

THE BUSINESS JUDGMENT RULE IS THE DIRECTOR'S BEST FRIEND



Photographer: David DeLoss

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Background

Background

The Deal

The Class Action

Business Judgment Rule - Basics

Refresher on Fiduciary Duties

Business Judgment Rule NY & Delaware Versions

The Decision

Guidance for Directors

Practical Tips

Application of Business Judgment Rule

Defensive Use of Business

Conclusion

- In 2009 and 2010, Wilber's asset quality deteriorated due to national recession and an imperfectly executed expansion into the Syracuse market.
- Result: regulatory enforcement action and management change.
- Wilber was forced to consider strategic options:
 - raising new equity capital and remaining independent; or
 - a business combination with a stronger organization.
- After Soliciting bids and considering several bona fide officers, October 2010, The Wilber Corporation, Wilber National Bank's parent bank holding company, entered into a merger agreement with Community Bank System, Inc., the parent of Community Bank.
- The Wilber Corporation and Community Bank System Inc. were public, exchange listed companies.
- Each company's board of directors approved the transaction unanimously.

The Deal

- Deal valued at \$101.8 million
 - At \$9.50 per share, Community's offer was a 55.48% premium over the market price of Wilber's common stock.
 - Wilber shareholders received 20% in cash and 80 % in Community common stock, subject to adjustment based upon Community's share price and Wilber's asset quality.

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

The Class Action

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- On Nov. 3, 2010, Wilber shareholders selected by the lawyers filed lawsuits in the New York Supreme Court in Otsego County. Both complaints sought class certification, named Wilber, Wilber's directors, and Community Bank System as defendants and alleged that:
 - the director defendants breached their fiduciary duties by failing to maximize shareholder value in connection with the merger; and
 - Community Bank System aided and abetted those alleged breaches of fiduciary duty.
 - Specifically, the complaints alleged that:
 - Community Bank agreed to appoint two of Wilber's directors to the boards of Community Bank System and to establish an advisory board of Community Bank, made up of the current directors of Wilber;
 - the directors and officers of Wilber entered into voting agreements to vote their shares of Wilber common stock in favor of the merger; and
 - the consideration to be received by Wilber's common shareholders was inadequate and unfair.
 - Plaintiffs sought an injunction stopping the merger and an award of attorneys' fees, arguably the main purpose of the litigation.

The Business Judgment Rule - Basics

- New York law vests a corporation's board of directors with responsibility for direction of the corporate business. Directors may delegate day to day management to officers, but they may not shed accountability for governance or their fiduciary duties of care, good faith and loyalty.
- The business judgment rule is a judge-made rule, not a statute enacted by the legislature or a regulation issued by an agency. The rule, which is substantially the same in New York and Delaware, protects directors' decisions from attack when the directors act consistently with their fiduciary duties.

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Refresher on Fiduciary Duties

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- Directors owe two duties to their companies: the duty of care and the duty of good faith/loyalty. These duties are inherent in all of the directors' governance responsibilities.
- Duty of Care:
 - The duty of care requires directors to act independently and thoughtfully, with that degree of care that a prudent person in the director's role would exercise. This duty requires directors to act on an informed basis, including the input of financial and legal advisors and that they devote sufficient time to their decision making.
- Duty of Good Faith/Loyalty:
 - The duty of good faith/loyalty demands that directors act in the best interest of the corporation, that you subordinate personal gain to the corporation's interests, and that they act with undivided loyalty to the corporation.

Business Judgment Rule – NY & Delaware Versions

The New York courts have described the business judgment rule as follows:

- “That doctrine bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. ‘Questions of policy, of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.’”

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Business Judgment Rule – NY & Delaware Versions (cont'd.)

The Delaware courts have phrased the rule this way:

- Under the business judgment rule, there is a “presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interest of the company.”
- In other words, courts “will not invalidate a board’s decision or question its reasonableness so long as its decision can be attributed to a rational business purpose.” Under this rule, the directors’ decision is protected unless plaintiff can show that the board breached its duty of care or loyalty.
- Most recently, the Delaware Supreme Court noted that “directors’ decisions must be reasonable, not perfect.”

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

The Decision

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- Community, Wilber and the Wilber directors answered the complaint and promptly moved for summary judgment.
- On March 28, 2011, the court granted the motion and dismissed both complaints.
- The merger closed as planned on April 8, 2011.
- The court based its decision on the following factors, all of which were described in the proxy statement/prospectus delivered to Wilber's shareholders:
 - The court gave substantial weight to the process the Wilber board followed once it decided to sell the company. This included many meetings with its financial and legal advisers, solicitation of bids from nine potential acquirers, detailed analysis and comparison of the three bids it received, and comprehensive instruction on directors' fiduciary duties when considering business combinations.
 - Wilber received a fairness opinion from a firm that was independent from the financial advisor that marketed the company and whose compensation was contingent on completion of the merger.

The Decision (cont'd.)

- The Wilber directors discharged their fiduciary duty by acting with disinterested independence. Plaintiffs furnished no evidence of bad faith.
- Wilber’s certificate of incorporation authorized the board to consider the factors set forth in the New York Business Corporation Law, including the long and short term interests of the company and its shareholders and the effects that the transaction may have on the growth, development, productivity and profitability of the company and its many constituencies, including employees, customers, creditors and the community.
- New York case law upholds deal protection provisions such as voting (“lockup”) agreements, breakup fees and other contractual terms the plaintiffs alleged to be wrongful.

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Guidance for Directors

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

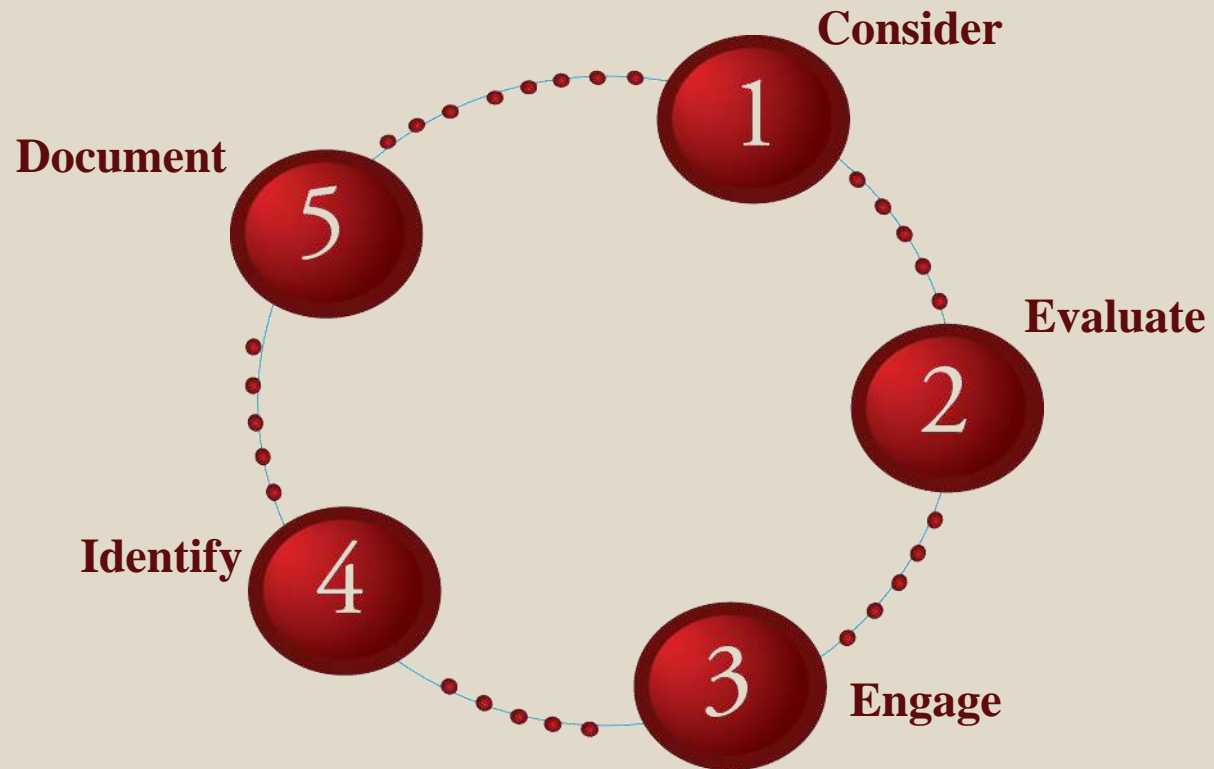
Defensive Use
of Business

Conclusion

- The Internet enables aggressive lawyers to pounce on deal announcements, make flimsy allegations, troll cyberspace for potential plaintiffs and commence litigation to extract a settlement and attorneys' fees. In this environment, the business judgment rule is a company's and its directors' best defense to any Monday morning attack on the board's decision to enter into a change of control or other transaction with material economic consequences.
- The defense boils down to this: if they properly discharge their duties, the business judgment rule protects from liability directors who are sued by shareholders alleging that they sold the company for an inadequate price (the typical claim) or that they benefited personally (another typical claim).
- To support invocation of the rule, evidence must exist that the directors upheld their duties. The evidence must show that the directors' conduct was consistent with due care and loyalty. Documentation of the board's deliberative process is the evidence that will support a successful business judgment defense in litigation seeking to second guess the board's transactional decisions.

Practical Tips

- Some takeaways for boards considering business combinations include:



Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Practical Tips

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Consider Board Flexibility

- Consider including provisions in the company's certificate of incorporation that give the board flexibility when considering offers.

Evaluate Potential Counterparties

- Evaluate the prepared marketing materials and expressions of interest from potential counterparties carefully and thoroughly. Ask questions and make certain that you understand the legal, accounting, financial and regulatory aspects of any proposed transaction. Educate yourselves to get the best-informed sense of market value.

Engage and Utilize

- Engage and utilize retained experts, including lawyers, accountants and financial advisors.

Practical Tips

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Identify and Disclose

- Identify and disclose any conflicts of interest posed by a potential transaction. For example, if you lease property to a potential acquirer or own its securities, make certain that you disclose same and seek advice as to whether you should abstain from any vote on the deal.

Document the Process

- Document the process in the minutes and through the adoption of appropriate resolutions at key junctures. Record dissenting votes. Documentation is essential to a winning business judgment rule defense.

Application of Business Judgment in Other Matters

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- The business judgment rule isn't limited to merger situations.
- Examples of other matters that could provoke challenges from shareholders include a board's decision to:
 - Issue preferred stock
 - Enter a major new line of business
 - Amend the certificate of incorporation to require supermajority votes on certain matters

Defensive Use of Business Judgment Rule

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- In the Wilber situation, the business judgment rule shielded the board from liability for **agreeing** to a deal.
- The rule is equally available to boards who, after due deliberation, decide to **reject** a deal.
- This is particularly noteworthy in the current environment where a week doesn't go by without a pundit opining in the American Banker that merger activity will heat up as smaller banks decide they can't survive in the post Dodd-Frank world.

Application of Business Judgment Rule to Non-Public Banks

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

- These principles are as relevant to banks with a closely held shareholder base as they are to public companies.
- For example, remember how, following their conversion to stock form, many newly public thrifts looking to deploy capital very persistently knocked on the doors of smaller independent commercial banks.
- The business judgment rule was there to protect boards who “just said no”.

Conclusion

- Mergers and other major transactions place enormous stress on directors, officers and employees.
- Aggressors count on stress and the fear of delay-by-injunction when they start hollow litigation.
- As the Wilber-Community case shows, companies don't have to cave in to a shakedown. They can meet the challenge with a sound decision-making process.
- The story can end well for boards that build a solid evidentiary record for the business judgment defense.

Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion

Thank you!

Thank you for attending.

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Background

The Deal

The Class Action

Business
Judgment Rule - Basics

Refresher on
Fiduciary Duties

Business Judgment Rule
NY & Delaware
Versions

The Decision

Guidance for
Directors

Practical Tips

Application of
Business
Judgment Rule

Defensive Use
of Business

Conclusion