



Fiduciary Duties of Credit Union Directors in the Merger Context

Joseph S. Melchione

Timothy I. Oppelt

Follow this and additional works at: <https://via.library.depaul.edu/bclj>

Recommended Citation

Joseph S. Melchione & Timothy I. Oppelt, *Fiduciary Duties of Credit Union Directors in the Merger Context*, 7 DePaul Bus. & Com. L.J. 203 (2009)

Available at: <https://via.library.depaul.edu/bclj/vol7/iss2/3>

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Business and Commercial Law Journal by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.

Fiduciary Duties of Credit Union Directors in the Merger Context

Joseph S. Melchione & Timothy I. Oppelt†*

I. INTRODUCTION

As with much of the law concerning credit unions, laws governing the fiduciary duties of directors and officers of credit unions often lack content. While the general rule that directors owe a fiduciary duty seems self-evident, any attempt to find more specific guidance flounders. Although the law concerning for-profit corporations has been discussed thoroughly in courts and academic circles, such discussions rarely consider how the law of fiduciary relationships might apply in the specialized context of a cooperative financial institution like a credit union.

Fundamental corporate change¹ is one of the areas in which it is the most critical that corporate fiduciaries fulfill their duties, but it is also one in which the law is the most vague. The day-to-day management of a credit union does not substantially differ from that of any other financial institution, at least not enough to affect the assumed application of general corporate standards of care and loyalty. Fundamental corporate change in the credit union context, however, carries with it important differences. Credit unions are cooperative institutions, operating on a "one-person, one-vote" system. Members of credit unions do not own stock that can be transferred like the equity ownerships of stock corporations.² The nature of credit unions makes the majority of

* Partner, Styskal, Wiese & Melchione; Member, Credit Union Committee of the American Bar Association, Co-Chair, Governance Sub-Committee; J.D., University of California at Davis; B.A., University of California at Santa Barbara.

† Associate, Styskal, Wiese & Melchione; J.D., Loyola Law School, Los Angeles; B.A., Emory University. The authors would like to thank Hal Scoggins and Christopher Pippett for their editorial and research contributions to this article. The authors would also like to thank members of the Governance Subcommittee of the Credit Union Committee of the American Bar Association for their input during the writing of this article.

1. "Fundamental corporate change" is used here as the general term for a change in the capital structure of an artificial entity, such as a merger, a sale of substantially all of a company's assets, or, with financial institutions, conversion to another type of charter.

2. Credit union members deposit funds in "share accounts," which have a minimum deposit of one share, usually between five and twenty-five dollars. With the purchase of a share, the depositor becomes a member and may use other credit union services. Ownership, ability to use services, and deposits are linked, unlike with most stock corporations. When a member wishes to

for-profit merger law inapplicable except by analogy—one cannot assume that law applicable to specific charter types or particular stock transactions would be appropriate for different situations. Presently, the law of fundamental corporate change as it relates to credit unions remains vague.

This lack of clarity is compounded by the fact that the area of fundamental corporate change for credit unions has become increasingly important. There has been a significant, consistent, and continuing trend of credit union mergers. Since 1998, an average of 298 federal and federally-insured credit union mergers have occurred per year, and over two thousand credit unions have disappeared in the past decade.³ Previously unseen merger phenomena, such as hostile merger offers, have occurred.⁴ Financial institution charter type conversions, mergers, and the issues surrounding these transformations have captivated the credit union industry and trade press.⁵ And yet, many of these changes are new enough that commentary on the roles and duties of directors is noticeably absent. While the National Credit Union Administration (“NCUA”)⁶ has recently begun the process of promul-

leave, sale of the member’s share is nearly always made back to the credit union and for the value paid for it—in essence, a withdrawal.

3. See STYSKAL, WIESE & MELCHIONE, LLP, CUES COMPLETE GUIDE TO MERGERS 16 (Credit Union Executives Society, 2003); STYSKAL, WIESE & MELCHIONE, LLP, CUES COMPLETE GUIDE TO MERGERS (Credit Union Executives Society, 2d ed. 2008). Data on state-chartered credit union mergers is largely unavailable from any central source; however, the trends appear to carry across this divide.

4. The first hostile merger offer involving a credit union, which occurred in the Spring of 2007, is discussed in Part IV below.

5. See, e.g., Michelle A. Samaad, *Sleepless Nights Aside, Former Nationwide FCU CEO Has No Doubts Bank Merger was Best for Members, Fought Hard to Return Their Earned Equity*, CREDIT UNION TIMES, May 16, 2007, at 10; James Wilcox, *Credit Unions, Conversions, and Capital*, FRBSF ECONOMIC LETTER (ECONOMIC RESEARCH FEDERAL RESERVE BANK OF S.F.), June 22, 2007; David Morrison, *Dispute at Columbia Leads to Board Members Being Expelled*, CREDIT UNION TIMES, Sept. 13, 2006, at 1; Paul Gentile, *The Good News, Bad News of Lafayette FCU Conversion*, CREDIT UNION TIMES, Sept. 13, 2006, at 14; Michelle A. Samaad, *Texas Credit Unions Don’t Have Much to Say on Unsolicited Merger Proposal*, CREDIT UNION TIMES, Aug. 8, 2007, at 3; Ed Roberts, *NCUA Is Crafting A Rule to Prevent Hostile Takeovers from Taking Hold*, CREDIT UNION JOURNAL, July 30, 2007, at 1; Paul Seibert, *CEOs, Board Must Prepare Now for Merger Question*, CREDIT UNION TIMES, Nov. 14, 2007, at 17; Casey Connelly, *Successful Merger Strategies – Part I*, CREDITUNIONS.COM, Feb. 2, 2004, http://www.creditunions.com/home/articles/template.asp?article_id=1152; Ed Callahan & Bucky Sebastian, *Why a Bank Merger is Often Bad and a Credit Union Merger Often Good*, CREDITUNIONS.COM, June 6, 2005, http://www.creditunions.com/home/articles/template.asp?article_id=1668.

6. The NCUA is the regulator of federal credit unions. State-chartered credit unions are regulated by state authorities. The NCUA additionally regulates those state-chartered credit unions that carry federal deposit insurance through the National Credit Union Share Insurance Fund (a fund akin to the FDIC), as opposed to private deposit insurance. Thus, state-chartered credit unions at times have two masters: the NCUA as the deposit insurer, and the state regulator as the primary regulator.

gating regulations which may cover the fiduciary duties of federal credit union directors,⁷ this area remains undeveloped and ignored in academic work.

This article's purpose is to fill some of that void. In general, this article will discuss the standards that apply in determining whether, in the context of a merger, be it hostile or consensual,⁸ the directors of a credit union have fulfilled their fiduciary duties.⁹ Throughout this article, the law governing for-profit corporations is applied by analogy to credit unions. Because Delaware courts have developed the area of corporate law more thoroughly than other jurisdictions, much of the law included below is Delaware law. Also included when available is a discussion of California law, an example of a jurisdiction with separate statutory schemes for its for-profit and non-profit corporations and financial institutions.

Rather than detailing the nuances of one area of law, this article covers its topics generally, providing a survey view of issues in credit union law which will need to be resolved—through regulation, legislation, or litigation—in the future. Part II discusses the choice of law issues in determining the applicable legal standards for state and federal credit unions. Part III presents certain general principles and concepts concerning fiduciary duties, specifically, to whom a fiduciary duty is owed, standing to pursue remedies for breach of the duty, the content of the duty, and the business judgment rule. Part IV analyzes fiduciary duty in the specific context of consensual mergers. Part V does the same in the context of a hostile takeover.

7. See *Mergers, Conversion From Credit Union Charter, and Account Insurance Termination*, 73 Fed. Reg. 5461 (advance notice of proposed rulemaking and request for comment Jan. 30, 2008) [hereinafter *Mergers, Conversion and Termination Advance Notice*]. It is important to note, also, that this Advance Notice or Proposed Rulemaking ("ANPR") may or may not result in any rulemaking activity by the NCUA. Therefore, the subject matter of this article remains, in all regards, a live issue, even for federal credit unions.

8. This article will not discuss fiduciary standards as they relate to conversion from a credit union to another type of financial institution. While charter conversion is a type of fundamental corporate change, the relative lack of a for-profit analogue to this type of transaction makes this issue fundamentally different from mergers, at least in terms of the application of fiduciary duty law.

9. As noted in one recent article, the law governing fiduciary duties of officers, even those of for-profit corporations, is often overlooked. See Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 *BUS. LAW.* 147, 148 (2007). The discussion at hand only includes the duties of directors; however, one could speculate that the principles behind officer fiduciary and agent duties would not differ significantly between for-profit and mutual corporations.

II. CHOICE OF LAW

The first step in determining the applicable legal standards for a board of directors is determining what jurisdiction's law applies to that board. For most corporations created by state law, this issue is easily resolved. Choice of law regarding corporate governance in the United States is generally decided by the internal affairs doctrine.¹⁰ Under this rule, the law of the jurisdiction in which the organization was incorporated governs the fiduciary duties and other internal affairs of the organization. For state-chartered credit unions, the law of the credit union's state of charter applies. Some states charter credit unions as non-profit mutual benefit corporations,¹¹ others charter credit unions under specialized financial institution charters,¹² and yet others have no legal basis for forming a state-chartered credit union.¹³

Federal credit unions, however, are not chartered under state law; they are chartered directly by the federal government under the Federal Credit Union Act ("FCUA").¹⁴ As with many other areas of federal law, this immediately raises a fundamental choice of law question and the question whether courts will create federal common law. While there has not been a high court ruling on the applicable law for federal credit unions, the U.S. Supreme Court has ruled that in the absence of a federal statute for breaches of fiduciary duty by federal savings bank officers and directors, courts should apply state law.¹⁵ The decision in *Atherton v. FDIC* is based on statutes and regulations that are nearly identical to the corresponding FCUA provisions.¹⁶ Courts would thus not create a federal law of fiduciary duties, but rather defer to a body of state law corresponding with the geographic location of the bank or credit union.

The guidance from the Supreme Court makes it unlikely that any court will decide to create a federal standard for fiduciary duties for directors of federal credit unions, particularly under the current statutory scheme. However, the NCUA recently made regulatory changes

10. This naturally ignores the increasing federalization of corporate law insofar as it relates to publicly traded companies.

11. California, for example. See CAL. FIN. CODE § 14100(a) (2008).

12. Pennsylvania, for example. See 17 PA. CONS. STAT. § 301 (2008).

13. Delaware, for example.

14. See generally 12 U.S.C. § 1751 (2000).

15. See *Atherton v. FDIC*, 519 U.S. 213, 216–26 (1997). This is admittedly a simplification: the Court in *Atherton* in fact said that in the absence of a federal statute, there would be no federal common law for national banks in the context of the fiduciary duty. See *id.* Additionally, the Court stated that a federal statute specifying a minimal "gross negligence" standard for liability to the FDIC did not supplant the application of state fiduciary duty law for other purposes. *Id.* at 226–31.

16. See *id.* Compare 12 U.S.C. § 1787(h) (2000), with 12 U.S.C. § 1821(k) (2000).

which create distinctions between the situation in *Atherton* and the current credit union regulations and indicate the present attitude of the NCUA with regard to fiduciary duties. First, the NCUA has passed a rule that reincorporates the federal credit union bylaws into the federal regulations.¹⁷ This increases federal control over credit union corporate governance. Second, the NCUA has adopted new rules on conversion from a federal credit union charter to a mutual savings bank charter.¹⁸

The commentary accompanying the final rule on conversions states: “[T]he FCUA imposes a duty to act in the best interests of the members on the directors of all federally-insured state-chartered credit unions regardless of whether state law also imposes such a duty.”¹⁹ This implies that the NCUA is creating an independent federal duty, as one is not explicitly stated in the FCUA. The commentary continues, “the duty to act in the best interests of members is primary, and, if there is any divergence or conflict between the interests of the institution and the interests of members, the latter takes precedence.”²⁰ This runs contrary to the discussion in *Atherton*, as well as to the assumptions in various cases addressing fiduciary duties as they apply to credit unions.²¹

This recent apparent change in the NCUA’s perspective on fiduciary duties may affect the application of the analysis in *Atherton* to federal credit unions. Under *Erie Railroad Company v. Tompkins* and subsequent decisions, such as *Atherton*, federal common law may not be created unless there is a “significant conflict between some federal policy or interest and the use of state law.”²² The Supreme Court has also stated that a desire for “uniformity” by the federal regulator will not alone support a need for federal common law,²³ and that the internal affairs doctrine will similarly not provide a sufficient reason to cre-

17. Federal Credit Union Bylaws, 72 Fed. Reg. 30,984 (proposed June 5, 2007); Federal Credit Union Bylaws, 72 Fed. Reg. 61,495 (Oct. 31, 2007) [hereinafter Bylaw Final Rule].

18. Conversion of Insured Credit Unions to Mutual Savings Banks, 71 Fed. Reg. 77,150 (Dec. 22, 2006) [hereinafter Conversion Final Rule].

19. Conversion Final Rule, *supra* note 18, at 77, 156.

20. *Id.* at 77, 155.

21. *E.g.*, *Gully v. Nat’l Credit Union Admin. Bd.*, 341 F.3d 155, 165 (2d Cir. 2003) (“The parties agree that New York law applies to Gully’s claim of breach of fiduciary duty and that the WFCU is considered a corporation for purposes of New York fiduciary law.”).

22. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938); *Atherton v. FDIC*, 519 U.S. 213, 218 (1997) (citing *Wallis v. Pan American Petroleum Corp.*, 384 U.S. 63, 68 (1966)).

23. *Atherton*, 519 U.S. at 220.

ate federal common law.²⁴ However, any increase in regulation of fiduciary duties and corporate governance by the federal government will increase the likelihood of a conflict between state and federal law, and will also increase the evidence of a federal legislative or regulatory intent to have courts create federal common law.²⁵

The increased regulation of corporate governance issues embodied by the new conversion rules and the reincorporation of the federal credit union bylaws into the federal register does increase the possibility of a conflict, but does not necessarily create one in and of itself. The current regulation still leaves substantial room for the application of state law in defining fiduciary duties. Thus, the *Atherton* decision will likely apply to federal credit unions, even though the additional regulation on the NCUA's part may help push the analysis in favor of creating or reviving a federal common law of fiduciary duties.²⁶

If state law applies to federal credit union fiduciary duties, then a determination must be made as to *which* state's law applies. The *Atherton* Court suggested a court might (but would not have to) apply the fiduciary duty law of the state where the organization's principal place of business rests.²⁷

In a similar vein, *Feuchtwanger Corp. v. Lake Hiawatha Federal Credit Union* held that the location of the business of a federal credit union, especially one with a local community charter, should be its citizenship for the purpose of hailing the credit union into federal court.²⁸ Some of the reasoning in *Feuchtwanger*, however, suggests that this basis for citizenship should not be used to determine an analogous state of incorporation for purposes of the internal affairs doctrine.²⁹ The *Feuchtwanger* court noted that, in future cases, it might also consider federal credit unions to be citizens of any state where

24. This is because the internal affairs doctrine "seeks only to avoid conflict by requiring that there be a single point of legal reference" as to the law on fiduciary duty that applies to a corporation. *Id.* at 224.

25. *See id.* at 219–26.

26. It is important to note that, at least in the area of mergers, the NCUA may create a federal fiduciary duty standard, as suggested by some passages in its recent ANPR. *See Mergers, Conversion and Termination Advance Notice, supra* note 7, at 5464 ("NCUA believes having a uniform federal standard may be useful to eliminate confusion resulting from differences in state law and may make it easier for credit union boards to fulfill their duties to members."). It remains to be seen whether such a duty would be upheld as within the Administration's rulemaking authority.

27. *Atherton*, 519 U.S. at 224 ("In the absence of a governing federal common law, courts applying the internal affairs doctrine could find (we do not say that they will find) that the State closest analogically to the State of incorporation of an ordinary business is the State in which the federally chartered bank has its main office or maintains its principal place of business.").

28. 272 F.2d 453 (3d Cir. 1959).

29. *Id.*

they do significant business, due to the public policy of expanding corporate citizenship for diversity purposes.³⁰ This would mean that under *Feuchtwanger*, a federal credit union could easily be considered a citizen of *multiple* states for diversity purposes; under the internal affairs doctrine, an organization can only have the fiduciary duty law of *one* state apply.

Thus, for federal credit unions operating in more than one state, *Feuchtwanger* does not seem to provide guidance on which state's law should apply. Common sense suggests that if there is a state in which either the majority of operations occur or the headquarters and majority of management are located, then that state's law will apply.³¹ This reliance on "common sense" and ill-fitting principles from the law of personal jurisdiction, however, does not contribute to solid legal analysis. It appears that, for federal credit unions and other federally-chartered corporations, a lack of federal legislation and regulation of fiduciary duties creates significant gaps in the legal landscape.

III. FIDUCIARY DUTIES: IN GENERAL

It is generally accepted that directors of corporations are fiduciaries of the corporation. Corporate fiduciary law has, since its inception, slowly morphed from a mirror of the law of trusts to a uniquely corporate body of law.³² Absent case law, there remains an open debate whether a "trustee" standard applies to credit unions, or whether courts and regulators would apply the modern corporate standards. Given the trends in the last century of case law, courts will likely continue expanding the application of the corporate fiduciary standards to credit unions, as they have with most other types of business entities. Thus, this article focuses on the modern law of fiduciary duties as

30. *See id.* at 454–56.

31. This resembles, but is not identical to, some of the law governing corporate citizenship for the purposes of personal jurisdiction, such as the so-called "nerve center" or "plurality" tests. However, as noted above, the exact analysis for the purposes of personal jurisdiction cannot apply for purposes of identifying a single state whose governance law would apply to a federal credit union.

32. *See* Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 37 (2005) ("The fiduciary duty concept is derived from the common law of trusts, but has been modified in its application to the business context."). Much later in the history of our legal system, this same change took place in relation to non-profit organizations in many jurisdictions. *See* La. World Exposition v. Fed. Ins. Co., 864 F.2d 1147, 1151 (5th Cir. 1989) ("The standard of care for a director of a nonprofit corporation was long held to be more demanding than that for a director of a for-profit business. The theory was that a nonprofit corporation was analogous to a public trust, and its directors were deemed its trustees. However, modern statutes and case law have altered that, and now the standard for nonprofit corporate directors is usually the same as that of their for-profit counterparts.").

the most likely to be applied to credit unions today, at least in the absence of legislation or regulation to the contrary.

This section covers the general principles of corporate fiduciary duties, including issues of: (1) to whom the duties are owed; (2) standing to pursue remedies for breach of the duty; (3) the content of those duties; and (4) the safeguard of the business judgment rule. The discussion below takes into account federal, Delaware, and California law on the duties owed by directors.

As a note, this section and this article in general do not focus on a director's best behavior. The Delaware Supreme Court has succinctly defined the distinction between the law of liability for breach of fiduciary duty and the goals of good governance practices:

All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.³³

Keeping in mind this distinction between minimum legal standards and the spirit of the fiduciary duty, the following discussions will largely be based on the minimum standards that define liability but will occasionally examine when the "aspirational goals" of corporate governance would dictate a significantly different course of action.

A. *To Whom the Duty is Owed*

This section discusses the law applicable to the "direct object" of the fiduciary duty, to use a grammatical term. Different jurisdictions apply this duty differently, with two distinct possible parties to whom directors and officers can owe such a duty—the members, or the corporate entity itself. The following three sections describe federal law, California law, and Delaware law. Section 4 below discusses the importance of this question in the context of credit union fiduciary duties, particularly in the context of fundamental corporate change.

1. Federal Law

According to the internal affairs doctrine discussed above, any federal law addressing fiduciary duties only applies to federally-chartered

33. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

institutions.³⁴ However, federal law dictates the content of the fiduciary duty only when an applicable statute or regulation exists; thus, the existence of federal law varies depending on the type of federally-chartered institution in question. Currently, there is no clear judicial analysis or determination on the subject of a federal common law fiduciary duty for credit unions. The NCUA has frequently asserted that the fiduciary duty is owed to both the credit union and its members, and the commentary accompanying recently adopted regulations clearly affirms this principle.³⁵ Previous litigation, however, largely left this determination up to state law.³⁶ As demonstrated by some recent state court cases involving state-chartered credit unions, state law may not provide credit union members with any cause of action by which to enforce such duties.³⁷ Thus, while specific federal regulations may dictate duties to members in certain circumstances—such as disclosures or charter conversion deliberations—it remains unclear whether courts will universally be willing to enforce fiduciary duties to the extent that the NCUA might wish.

2. California Law

Pursuant to statute, directors in California stock corporations owe a duty to both the corporation and the shareholders.³⁸ The California Nonprofit Mutual Benefit Corporation law only includes an explicit duty to the corporation.³⁹ However, this may merely reflect the fact that mutual benefit corporations may or may not have members. When taken as a whole, the Mutual Benefit law does contemplate that directors owe some duties to the membership, but more in the sense that they are representatives of the corporation as a charitable trust, with the directors as trustees.⁴⁰ To confuse the issue further, in dicta, at least one case has stated that directors of nonprofit corporations are deemed to be agents and fiduciaries of the members, and are also shielded by the business judgment rule.⁴¹ The ambiguity in this area makes it difficult to assess whether members of California credit un-

34. This assumes that Congress will not choose to preempt state chartering of credit unions or state governance law as it relates to state chartered credit unions via new legislation.

35. Conversion Final Rule, *supra* note 18, at 77, 153.

36. *E.g.*, *Gully v. Nat'l Credit Union Admin. Bd.*, 341 F.3d 155, 165 (2d Cir. 2003).

37. *E.g.*, *Save Columbia Credit Union Comm. v. Columbia Cmty. Credit Union*, 139 P.3d 386 (Wash. Ct. App. 2006).

38. CAL. CORP. CODE § 309(a) (2008).

39. CAL. CORP. CODE § 7231(a).

40. *See* CAL. CORP. CODE § 7142; *see also* CAL. CORP. § 7710.

41. *See* *Lee v. Interinsurance Exch.*, 50 Cal. App. 4th 694, 712 (Cal. Ct. App. 1996).

ions would be able to sue directors for a breach of duty even under a derivative theory.

3. Delaware Law

Delaware courts have held that directors owe a duty to both the corporation and the shareholders.⁴² Because Delaware has no statute providing for the chartering of credit unions, there are no state-chartered credit unions in Delaware. Therefore, if state law is applied to a federal credit union in Delaware, the general provisions of Delaware corporate law would apply and duties would theoretically also extend to credit union members.

4. Importance and Implication of the "To Whom" Question

The determination of the party to whom the duty is owed will necessarily dictate the information the directors must consider in making a particular decision. If the duty is owed only to the credit union as an entity, mergers or conversions that adversely affect services to members may, in some instances, be more acceptable. In such a scenario, the more important considerations may be whether the merger will positively affect the credit union's capital, profitability, and security. While these are also important considerations when a fiduciary duty is owed to members, a change in focus to the members raises additional considerations, such as the quality of member service and rates on member loans and accounts. That the distinction could be plausibly made by a court can be seen in a Rhode Island case, *Harritos v. Cambio*, in which the court did not even consider whether there was a breach of fiduciary duty by directors because the court found that no duty was owed to the plaintiff members.⁴³ The court concluded that the members were merely borrowers from, rather than owners of, the institution.⁴⁴

B. *Standing to Pursue Remedies for Breach of the Duty*

Parallel to the "to whom" question is the question of standing: Who may enforce a duty in a court of law? A major limitation on any legal duty is its enforceability in a court of law. Ability to enforce a duty can

42. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

43. No. 92-1162, 1996 R.I. Super. LEXIS 58 (1996).

44. *Id.*; Another Rhode Island case held that depositors at a credit union could not assert derivative claims, and instead, left any assertion of claims on behalf of the institution up to the receiver. *In re RISDIC Litigation*, 662 A.2d 64, 66 (R.I. 1995). The answer to the question of *to whom a duty is owed* is also affected by a determination of who may *assert* claims based on legal requirements.

be assessed from two standpoints: (1) whether the individual suing to enforce the duty may do so, and (2) under what cause of action the person suing may do so. Without standing to sue and a cause of action under which to sue, individuals have no recourse in court.

While other entities, such as a state or federal regulator, might have the ability to police the behavior of a director or officer in relation to the members of a credit union, this would be correctly termed a duty *to the regulator* with the membership as the beneficiary, rather than a duty to the members. Specific legal requirements for disclosure to members do not necessarily create duties *to members*; rather, they create obligations to act in certain ways.

As an example of this distinction, the NCUA has the power to issue orders of prohibition against officers, directors, or other “institution-affiliated parties” of federally insured credit unions for “any act, omission, or practice which constitutes a breach of such party’s fiduciary duty.”⁴⁵ The NCUA has interpreted this statute as implying a fiduciary duty to the members of a credit union.⁴⁶ However, the sources cited by the NCUA in this area either do not relate to credit unions or involve actions, or inactions, that are clearly a conflict of interest—illegal loans to relatives, embezzling, and the like.⁴⁷ Thus, the content of such an implied duty, if it exists, particularly in the context of a merger, remains unexplored. Additionally, as discussed below, it remains unclear whether private parties, particularly members, may seek redress for breaches of this implied fiduciary duty. To call this sort of requirement on credit union directors a “fiduciary duty” is thus a misnomer, at best.

1. Standing

Generally, courts will only hear cases in which the plaintiffs have standing. In federal courts, the minimum requirements of standing are injury, causation, and redressability.⁴⁸ These prerequisites require members of a credit union who wish to dispute a director’s action to have a *legally recognized* injury. Accordingly, the ability to file suit based on a statutory or common law cause of action is vital to estab-

45. 12 U.S.C. § 1786(g)(1)(A) (2000); *also see* 12 C.F.R. § 701.14(e) (2007).

46. *See In re Majette*, Nat’l Credit Union Admin. Bd. Final Decision & Order, Docket No. 98-0401-11 (1999) (“It is well accepted law that officers and directors of depository institutions are held by a strict fiduciary duty to act in the best interest of the institution, its shareholders and its depositors.”) (citing *Grubb v. FDIC*, 34 F.3d 956 (10th Cir. 1994); *In re Bush*, OTS Order No. AP 91-16, 1991 WL 540753 (Apr. 18, 1991)). *Harritos*, 1996 R.I. Super. LEXIS 58; *RISDIC Litigation*, 662 A.2d at 66.

47. *See Grubb*, 34 F.3d 956; *Matter of Neil M. Bush*, 1991 WL 540753.

48. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992).

lishing a legally cognizable duty. Thus, the standing requirement intertwines with the issues discussed in Part A above.

In a recent case, *Save Columbia Credit Union Committee v. Columbia Community Credit Union*, a Washington court denied a member standing because the applicable statute governing fiduciary duty said only that directors owed a duty to the credit union and did not include a duty to the members.⁴⁹ Because the statute did not provide the members with a legally cognizable interest,⁵⁰ they were deemed not to have been injured in a legally cognizable way by the actions of the directors and thus had no standing. Without the standing to sue, there remained no recourse for Columbia's members. By eliminating the directors' duties to the members, the court effectively restricted oversight of directors and officers to regulators and the supervisory committee. This is a prime example of how the question of "to whom the duty is owed" determines the remedies available to members. In order to have standing to sue, members must assert an injury based on a statute that supplies them with a legal interest that can be injured.

2. Available Remedies

Beyond the question of standing is the question of the remedy itself. Under a tort action for breach of fiduciary duty, the plaintiff would normally be entitled to recover those damages caused by the breach. In the corporate context, such actions are usually brought in a derivative form—an individual shareholder sues the corporation as an entity to force it to bring suit against a director, rather than a suit being filed in the names of any individual shareholders against a director.⁵¹ The concept of a derivative action springs from the notion that the directors' fiduciary duty is owed to the corporation or the shareholders in general, rather than any individual shareholder.⁵² In general, it is difficult to bring derivative actions involving stock corporations as multiple barriers have been erected to protect management from frivolous actions.⁵³

Rights to bring derivative actions, like other proceedings in this area, are usually created by statutes—while some courts have estab-

49. 139 P.3d 386, 392-93 (Wash. Ct. App. 2006).

50. The court denied standing because the Washington statutes controlling fiduciary duties of credit union directors provided only that directors "stand in a fiduciary relationship to the credit union." See WASH. REV. CODE § 31.12.267 (2008). Note that neither the Federal Credit Union Act nor NCUA Rules and Regulations contain a similar statement.

51. See Baums & Scott, *supra* note 32, at 49.

52. *Id.*

53. See *id.* at 49-50.

lished common law derivative actions,⁵⁴ such decisions have not been the norm. Without the statutory ability to file derivative or individual tort actions against directors, equity owners typically have no recourse. For federal credit unions, it appears that the derivative action has largely been overlooked,⁵⁵ while for some state-chartered credit unions, derivative actions are available by virtue of state corporate law.⁵⁶ Considering the relatively “endangered” nature of derivative suits in the United States,⁵⁷ their applications to credit unions are likely limited even if additional legislation is enacted.

An alternative course for equity owners is an action for appraisal. In the corporate context, these actions can generally only be brought upon an instance of a merger or other buy-out by a dissenting shareholder.⁵⁸ A court ruling on an appraisal action performs a valuation of the corporation, compares the results to the valuation performed by the corporation before the merger and the corresponding compensation to shareholders, and awards the difference to the dissenting shareholders who filed suit.⁵⁹

An appraisal right can be found in a federal bank statute, the ABA Model Business Corporation Act, and various states’ laws. Under the National Bank Act, dissenting shareholders in mergers of national banks or state banks into national banks may request the fair value of their shares in return for the surrender of their stock certificates.⁶⁰ Under the National Bank Act scheme, valuation is made by a committee selected in part by both the majority stockholders and the dissent-

54. *E.g.*, *Tzolis v. Wolff*, 884 N.E.2d 1005, 1008–10 (N.Y. 2008).

55. There is no provision in the Federal Credit Union Act or the NCUA’s Rules and Regulations providing for derivative or direct causes of action for breach of fiduciary duty.

56. *See, e.g.*, CAL. CORP. CODE § 7710 (2008) (providing for derivative actions by members of California Nonprofit Mutual Benefit Corporations).

57. *See* Baums & Scott, *supra* note 32, at 50.

58. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (2008). *But see* FLA. STAT. § 607.1302 (2008). Appraisal statutes are generally limited to their purposes: providing minority shareholders a “way out” of an altered investment. *See* Barry M. Wertheimer, *The Shareholders’ Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 613–16 (1998). One can see why shareholders should not be permitted to demand a “buyback” of their shares in a situation in which they are not already receiving cash in return for their equity interests. While the Delaware statute limits appraisals to mergers or consolidations, Florida appraisal rights extend to changes to Articles of Incorporation that would change the relative value of shares. *Compare* DEL. CODE ANN. tit. 8, § 262, *with* FLA. STAT. § 607.1302.

59. Commentators have questioned the efficiency of the appraisal remedy. *E.g.*, Samuel C. Thompson, Jr., *Change of Control Board: Federal Preemption of the Law Governing a Target’s Directors*, 70 MISS. L.J. 35, 94–96 (2000). This article does not examine the merits of appraisal actions, but rather merely notes that this is one option normally available to stock institutions which is not currently available to credit unions.

60. 12 U.S.C. § 215a(b) (2000).

ing stockholders.⁶¹ Chapter 13 of the Model Business Corporation Act also provides an appraisal right with slightly different aspects.⁶²

In some jurisdictions, a dissenting shareholder in a merger is limited to an action for appraisal—derivative actions are largely unavailable. For example, due to the statutory scheme, the usual remedy in California for dissenting shareholders in a merger is an action for appraisal, rather than a suit for breach of fiduciary duty.⁶³ For California stock corporations, this has the effect of nearly eliminating the breach of fiduciary duty cause of action in the merger context (and consequently any case law clarifying those duties).

Note that most of the statutes on appraisal mentioned above apply to stock institutions, not credit unions or other mutual institutions. Because rights to bring actions for appraisal are created by statutes,⁶⁴ they do not apply unless a statutory or regulatory scheme so provides. Thus, there is no appraisal right in most credit union mergers. This leaves the primary cause of action and remedy as an action for breach of fiduciary duty, though, as seen above, such a cause of action is not so readily available.

Despite the enforcement and procedural limitations discussed above, which necessarily define the contours of the fiduciary duty, the content of the duty remains important. An understanding of the interplay between enforcement mechanisms and the content of the duty is vital to understanding the legal landscape in this area. The following sections discuss the content and substantive limitations on the fiduciary duties of directors of credit unions.

C. *Content of the Duty and General Principles*

Fiduciary duty is commonly referred to as having three separate components: good faith, loyalty, and care.⁶⁵ The duty of good faith has largely been subsumed into the duties of loyalty and care. Under Delaware law, the duty of good faith cannot in itself give rise to director liability.⁶⁶ Instead, a breach of the duty of good faith indirectly leads to liability by showing a breach of the duty of loyalty.⁶⁷ This is because

61. § 215a(c).

62. MODEL BUS. CORP. ACT § 13 (2008).

63. See CAL. CORP. CODE §§ 1300, 1312 (2008).

64. Some courts did, prior to the wide-spread adoption of appraisal statutes, conclude that the proper remedy for a dissenting shareholder was a “pro rata share of the corporation’s value.” Wertheimer, *supra* note 58, at 619 n.29. Currently, however, actions for appraisal are invoked in the context of specific charter-related statutes.

65. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

66. *Id.* at 369–70.

67. *Id.* at 370.

a “director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”⁶⁸

1. Loyalty

The duty of loyalty is the duty to act in the best interests of the corporation and/or its shareholders. In conjunction with the duty of good faith, the duty of loyalty encompasses three types of situations: (1) where directors have some financial or other cognizable fiduciary conflict of interest; (2) where directors fail to act in good faith; and (3) where directors act to perpetuate themselves in office.

a. Conflicts of Interest or Self-dealing

Common examples of conflicts of interest, also known as “self-dealing,” include: being a director of both the merging and the continuing credit union; selling property or providing services to the credit union; or receiving some sort of consideration or benefit as a result of an action upon which the director votes. Self-dealing does not, however, include an interest the director holds as a shareholder of the corporation or an interest that is the same as that available to all shareholders alike.⁶⁹ Thus, opportunities to sell or buy stock, or distributions on accounts that are the same for all members, will not generally be seen as self-dealing under the law. Nonetheless, to fulfill the aspirational ideals of the fiduciary duty, directors should not structure a transaction in a manner that enables them to benefit from a stock purchase or other incentive plan if that plan will not be used by the majority of members or if it will diminish services that the members use and enjoy. The stock-purchase context is one in which the law and the ideals of fiduciary duty diverge.

Self-dealing does not always cause a breach of the fiduciary duty, however. Most jurisdictions allow for some method by which directors can disclose the conflict of interest, recuse themselves, or submit the matter to a shareholder vote.⁷⁰ Dual directorships are often covered in statutes that allow for disclosure and recusal in the face of a conflict of

68. *Id.* (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. 2003)).

69. “The mere fact that some of the . . . directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder.” *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964). Developments in the law after *Cheff* have clarified that there are some cases in which substantial or majority control of stock in a company can create a conflict of interest. Thus the rule is that the interest must be *shared* with the other shareholders.

70. *E.g.*, DEL. CODE ANN. tit. 8, § 144 (2008).

interest.⁷¹ Interested director transactions are similarly often permissible despite a conflict of interest if certain steps are taken to ratify the transaction. In many states, ratification can occur through a vote of the disinterested directors or disinterested shareholders or through a determination of fairness by a court.⁷²

Disclosure and subsequent approval by disinterested parties is not without its wrinkles though. Many jurisdictions have determined that directors need only disclose to shareholders those *material* facts regarding a particular action which might benefit their personal interests.⁷³ The rationale is that requiring disclosure of all facts would increase the costs of decision-making and paralyze boards. Material facts are defined as those that a reasonable shareholder would consider important in deciding how to vote on a given issue.⁷⁴

However, exceptions exist to the materiality rule. Some courts, particularly in Delaware, have adopted a “self-flagellation” doctrine, which exempts directors from characterizing their behavior as interested, negative, or illegal.⁷⁵ The rationale behind the “self-flagellation” rule is that directors should not have to speculate about how their conduct will be characterized or publicly admit misconduct.⁷⁶ Sometimes this doctrine even exempts directors from fully describing the facts surrounding a transaction, thus negating the initial public policy motivation of allowing shareholders to judge facts for themselves.⁷⁷ Federal courts have applied a similar test—leaving characterizations up to shareholders—though the courts have generally required full disclosure of facts.⁷⁸ Even under the federal test some facts are frequently omitted, such as those suggesting motivations contrary to shareholders’ best interests.⁷⁹

This prohibition on self-flagellation effectively exempts directors from admitting to wrongdoing, decreasing the chance that sharehold-

71. See, e.g., CAL. CORP. CODE § 7233(b) (2008); DEL. CODE ANN. tit. 8, § 144(a).

72. See, e.g., CAL. CORP. CODE § 7233(a). Note that a recent Delaware Supreme Court case, *Gantler v. Stephens*, which is as yet not certified for publication, supplies additional guidance on the Delaware rules on ratification. No. 32, 2008, 2009 WL 188828, at *13, n.54 (Del. 2009).

73. See, e.g., Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 137 (Del. 1997); DEL. CODE ANN. tit. 8, § 144(a)(1)-(2).

74. Loudon, 700 A.2d at 143.

75. “[A] board is not required to engage in ‘self-flagellation’ and draw legal conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter.” *Id.* at 143 (quoting Stroud v. Grace, 606 A.2d 75, 84 n.1 (Del. 1992)).

76. *Id.* at 143.

77. See J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 HASTINGS L.J. 641, 643, 671-74 (2003).

78. *Id.* at 674-75.

79. *Id.* at 676; see, e.g., Mendell v. Greenberg, 927 F.2d 667, 673-76 (2d Cir. 1991).

ers will acquire evidence of self-dealing that might lead them to bring an action for breach of fiduciary duty. While the self-flagellation doctrine does not create a substantive rule or a specific standard, it does provide directors with significant protection. In conjunction with the business judgment rule, described in depth in the sections below, the exceptions to the materiality rule effectively shield directors from liability by removing information and shifting burdens to those without said information.

In contrast to the disclosure and ratification standards present in some jurisdictions, others follow a recusal standard. An example of a pure recusal standard, the Federal Credit Union Bylaws, recently incorporated into the NCUA Rules and Regulations,⁸⁰ state:

No director, committee member, officer, agent, or employee of this credit union may participate in any manner, directly or indirectly, in the deliberation upon or the determination of any question affecting his or her pecuniary or personal interest or the pecuniary interest of any corporation, partnership, or association (other than this credit union) in which he or she is directly or indirectly interested.⁸¹

The regulations covering federal credit unions thus contain a strict prohibition on director participation in deliberations that involve a conflict of interest. This does not, by itself, require a director's pecuniary interest in a transaction be disclosed to the members of a credit union, however.

b. Good Faith

Failure to act in good faith is usually found only when a director acts in a way that would have an adverse impact on the credit union, such as selling assets for less than market value. A director need not reap a personal benefit from the act for it to be contrary to the interests of the credit union.

80. Bylaw Final Rule, *supra* note 17.

81. Federal Credit Union Bylaws, 71 Fed. Reg. 24,551 (April 26, 2006). This section continues:

In the event of the disqualification of any director respecting any matter presented to the board for deliberation or determination, that director must withdraw from the deliberation or determination; and if the remaining qualified directors present at the meeting plus the disqualified director or directors constitute a quorum, the remaining qualified directors may exercise with respect to this matter, by majority vote, all the powers of the board. In the event of the disqualification of any member of the credit committee, if applicable, or the supervisory committee, that committee member must withdraw from the deliberation or determination.

Id.

c. Perpetuation in Office or Entrenchment

Self-perpetuation in office, possibly the most common example of a director pushing the limits of the duty of loyalty, occurs when a director acts or votes with the motivation of ensuring his continued participation on the board of directors.⁸² In the non-merger context, this can include using corporate funds for proxy contests. In the merger context, as discussed at length below, self-perpetuation often includes negotiating and voting on the merger based on who will get to participate on the board of the continuing credit union.

2. Duty of Care

A common statement of the duty of care dictates that directors act with such care “as an ordinarily prudent person in a like position would use under similar circumstances.”⁸³ This reads as a codification of the standard for negligence, but, as seen below, the standard under the business judgment rule is often stated as gross negligence. The duty of care has often been further interpreted to mean that directors must act with the diligence they would show toward their personal transactions, including inquiring as to details, having sufficient information and time for deliberation, and using sound business judgment as to the efficacy of the transaction. This standard is discussed in greater detail below in the context of a consensual merger.

D. *The Business Judgment Rule*

All of these duties are modified in part by the protections afforded to director decisions by the business judgment rule. While the specifics of the rule vary from state to state, the general business judgment rule has been a part of corporate law in the United States for over 150 years.⁸⁴ The Delaware business judgment rule is both a procedural and substantive rule.⁸⁵ The essence of the rule is that a court will not inquire into the substantive result of a business decision if the directors acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company.⁸⁶ If the rule attaches, then it is up to the shareholder challenging the business decision to show there was a breach of fiduciary duty.⁸⁷ The rule at-

82. *Cf.* *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964).

83. *E.g.*, CAL. CORP. CODE § 309 (2008); *see also* *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891).

84. *See* S. Samuel Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979).

85. *See* *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

86. *Id.*

87. *Id.* at 361.

taches when the action taken was within the authority of the board and there is no evidence of fraud, bad faith, or “self-dealing.”⁸⁸ As discussed below, the tests to determine whether there is evidence of bad faith or self-dealing vary depending on the circumstances.

The business judgment rule does not define good practice and proper performance for directors. Rather, it defines what courts are willing to examine. This distinction is important because the standards outlined under any business judgment rule analysis are not aspirational goals—they are minimum standards, the outer limits of what might be acceptable board performance. To avoid litigation, directors should ideally exceed the requirements of the business judgment rule, following the spirit of the duties of care and loyalty rather than the limits of liability.⁸⁹ If a director’s performance is within the standards of the business judgment rule, it does not matter what decision is reached or action is taken so long as that decision is rational. A court will let rest any rational and well-informed decision as a product of sound business judgment, even if the results of the decision are disastrous to the corporation or shareholders.

If a decision fails to meet the standards of the business judgment rule, then a court will test the decision to determine whether it was in fact in the best interests of the corporation and shareholders. The test for fairness under Delaware law, known as the “entire fairness” doctrine, was established in *Weinberger v. UOP, Inc.*⁹⁰ Because *Weinberger* involved a cash-out merger, the standard and discussion below specifically apply to a merger scenario, but the standard arguably applies to other types of transactions as well.⁹¹ The *Weinberger* standard divides fairness into two categories, “fair dealing and fair price,” which are taken together as a whole.⁹²

An analysis of fair dealing involves an examination of candor to the corporation and shareholders, as well as the depth of negotiations,

88. *Id.* at 360. No evidence of “self dealing” in this context means there is no “personal profit or betterment” for the directors outside of their roles as shareholders. *Id.*

89. See *supra* text accompanying note 33.

90. 457 A.2d 701, 711 (Del. 1983). *Weinberger* did not itself establish so broad a rule as this. The *Weinberger* court, dealing with a duty of loyalty question skipped over the question of the business judgment rule. See *id.* at 708–11. However, this can easily be taken as a leap in logic, rather than a change in rule. This is because the evidence of a breach of the duty of loyalty immediately took the case out of the purview of the business judgment rule. This aspect of the business judgment rule is explained in greater detail in the sections below relating to consensual mergers.

91. In fact, Delaware courts are likely to apply the “entire fairness” standard whenever the business judgment rule is rebutted no matter whether the board decision is a transaction at all. See *Gantler v. Stephens*, No. 132, 2008, 2009 WL 188828, at *9 (Del. 2009).

92. *Weinberger*, 457 A.2d at 711.

time constraints on the decision, and the structure of the transaction. Ideally, none of these aspects should be dictated entirely by one party to the transaction, and each should be dealt with in a way that serves the interests of the shareholders. In *Weinberger*, information on the price that the purchaser was able and willing to pay was withheld from minority shareholders,⁹³ the target company's board had only four days to consider the offer,⁹⁴ and the transaction was not completed as an "arm's length" deal.⁹⁵ Together, these factors made the process potentially "unfair."

Fair price is determined by assessing the value of the corporation as compared to the value the shareholders received for their shares.⁹⁶ The *Weinberger* court rejected previously used rigid valuation methods and instead adopted a more liberal approach, including "proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."⁹⁷ This includes considerations of "market value, asset value, dividends, earning prospects, the nature of the enterprise," and any future prospects of the merged corporation.⁹⁸ Fair price can also include damages the shareholders sustain as a class due to the improper transaction.⁹⁹

Although California law on the business judgment rule is less extensive than Delaware law, California courts have provided some guidance as to fiduciary duties and the application of the business judgment rule. Unfortunately, most of the relevant cases contain sparse recitations of the facts, and most are appealed on pleading requirements and qualifications for derivative suits rather than on the substantive standards of director fiduciary duties. Thus, they provide little guidance as to specific steps directors and officers must take in fulfilling their duties.

Eldridge v. Tymshare, Inc. explains the California stance on the business judgment rule in the merger context:

In the context of merger negotiations, "[a] 'target' corporation's decision to accept or resist a takeover bid . . . necessarily rests with the board of directors, since it is the directors, and not the shareholders, who are best able to evaluate the numerous and often complex financial factors which must be considered in determining whether

93. *Id.* at 709.

94. *Id.* at 711.

95. *Id.* at 710.

96. *See id.* at 712-15.

97. *Id.* at 713.

98. *Weinberger*, 457 A.2d at 713.

99. *Id.*

the takeover proposal serves the best interests of the corporation.” A plaintiff challenging a decision made in this context must be able to make specific allegations of malfeasance or bad faith. Where an improper motive is claimed, plaintiff must allege that it was the sole or primary reason for the directors’ actions.¹⁰⁰

The presumption that the board’s decision was based on sound business judgment can only be rebutted “by a factual showing of fraud, bad faith or gross overreaching.”¹⁰¹ This definition of the business judgment rule is similar to the Delaware rule stated above, and, as in Delaware, the business judgment rule sets a lower bar for director decisions to avoid liability than the statute that defines the duty of care.¹⁰² California courts have further explained that when the business judgment rule attaches, the decision will not be disturbed unless the decision “could not be construed as incidental or expedient for the attainment of corporate purposes.”¹⁰³ For the past decade, the language in California cases has shifted to include the wording of Delaware law, largely due to *Katz v. Chevron Corporation*, a California case that applied Delaware corporate law.¹⁰⁴

In the event that directors lose the protection of the business judgment rule, California courts will have to apply a valuation test, just as Delaware courts would in similar circumstances apply the *Weinberger* fairness test.

This general discussion of fiduciary duties gives some indication of the standards that would be applied to an examination of director action in the context of a merger. Sections IV and V below discuss these standards in the specific contexts of consensual mergers and hostile mergers.

100. 186 Cal. App. 3d 767, 776–77 (1986) (quoting *Enterra Corp. v. SGS Associates*, 600 F. Supp. 678, 686 (E.D. Pa. 1985)) (citations omitted).

101. *Id.* at 776.

102. Compare *Eldridge*, 186 Cal. App. 3d 767 (“fraud, bad faith or gross overreaching”), with CAL. CORP. CODE §§ 309, 7231 (2008) (with the care “an ordinarily prudent person in a like position would exercise under similar circumstances”). California has not adopted the Model Business Corporation Act (“MBCA”) in its entirety: California Corporations Code § 309 corresponds with MBCA § 8.30 on director standards of conduct, which is followed by MBCA § 8.31 on standards for liability. Compare CAL. CORP. CODE § 309 (2008), with MODEL BUS. CORP. ACT §§ 8.30, 8.31 (1979). MBCA § 8.30 is the codification of the business judgment rule, whereas Corporations Code § 309 is the codification of fiduciary duty. California has not enacted a codification of the business judgment rule.

103. *Marsili v. Pacific Gas & Elec. Co.*, 51 Cal. App. 3d 313, 324 (1975); *Eldridge*, 186 Cal. App. 3d at 776.

104. 22 Cal. App. 4th 1352 (1994).

IV. CONSENSUAL MERGERS

Putting together the principles outlined in Section III above, absent bad faith, self-dealing, fraud, or gross negligence, a director's decision to authorize a consensual merger will not expose the director to liability for breach of fiduciary duty so long as that decision is not irrational. As discussed in Section V below, a different rule applies to hostile takeovers due to the inherent dangers of self-dealing and entrenchment in such a context. This section discusses the standards applicable in the consensual merger context only.

A. *Business Judgment Rule and Particular Ways to Lose Its Protection*

As previously stated, the business judgment rule protects boards from court scrutiny of their decisions. Because this is a "substantive" rule, the beginning of any examination of fiduciary duties is the business judgment rule. As noted above, the limits of the business judgment rule's protections are the threshold requirements for proper director action. The following are the clear categories of actions that will take a decision outside of the rule's protection.¹⁰⁵

1. Actions Not Within the Authority of the Board

If an action is *ultra vires*, or outside of the powers available to the corporation or credit union in its articles of incorporation,¹⁰⁶ then it will not be protected by the business judgment rule. Examples of *ultra vires* actions might be a credit union board attempting to perform actions which are forbidden to it by its chartering statutes. The *ultra vires* doctrine is rarely invoked in modern corporate law due to the general charters used by most corporations. While *ultra vires* occasionally finds its way into rhetoric in credit union governance disputes, the doctrine rarely receives the same attention in actual litigation or rules of decision. The danger for directors in the merger context is that if a board attempts a merger without receiving proper shareholder or regulatory approval, the board's actions may not be protected by the business judgment rule.

105. The following situations are taken from the Delaware common law business judgment rule. As concisely stated in *Cede & Co. v. Technicolor, Inc.*, the business judgment rule attaches when the action taken was within the authority of the board, there is no evidence of fraud, no evidence of bad faith, and no evidence of self-dealing. 634 A.2d 345, 360 (Del. 1993).

106. See MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 1357 (11th ed. 2005).

2. Evidence of Bad Faith

As demonstrated by the previous discussion, the specific elements of bad faith are difficult to define. Evidence of bad faith will arise when it is clear that directors are placing the interests of some third party above those of the credit union. Examples in the corporate setting include situations where directors consider interests of bond and debenture holders above those of shareholders. In the credit union context, this distinction breaks down because most creditors to and borrowers from credit unions are credit union members. In general, though, excessive consideration of constituencies other than the members as a whole may result in the loss of the business judgment rule's protection.

3. Evidence of Self-dealing

As detailed in the previous sections on the duty of loyalty, self-dealing is often defined as using the corporation for personal profit or betterment. As noted above, some transactions involving directors or that benefit directors are not breaches of the directors' fiduciary duties. Federal credit union bylaws prohibit directors to participate in deliberations on such transactions, but allow the transactions to take place otherwise. State law often allows for disclosure of any interest, or in some cases disclosure and approval by disinterested parties, as a way to validate an otherwise self-interested transaction. The law on ratification of interested transactions varies from jurisdiction to jurisdiction and can be limited by protective doctrines such as, for example, the "self-flagellation" rule.

4. Evidence of Fraud

Even in those situations where directors' actions are not characterized as self-dealing, making false statements can cause directors to lose the protection of the business judgment rule. Naturally "fraud" carries with it other technical legal definitions, though directors will still wish to avoid knowingly making any false statements to shareholders or other directors.

5. Gross Negligence

A showing of gross negligence is the general standard for rebutting the presumption contained in the business judgment rule; it does not automatically bar application of the business judgment rule.¹⁰⁷ Gross negligence is generally proven by showing a complete lack of care, or

107. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

a behavior approaching recklessness.¹⁰⁸ This standard is nebulous, and generally courts are unwilling to supply it with specific content. As one court suggested in the context of director fiduciary duties:

It is impossible to establish an exact measure of care which will be deemed sufficient, or negligence which will be deemed culpable, with respect to the duty owing on the part of directors and officers of corporations in the performance of their official functions, because the degree of care required depends upon the subjects to which it is applied, the particular circumstances of the case, and the usages of business.¹⁰⁹

Because of the vagueness of this standard, the sections below focus upon the facts of the cases in which it has been applied, and the lessons that can be drawn from each. Unfortunately, the law does not provide clear guidance for directors attempting to fulfill their duties. It does, however, provide leeway for business decisions so long as those decisions are made after a process that demonstrates care, diligence, and attention to duty.

Absent evidence of any of these possible breaches, the business judgment rule attaches and a board's decision will not be scrutinized by a court so long as it is not irrational. "Due care in the decision-making context is *process* due care only. Irrationality is the outer limit of the business judgment rule."¹¹⁰ Directors of corporations and credit unions thus receive significant shelter from liability so long as they follow a proper process in the course of their decision-making. This process is the subject of the next section on the duty of care.

B. *Duty of Care*

Acting with such care "as an ordinarily prudent person in a like position would use under similar circumstances" in the merger context involves what is commonly referred to as "due diligence."¹¹¹ Directors must investigate and deliberate on the aspects of a proposed merger enough to convince a court they made an informed business decision. Directors "have a duty to inform themselves . . . of all material information reasonably available to them."¹¹² But what is enough diligence, and what is not?

Smith v. Van Gorkom supplies the primary example of a court giving content to the fiduciary duty of care in the context of a consensual

108. See BLACK'S LAW DICTIONARY (8th ed. 2004).

109. *Grand Union Mount Kisco Employees Fed. Credit Union v. Kanaryk*, 848 F. Supp. 446, 458 (S.D.N.Y. 1994).

110. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000).

111. CAL. CORP. CODE §§ 309, 7231 (2008).

112. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993).

merger.¹¹³ In *Van Gorkom*, Trans-Union, a holding company, was having difficulty generating sufficient income to offset large investment tax credits.¹¹⁴ The company had years to solve this problem before the credits would be wasted, but an officer/board-member, Van Gorkom, became fixated on the idea of a leveraged buy-out at fifty-five dollars per share.¹¹⁵ This value was derived largely from guesswork done by the CFO, as opposed to a professional valuation of the company, and was chosen by Van Gorkom based on the price for which he would be willing to sell his shares.¹¹⁶

The *Van Gorkom* court found the process the Trans-Union directors followed in their initial decision to sell the company was reckless and imprudent, and thus the board lost the protection of the business judgment rule.¹¹⁷ Additionally, the directors subsequently failed to take sufficient action to correct that failure and regain the rule's protection.¹¹⁸

The factors that can be derived from *Van Gorkom* on whether directors made an informed business judgment and thereby fulfilled their duty of care are:

1. amount of time spent researching the deal, preparing for the decision, and investigating the information and proposals;
2. amount of time spent deliberating whether to proceed with the merger;
3. where any numbers and dollar amounts in the merger came from, and whether they were based on solid financial information or were arbitrary;
4. whether the merger proposal and subsequent deliberations were unilateral or bilateral discussions, i.e. whether anyone actually opposed the idea or brought up opposing views;
5. whether directors had prior notice of what would be discussed before the meeting in which they deliberated and voted;
6. whether the directors were presented with or sought outside information, such as a fairness opinion;¹¹⁹
7. whether the directors asked questions during deliberation over the merger; and

113. 488 A.2d 858 (Del. 1985).

114. *Id.*

115. *Id.* at 865.

116. *See id.* at 865-69.

117. *See id.* at 871-74.

118. *See id.* at 883-84.

119. The *Van Gorkom* court made clear that a fairness opinion was not necessary to fulfill the board's fiduciary duty, but suggested that it would have been a way to come closer to fulfilling their duty. *Van Gorkom*, 488 A.2d at 876.

8. whether the board sought other bids or shopped the deal with other potential merger partners.¹²⁰

The court did not provide specific criteria or benchmarks for any of these factors. While the facts in *Van Gorkom* present an example of what *does not* pass the test,¹²¹ and there are cases which give examples of what *does* pass muster, the lines between the two are not clearly drawn under the *Van Gorkom* analysis. As a whole, the decision stands generally for the premise that, to fulfill their duty of care, directors should seek information from both internal and outside sources, give time for deliberation, fully analyze all information, be critical of plans, and seriously consider alternatives.

While the facts and factors in *Van Gorkom* do not directly relate to credit unions, the principles can easily be extended into concrete advice. To provide more detail to these duties for credit union directors, it is helpful to examine them in a specific context. The NCUA has suggested, in connection with conversions from federal credit unions to mutual savings banks,¹²² that the directors of a credit union, as part of their due diligence, answer the following questions:

What financial services do the majority of my members want? How do I know this? Can the institution best provide these services to its members as a credit union or a bank? If the credit union converts to a bank, how will that affect the rates and fees that the institution charges the members for these services? And if the credit union converts to a bank, will it be able to offer members (now customers) something in the way of services or value that existing banks in the area are not offering?¹²³

These questions are equally applicable in the merger context. After asking these questions, deals should be structured only after receiving reliable information on the value of the credit union, the potential benefits and detriments of a merger (in general and with the specific merger partner being considered), and the effects a merger will have on the members and the credit union as a corporate entity. Naturally, more than one or two directors should participate in structuring the deal and reviewing information and all directors should have sufficient time to fully review any materials and information provided. In many cases where the board is found to have breached its duty of care, multiple directors either did not know the subject of the special meeting

120. See generally *id. passim*.

121. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (representing another example of a breach of the duty of care).

122. Credit unions, particularly federal credit unions, may "convert" from a credit union to a mutual savings bank. See 12 U.S.C. § 1785(b)(2) (2000).

123. Conversion Final Rule, *supra* note 18.

until they arrived or only had two to four days between hearing of a merger proposal and a vote on it. Ensuring that enough time is taken to evaluate information is vital to fulfill the duty of care.

C. *Duty of Loyalty*

As described above, the duty of loyalty encompasses both loyalty and good faith. Breach of this duty can occur in many different ways. In the consensual merger context, directors often place too much emphasis on who will continue to serve as directors and officers of the surviving entity.¹²⁴ Another scenario which can give rise to a breach of this duty is where one or more directors have a financial or reputational stake in the merger. Often, these are the individuals who are driving the merger process.¹²⁵

For a conflict of interest to remove the protection of the business judgment rule, the conflict must be “material.” The Delaware Supreme Court in *Cede & Co v. Technicolor, Inc.* stated that “to disqualify a director, for rule rebuttal purposes, there must be evidence of *disloyalty*,” not self-interest alone.¹²⁶ Examples of sufficient disloyalty include, but are not limited to, motives of entrenchment, fraud upon the corporation or the board, abdication of directorial duty, or the sale of one’s vote.¹²⁷ The precise standard of proof required under the materiality standard was provided in a later appeal in the same case:

[A] material interest of one or more directors less than a majority of those voting would rebut the application of the business judgment rule if the plaintiff proved that the interested director controls or dominates the board as a whole or that the interested director failed to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.¹²⁸

124. When taken too far this could potentially implicate the duty of loyalty (as discussed in this section), though *Gantler v. Stephens* suggests that “to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological.” No. 132, 2008, 2009 WL 188828, at *8 (Del. 2009). The court continued:

By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.

Id.

125. See, e.g., *Cede & Co.*, 634 A.2d 345.

126. *Id.* at 363 (emphasis added).

127. *Id.*

128. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995) (internal quotation marks omitted).

Again, this analysis provides little guidance on the minimum standards to be followed in fulfilling a director's fiduciary duty. In the consensual merger context, the duty of loyalty requires, at minimum, disclosure of any self-interest to the other directors (and possibly the members as well). Also, prudent directors will not act to entrench themselves in their roles, but will be sure to exercise independent judgment based upon what is in the best interests of the credit union and the members.

It is important to note here the danger of entrenchment. A long established rule under the duty of loyalty is that directors may not vote solely or primarily to perpetuate themselves in office.¹²⁹ This rule was established in *Cheff v. Mathes* in the context of a hostile takeover,¹³⁰ but applies equally to consensual mergers. The *Cheff* court analogized the case at hand to the use of proxy statements and stated:

[I]f the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course. . . . On the other hand, if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper.¹³¹

Directors may thus be considered acting in bad faith or in a self-interested manner when perpetuating themselves in office to the detriment of the credit union or its members. However, in the case of self-interest, as explained in *Cede*, the interest would have to be material to cause the decision to lose the protection of the business judgment rule.

D. *Other Jurisdictions*

Due diligence principles for corporations in different jurisdictions vary widely—from requiring enough due diligence to form a rational decision on one end of the spectrum to requiring “full consideration and documented analysis of all alternatives” on the other.¹³² Thus while the principle that some “diligence” is “due” extends across state lines, the extent of the required investigation will depend on the specific rules in the applicable jurisdiction.

129. *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964).

130. *Id.*

131. *Id.*

132. Mergers, Conversion and Termination Advance Notice, *supra* note 7, at 5464.

V. HOSTILE TAKEOVERS (NON-CONSENSUAL MERGERS)

A hostile takeover, in the corporate setting, is defined as the acquisition of a company despite the management and directors' resistance. While some jurisdictions allow shareholder voting on a merger prior to board approval,¹³³ many jurisdictions view the board of directors as serving a gatekeeper function. Corporate hostile takeovers, unlike consensual mergers, often involve stock purchase offers to give the acquiring party a majority share in the corporation and thus dictate the board vote. In the credit union context, traditional stock offers are not possible, but the same principles concerning the duty of directors may apply when they resist repeated merger requests or when an acquiring credit union attempts to go directly to the members with promises of a dividend, capital distribution, or some other incentive.

Law on credit union hostile offers has not developed because until recently this phenomenon was entirely unknown. The first so-called hostile bid on a credit union was made in the spring of 2007 by Wings Federal Credit Union in an attempt to acquire Continental Federal Credit Union.¹³⁴ Since this time, the credit union industry has been concerned about what, if any, standards apply in such situations. Some jurisdictions have begun to regulate such transactions¹³⁵ and the NCUA has begun to consider regulations on the subject,¹³⁶ but the novelty of hostile bids for mutual institutions has not yet faded. While the law on other fundamental corporate change issues has been vague for credit unions, the absolute lack of guidance in the area of credit union hostile takeovers necessitates a turn to the laws governing for-profit corporations.

Delaware has the most extensive law covering fiduciary duties in the hostile merger context. As discussed below, there is some guidance available in California cases, but not with the nuance in the Delaware cases discussed below. Over all, the reasoning behind the specific rules governing director fiduciary duties in hostile takeover situations is equally applicable to credit unions. This seems to suggest that similar guidelines might also apply in the credit union context.

133. See, e.g., CAL. CORP. CODE § 8012 (2008).

134. Styskal, Wiese & Melchione, LLP represented Continental Federal Credit Union in matters concerning the offer to its members by Wings Federal Credit Union.

135. See, e.g., Tex. Admin. Code tit. 7, § 91.1003 (2008).

136. See Mergers, Conversion and Termination Advance Notice, *supra* note 7.

A. *Cheff v. Mathes: The Historical Rule*

Cheff v. Mathes, as explained above, established that boards cannot act solely or primarily to perpetuate themselves in office.¹³⁷ *Cheff* specifically applied this principle to the use of corporate funds,¹³⁸ but the rule has since been expanded to become part of the general duty of loyalty.¹³⁹ In response to a hostile threat, the board of the target corporation enacted defensive measures that included use of corporate funds to repurchase shares of the company.¹⁴⁰ However, the defendant directors in *Cheff* were not held personally liable for this defensive tactic because they had an alternative business reason for their actions: fending off “a reasonable threat to the continued existence of Holland, or at least existence in its present form.”¹⁴¹ Thus, the historical rule in the case of hostile threats was that a board would not be held liable for perpetuating themselves in office if there was a good faith decision that the corporate interest would be served by it.¹⁴²

B. *Unocal: The Basic Rule in Hostile Takeovers*

The modern rule for the fiduciary duty in hostile takeover scenarios is found in *Unocal Corp. v. Mesa Petroleum Co.*¹⁴³ This case asserted that in a takeover context, the duty of care and loyalty apply, and therefore the directors owe a duty to protect the corporate enterprise and also the interest of the stockholders.¹⁴⁴ This also means that the business judgment rule applies. The *Unocal* court, however, noted that in a hostile context, there is a strong likelihood that the directors will be entrenched and a decision to protect the corporate enterprise will instead be a self-interested move to protect their positions.¹⁴⁵ As stated in *Cede & Co.*, the business judgment rule does not provide protection in a case where there is evidence of “self-dealing.”¹⁴⁶ Because of the inherent danger of resistance to the merger being self-interested, a court will review the transaction thoroughly prior to applying the business judgment rule.

137. 199 A.2d 548, 554 (Del. Ch. 1964).

138. *Id.*

139. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–55, *passim* (Del. 1985).

140. *Cheff*, 199 A.2d at 549.

141. *Id.* at 556.

142. “[I]f the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course.” *Id.* at 554.

143. 493 A.2d 946.

144. *Id.* at 958.

145. *Id.* at 954.

146. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

The *Unocal* court articulated a test for whether the business judgment rule will attach.¹⁴⁷ First, the board must have reasonable grounds for believing there is a danger to corporate policy and effectiveness.¹⁴⁸ Second, the vote must not be solely or primarily to perpetuate themselves in office.¹⁴⁹ Third, the defensive measures taken must have a reasonable relation to the threat posed by the hostile attempt.¹⁵⁰ The following sections discuss these requirements in the context of credit union hostile merger bids.

1. Reasonable Belief

The first prong of the test allows directors to resist hostile offers in order to protect the corporate enterprise.¹⁵¹ Many takeovers are initiated by raiders, whose sole purpose in purchasing the company is to break it apart and sell its constituent pieces, effectively destroying the company as a separate entity. These offers are also frequently made using highly leveraged securities, which will saddle the surviving company with large amounts of debt. While these circumstances do not directly apply to credit unions, unsolicited offers for mergers by other credit unions or financial institutions with lesser capital ratios or lesser financial stability might be analogous. Additionally, the corporate enterprise of a credit union is unlike that of a stock corporation—credit unions are member-owned cooperatives with the mandate to serve and be loyal to their constituents exclusively.¹⁵² Hostile attempts by credit unions with similar fields of membership may have no other purpose than to eliminate available sources of services in the marketplace, and thereby restrict competition. Hostile attempts by credit unions with differing fields of membership might result in the loss of the credit union's unique focus on its constituency. A takeover attempt by a bank or other financial institution might also threaten a credit union's corporate enterprise because of the threat to the exclusivity and identity of the credit union, including its very nature as a mutual institution, and the resulting decrease in competition in the financial services market. Thus, the concept of a threat to the corporate enterprise of a credit union may make more sense than the same idea does with stock institutions, and may occur more frequently.

147. See *Unocal*, 493 A.2d at 953.

148. *Id.* at 955.

149. *Id.*

150. *Id.*

151. *Id.*

152. After all, credit unions traditionally have no customers other than their equity owners, no equity owners other than their customers, and no equity owners or customers other than their creditors.

2. Not Perpetuate Oneself in Office

The second prong is designed to ensure the defensive actions were not taken for self-interested reasons.¹⁵³ As explained above, acting with the objective of perpetuating oneself in office has, since *Cheff v. Mathes*,¹⁵⁴ been considered a breach of fiduciary duty. This remains a vital part of the Delaware analysis in the hostile takeover context.

3. Reasonableness of Defensive Measures

The third prong is also designed to ensure the defensive measures are not self-interested.¹⁵⁵ *Ivanhoe Partners v. Newmont Mining Corp.* serves as an illustration of when defensive measures are *not* disproportionate.¹⁵⁶ Ivanhoe Partners made a coercive offer and took a series of other actions that made it quite clear it would act contrary to the interests of shareholders and the company.¹⁵⁷ In response, Newmont, the target, took defensive measures. First, it approved “golden parachutes” for twenty-five key employees and prepared to take on large amounts of additional debt if any entity acquired more than 50% of its stock.¹⁵⁸ Next, it paid a sizable dividend to the shareholders, causing them to realize previously undervalued assets.¹⁵⁹ This in turn caused a previously affiliated company to purchase large amounts of Newmont stock on the open market and obtain a 49.7% interest in Newmont.¹⁶⁰ Finally, Newmont negotiated with the previously affiliated company (and now near-majority owner) to obtain a standstill agreement and maintain corporate independence.¹⁶¹ The re-

153. *Unocal*, 493 A.2d at 955.

154. 199 A.2d at 554.

155. *Unocal*, 493 A.2d at 955.

156. 535 A.2d 1334 (Del. 1987).

157. The specific device used was a two-tier tender offer, which is classified as coercive because a higher price is offered for the first tier, making it more likely that individual shareholders will sell in the first round. A credit union equivalent might be a per capita purchase offer, which would cause small account shareholders to want to vote in favor but disadvantaging account holders with large balances. The NCUA has declared such offers illegal for federal credit unions, though they might still be possible for some state chartered institutions. See Media Release, National Credit Union Administration, NCUA Responds to Wings FCU Proposal (Apr. 17, 2007), available at http://www.ncua.gov/news/press_releases/2007/MR07-0417-2.htm; Letter from Robert M. Fenner, General Counsel, NCUA, to Paul Parrish, President and Chief Executive Officer, Wings Federal Credit Union (Apr. 17, 2007); Letter from Robert M. Fenner, General Counsel, NCUA, to Bruce O. Jolly, Jr., Venable, LLP (Apr. 13, 2007); Letter from Sheila A. Albin, Associate General Counsel, NCUA, to Anita Gieser, President, Pepto Makers Federal Credit Union (Sept. 29, 1997).

158. *Ivanhoe Partners*, 535 A.2d at 1338 n.7.

159. *Id.* at 1339–40.

160. *Id.* at 1340.

161. *Id.*

sult was that there was no sale of the company. All actions were integral parts of a defensive plan, and over all, the response maintained shareholder value and corporate integrity.

The *Unocal* court emphasized that the protection of the business judgment rule is not lost merely because the directors could benefit on their shares by taking part in a defensive measure.¹⁶² The directors in question in *Unocal* stood to benefit as shareholders because they had the option to sell their own shares at the same time as everyone else. Similarly, if a credit union proposes to resist a hostile takeover by selling to a bank or by instituting some modified poison pill, the action would not be considered self-interested merely because the directors as members can take part.

Specific facts that made resistance to a hostile merger attempt acceptable under the *Unocal* standard can be found in *Katz v. Chevron Corp.*¹⁶³ There, the board took defensive actions “only after an assessment of the situation over the course of two months, including six meetings and extensive discussion with retained expert advisers.”¹⁶⁴ The board was advised of possible disruptive actions by the hostile bidder, and the inadequacy of existing corporate defenses.¹⁶⁵ The board was also advised of the effects of new defenses on shareholder value and shareholder voting, specifically the ability of shareholders to maintain an effective proxy fight against management.¹⁶⁶ These actions seem to be the proper course of director action when faced with a possible hostile bid.

C. Revlon: Director Duty When Sale and Breakup Are Inevitable

The duties discussed in *Unocal* were complicated by the holding in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹⁶⁷ *Revlon* involved a company that was clearly going to be sold and likely split up.¹⁶⁸ The directors proceeded to take defensive action and accept a deal that gave a lower or equivalent price to shareholders, but benefited note-holders and particular bidders.¹⁶⁹ The *Revlon* court held that *Unocal* still applies in inevitable sale situations, but when it becomes clear there is no interest in protecting the corporate enterprise (as it will cease to exist when the company is inevitably sold), the *only*

162. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).

163. 22 Cal. App. 4th 1352 (1994).

164. *Id.* at 1369.

165. *See id.* at 1370.

166. *Id.* at 1370.

167. 506 A.2d 173 (Del. 1986).

168. *See id.* at 182.

169. *Id.* at 179.

duty remaining is the fiduciary duty to the shareholders.¹⁷⁰ At that point, it is also clear there is no interest in preserving any services or future earning potential for the shareholders, and therefore the interest remaining is in getting the highest price possible for the shareholders.¹⁷¹

Without the benefit of the above reasoning, the *Revlon* holding seems anomalous: When the sale of a company becomes inevitable, the directors have a duty to act as auctioneers and get the highest price possible for shareholders. The missing piece in some explanations of *Revlon* is that any takeover defense that is unrelated to shareholder protection cannot be related to the threat to the enterprise because there is no corporate enterprise interest remaining to protect.¹⁷² Thus, failure to act to get the highest price fails the third prong in the *Unocal* analysis. Because it fails the *Unocal* analysis, the directors' defensive actions would not be entitled to the protection of the business judgment rule, and a court would therefore examine the board's substantive decisions under the *Weinberger* total fairness test.

Later cases, particularly *Ivanhoe*, clarify that *Revlon* concerned breaches of the duties of care and loyalty and only applies in the hostile takeover context.¹⁷³ Additional clarification came in *Paramount Communications v. Time, Inc.*, in which the Delaware Supreme Court held that entering into the merger process does not trigger *Revlon* duties by itself.¹⁷⁴ *Revlon* only applies when the breakup of the corporate entity is inevitable.¹⁷⁵ In *Paramount*, Time's board contemplated a merger with Warner that would have fluidly transitioned Time's corporate process, business, culture, and control.¹⁷⁶ By contrast, in *Revlon* the board, in response to a bidder's offer, abandoned any long-term plans and sought options that involved breaking up the company.¹⁷⁷

D. Delaware Law's Application to Credit Unions

As stated above, the Delaware law on hostile takeovers applies directly to for-profit corporations. It is only by analogy that these tests would apply to credit unions and other non-profit cooperatives. A cooperative's board of directors clearly owes a fiduciary duty to the en-

170. *Id.* at 182.

171. *Id.*

172. *Id.* at 182-83.

173. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987).

174. 571 A.2d 1140, 1142 (Del. 1990).

175. *Id.* at 1150-51.

176. *Id.* at 1143-49.

177. *Id.* at 1150.

tity. As noted, in some jurisdictions, directors also owe a duty directly to the members; federal regulations may impose a similar duty to the members. Credit union directors may also be motivated by entrenchment when confronted by an unsolicited merger proposal. This combination of circumstances is nearly identical to the situation in *Unocal*. This warrants application to credit unions of the *Unocal* principle that courts must be more suspicious of defensive actions in the face of a possibly entrenched board.

Similarly, the principles in *Revlon* are not dependent on a corporation's capital structure—when it is certain that there will no longer be a corporation to protect, the only remaining duty owed by directors is to the shareholders. With a credit union, when it is certain that there will no longer be an entity to protect, among the duties to corporate entity and equity owners, only the duty to the members logically remains.¹⁷⁸ As applied to credit unions, the *Revlon* principles would dictate that, in the face of an inevitably disappearing entity, the credit union's directors would have to try to obtain the maximum value for their members. The available options would include merger with another institution, sale to a bank, or voluntary liquidation. The questions noted in the section on the duty of care above—what services are important to the members and what options will either continue services or create cash payments to members—are instrumental in determining the best option for the members.

E. *California Law*

In California, only the law cited above in *Eldridge v. Tymshare, Inc.* is available in analyzing these issues.¹⁷⁹ In *Eldridge*, the California Court of Appeal did not use standards like those found in *Unocal*, instead stating:

[a] 'target' corporation's decision to accept or resist a takeover bid . . . necessarily rests with the board of directors, since it is the directors, and not the shareholders, who are best able to evaluate the numerous and often complex financial factors which must be considered in determining whether the takeover proposal serves the best interests of the corporation.¹⁸⁰

Based on this statement, it appears that California courts are not as concerned with the possible loyalty problem that arises with entrenched boards. Without the entrenchment worry, the hostile take-

178. This principle could arguably also extend to situations where the entity will become another charter type or lose its nature as a mutual enterprise.

179. 186 Cal. App. 3d 767 (1986).

180. *Id.* at 776–77 (quoting *Enterra Corp. v. SGS Associates* 600 F. Supp. 678, 686 (E.D. Pa. 1985)).

over context may be identical to the consensual merger context. Thus, without developments in the attitude of California courts in the two decades since *Eldridge*, the California analysis would not change.

A significant problem for the application of *Revlon* duties to credit unions outside of Delaware is the possibility that directors will be deemed not to owe duties directly to members. The application of fiduciary duties varies between jurisdictions. In the case of *Revlon* duties, the reasoning that leads to the duty to auction depends on the premise that, without a continuing institution, there is a residual duty to members.¹⁸¹ Thus, the jurisdictionally based extension of the fiduciary duty to members or shareholders is the lynchpin in any analogy to *Revlon*. As discussed above, it is unclear whether directors of California credit unions have a fiduciary duty to the members as well as the credit union itself.

Further increasing the uncertainty in this area is the fact that *Eldridge* was decided before the *Unocal* and *Revlon* decisions became a part of the common legal landscape. It is possible that today's California courts and other states' courts might follow the now well-established and much-discussed precedents from Delaware.

VI. CONCLUSION

Evidenced by the above discussion, the law in the area of fiduciary duties of credit union directors does not provide clear answers. The ideal standards for corporate governance certainly differ from the rules that govern liability. The tests reviewed in the foregoing sections identify the minimum standards for director action, rather than defining the aspirational goals. Use of some of the tests, particularly in the hostile merger context, could be jurisdiction specific, based on the constituencies to whom a duty is owed. Application of any test to federal credit unions will depend on whether the statutes and regulations provide specific guidance, whether the federal courts are willing to create federal common law,¹⁸² and which state's laws courts decide to apply.

In the consensual merger context, the business judgment rule will likely apply absent one of the five factors that might remove its protections: *ultra vires* action, bad faith, self-dealing, fraud, or gross negligence. With the protection of the business judgment rule, a court will not examine the substance of a board's decision unless that decision is

181. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179-83 (Del. 1985).

182. See the discussion on choice of law above, specifically the decision in *Atherton v. FDIC*, 519 U.S. 213 (1997), and its possible application to federal credit unions.

irrational. Directors need only establish a rational basis for their decisions and go through a proper procedure to avoid liability. While the nuances of this doctrine will vary between jurisdictions, it is, in essence, a protective doctrine that will, to varying degrees, shield directors from liability.

In the context of a hostile takeover attempt, different standards may apply. Because of the nature of a hostile takeover, there is an inherent danger of directors refusing a merger out of self-interest and a desire to perpetuate themselves in office. Therefore, some courts apply greater scrutiny than they would in the case of a consensual merger. If a jurisdiction's fiduciary duties run to members as well as the entity, it is likely that a court would apply the *Unocal* test to a credit union board's decision in the hostile context. In such a situation, it is also likely that if it becomes inevitable that the credit union will be sold or dissolved in a hostile context, the board will have a duty to maximize member value under *Revlon*-like duties.

Beyond these general principles, credit unions, as well as other non-profit and mutual institutions, remain without direct guidance; in many jurisdictions, they remain entirely in the dark. As the trends toward larger mergers, more frequent charter conversions, and more complex transactions continue for credit unions, it is likely that litigation on these issues will increase. The rules for duties of credit union directors when dealing with fundamental corporate change will slowly be clarified through litigation, or through new statutes and administrative rulemaking. Finally, we hope that this article will assist in bringing light to this area of the law and providing guidance to the credit union industry.

