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It is the Process, Not Necessarily the Price

An analysis of the fiduciary duties that directors of financial institutions should consider and address in order to reduce or eliminate the risk of liability in the context of major corporate transactions.

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The weak economic recovery, continuing extremely low interest rate environment, increased regulatory burdens and uncertainty, and other factors have led all banks, but particularly community and regional banks, to take a hard look at their business plans and question where to go from here. Deposits seem easy to come by, and the cost of those funds is historically low, but difficulties in growing loans and ever increasing margin compression are making it tough. At the same time that banks are struggling with these existential questions, we are seeing an increase in challenges to board and director decision making, particularly in the merger and acquisition context. In short, the environment is growing more hostile. Against this backdrop, we thought it would be useful to remind directors of their fiduciary duties and steps that can be taken to insulate themselves as best they can from personal liability in the context of major corporate transactions. This article will briefly explore the director's two primary fiduciary duties - of care and loyalty - and the legal concept of the Business Judgment Rule.

The Business Judgment Rule is a legal presumption that a director of a company, in making a business decision, has acted on an informed basis, in good faith and with the honest belief that the action taken was in the best interests of the company and its shareholders. In short, the Business Judgment Rule presumes directors have met their fiduciary duties of care (acted on an informed basis) and loyalty (honestly believed that the action was in the best interests of the company and its shareholders). When it applies, the Business Judgment Rule acts as a shield from personal liability for directors. This places the directors and the company in a favorable litigation position; when the Business Judgment Rule applies, in effect, a court will not second-guess the board of directors' decision. The Business Judgment Rule allows directors to make decisions without being the insurers of results. To shatter the shield of the Rule, an attacking shareholder must establish that the director violated either the duty of care or duty of loyalty.

Duty of care is defined as acting with such care, including reasonable inquiry, as an ordinary prudent person in a like position would under the circumstances. In exercising due care, a board's conduct will be evaluated primarily by review of its decision making process. In fact, in the sale of a company, directors have been successfully sued because the process they followed was flawed even though they obtained a premium price. A Delaware Chancery Court Vice Chancellor has admonished directors on the duty of care to, "act like it was your own money." That is a simple formulation, but an apt description. The duty of care is all about how a board reaches a decision. Taking adequate time to deliberate, consider and evaluate key decisions, as well as documenting the process, is extremely important. The process should include frequent

board meetings, prompt dissemination of material information to board members, thorough review of such information, constant documented oversight of potential conflicts, placing disinterested directors in key roles, decision making on an informed and insightful basis, accurate record keeping, and reliance on professionals. A board that patiently takes the time to evaluate all material information regarding a potential transaction, asks questions, relies on professional experts, diligently considers a decision and documents its informed analysis will likely have satisfied its duty of care.

In addition to the duty of care, directors need to fulfill their duty of loyalty, which requires that directors act in good faith and with an honest belief that the action being taken is in the best interests of the company and its shareholders. The duty of loyalty focuses on the motivations behind a director's decision, as opposed to the duty of care, which focuses on the manner in which the decision is made. Specifically, to satisfy their duty of loyalty directors may not act for personal or non-corporate purposes. In other words, directors must check their own personal interests at the boardroom door. Two obvious fact patterns suggest a possible breach of the duty of loyalty: (1) a director who has a direct or indirect financial interest in the decision that is at odds with the company's, and (2) a director who is financially or otherwise obligated to a person whose interests conflict with those of the company in the particular transaction. Examples of a director's competing financial interest are easy to identify, while the latter may not be as intuitive. There are a number of cases arising in the merger context where an otherwise disinterested board's loyalty was questioned because it appeared the board sought to protect the positions of its management team at the potential expense of the shareholders. For instance, a board that chooses a merger partner with a lower priced offer, but that will keep the management team in place, over a higher offer that will result in all management being terminated at the close of the merger should expect to have its loyalty to the shareholders questioned.

As directors attempt to fulfill their duties of care and loyalty, the underlying question of good faith should not be overlooked. The concept of good faith requires that a director have an honest belief that the action he takes is in the best interests of the company or its shareholders. Good faith, much like the Business Judgment Rule itself, recognizes that directors cannot be expected to know with certainty the results of their decisions – again, directors are not insurers of results. However, directors must act honestly both in the goals they seek to achieve through their decisions and through the process by which those decisions are made. A lack of good faith, or bona fides, risks the loss of the protection of the Business Judgment Rule.

As directors evaluate significant corporate transactions we recommend they start by leaving their personal interests outside the boardroom, and then focus on the process most likely to achieve the best interests of their shareholders to better their chances of being covered by the Business Judgment Rule. The following is a recommended approach to fulfill the duties of care and loyalty, and to help achieve protection under the Rule:

- Leave Personal Interests Out of Discussions
- Be Deliberate and Patient in Decision Making
- Use and Rely on Experts
- Read Materials Thoroughly
- Ask Questions
- Make a Record

Many tough decisions lay ahead given the present banking environment, and directors

must be careful as they maneuver through treacherous waters. We recommend that board members remain focused on their fiduciary duties and act in good faith with the best interests of their bank and its shareholders in mind. Doing so offers the best shield from personal liability through the protection of the Business Judgment Rule.

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