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Delaware Supreme Court Rejects Bad Faith Claims in Sale of Corporation

On Wednesday, March 25, 2009, the Delaware Supreme Court issued its opinion in *Ryan v. Lyondell Chemical Co*. The court reversed the Delaware Court of Chancery's decision and dismissed a stockholder's claim that members of a board of directors, a majority of whom were disinterested and independent, violated their duty of loyalty by acting in bad faith in failing to satisfy their so-called *Revlon* duties. The decision is the latest on directors' duties in a sale of a corporation and provides guidance on the relationship between the board's manner of conducting a sale process and the directors' duty of loyalty, which includes the obligation to act in good faith. The effect of the decision is to largely insulate disinterested and independent directors from personal liability in third-party sale transactions.

Background

The litigation arose from a challenge to Basell AF's July 2007 all-cash merger offer to acquire Lyondell Chemical Company at a 45 percent premium to its pre-announcement trading price. In May 2007, a Basell affiliate filed a Schedule 13D with the Securities and Exchange Commission disclosing its interest in potential transactions with Lyondell. In response, the Lyondell board immediately convened a meeting, but decided to take no action. Approximately two months later, Basell made an acquisition proposal that, following brief negotiations between the parties, led to a price that was ultimately approximately 20 percent greater than Basell's initial offer.

During the process, Lyondell's board of directors met for a total of seven hours during three meetings held in a single week. It also directed its outside financial advisor to evaluate the proposal but not to contact other potential bidders. After considering presentations from its financial and legal advisors, the board approved a merger agreement that contained a fiduciary out in the event Lyondell received a superior proposal from a third party. On the defendants' motion for summary judgment, the court of chancery found that the plaintiff had raised an inference that, despite the board's independence and disinterestedness, the directors breached their duty of loyalty by failing to act in good faith in considering, and responding to, the Basell proposal.

The Delaware Supreme Court's Opinion

The supreme court found that the court of chancery erred in three ways. First, the court of chancery improperly "imposed *Revlon* duties on the Lyondell directors before they either had decided to sell, or before the sale had become inevitable." Specifically, the lower court should not have found that the board's conscious inaction in the face of the Schedule 13D provided evidence of bad faith. "*Revlon* duties," the supreme court explained, "do not arise simply because a company is 'in play.'" Thus, the board's "wait and see" approach was an "entirely appropriate exercise of the directors' business judgment."

The court of chancery's other two mistakes were (i) interpreting *Revlon* as creating a specific set of requirements that must be followed in a sale process and (ii) equating an imperfect attempt to carry out *Revlon* duties with a knowing disregard of those duties. The supreme court confirmed that directors have wide latitude in selling a company as long as they accomplish their only *Revlon* duty: to get the best price reasonably available. The court of chancery was unable to conclude that the directors satisfied their duty of care based on the limited sale process. The supreme court noted its inclination to find in favor of the directors on the duty of care claim, even on the limited record before the court, but would not have questioned the court of chancery's decision to seek additional evidence in that respect.

However, the court explained that when the issue is "whether the directors failed to act in good faith, the analysis is very different." Specifically, a claim that the directors violated their duty of loyalty by acting in bad faith requires "a showing that the directors knew that they were not discharging their fiduciary obligations." Because there are no legally required steps for a board's process to satisfy *Revlon*, "the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties." Thus, the court held that the relevant inquiry was "*whether those directors utterly failed to attempt to obtain the best sale price*." The directors would have breached their duty of loyalty only

if they "knowingly and completely failed to undertake their responsibilities."

Implications

Lyondell largely protects disinterested and independent directors from personal liability because it increases the difficulty of proving bad faith. Although the court of chancery had indicated that the board might have breached its duty of care, directors can be exculpated for due care violations pursuant to an exculpatory provision in a company's certificate of incorporation. Thus, the only way to hold directors personally liable is to prove a breach of the duty of loyalty by showing either that a director had a personal interest in the transaction or that a director acted in bad faith.

Lyondell is therefore important because the supreme court imposed a high standard to prove bad faith when disinterested and independent directors agree to the sale of a corporation to a third party in an arms-length transaction. So long as boards are guided by competent advisors, it will be difficult to show that directors "utterly failed" to obtain the best price reasonably available. The decision also goes a long way in curtailing recent efforts by plaintiffs to circumvent exculpatory clauses by packaging due care violations as bad faith claims. Going forward, stockholder-plaintiffs are likely to respond to this decision by pursuing disclosure challenges and perhaps seeking to enjoin transactions prior to closing based on allegations of due care violations.

Lyondell is a reaffirmation of boards' wide discretion in conducting sale processes. As the Delaware Supreme Court observed, "[n]o 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." In this case, the board was presented with a bidder determined to move quickly and was armed with advice from its outside financial advisor that the merger consideration constituted a "blowout price." As a result, the board could not be accused of acting in bad faith when it proceeded while relying on a post-signing market check through its fiduciary out. Nevertheless, the decision should not be mistaken to lower the level of judicial review in mergers involving conflicts of interest. Moreover, the Lyondell process is not necessarily a model one. The court of chancery indicated that the board may have been grossly negligent for failing to actively check the market for other potential bidders.

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