to the stock options and warrants challenged in *Lichtenberg* collaterally estopped a challenge to Harris, Habib and Rosen’s independence with respect to indemnification payments in *Bansbach*. The court stated that the finding in *Lichtenberg*, where Harris, Habib and Rosen were not members of Besicorp’s board at the time of the wrongdoing alleged in that case, and where there was a record including “affidavits and other materials evidencing the directors’ independence,” did not “for all time and in all circumstances insulate their conduct from similar claims.”

With respect to demand futility, the Court of Appeals reaffirmed the *Marx* test and the rule that “[s]imply naming a majority of the board as defendants with conclusory allegations of wrongdoing or control is insufficient to circumvent the requirement of demand.” The court then held that demand was excused because a majority of Besi-

corp's board lacked disinterestedness: "either a director's self-interest in the matter or a loss of independence owing to domination and control by a self-interested director."

The court noted that "[i]n *Barr*, interest was found and demand excused where the board approved an offer less favorable to the company but more beneficial to board members personally," and "in *Marx* self-interest was shown by allegations that the outside directors comprised a majority of the board and therefore received a personal benefit in fixing their own excessive compensation."

The court described the claim in *Bansbach* as "different": plaintiff alleged that "the board was dominated and controlled by Zinn, who by reason of his position and associations with defendants caused them to place his interests above those of the corporation." Unlike the Appellate Division's focus upon past personal and business relationships, the Court of Appeals focused upon the board's "immediate action covering Zinn's fees upon issuance of subpoenas, yet delaying reimbursement – indeed, continuing to advance defense costs – after Zinn in open court admitted having implicated the corporation in his criminal conduct."

The court pointed to the criminal nature of Zinn's conduct, his admission that he knowingly and willfully violated the law, and the Business Corporation Law's (1) requirement in Section 722(a) that a director or officer must have acted "in good faith, for a purpose which he reasonably believed to be \* \* \* the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful" in order to obtain indemnification, and (2) prohibition in Section 721 against indemnification where "a judgment or final adjudication adverse to the director establishes that his acts were committed "in bad faith or were the result of active and deliberative dishonesty." The court stated that Zinn's admission at sentencing that his violations of federal law – punished with fines and imprisonment – were "knowing and willful" left "no room for finding that he was entitled to

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## SDNY Holds Antitrust Claims Against IPO Underwriters Are Barred Under "Implied Immunity" Doctrine

*By Haron W. Murage*

In *In re Initial Public Offering Antitrust Litigation*, 287 F. Supp. 2d 497 (S.D.N.Y. Nov. 3, 2003), the United States District Court for the Southern District of New York dismissed federal and state antitrust claims against underwriters of initial public offerings ("IPOs"), based on the "implied immunity" doctrine. The district court found that because the Securities and Exchange Commission ("SEC") either permits, or has authority to regulate, the allegedly anticompetitive conduct challenged by plaintiffs, the potential conflict between the federal securities laws and the antitrust laws required a finding that the underwriters were immune from liability under the antitrust laws.

Plaintiffs, purchasers of shares in IPOs of technology companies, sued the underwriters of the IPOs claiming that the underwriters conspired to artificially inflate the aftermarket price of the IPO shares thereby generating underwriting commissions, charges, and investment banking fees. Plaintiffs challenged certain arrangements and practices by members of the underwriting syndicates, including the commissions they charged, their sharing of information during "road shows," and their supposed use of "laddering" arrangements under which potential purchasers in the IPOs allegedly agreed to make additional purchases in the aftermarket at prices above the IPO. Plaintiffs claimed that these activities violated the Sherman Act (15 U.S.C. § 1 *et seq.*) and state antitrust statutes. The underwriter defendants moved to dismiss the antitrust claims, including on the grounds that the challenged conduct is protected under the implied immunity doctrine. (The SEC, the Department of Justice ("DOJ") and the New York Attorney General ("NYAG"), submitted *amicus curiae* briefs. The SEC argued in favor of implied immunity while the DOJ and the NYAG argued against implied immunity).

The district court stated that the implied immunity doctrine "is grounded in the shibboleth that Congress does not intentionally vitiate its own regulatory mandates, and therefore 'antitrust laws do not come into play when they would prohibit an action that a regulatory scheme permits'" (quoting *Finnegan v. Campeau Corp.*, 915 F.2d 824, 827 (2d Cir. 1990)). The court explained that the doctrine of implied immunity "provides that federal securities laws impliedly repeal the Sherman Act with respect to certain conduct, and confer immunity from liability under the antitrust laws for that conduct" (citing *United States v. Nat'l Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694 (1975), *Gordon v. New York Stock Exch., Inc.*, 422 U.S. 659 (1975), and *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963)).

The district court stated that the Supreme Court decisions in *Silver*, *Gordon*, and *NASD* "yield 'two narrowly-defined situations' in which the doctrine of implied immunity will apply: 'first, when an agency, acting pursuant to a specific Congressional directive, actively regulates the particular conduct challenged . . . and second, when the regulatory scheme is so pervasive that Congress must be assumed to have foresworn the paradigm of competition'" (quoting *In re Stock Exchs. Options Trading Antitrust Litig.*, 317 F.3d 134 (2d Cir. 2003) and *Northeastern Tel. Co. v. AT & T*, 651 F.2d 76, 82 (2d Cir. 1981)). But the court cautioned that implied repeal is disfavored and, therefore, "only where there is a plain repugnancy between the antitrust and regulatory provisions will repeal be implied" (quoting *Gordon*, 422 U.S. at 682). The court also stated that under two Second Circuit decisions clarifying the interrelationship between the securities laws and the antitrust laws – *Friedman v. Salomon/Smith Barney, Inc.*, 313 F.3d 796 (2d Cir. 2002), *cert. denied*, 124 S. Ct. 152 (2003) and *In re Stock Exchs. Options*, 317 F.3d 134 – the requirement that antitrust laws and securities laws be "plainly repugnant" is "satisfied by potential, as well as actual, conflicts."

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## Antitrust Claims Barred Under “Implied Immunity” Doctrine

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Applying these standards, the district court held that the challenged conduct was immune from antitrust scrutiny, noting that “the SEC explicitly permits” much of the conduct, and more important, the SEC has broad regulatory authority over “conduct related to securities offerings”: “[i]t is this sweeping power to regulate that spawns the potential conflict with the antitrust laws that . . . requires a finding of implied immunity.”

For example, the court characterized plaintiffs’ allegations regarding the underwriting syndicate system as “nothing more than a theater-wide attack on the syndicate system, the predominant structure for the public distribution of equities since the infancy of the securities markets.” Furthermore, the syndicate system is directly regulated by the securities self-regulatory organizations, such as the National Association of Securities Dealers which, in turn, are supervised by the SEC. The court also found that the challenged information-sharing during “road shows” is permitted under Section 2(a)(3) of the Securities Act and SEC Rule 134. The court held that “[a]s each

of the aforementioned activities alleged in the Sherman Act Complaint are expressly permitted under the current securities regulatory regime, a determination by a court that any of them constituted an antitrust violation would bring the antitrust laws into direct conflict with the securities laws. This species of ‘plain repugnancy between the antitrust and regulatory provisions’ would, in the absence of a finding of implied immunity, ‘render nugatory the legislative provision for regulatory agency supervision’” (quoting *Gordon*, 422 U.S. at 682).

Moreover, the court found that although some of the challenged conduct, such as the alleged “laddering” arrangements, could be considered prohibited under both the securities laws and the antitrust laws, a finding of implied immunity was still required. The court stated that because the SEC has broad power, under federal law, to regulate “all aspects of the national securities markets,” “potential conflicts exist even between activities that are, at the current time, prohibited under both the securities and antitrust regulatory regimes” and, under the Supreme Court decisions in *Silver*, *Gordon* and *NASD*, “such potential conflicts require a finding of implied immunity.” The court noted that unlike the antitrust laws, whose touchstone is competition, the

“securities laws take into consideration more than just free competition, and in fact permit price manipulation in certain instances despite its effect on competition.” According to the court,

The breadth of the SEC’s authority, in conjunction with its unique mandate to balance competition with other market concerns, increases the likelihood of conflict with antitrust laws, and thus weighs heavily in favor of granting implied immunity where the securities regulatory regime . . . is implicated.

The court thus held that here, a failure to find implied immunity would “‘conflict with an overall regulatory scheme that empowers the [SEC] to allow conduct that the antitrust laws would prohibit’” (quoting *In re Stock Exchs. Options*, 317 F.3d at 149).

Finally, the court held that, notwithstanding the lack of Supreme Court or Second Circuit precedent, the challenged conduct was also immune from attack under state antitrust law, noting that, “[t]o shield the securities regulatory regime from encroachment by the Sherman Act, only to expose that regime to assault by a swarm of state antitrust claims” would “eviscerate the implied immunity doctrine” and “shatter the federal regulatory framework for national securities markets.”

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## Shareholder Derivative Litigation In New York After *Bansbach*

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indemnification.” The court held that this conduct demonstrated the domination and control by an interested director required to show a lack of independence.

The court also observed that “[e]vidence of post-litigation events” – a request for “only partial repayment in the form of a promissory note” after Zinn was sentenced to prison, and full indemnification, including Zinn’s fine, after the trial court had found that demand was required and dismissed the action – “confirms” that demand was futile. The court’s decision does not state whether the court relied upon these post-litigation events or simply

noted them as confirmation of its conclusion that demand was excused. The court noted the Appellate Division’s statement that “plaintiff cannot plead the futility of such a demand based upon facts that occur after the commencement of the action”; the Appellate Division, in turn, cited *Bryan v. West 81 St. Owners Corp.*,<sup>9</sup> which affirmed a trial court decision by now Court of Appeals Judge Ciparick, who joined the court’s unanimous decision in *Bansbach*. Outside of New York, “many cases hold that the proper time to measure demand futility is at the filing of the complaint.”<sup>10</sup>

### Conclusion

*Bansbach* re-affirms the fundamental corporate governance principles underlying the demand requirement and

the difference between the usual case where demand should be required and the unusual case where demand should be excused. The issue not addressed in *Marx* or *Bansbach* – or any other Court of Appeals decision – is what happens when a shareholder makes a demand and the demand is refused for reasons the shareholder considers unsatisfactory.

1. 1 N.Y.3d 1 (2003).
2. 88 N.Y.2d 189 (1996).
3. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991).
4. *Marx*, 88 N.Y.2d at 193.
5. *Kamen*, 500 U.S. at 101.
6. 36 N.Y.2d 371 (1975).
7. 47 N.Y.2d 619 (1979).
8. 260 A.D.2d 741 (3d Dep’t 1999) and 294 A.D.2d 762 (3d Dep’t 2002).
9. 186 A.D.2d 514 (1st Dep’t 1992).
10. *Harris v. Carter*, 582 A.2d 222, 228 (Del. Ch. 1990).