

# Self-Dealing Transactions under the Business Judgement Rule (for owners and managers)

By Giselle Ayala Mateus, Esq.

Whether you are a small business owner a beginner investor or an artist, forming a corporate entity will probably be part of your legal strategy, to limit your liability and for tax planning purposes. Thus, it is important for you to understand, that those who manage a business, whether it is a partnership, or a corporate entity are considered fiduciaries.

A fiduciary is an individual that manages the day-to-day activities of the business and is required to put the best interest of the business above his own. Accordingly, a fiduciary has a duty of diligence, a duty of good faith, and a duty of loyalty. We will focus on the duty of loyalty in this note.

Under New York common law, the duty of loyalty, "...is a sensitive and inflexible rule of fidelity, barring not only blatant self-dealing but also requiring avoidance of situations in which a fiduciary's personal interest possibly conflicts with the interest of those owed a fiduciary duty". *Pokoik v. Pokoik*, 115 A.D.3d 428

In other words, the duty of loyalty requires managers to avoid self-dealing and conflicts of interest. Self-dealing exists when a fiduciary acts in their own best interest in a transaction, rather than in the best interest of the business entity. On the other hand, a conflict of interest exists when the fiduciaries get involved in a transaction that puts the interest of the business entity in direct or indirect conflict with his own. Fiduciaries are found to be interested if they "appear on both sides of a transaction or expect to derive any personal financial benefit from it. *Arson v. Lewis*, 473 A.2d 805 (Del. 1984).

Understanding the duty of loyalty and what it means in "real life" is important for the owners of a business or venture, whether they are managers or not. In fact, even in the presence of limited liability, fiduciaries (like directors, managers, partners, etc.) may face personal liability if they breach their duty of loyalty.

## The business judgment rule

It is ideal that fiduciaries put always the company's interest first when it comes to managing the business. However, even in situations affected by a conflict of interest, the law does not automatically void transactions. Under the *Business Judgment Rule*, courts may not inquire into actions of corporate managers taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.



Basically, the business judgment rule has two components. The first component protects fiduciaries from personal liability if they act in accordance with their duties to the full extent of the law, the second component, on the other hand, prevents courts from intervening in management decisions made by the directors.

In the context of litigation, a plaintiff challenging a decision of the fiduciaries (managers or directors) of a business has the burden of providing evidence that the fiduciaries, in reaching the challenged decision, breached the duty of good faith, loyalty or due care (aka duty of diligence). If the plaintiff fails to meet this evidentiary burden, courts will not second-guess the fiduciaries' business judgment. However, if the plaintiff provides sufficient evidence, the burden shifts to the defendant to prove *the entire fairness* of the transaction to the plaintiff.

Under the *entire fairness standard* of judicial review, the analysis is focused on whether a self-dealing transaction should be permitted or set aside, specifically, on whether the transaction, viewed objectively, is fair and reasonable. In other words, here courts examine whether the transaction is entirely fair to the company and its owners.

To meet the requirements of the entire fairness standard, fiduciaries have the burden of proving that the transaction was approved either by a special committee of independent individuals or by an informed vote of the majority of the disinterested stockholders (or owners of the business). Additionally, when the majority of those in charge of approving the decision are not disinterested, a transaction may only be valid if the terms were entirely fair to the shareholders or the owners of the business. When the entire fairness test applies, a transaction must be fair as to both process and price.

## **Recent Delaware Decision on the Subject**

In a recent decision by the Court of Chancery of the State of Delaware, the application of the business judgment rule was the focal point of the analysis. The defendants, directors of WinView Inc. filed a Motion to Dismiss against the plaintiff's complaint. According to the plaintiffs, a merger transaction approved by the directors had been approved in violation of the business judgment and required review by the court, specifically, the plaintiffs alleged breach of the director's duty of loyalty and unjust enrichment.

In May 2020, the board of directors of a privately held Delaware corporation approved and closed a merger transaction. Prior to the merger, several directors had received incentive awards and securities in connection with a series of debt and equity transactions. As a result of these transactions and the approved merger, the directors resulted being both secured creditors of the new company and preferred stockholders. The plaintiffs, on the other hand, who owned common stock (which gets paid the last) would receive compensation subject to the success of a patent litigation.

The plaintiffs alleged that the merger was not in the best interests of the company and that director had interfered with attempts to secure financing to pursue the said patent litigation. Additionally,



the merger had been approved without having commissioned a fairness opinion or retained outside advisors to evaluate the treatment of different classes of shareholders.

In this case, the Court of Chancery declined to dismiss the complaint and explained that even though the rationale underlying the business judgment rule is not to second-guess the judgment expressed by a majority of unconflicted stockholders, the transaction at issue was worth doing more deep analysis.

The court considered the context of the transaction and pointed out that excluding an interested director from the vote of a transaction may not be enough to defend the validity of the transaction. In fact, “...*Delaware law does not allow directors who negotiated a transaction to “specifically to shield themselves from any exposure to liability” by “deliberately absent[ing] themselves from the directors’ meeting at which the proposal is to be voted upon.”*”.

Accordingly, it is at least conceivable that a fiduciary breaches the duty of loyalty if he directly by participates in the negotiations of a self-dealing transaction.

## Key takeaways

Considering the requirements of the business judgment rule and the entire fairness standard, business owners, stockholders, and fiduciaries should consider this:

- A fiduciary is an individual that manages the day-to-day activities of the business and is required to put the best interest of the business above his own.
- Fiduciaries (managers or directors) of a business should avoid self-dealing transactions.
- Fiduciaries who wish to engage in self-dealing transactions must make full disclosure of all material details of the transaction and then either obtain the assent of disinterested fiduciaries.
- To meet the requirements of the entire fairness standard, fiduciaries have the burden of proving that the transaction was approved either by a special committee of independent individuals or by an informed vote of the majority of the disinterested stockholders (or owners of the business).
- The approval of a self-dealing transaction will usually be subject to “stricter scrutiny” than the approval of an independent business opportunity.
- Interested fiduciaries should not be directly involved in the negotiation of the self-dealing transaction.
- If disclosure is made, but there is no disinterested majority of voters or the stockholders, the fiduciaries have the burden of demonstrating that the transaction was entirely fair.



## Giselle Ayala Mateus



As an entrepreneur herself and an immigrant, Giselle knows precisely how to counsel clients and serve them with excellence. Giselle Ayala Mateus was born in 1991 in Bogotá – Colombia. Her mother is a district attorney in Colombia. Her father is a retired Colombian attorney and community health worker with Planned Parenthood in New York City.

After finishing law school in Colombia and being admitted to practice law in this country, Giselle came to the United States to complete a Masters of Laws with the Brooklyn Law School. While being a single mom law school student in the U.S., Giselle completed her studies and a Business Law specialization. As part of her legal education in the U.S., Giselle worked with Good Counsel Services; a nonprofit organization focused on educating and empowering nonprofits and social entrepreneurs.

### New York – Immigration, Business and IP Attorney

In 2018, Giselle created FOCUS, a not-for-profit project focused on supporting entrepreneurs and artists. Giselle has served as counsel and representative on issues related to the review and drafting of commercial contracts, creative developments, transfer of intangible rights, and business formation in the United States. Giselle has also performed as a leading attorney in adjustment of status processes, asylum applications, work visas, interviews with immigration officials, presentation, and foreign documents validation.

Likewise, she has worked as a simultaneous interpreter for family processes, immigration, and application for public benefits. On March 27th, 2021, during the celebration of Latin Women, titled “Powerful Women”, Giselle was recognized by the New York State Assembly with a Certificate of Merit for Outstanding Achievement Entrepreneur.

Dedicated to her clients and her law practice, Giselle is currently communicating to her audience via social media, Facebook, Youtube, Quora, and more. Her service-oriented approach has lead her to where she is now. Giselle is a current member of the New York State Bar (NYSBA), the American Immigration Lawyers Association (AILA), the FAME Center for Fashion, Art, Media & Entertainment Law of Cardozo Law School, and the American Intellectual Property Law Association.

