

April 23, 2009

Delaware Supreme Court Rejects Bad Faith Claim Against Lyondell Board

The Court Rejects a Claim that a Truncated Sale Process Run by an Independent Board Violated the Directors' Duty to Act in Good Faith

SUMMARY

On March 25, 2009, the Delaware Supreme Court, in a rare interlocutory appeal from the denial of a motion for summary judgment, reversed the Chancery Court and entered judgment for the directors of the Lyondell board who were alleged to have breached their duty of loyalty by failing to act in good faith. The Court held that a breach of a duty of care can be sufficiently extreme to constitute bad faith and a breach of the duty of loyalty only where the directors consciously disregarded their duties, which, in a cash sale process, means the board "utterly failed to attempt to get the best sale price." *Lyondell Chemical Co. v. Ryan*, No. 401, 2008 (Del. Sup. Ct., March 25, 2009). In *Lyondell*, the Court concluded that summary judgment was appropriate because an informed and independent target board solicited and followed the advice of its financial and legal advisors, was sufficiently aware of the company's value and prospects, and approved a deal representing a very substantial premium they believed was unlikely to be topped by any other party. The *Lyondell* decision confirms that there is no specific blueprint for an independent board to follow in seeking to meet its so-called *Revlon* duties, and the level of process required depends upon the particular circumstances, including the value achieved for the shareholders. The Supreme Court also confirmed that *Revlon* duties do not apply until a decision to sell is made by the board.

THE LYONDELL CASE: THE FACTS

The *Lyondell* decision concerned the cash merger between Lyondell Chemical Company, previously the third-largest independent public chemical company, and Basell AF, a privately held Luxembourg chemical company. For two years or more, Basell expressed an interest in acquiring Lyondell, but each of those efforts was rebuffed as inadequate by Lyondell's board. In May 2007, a Basell affiliate filed a Schedule

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13D with the SEC that alerted the market to its potential interest in a transaction with Lyondell, but did not produce any interest from competing bidders. In late June 2007, Basell announced an agreement to acquire Huntsman Chemical, but shortly thereafter Basell's bid was topped by Hexion Specialty Chemicals, Inc.

On July 9, 2007, the CEOs of Lyondell and Basell had a series of meetings and telephone calls. Basell first proposed a \$40 per share all-cash deal, which the Lyondell CEO rejected. Basell next proposed a range of \$44-\$45, which Lyondell's CEO still viewed as too low, but he offered to present it to the Lyondell board even though they would likely reject it. Lyondell suggested that Basell make its best and final offer. Later the same day, Basell produced its best and final offer at \$48 per share in cash, so long as Lyondell agreed to a \$400 million break-up fee and executed a merger agreement with a standard "fiduciary out" within a week. The \$48 offer was more than a 45% premium to the price the day before Basell filed its Schedule 13D.

The Lyondell board met the next day to consider the Basell proposal, and directed management to solicit a written offer from Basell. The board met again on July 11 and 12 to consider the proposal, and Deutsche Bank Securities, Inc. thereafter was retained to serve as Lyondell's financial advisor. The parties negotiated the terms of a merger agreement and, at the board's request, management sought to improve the terms, including a higher price, a go-shop provision, and a reduced break-up fee. Basell agreed to reduce slightly the break-up fee, but refused Lyondell's other requests. On July 16, the Lyondell board approved the transaction, and the merger closed four months later, during which time no other potentially interested party came forward.

THE LYONDELL CASE: THE DECISION

This action was commenced shortly after the deal was announced, asserting breaches of the directors' duty of care and duty of loyalty. The plaintiff did not seek any pre-closing injunctive relief in Delaware, but instead pursued only a claim for money damages. The Chancery Court granted summary judgment on most of the claims. Although the Chancery Court found that the directors might have breached their duty of care to seek the best price reasonably available in a sale of the company under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the Chancery Court found that a damages claim under that theory was barred by the exculpatory provision in Lyondell's charter under 8 Del. C. § 102(b)(7). The Chancery Court also found that the board was independent and disinterested, eliminating most of the duty of loyalty claims. The Chancery Court nevertheless concluded that there was a sufficient issue for trial as to whether the Lyondell directors breached their duty of loyalty by failing to act in good faith because they acted in "conscious disregard" of their duties under *Revlon*. The Chancery Court did so in a controversial decision that was notable for its unusually inflammatory language characterizing the Lyondell directors' conduct.

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If read only as a procedural decision resulting from the evidentiary presumptions favoring plaintiffs in a motion for summary judgment, the Chancery Court decision would not have been as surprising or controversial. But it was impossible not to infer from the Vice-Chancellor's harsh characterization of the directors' conduct¹ that the Vice-Chancellor regarded the process through which Lyondell was sold as flawed in ways that were so fundamental as to raise a serious issue of whether the directors' alleged failure to discharge their *Revlon* duties were serious enough to amount to a breach of their duty of loyalty — a breach that can lead to personal liability of directors. The Vice-Chancellor was critical of the board's acceptance of the CEO's leadership and direction of an unsolicited sale process, the brevity of board meetings, the decision to wait and see what might happen following the 130 filing, the failure to conduct a formal market check, and the speed of the sale process.

The Supreme Court reversed. First, the Court concluded that the Chancery Court improperly imposed *Revlon* duties on the Lyondell directors in the two-month period following the filing of the Schedule 13D, at a time that the board was not considering any possible sale. The "wait and see" approach adopted by the board, the Court held, was an "entirely appropriate exercise of the directors' business judgment."

Second, the Supreme Court rejected the Chancery Court's conclusion that the Lyondell board violated a "known set" of *Revlon* duties because it "did not conduct an auction or a market check" and otherwise lacked "impeccable" market knowledge. The Supreme Court reiterated that there is no uniform or required set of rules that must be followed by a board in order to meet its fiduciary duty to get the best price for the shareholders under *Revlon*. The Supreme Court held that 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." The Court observed that the Lyondell board took a variety of steps to inform themselves and evaluate the transaction during the week the deal was under consideration. Notably, the Supreme Court indicated that it would have been inclined to find no *Revlon* violation at all, much less a bad faith violation of those duties.

Finally, the Supreme Court found that the claims here alleged only an imperfect attempt to carry out *Revlon* duties, which could not amount to a conscious disregard of duties that might constitute bad faith. The Lyondell directors' failure to take any particular step in the sale process could not show a conscious

¹ Among other criticism that appears in the Chancery Court opinion, the Chancery Court stated that, "[o]nce one scratches the patina of this 'blowout' market premium, however, a troubling board process emerges." In Chancery Court's view, the facts revealed: (a) that "the Board did nothing (or virtually nothing) to confirm the superiority of the price but, nonetheless, it provided Basell a full complement of deal protections;" (b) "the Board's apparent failure to make any effort to comply with the teachings of *Revlon*;" (c) that the "board was indolent;" (d) that "during a 45 minute meeting the board claims to have thoroughly considered several aspects of the Basell proposal;" (e) that "the Lyondell Board was largely out of the loop until the very end of the process when it, more or less, ceremonially approved the deal [the CEO] had negotiated." *Ryan v. Lyondell Chemical Co.*, No. 3176-VCN (Del. Ch. Ct. July 29, 2008).

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disregard of their duty because *Revlon* does not establish a pre-ordained set of steps that must be followed in all cases. The Supreme Court noted the difference in a duty of care and duty of loyalty review, and held that the duty of loyalty “inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.” The Supreme Court held that this standard could not be met because, even assuming “that the Lyondell directors did absolutely nothing to prepare for Basell’s offer,” the Board took a variety of steps in the week the deal was under consideration designed to get the best price reasonably attainable, including soliciting and following the advice of its financial and legal advisors, attempting to negotiate a better deal, and approving the merger at a “blowout price” that it deemed too good not to pass along to the stockholders.

COMMENT

The *Lyondell* decision confirms that the bar for a successful duty of loyalty claim against independent, disinterested directors is, appropriately, extremely high. For companies that have adopted — as virtually all public companies have — an exculpatory provision for duty of care violations of the sort permitted by Delaware law and the corporation statutes in most states, under *Lyondell*, an independent and disinterested board may be subjected to a claim for money damages only where directors consciously failed even to attempt to carry out their fiduciary duties.

The director liability portions of the decision in *Lyondell* will have no effect on litigation seeking to enjoin transactions pre-closing, because exculpatory provisions limit only liability for money damages, but do not immunize duty of care violations from injunctions or other equitable relief. If anything, the *Lyondell* decision may prompt shareholder plaintiffs to more aggressively pursue injunctions preventing the deal closing, since relief of any kind may be difficult post-closing. The *Revlon* portion of the *Lyondell* decision, by emphasizing the broad latitude given to decisions by disinterested, independent directors, also may make it more difficult for plaintiffs to proceed with duty of care claims.

Lyondell also confirms the importance of board independence and disinterestedness when considering control transactions. In situations involving a board that lacks independence and disinterestedness, the board may have the affirmative burden of proving the “entire fairness” of the deal, which is a heavy burden that is infrequently met. The criticism directed at the Lyondell directors, in a situation where subsequent events confirmed the soundness of their business judgment, highlights the importance of establishing a strong record of careful deliberations by the directors on major decisions.

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