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M&A Commentary

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Ryan v. Lyondell Chemical Co.: Delaware Court Says Directors Who Approved Merger May Face Trial On Issue of Personal Monetary Liability For Alleged Breach of Duty of Good Faith

Highlights

- Court of Chancery held that a target company's board of directors was not entitled to summary judgment on the plaintiff's claims that the board violated its *Revlon* duties by failing to involve itself in a CEO-dominated sale process that led to a substantial premium bid for the company. In particular, because the board made no effort to shop the bid prior to signing and was unable to demonstrate on summary judgment that it otherwise possessed sufficient knowledge of the M&A market, and the value of the company, to justify "ceremonial" acceptance of the bid, the court was unable to find for the directors.
- The target company's directors were not entitled to exculpation, on summary judgment, under the company's § 102(b)(7) charter provision where the alleged fiduciary breach involved the board's failure to engage in an active sale process. An adequate record had not been developed to demonstrate that the board acted with the good faith required for exculpation. The decision suggests that directors of Delaware corporations may face a trial, and potential personal liability, whenever a plaintiff can allege inadequate board action in connection with a sale of the company.
- Boards can improve their chances of having claims of this type dismissed in advance of trial by engaging in regular contingency planning to assess strategic alternatives (even if the company is not "for sale"), by responding proactively to market developments and by building a record of careful board deliberation, with the assistance of financial and legal advisors, both in advance of and throughout the sale process.

Introduction

In a rare decision on a post-closing motion in *Ryan v. Lyondell Chemical Co.*,[1] the Delaware Court of Chancery addressed the question of whether the independent members of a target company's board of directors were entitled to summary judgment on claims that they breached their fiduciary duties by conducting an inadequate sale process. Although the court suggested that the transaction's 45 percent premium was likely to prove exceptional, that the price was certainly "fair" and that the agreed deal protection measures might prove to be "reasonable," the limited record of a passive board process in a CEO-dominated transaction with no market check likely mandated a trial to assess the open factual matters. The decision highlights (1) the judicial perception of CEO-dominated M&A processes and the implications of those negative views on the ability of defendants to secure dismissal of claims prior to trial, (2) the critical importance of developing a thorough record of board evaluation (with financial and legal advisors) early in any strategic process, <u>whether company-initiated or defensive</u>, of the most

effective means of maximizing shareholder value, and (3) the equal importance of building a record of careful board deliberation, with the assistance of legal and financial advisors, as to the effect of deal protection terms on the likelihood of subsequent bidders emerging and bidding full value.

Background

Basell AF first expressed interest in acquiring Lyondell Chemical Co. in April 2006 at an introductory meeting between Lyondell's Chairman and Chief Executive Officer, Dan F. Smith, and the Chairman of Basell's corporate parent, Leonard Blavatnik. Those discussions were brief, as the parties were far apart on price. A year later, a Basell affiliate acquired an 8.3 percent block of Lyondell shares and filed a Schedule 13D with the Securities and Exchange Commission, in which it indicated that it may seek to engage Lyondell in discussions regarding a potential change of control transaction. At that time, Lyondell was a financially strong and viable company and not otherwise "for sale" or in need of pursing other strategic alternatives.

Lyondell's board understood that, following the 13D filing, the Company was "in play," but according to the court, the board took no action in response to the filing, opting instead to wait and see if any suitors would express interest in acquiring the Company. One potential private equity suitor emerged, suggesting a management-led leveraged buyout; Lyondell's CEO Smith flatly rebuffed the overture, viewing such a transaction as too fraught with conflicts of interest for both management and the board.

Instead, Smith independently pursued negotiations with Basell and at one point suggested to Basell his view that a price of $48 per share for Lyondell would be "justified." Critically from the court's perspective and based on the record available to it, the board was both (1) largely unaware of Smith's activities and contacts with Basell, and (2) "indolent [following the Schedule 13D filing], making no effort to value the Company or assess what options might be on the table *if* Basell (or another acquirer) made a move to acquire Lyondell."

Without any input or participation from the board, Smith continued to negotiate price and eventually urged Basell to make its best offer for Lyondell. On July 9, 2007, Basell offered $48 per share for Lyondell but only if the Lyondell board would approve a merger agreement by July 16 and agree to a $400 million break-up fee. Smith brought that proposal to the board, which, over the next week met several times, for a total of six or seven hours. Half or more of those hours accrued on the day the board reviewed the final terms of the merger agreement with its advisors and voted to approve the deal.

At one point during the week, the Lyondell board instructed Smith to seek a number of concessions from Basell, but because there were no other serious bidders in the picture, the Lyondell board had little leverage with which to negotiate. As a show of good faith, Basell agreed to lower the break-up fee to $385 million, which was about 3 percent of the equity value and 2 percent of the enterprise value of Lyondell (a fairly standard size termination fee in transactions of this type). Other deal protections in the final merger agreement included a no-shop clause and matching rights for Basell. The board hired Deutsche Bank to serve as its financial advisor for the Basell proposal and to give a fairness opinion. Deutsche Bank's valuation used both "bullish" financial projections based on Lyondell management's views and more "conservative" financial projections based on a consensus equity analyst view. Those analyses yielded a valuation range for Lyondell between $44.74 and $51.50 per share and $37 and $47 per share, respectively.

Lyondell's stockholders nearly unanimously approved the transaction, which represented a 45 percent premium over the price of the stock prior to the filing of the Schedule 13D and a 20 percent premium over the trading price prior to the announcement of the merger agreement.

The Litigation

Lawsuits challenging the transaction were filed in Texas and Delaware. While the Texas plaintiffs unsuccessfully sought a preliminary injunction, the Delaware plaintiff did not seek any pre-merger relief. Rather, the Delaware plaintiff continued to press breach of fiduciary duty claims against Lyondell's board following the closing of the merger, seeking a monetary remedy against Lyondell's directors. The defendants brought a motion for summary judgment on the plaintiff's claims.

The procedural posture of the litigation is important. In denying the defendants' motion for summary judgment on the plaintiff's *Revlon* claims, the court focused heavily on the applicable summary judgment standard, which required the court to draw all reasonable inferences in favor of the non-moving party—here, the shareholder plaintiff. At several turns in the opinion, the court expressed skepticism about the ultimate viability of the plaintiff's claims, especially given the "blowout" price that appeared to have been attained. The court intimated that it would not have enjoined the transaction on the facts presented had the plaintiff moved for an injunction prior to the closing of the transaction. But the court was troubled by the paucity of the summary judgment record and determined it could not conclude at this stage of the litigation (when only a few depositions had been conducted) that there was no material dispute of fact regarding the reasonableness of the board's actions in seeking to attain the highest value for Lyondell's stockholders.

The Court's *Revlon* Analysis

In allowing the plaintiff's *Revlon* claims to proceed to trial, the court focused heavily on the fact that the Lyondell board "did very little, if anything, to 'seek' the best transaction available to the Lyondell stockholders." As the court explained, a target company's board does not satisfy its *Revlon* duties when it merely acts "as a passive conduit to the stockholders for an unsolicited, attractive bid for the Company." The key drivers of the court's decision included the following:

- The board considered, negotiated and agreed to the deal in less than seven days. Although the court noted that this is not an impossible feat to pull off within the confines of *Revlon's* mandate, "it does give pause as to how hard the board really thought about this transaction and how carefully it sifted through the available market evidence." The court was particularly troubled by the fact that the board deliberated over the merger for no more than six to seven hours in total. These facts are not uncommon to many well-justified accelerated strategic processes, and the court's difficulty in appreciating how a board of directors faced with an extraordinary premium offer accompanied by a reasonable termination fee might move rapidly in this manner, and properly so, is surprising to many practitioners.
- The board took no action in response to Basell's Schedule 13D filing. While the defendants argued that the 13D filing "effectively put a 'For Sale' sign on the company and that no bidders were forthcoming," the court suggested that the Lyondell board should have taken some action "*in anticipation* of a possible proposal from Basell or another suitor." According to the court, the 13D filing would have prompted a reasonable board to retain investment bankers or at least ask management to prepare projections and valuations of the company in order to be prepared to respond to an acquisition proposal of the type submitted by Basell. It is our sense that this omission may have significantly colored the court's view of the balance of the board's process.
- The board played no active role in the negotiations and "made no discernable effort at salesmanship either before or after the merger was announced." The court suggested that the Lyondell board should have become involved in the negotiations sooner and played a role in "shap[ing] the negotiating strategy before a firm (and possibly final) offer was on the table." As the court explained, a target company board does not satisfy its *Revlon* duties by simply ceremoniously approving a deal negotiated by the CEO, which appears

favorable to stockholders—"the hallmark of a 'paradigmatic' *Revlon* claim is a supine board."

- The board never made an effort to conduct a pre-signing market check of any kind. Although a pre-signing auction or a post-signing go-shop will not always be required in order for a board to comply with its fiduciary duties in connection with a sale of the company, whether it is appropriate to pursue a "single-bidder strategy" without conducting a formal market check will turn on the board's knowledge of the current M&A market and the value of the company in that context. Because there was no record of the board having taken action to value the company or see what options might be available to maximize stockholder value in response to the 13D filing and in anticipation of a Basell proposal, the court could not conclude on summary judgment that the Lyondell board had sufficient up-to-date knowledge of value. The court was clearly bothered by the passivity of the board—when combined with the board's lack of action in response to the initial 13D filing it appears the Vice Chancellor lost confidence in the mandated stewardship of the M&A process by the board. It is in the context of that skepticism that we believe the court reached its conclusion that "[a] fairness opinion coupled with idle speculation as to why no other company would submit a competing bid for Lyondell, particularly given Lyondell's instruction to Deutsche Bank not to solicit competing bids, does not demonstrate a satisfactory discharge of the directors' *Revlon* duties on summary judgment."

- The court was unable to determine that the deal protections were appropriate in light of the inadequate sale process. Although the deal protections employed in the merger agreement are standard in many transactions of this type, the reasonableness of any deal protections depends on the sale process that led to them. "Where there is lingering doubt as to the Board's efforts to ensure that it had secured the 'best' transaction available," courts will be skeptical of a board's decision to grant considerable deal protections, "simply as a matter of course, that limit its ability to discharge proactively its fiduciary obligations after the fact." The court also took the opportunity to remind companies that there is no "formulaic" or safe-harbor approach to deal protection; that the target board in each transaction must justify the terms it accepts from a bidder.

Potential Director Monetary Liability (What About 102(b)(7)?)

The CEO-centered fact pattern of *Lyondell* is hardly unique among Delaware's corporate law decisions. The Delaware Supreme Court's seminal 1985 decision in *Smith v. Van Gorkom*, for example, involved a similar CEO-negotiated buyout of Trans Union Corporation, swiftly approved by the target company's board. In that case, the court found the board grossly negligent for having approved the merger without substantial inquiry or the receipt of any expert advice. The Trans Union board breached its duty of care because its decision to approve the merger was uninformed. The *Van Gorkom* case prompted an outcry from boards of directors of public companies, a sharp increase in insurance premiums for directors and officers' insurance, and the eventual adoption by the Delaware General Assembly of Delaware General Corporation Law § 102(b)(7). Section 102(b)(7) expressly allows corporations to exculpate their directors from personal liability for all breaches of fiduciary duty other than for breaches of the director's duty of loyalty to the corporation or its stockholders, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law or for transactions from which the director derived an improper personal benefit. The clear intent of Delaware's General Assembly in adopting § 102(b)(7) was to avoid monetary liability on the part of directors in situations like *Van Gorkom*.

Interestingly, the court in *Lyondell* never cites *Van Gorkom*. But the Lyondell board appears to have done far better than the Trans Union board did in that case, in which the Trans Union board never made any effort at all to evaluate the bid for, or to value, the Company. By contrast, once the Basell proposal was presented to it, the Lyondell board hired investment bankers, obtained a fairness opinion that placed the offer price at the high end of the value

ranges, and even sought, albeit unsuccessfully, several concessions from Basell.

Yet, in a more-than-surprising move, the court was unable to conclude on summary judgment that the protections of § 102(b)(7) applied. Quoting the Delaware Supreme Court's recent decision in *Stone v. Ritter*, the court stated that "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." Again, the court was concerned with the summary judgment record, or lack thereof. As the court stated, "[t]he record does not demonstrate that the Board . . . made [any] discernable effort at salesmanship either before or after the Merger was announced. . . . [I]nstead, this is a board of directors that appears never to have engaged fully in the process to begin with, despite *Revlon*'s mandate. Thus, the good faith aspect of the duty of loyalty may be implicated, which precludes a Section 102(b)(7) defense."

Many commentators have criticized the court's analysis of the § 102(b)(7) issue. The court's reliance on *Stone v. Ritter* in holding that the disinterested members of Lyondell's board potentially breached their duty of loyalty in connection with the transaction is striking because (1) the court actually rejected all of the plaintiff's arguments suggesting bias on part of the directors (more on this below) and (2) *Stone v. Ritter*, is largely inapposite. In a non-change of control context where the business judgment rule would normally protect the board's actions, *Stone v. Ritter* commented, but did not hold in that case, that a board's complete failure to act in the face of a known duty to act may amount to a failure to act in good faith and thus a breach of the duty of loyalty. Chancellor Allen once described that theory, in the context of failure of day-to-day corporate oversight as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In a so-called *Caremark* director oversight claim, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability." The concept of a "sustained" and "systematic" failure to act does not seem to lend itself to application in a one-time transaction such as a sale of the company.

However, in connection with the sale of the company—one of the most critical decisions a board will ever make—the board is not entitled to the automatic protective presumptions of the business judgment rule. Instead, the burden is shifted to the directors to demonstrate that they were adequately informed and acted reasonably—and that showing is subject to enhanced judicial scrutiny. In this context, the *Lyondell* court suggests that "knowledge" is the hallmark of good faith. On that point, the court held that on the record before it, the directors were not able to sustain *their* burden under *Revlon* of demonstrating that there was no factual dispute after drawing every inference in the plaintiff's favor (the summary judgment standard) that they were adequately informed and acted reasonably. From the court's perspective, a record had not been developed to show that the directors had adequately tested or otherwise demonstrated their knowledge of the adequacy of the offer or that the deal protections were reasonable or required.

Other Holdings

Lyondell is a dense corporate law decision with a number of additional issues being addressed. Some of the decision's other important holdings include:

- Lyondell's independent directors were not "interested" in the transaction where as a result of accelerated vesting of their director options, they stood to gain anywhere from $233,000 to $3.75 million. The court gave no consideration to the time value of the acceleration or the avoidance of risk of forfeiture. Rather, the court found that notwithstanding the acceleration, the directors were not treated any differently from other stockholders and did not receive any special benefit because their options were paid out at the deal price.

- Basell did not aid and abet the Lyondell board's possible fiduciary breaches. Although Basell certainly "drove a hard bargain," that did not suffice to establish an aiding and abetting claim where the parties negotiated the transaction at arms' length.
- The plaintiff's sole viable disclosure claim—that the proxy statement used to solicit votes for the merger failed to disclose that Lyondell's management had supplied Deutsche Bank, but Deutsche Bank did not use, a lower weighted average cost of capital that would have shifted the range of values of Lyondell upward—was a duty of care claim that was exculpated by Lyondell's § 102(b)(7) provision.
- Lyondell's directors were not entitled to a defense of stockholder ratification. Although the stockholders nearly unanimously approved the transaction, "the precise loyalty issue being challenged in [the] case—the board's good faith discharge of its *Revlon* duties—arguably was not before the shareholders in voting on the Merger. . . . The Lyondell shareholders were entitled to rely upon the board to discharge its fiduciary obligations in good faith prior to recommending a particular change in control transaction, and, thus, they could not have been asked to ratify the board's alleged unilateral decision to abdicate its fundamental fiduciary obligations in that regard simply by voting in favor of the Merger."

CONCLUSIONS: M&A PROCESS AFTER *LYONDELL*

For the time being, plaintiffs will likely see *Lyondell* as an invitation to initiate post-merger litigation and then to demand higher settlements in cases where the record is less than perfect. Even if a defendant is successful in defending a preliminary injunction motion, the possibility of damages following a post-closing trial may give plaintiffs increased bargaining power in settlement negotiations. Directors should bear in mind, however, that, absent a claim of self-dealing, they will still benefit from directors and officers' insurance and the corporation's provisions on indemnification.

It is also unlikely that *Lyondell* will be extended beyond its discrete set of facts, and another Delaware court might well reach a different conclusion if again presented similar facts—and the court in *Lyondell* itself was skeptical of the likelihood of the plaintiff ultimately proving that actual damages were suffered. Nonetheless, there are some simple and valuable lessons that can be gleaned from the decision about how corporate boards should approach a sale process consistent with their fiduciary duties under *Revlon* and in a manner that will mitigate directors' vulnerability to after-the-fact lawsuits for damages:

- Boards must create a documentary record of actions taken in response to or in anticipation of acquisition proposals, whether solicited or hostile. The *Lyondell* decision made clear that the court did not believe the plaintiff had much chance of ultimate success on his claims. But the paucity of the summary judgment record regarding the Lyondell board's efforts to discharge its duties prevented the court from deciding the case on summary judgment. It appeared the court desired to rule in favor of the defendants, but felt the existing record prevented it from doing so. A better documentary record regarding the board's actions in relation to the Basell proposal may have persuaded the court otherwise. In fact, the court, in a concluding note, invited the defendants to move for summary judgment again after a more fulsome record had been developed.
- Boards should act proactively in response to market developments. Other than to quibble with the length of the relevant board meetings, the *Lyondell* decision actually does little to criticize the board's actions in the period between the time the Basell proposal was submitted to the board and the merger agreement was approved. Rather, the court took issue with the Lyondell board's failure to engage in any contingency planning in anticipation of the Basell proposal. Following the aggressive 13D filing by Basell, the court expected the Lyondell board to have begun immediately seeking expert advice and

evaluating all potentially available options to maximize stockholder value. In the current activist (and increasingly hostile) strategic environment, we recommend (as we have for some time) that boards of directors meet no less frequently than annually with their financial advisors and counsel to evaluate the company's strategic position and alternatives so as to be prepared both as a business matter and now, in light of *Lyondell*, from a record perspective, to respond rapidly and effectively to both corporate threats and opportunities.

- Boards should also build a careful record of deliberation, supported by the views and analyses of outside legal and financial advisors, as to deal protection terms. The specific group of deal protection terms should be evaluated and justified in the context of the deal process conducted. The impact of the financial (*e.g.*, the break fee) and process (*e.g.*, matching rights) deal protection terms upon the prospects of subsequent bidders emerging and bidding full value should be considered not only independently, but collectively as a whole.
- Boards, either as a whole or through a lead director (initially), need to be intimately involved in the sale process. The court's perception of the board's stewardship was clearly colored in *Lyondell* by the fact that the board was completely unaware of the negotiations between its CEO and Basell until after the deal terms were finalized and the proposal was submitted, pre-negotiated, to the board. While this turned out to be a fairly effective negotiating strategy, as an apparently favorable price was attained, the decision to pursue such a strategy should have rested with the board, the discussion and approval of which needed to have been documented thoroughly in Lyondell's board minutes.
- Boards should continue to bear in mind that a fairness opinion, regardless of the reputation of the issuing bank and the thoughtfulness of the underlying analyses, cannot adequately compensate for a judicial perception of a deficient M&A process.

—Mark Gerstein, James Hanna and Adam Kestenbaum.

Endnote

[1] C.A. No. 3176-VCN (Del. Ch. July 29, 2008), available by clicking here. The procedural posture of *Lyondell* was unusual because most important merger litigation in Delaware unfolds before the transaction closes. Lengthy and complex preliminary injunction decisions are the norm, with the court addressing only the single question of whether plaintiffs have demonstrated a substantial likelihood of irreparable harm to shareholders, a very high standard, if the transaction is allowed to proceed. Unlike a pre-merger proceeding where the burden is on plaintiffs to demonstrate substantial likelihood of irreparable harm, in seeking summary judgment, the burden is on the defendant directors to demonstrate that there was no disputed issue of fact as to whether their conduct satisfied their fiduciary responsibility under the enhanced judicial scrutiny afforded to change of control transactions.

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