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Delaware Supreme Court Provides Further Guidance On *Revlon* Duties and Duty of Good Faith

The Supreme Court of Delaware has ruled that directors of one chemical company did not breach their fiduciary duty of loyalty by failing to act in good faith in evaluating and approving a $13 billion merger with another chemical company. The decision in *Lyondell Chemical Company v. Ryan*[1] reverses the decision of the Delaware Court of Chancery and clarifies certain aspects of the *Revlon* duties and the duty of "good faith" of directors in the context of a sale-of-control transaction.

Implications of *Lyondell*

The Supreme Court of Delaware's decision in *Lyondell* is significant in several respects. First, *Lyondell* clarifies when a board's *Revlon* duties apply. By finding that *Revlon* duties apply "only when a company 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 emphasized the role of the company and its directors in determining when *Revlon* duties are triggered, as opposed to when third-party actions, such as a Schedule 13D filing, generally inform the market that a third party is interested in acquiring a company. This is an important concept for practitioners and M&A professionals as it generally allows for the target company, through its actions, to control whether *Revlon* duties apply. Based on this principle, the Supreme Court found that it is a valid exercise of a director's business judgment to take a "wait-and-see" approach (and to not actively begin shopping the company) in response to a third-party overture that puts the company "in play."

Second, *Lyondell* reaffirms the Supreme Court's long-standing principle that there is "no single blueprint," or legally prescribed steps, for satisfying *Revlon* duties. It is not necessary, in every instance, for the directors to conduct an auction or a market check or to develop "impeccable" market knowledge. Rather, directors' decisions must be reasonable, not perfect.

Finally, the *Lyondell* decision confirms the high bar that must be cleared to establish a breach of a duty of loyalty based on a failure to act in good faith. Because loyalty claims for failure to act in good faith are reserved only for situations where the board "knowingly and completely failed" or "utterly failed" to undertake its responsibilities, there is a high burden of proof to overcome to impose liability on the directors. Indeed, the Supreme Court acknowledged that an extreme set of facts is required to sustain a disloyalty claim premised on the assertion that disinterested directors intentionally disregarded their fiduciary duties. Notably, however, the Supreme Court suggested that the bar is much lower when a claim is based on a breach of duty of care, meaning directors need to be concerned about exercising care and establishing a careful, deliberate and well-documented process in reviewing sale of control transactions.

Background

The *Lyondell* case concerns the events leading up to the decision by the board of Lyondell Chemical Company to enter into an all-cash merger with Basell AF, a privately held Luxembourg chemical company. Lyondell had rejected a takeover proposal from Basell

in April 2006. Then, in May 2007, an affiliate of Basell filed a Schedule 13D disclosing its right to acquire an 8.3 percent block of Lyondell stock and indicating its interest in possible transactions with Lyondell.[2] In response to the Schedule 13D, the Lyondell board convened a special meeting. Although the board recognized that the filing signaled to the market that the company was "in play," it decided to "wait and see" the market's reaction to the Schedule 13D and whether any potential suitors would express an interest in the company.

On July 9, 2007, Leonard Blavatnik, Basell's controlling shareholder, met with Dan Smith, Lyondell's Chairman of the Board and CEO, to discuss Basell's interest in acquiring Lyondell. Blavatnik's initial proposal was $40 per share; he later increased his offer to between $44 and $45 per share. Smith told Blavatnik to make his best offer for the board to consider because the company was not on the market. Later that day, Blavatnik made a final offer of $48 per share, conditioned on Lyondell agreeing to a $400 million break-up fee and committing to sign a merger agreement by July 16, 2007. (The tight time frame was driven by the timing of another deal Basell was considering.) The proposed price of $48 per share represented a 45 percent premium over the closing share price on the last trading day before the public became aware of Basell's interest in Lyondell, and a 20 percent premium over Lyondell's closing price on the day before the merger was publicly announced.

The Lyondell board convened on July 10 to consider Basell's offer. The meeting lasted slightly less than one hour and, at the conclusion of the meeting, the board instructed Smith to obtain a written offer from Basell and to gather more information on Basell's financing. On July 11, the board decided it was interested in Basell's offer, retained Deutsche Bank as its financial adviser and instructed Smith to negotiate with Blavatnik. On July 12, the Lyondell board met again to discuss the merger proposal. The board instructed Smith to attempt to negotiate better terms, including a higher price, a go-shop provision and a reduced break-up fee. In response to these demands, Blavatnik agreed to reduce the break-up fee from $400 million to $385 million, but Smith was otherwise unsuccessful in negotiating better terms.

From July 12 through July 15, the parties negotiated the terms of the merger agreement, Basell conducted due diligence and Deutsche Bank prepared a fairness opinion. On July 16, the Lyondell board, along with Lyondell management and its financial and legal advisers, met again to analyze the merits of the proposed merger. Lyondell's advisers explained that, even with the no-shop provision in the merger agreement, Lyondell would be able to consider any superior proposals that it might receive after signing a merger agreement with Basell because of a "fiduciary out" provision. In addition, Deutsche Bank opined that the proposed merger price was fair for Lyondell stockholders. Deutsche Bank also compiled a list of approximately 20 other potential acquirers. Though none of these potential acquirers had been contacted, the bankers offered various explanations as to why it was unlikely any of these parties would be willing or able to top Basell's offer. After considering the various presentations by management and advisers, the Lyondell board approved the deal with Basell and recommended that Lyondell's shareholders approve the merger. At a special stockholders' meeting held on November 20, 2007, the merger was approved by more than 99 percent of the voted shares.

Against this factual backdrop, Walter Ryan, a Lyondell shareholder, challenged the merger in a class action alleging, among other things, that the Lyondell directors breached their fiduciary duties of care and loyalty.

Opinion of the Supreme Court of Delaware

The Lyondell board moved for summary judgment against the claims directed at the process by which the directors sold the company. The Chancery Court denied the motion, holding there was an issue of material fact as to whether the board had acted in good faith in discharging its known fiduciary duties in connection with the sale. The Supreme Court granted the defendants' interlocutory appeal.

The Supreme Court started its discussion by noting that the Chancery Court had rejected all of the plaintiff's claims except for those directed at the process the Lyondell directors followed in selling the company and the deal protection provisions in the merger agreement. These claims, the Supreme Court noted, essentially

amounted to a *Revlon* claim—that the directors failed to obtain the best available price in selling the company. Though the Chancery Court found that, based on the record, the plaintiff might be able to prevail at trial on a claim of breach of duty of care (a conclusion that the Supreme Court did not take issue with), this was a non-issue in light of the exculpatory provision in Lyondell's charter, which protected the directors from personal liability for breach of duty of care. Rather, the case turned on whether the shortcomings on the part of the directors implicated the duty of loyalty, a breach of which cannot be exculpated in a company's charter under Delaware law.[3]

Because the Chancery Court found that the directors were independent and not motivated by self interest, the plaintiff had to show that the directors failed to act in good faith to establish that the directors breached their duty of loyalty (and, in turn, were not protected by the exculpation provision). In reviewing the holdings of several of its recent decisions, the Supreme Court stated that a finding that the directors did not act in good faith would require a showing that the directors had an intent to harm or that they intentionally ignored their duties—a very high bar.

Despite flaws in the sale process, the Supreme Court found that there was no evidence in the record before it from which to infer the directors "knowingly ignored their responsibilities, thereby breaching their duties of loyalty." In reaching this conclusion, the Supreme Court found error with several aspects of the Chancery Court's decision and, in doing so, further explained the fiduciary duties of a board of directors in the context of a sale of control.

First, the Supreme Court found that it was an error to impose *Revlon* duties on the Lyondell directors either before they decided to sell the company or before the sale had become inevitable. *Revlon* duties were not triggered by a third party's filing of the Schedule 13D simply because it arguably put Lyondell "in play." Rather, the Supreme Court found that Revlon duties apply "only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."

The Schedule 13D filing did put the Lyondell directors, and the market, on notice that Basell was interested in acquiring Lyondell. However, the directors responded by promptly holding a special meeting in which they decided neither to put the company up for sale nor to institute defensive measures to fend off a potential hostile offer. Rather, the directors decided to take a "wait and see" approach to a possible transaction, which the Supreme Court found was an entirely appropriate exercise of the directors' business judgment.[4]

The Supreme Court concluded that the board's *Revlon* duties did not begin until July 10, 2007, the date on which the directors began negotiating the sale of Lyondell. As a result, the Supreme Court focused its analysis on the plaintiff's *Revlon* claims by examining the conduct of the directors solely during the week in which they considered Basell's offer, rather than the two months of inaction prior to July 10, which were the focus of the Chancery Court's analysis (and which the Chancery Court described as "two months of slothful indifference despite *knowing* that the Company was in play," a time in which directors "languidly awaited overtures from potential suitors…").

Second, the Supreme Court eschewed the notion advanced by the Chancery Court that under *Revlon*, directors must conduct an auction, conduct a market check or otherwise demonstrate an impeccable knowledge of the market in order to confirm that the proposed transaction represents the best available price. In doing so, the Supreme Court reiterated its long-standing rule that there is "no single blueprint" that directors must follow to satisfy their *Revlon* duties, stating "[t]here is only one *Revlon* duty—to [get] the best price for the stockholders at a sale of the company."

The Supreme Court stated that, based on the record before it, it would be inclined to disagree with the Chancery Court's finding that the Lyondell directors breached their *Revlon* duties in this instance. Nevertheless, the Supreme Court specifically stated that it would not have questioned the Chancery Court's decision if the question was whether the directors had exercised due care. However, because the issue was whether the directors acted in good

faith, the analysis was very different and summary judgment in favor of the directors was warranted.

The Supreme Court found that the Chancery Court incorrectly determined that an arguably imperfect attempt to carry out *Revlon* duties constituted a knowing disregard of one's duties and, in turn, bad faith. Bad faith will be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

In the Supreme Court's view, the Chancery Court approached the inquiry from the wrong perspective. The inquiry was not whether disinterested, independent directors did everything they should have done to obtain the best sale price, but rather whether the directors "utterly failed to attempt to obtain the best sale price." The Supreme Court emphasized that there is "a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties." The former implicates the duty of care, while only the latter will implicate the good faith component of the duty of loyalty. Only if directors "knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."

Viewing the record through this prism, the Supreme Court found that the directors did not breach their duty of loyalty by failing to act in good faith. The Supreme Court pointed to (i) the directors meeting several times to consider Basell's offer, (ii) their general awareness of the company's value and the chemical company market, (iii) their solicitation of and following the advice of their financial and legal advisers, (iv) their attempt to negotiate a higher offer even though the evidence indicated that Basell had offered a "'blowout'" price, and (v) their approval of a merger agreement because "it was simply too good not to pass along [to the stockholders] for their consideration."

Conclusion

The case of *Lyondell Chemical Company v. Ryan* is significant in several respects. First, it makes clear that *Revlon* duties generally only begin to apply when the target company takes affirmative steps to sell itself and not when a third party takes actions that arguably put the company in play. Second, the Supreme Court in *Lyondell* clearly reaffirmed that *Revlon* and its progeny do not require directors to follow a prescribed course of action in the context of a sale transaction. Rather, the directors are required to obtain the best price for the stockholders in connection with the sale of control of the company, and there is no single blueprint for a board to follow to achieve this objective. Lastly, the Supreme Court emphasized that in cases that turn on establishing a breach of the duty of loyalty based on a failure to act in good faith, the bar that must be cleared to successfully challenge a board's decision is high and will entail showing that the directors knowingly and completely failed to undertake their responsibilities in connection with the transaction.

Endnotes

1. *Lyondell Chemical Company v. Ryan*, No. 401, 2008 (Del. March 25, 2009), available at http://courts.delaware.gov/opinions/(hrrhk555i4ganmy0ssffycum)/download.aspx?ID=119350.

2. The Schedule 13D stated, "The Reporting Persons may seek to engage in discussions with [Lyondell] concerning, among other possible scenarios, the merits of an offer to acquire all of the Shares of [Lyondell] and the merits of a merger, combination or similar transaction between [Lyondell] and affiliates of Newco, including Access or Basell Holdings B.V."

3. Though exculpation provisions such as these are very common in the charters of public companies incorporated in Delaware, that in no way suggests that the duty of care is effectively irrelevant in connection with challenges to M&A deals. Many challenges to M&A deals seek declaratory relief or seek to enjoin the proposed transaction before it is consummated. In that context, a breach of the duty of care can serve as grounds for declaratory relief or an injunction. It is only in situations where disgruntled shareholders seek damages against the directors of the target company after the transaction has closed that exculpation provisions come into play and the plaintiff is not able to rely on a breach of the duty of care to make a successful claim.

4. In its *Gantler v. Stephens* decision, issued in January 2009, the Delaware Supreme Court stated "a board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework. In that context the board is entitled to a strong presumption in its favor, because implicit in the board's statutory authority to propose a merger is also the power to decline to do so." *Gantler v. Stephens*, No. 132,2008 (Del. January 27, 2009), available at http://courts.delaware.gov/opinions/(j2glxx45d0ewqp45ejdoarfi)/download.aspx?ID=116710.

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