Director Fiduciary Duties in Mergers

Over the past several years, we have seen a good number of bank mergers in Virginia. The deals come in all shapes and sizes, and for a variety of reasons. Banks have combined to gain not only size but operating efficiencies in terms of back office operations, vendor expense and regulatory compliance (speaking of the latter, we at the VBA are continuing our efforts to get Capitol Hill to recognize the unnecessary burden placed on banks over the last decade and to reduce aspects of the regulatory scheme that continue to hamper America's banks). Other reasons deals have been made include management succession, improving growth opportunities and strengthening contiguous markets. Of course, in a number of mergers the consideration offered was just too good for the boards to pass up.

Just like deposit taking and lending, keeping an eye on M&A activity is a part of life for all banks. With the holidays in the rear-view mirror and Spring right around the corner, now may be a good time to review with your board its fiduciary duties in a merger transaction and help prepare your directors in the event that one day your bank decides to partner with another institution. There are many aspects to merger preparation from a board perspective – recognizing and following fiduciary duties and taking action for good corporate governance is one of the most important.

Fiduciary Duties Generally

In general, a board of directors that has complied with its basic fiduciary duties of care and loyalty is entitled to the protection of the business judgment rule. The business judgment rule is the principle that directors are presumed to have acted in good faith and in the best interests of the company when making a decision. Courts are looking for objective evidence that directors have made careful, educated and honest decisions.

Duty of Care. Directors must weigh decisions carefully in light of all available information. Unlike other jurisdictions, Virginia law does not apply a "reasonableness" standard in considering board action. Instead, it adopts a more process-oriented approach, focusing on the extent to which the board of directors engaged in an *informed decision-making process of what, in the exercise of their good faith business judgment, is in the best interests of the company*. The issue is not the substance of the board's decision, which can always be second-guessed, but the process followed by, and good faith intentions of, the board. Continuous and substantial director involvement is imperative.

The roles of the CEO and other insiders in negotiating a merger transaction and selecting financial and legal advisors should be balanced by active, direct participation of independent, outside directors. The board's careful consideration of strategic and financial alternatives should be made clear in the minutes and other records of board action.

To ensure that the board of directors has complied with its duty of care under Virginia law, it should, at a minimum, take the following actions when considering a merger:

- Gather and consider all available information and documentation about the transaction, making sure it is adequate and sufficient to fully understand the deal;

- Evaluate the transaction in light of alternatives, including the company's existing strategy and projections, and associated advantages, disadvantages and probabilities of success;

- Evaluate the likelihood of achieving anticipated benefits of the proposed transaction and the anticipated risks;

- Consider the proposed operating strategy of the combined company and the extent to which such strategy is consistent with the board's view of an appropriate strategic direction;

- Consult with outside experts, including financial and legal advisors;

- Ask questions of management and outside advisors and deliberate candidly about the transaction before making a decision; and

- Identify and mitigate any applicable conflicts of interest (as described below).

The terms of the merger (whether it's the value of the consideration received by the shareholders, the economic provisions of the deal protection provisions, the financial incentives for particular officers and directors or the ability to pursue alternatives) must be considered both separately and in the aggregate. If the totality of the arrangements go too far, each one individually may be tainted.

Duty of Loyalty. The duty of loyalty requires directors to act in good faith and in the best interests of the company and its shareholders. Directors must put the interests of the company and its shareholders ahead of any personal interests. Transactions involving conflicts of interest are not prohibited, but steps must be taken to mitigate the conflicts to avoid breaching the duty of loyalty. These mitigation steps are discussed below.

Special Considerations for Transactions Involving Interested Directors

Certain transactions involving directors that are not "disinterested" are voidable under Virginia law under certain circumstances. A director is interested (i.e. not "disinterested") in a matter if the director (or a close associate[1]) has a financial interest that would reasonably be expected to adversely affect the director's objectivity. A transaction in which a director is interested is not voidable if it is either fair to the company or approved, with knowledge of the material facts, by (i) a majority of disinterested directors, (ii) a committee of disinterested directors or (iii) the shareholders.[2]

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[1] A close associate is a person who has a financial interest in a matter and a familial, financial, professional, employment or other relationship with a director.

[2] Approval of the shareholders in this context would mean that (i) the directors would not make any recommendation as to how shareholders should vote, and (ii) shareholders holding more than two-thirds of the

When a board is considering a transaction involving conflicts of interest or an interested director, it should take the following actions to mitigate the conflicts:

- Identify the conflicts and determine whether the conflicts would reasonably be expected to affect a director's objectivity;
- Establish the body of disinterested directors that will consider the transaction and any alternative transactions (either all disinterested directors or a special committee of disinterested directors);
- Deliberate without influence from the interested director(s) and ensure that deliberations and decision criteria remain confidential; and
- Take appropriate actions, including those listed under "Duty of Care" above, to ensure an arms-length transaction in the best interests of the company and its shareholders.

The best time to remind directors of their fiduciary duties is not in the middle of a merger, but well beforehand. By properly exercising their responsibilities of being well-informed, involved and carefully considering all of the information presented on a merger, your directors can engage in good risk management practices and solid corporate governance.

For more information about directors' duties in the merger context, contact Mel Tull, VBA General Counsel, at mtull@vabankers.org or (804) 819-4710. This article has been prepared for informational purposes only and is not legal advice.

company's outstanding shares, excluding shares held by any interested shareholder, would have to vote in favor of the transaction.