

Corporate Governance and Securities Litigation ADVISORY

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Delaware Supreme Court Reaffirms Director Protections in Change of Control Context

On March 25, 2009, the Delaware Supreme Court issued its highly anticipated decision in the case of *Lyondell Chemical Company et al., v. Ryan*.¹ The denial of summary judgment by the Chancery Court had given rise to serious concerns that monetary liability for directors based upon violations of the duty of good faith in a sale of corporate control was much more likely than previously thought.² In reversing the Chancery Court and entering summary judgment for the directors, the Supreme Court reaffirmed its previous decisions outlining the contours of the duty of good faith, and provided welcome comfort to directors and their advisors as they consider how to fulfill directors' fiduciary duties relating to change of control transactions.

Factual Background

Lyondell Chemical Company (Lyondell) was a financially strong company that was not looking to raise capital and was not otherwise for sale. Through Lyondell's CEO, it received an unsolicited offer from Basell AF (Basell) in April 2006, which was rejected due to the low offer price. Less than a year later, an affiliate of Basell filed a Schedule 13D identifying its right to acquire a large (but non-controlling) block of Lyondell stock and Basell's interest in a possible transaction with Lyondell. Lyondell's board met to consider whether Lyondell should take any action in response to the Schedule 13D, but it decided not to put the company up for sale nor initiate defensive measures to block hostile bids at that time. The board also made no attempt to value the company in light of the Schedule 13D filing. Aside from one brief approach by another suitor, the Schedule 13D filing did not lead to any additional expressions of interest in Lyondell. Two months after the Schedule 13D filing, Lyondell's CEO met with the chairman of Basell's parent company. Basell initially offered \$40 per share and, after some negotiations during the meeting, Basell made its best offer of \$48 per share in cash later that day. The offer was contingent upon the signing of a merger agreement in just seven days and a break-up fee of \$400 million. Over the following two days, Lyondell's board considered the offer, engaged a financial advisor, Deutsche Bank, and formally authorized Lyondell's CEO to negotiate with Basell.

¹ C.A. No. 3176 (Del. March 25, 2009).

² C.A. No. 3176-VCN (July 29, 2008 Del. Ch.); See Alston & Bird LLP Securities Litigation Advisory "Board's Hasty Approval of Merger May Violate *Revlon* Duties and Constitute Bad Faith" (August 13, 2008).

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During the negotiations, the Lyondell board, through its CEO, asked Basell to increase its price, to reduce the break-up fee and to include a go-shop provision. After offering its best price at a substantial premium to Lyondell's current share price, Basell's chairman would only agree to marginally reduce the break-up fee to \$385 million. The following day, Deutsche Bank provided the board with its opinion that the \$48 per share offer was fair and its assessment of the likelihood of a superior offer. The board then voted unanimously to approve the merger agreement and recommend the merger to Lyondell's stockholders—seven days after Basell's first offer. The driving force behind the board's decision was its belief that the substantial premium over the market price was too good not to accept.³

Plaintiff (Ryan) filed suit in the Delaware Chancery Court. Ryan alleged, among other things, that the Lyondell board breached its fiduciary obligations as articulated in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁴ to obtain in a sale of corporate control the best price reasonably available. Although Lyondell's charter contained an exculpatory provision authorized by Section 102(b)(7) of the Delaware General Corporation Law (the DGCL), which would eliminate any monetary liability of the directors in most instances, the Chancery Court denied the motion of the Lyondell board for summary judgment. The court reasoned that the "unexplained inaction" by the Lyondell board and other deficiencies in the process created an issue of fact for trial as to whether the board consciously disregarded their fiduciary duties and breached their fiduciary duty of loyalty by failing to act in good faith, which would not be exculpated under Lyondell's charter.

The Supreme Court Decision

The Delaware Supreme Court accepted an interlocutory appeal "to consider a claim that directors failed to act in good faith in conducting the sale of their company." Because the Lyondell board was "independent and not motivated by self-interest or ill will," the issue before the Supreme Court was whether the directors were entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith. The Supreme Court discussed the range of conduct that might be characterized as failures to act in good faith (and therefore violated the duty of loyalty) and noted that bad faith required intentional dereliction of duty on the part of the board. The Supreme Court concluded that the record in this case, at most, created an issue of fact as to whether the directors breached their duty of due care, for which monetary liability would be eliminated under Lyondell's charter. The record did not, in the Supreme Court's view, present a triable issue as to whether the directors knowingly ignored their responsibilities, thereby violating the duty of loyalty.

The Supreme Court identified three specific errors in the Chancery Court's reasoning, each of which provides important clarification to directors and their counsel as they navigate a sale of corporate control:

³ The Basell offer represented a premium of 20 percent over the market price for Lyondell stock immediately preceding announcement and a 45 percent premium over the market price prior to the filing of the Schedule 13D. Deutsche Bank's managing director described the offer price as "an absolute home run."

⁴ 506 A.2d 173 (Del. 1986).

1. *At what point do Revlon duties begin to apply?*

The Supreme Court clarified that “the duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to a specific offer—that will result in a change of control,” rejecting the Chancery Court’s reasoning that the failure of the Lyondell board to prepare for a possible acquisition proposal during the two months from the filing of the Schedule 13D until Basell’s parent presented a specific proposal may have constituted bad faith as an intentional dereliction of duty. According to the Chancery Court, the filing of the Schedule 13D put the Company “in play,” but the Supreme Court rejected the suggestion that action by a third party that falls short of a specific offer triggers *Revlon* duties. The “wait and see” approach taken by the directors after the filing of the Schedule 13D was an acceptable exercise of business judgment and, according to the Supreme Court, the relevant time frame to examine the board’s actions was during the period that began when negotiations commenced following Basell’s \$40 per share offer.

2. *Does Revlon create a specific set of requirements that must be satisfied during a sale process?*

Absolutely not. The Chancery Court focused on a limited menu of options a board could use to satisfy *Revlon* duties (such as a pre-signing auction, a post-signing market check or “impeccable” knowledge of the market that removes the requirement for either). The Supreme Court, however, reaffirmed existing Delaware law, stating the following:

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 they will be facing a unique combination of circumstances, many of which will be outside their control. . . “[T]here is no single blueprint that a board must follow to fulfill its duties.” [citations omitted]

3. *Does an imperfect attempt by a board to carry out its Revlon duties equate to bad faith?*

The Supreme Court confirmed that the failure to take any specific steps during a sale process could not be viewed as bad faith. Even when measured against the *Revlon* standard of obtaining the best available price, unless a board has acted with a conscious disregard of its duties, any shortcomings in a sale process should be viewed by Delaware courts as duty of care violations (assuming no allegations that the board was conflicted), not violations of the duty of good faith. As the Supreme Court noted, “there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.” Since most shortcomings in a sale process will generally be viewed as duty of care violations, most corporations will have eliminated monetary liability for these violations through the commonly adopted exculpatory provision permitted by DGCL Section 102(b)(7).

Practical Lessons

Although the Supreme Court’s decision provides significant assurance that the good faith “exception, absent extreme circumstances,” will not swallow the rule of exculpation from monetary damages for breaches of the duty of care, the decisions of both the Supreme Court and the Chancery Court provide a number of important practical lessons in connection with a change of control.

- *Creating a Factual Record is Critical.* Because there is no single blueprint of board action that fulfills *Revlon* duties, the question of whether or not a board has done so is inherently fact-specific. Therefore, boards should work to create a record that the board consistently acted to seek the best price reasonably available, and be mindful of how that record, memorialized in the background section of a proxy statement, will be scrutinized by stockholder plaintiffs and their counsel. That record should indicate active involvement by the board at all stages of the process, avoiding excessive delegation of responsibility to management. To the extent that active board involvement is logistically burdensome, boards should consider creating “committees of convenience,” consisting of directors with the time and energy to remain actively involved.⁵
- *Start Thinking about the Record Early.* Although the Supreme Court clarified that preliminary actions by a third party, such as filing a Schedule 13D, are not sufficient to invoke *Revlon* duties, the standard articulated by the Supreme Court—that the duty to seek the best available price applies only when a company embarks on a transaction—is likely to remain uncertain in practice. Since this uncertainty is likely to persist, boards should think defensively about how their actions will be viewed in hindsight, whether or not *Revlon* applies as a technical matter, particularly at the preliminary stages of a transaction.
- *Traditional Processes Should Largely Be Effective.* The Chancery Court criticized the Lyondell board’s inability to show that they had obtained the best price available by failing to conduct an auction, a market check or demonstrating impeccable knowledge of the market. A board that is generally aware of the value of the company and the dynamics of its industry, and obtains customary legal and financial advice, should generally not have to worry that it is not acting in good faith, even if the board does not conduct an auction prior to the signing of or obtain a “go shop” in a merger agreement. A merger agreement with passive-post signing market check involving a customary window shop provision, a fiduciary termination right and a customary break-up fee will often be consistent with the board’s duties in the *Revlon* context, absent other specific circumstances.

⁵ Of course, creating a committee of convenience does not remove the need for the committee to update the full board at appropriate intervals or excuse the full board from their fiduciary obligations.

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