Keeping current: fiduciary duties

By Julie Kaufer and Justin Radell

Delaware courts set high bar for directors' breach of duty of loyalty

On March 25, 2009, the Delaware Supreme Court reversed the Delaware Court of Chancery's decision in *Lyondell Chemical Company v. Ryan*. No. 401, 2008 (Del. Mar. 25, 2009). In doing so, the supreme court reaffirmed the breadth of director discretion in fulfilling *Revlon* duties (*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173 (Del. 1986)) and clarified that only in "extreme" circumstances can disinterested directors be held liable for breach of the duty of loyalty in connection with the sale of a company.

Background

In April 2006, the controlling shareholder of Basell AF (Basell) made an offer to acquire Lyondell Chemical Company (Lyondell), which Lyondell rejected as inadequate. In May 2007, an affiliate of Basell filed a Schedule 13D indicating its interest in possible transactions with Lyondell, thereby signaling to the market that Lyondell was "in play." The Lyondell board immediately met to discuss its responses to the Schedule 13D and decided to take a wait-and-see approach.

On July 9, 2007, Basell made an offer to buy Lyondell for a significant premium to Lyondell's market price measured as of the day before the Schedule 13D filing, provided Lyondell would agree to a $400 million breakup fee and sign a merger agreement by July 16, 2007. The Lyondell board met the next day and on each of the next two succeeding days to consider the Basell proposal, whereby the board determined it was interested in the proposed offer, authorized the retention of a financial advisor, and instructed its CEO to try to negotiate better terms, including a higher price, a go-shop provision, and a reduced breakup fee. Basell agreed to reduce the breakup fee to $385 million but refused the CEO's other requests.

On July 16, 2007, the Lyondell board met to consider the Basell merger agreement and to hear reports from its management and its financial and legal advisors. Lyondell's financial advisor opined that the merger price was "fair" and advised Lyondell that no other entity would likely top Basell's offer. Based on these reports and the substantial premium that Basell was prepared to pay, the board voted to approve the merger and recommend it to the stockholders. Lyondell's stockholders subsequently approved the merger at a special meeting by more than 99 percent of the voted shares.

Certain Lyondell stockholders filed a class action complaint challenging the merger. The chancery court refused to grant defendant's motion for summary judgment on claims that the directors of Lyondell failed to act in good faith. Even though the acquisition price was at a significant premium to the market, the chancery court was particularly concerned that the directors had failed for two months to take any action to prepare for a possible acquisition once Basell made its intentions known, the merger agreement was negotiated in just one week's time, and the board allegedly failed to press seriously for a better price or to conduct even a limited market check before agreeing to the merger.

Delaware Supreme Court's Reversal

Because Lyondell's certificate of incorporation included an exculpatory provision pursuant to section 102(b)(7) of the Delaware General Corporation Law that protects directors from personal liability for breaches of the duty of care, the Delaware Supreme Court focused solely on whether the directors breached their duty of loyalty by failing to act in good faith, a breach that would not be exculpated. In reversing the chancery court's decision, the supreme court found that the chancery court misapplied the applicable law in three respects by

- Imposing *Revlon* duties on Lyondell's directors before they had decided to sell or before the sale had become inevitable,
- Reading *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process, and
- Equating an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith.

Revlon duties do not arise simply because a company is "in play." The failure of Lyondell's directors to act during the two months after the Schedule 13D filing, despite knowing the company was "in play," was critical to the chancery court's analysis of good faith. Revlon duties, however, do not arise simply because a company is "in play," but rather apply only when a company

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embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control. The supreme court found that the chancery court should have focused on the one week when Lyondell's board considered Basell's offer. During this time the directors met several times; attempted to negotiate better terms in the merger agreement; evaluated Lyondell's value, the price offered, and the likelihood of obtaining a better price; and ultimately approved the merger. The supreme court also found the board's decision to adopt a wait-and-see approach to the Schedule 13D filing to be an appropriate exercise of the board's business judgment.

Revlon does not provide a single blueprint that a board must follow. The supreme court clarified that there is only one *Revlon* duty—to get the best price for the stockholders at a sale of the company. No court can tell directors exactly how to accomplish that goal because directors will be facing a unique combination of circumstances in each transaction. The chancery court focused on whether the directors had exercised due care. The supreme court emphasized that the proper analysis was whether the directors had failed to act in good faith.

To breach the duty of loyalty, directors must have utterly failed to attempt to obtain the best sale price. The chancery court improperly equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith. Because there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties, the directors' failure to take any prescribed steps during the sale process could not have demonstrated a conscious disregard of their duties. The chancery court should have focused on whether the directors utterly failed to attempt to obtain the best sale price rather than questioning whether disinterested, independent directors did everything that they arguably should have done to obtain the best sale price. The supreme court stated that there is a vast difference between an inadequate and flawed effort to carry out fiduciary duties and a conscious disregard for those duties.

The supreme court found no evidence to infer that the directors knowingly ignored their responsibilities and therefore granted summary judgment in favor of the directors.

Observations Regarding *Lyondell*

The Delaware Supreme Court's decision in *Lyondell* sends a strong message that, absent extreme circumstances, disinterested directors will not be found to have acted in bad faith in connection with the sale of a company. The decision makes clear that plaintiffs will not be able to circumvent exculpatory clauses by packaging due care violations as bad faith claims. In each of the recent decisions in *Lyondell* and *In re Citigroup Inc. Shareholder Derivative Litigation* (Civ. Action 3338-CC (Del. Ch. Feb. 24, 2009), the Delaware courts reaffirmed that to establish bad faith there must be a showing that the directors knew they were not discharging their duties or that the directors demonstrated a conscious disregard for their responsibilities. Taken together, these cases set a high bar that plaintiffs must overcome in establishing that disinterested directors have breached their duty of loyalty.

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