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OFFICERS AND DIRECTORS

Delaware Courts Create, Then Allay, Director Fears Regarding Personal Liability—Also Clarify Revlon Duties in the Process

BY MARC ALPERT AND ALISON KRONSTADT

Several decisions by the Delaware Chancery Court and, significantly, a recent decision by the Delaware Supreme Court have helped to allay concerns of Delaware corporate directors that they could be subject to personal liability for conduct many considered to constitute a violation of their fiduciary duty of care. These concerns were generated by a Delaware decision in July 2008, *Ryan v. Lyondell Chemical Co*.[1] In that decision, Vice Chancellor Noble denied summary judgment for the defendant directors of Lyondell Chemical Company in a stockholder derivative suit alleging breach of fiduciary duties in connection with the sale of Lyondell. However, a subsequent letter opinion issued by Vice Chancellor Noble, two later decisions issued by the Delaware Chancery Court in *McPadden v. Sidhu*[2] and *In re Lear Corp. Shareholder Litigation*[3] and the Delaware Supreme Court's recent decision on appeal in *Lyondell*[4] have helped to assuage the concerns of directors that resulted from the original *Lyondell* decision.

The Delaware Supreme Court also made significant findings in *Lyondell* regarding the application of *Revlon*[5] duties, including when those duties arise and holding that there are no set requirements that must be satisfied for directors to fulfill those duties.

Background: Director Fiduciary Duties and Section 102(b)(7) of the DGCL

In carrying out their responsibilities, directors are charged with certain fiduciary duties to both the corporation and its stockholders. A director's fiduciary duties consist of two principal components, the duty of care and the duty of loyalty:

Marc Alpert is a partner in the corporate and securities practice at Chadbourne & Parke LLP in New York and Alison Kronstadt is an associate in the practice. They can be reached at 212-408-5100 or malpert@chadbourne.com and akronstadt@chadbourne.com.

[1] *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176 - VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008).

[2] *McPadden v. Sidhu*, 964 A.2d 1262 (Del. Ch. 2008).

[3] *In re Lear Corp. Shareholder Litigation*, C.A. No. 2728 - VCS, 2008 WL 5704774 (Del. Ch. Sep. 2, 2008).

[4] *Ryan v. Lyondell Chemical Co.*, No. 401, 2008, 2009 WL 790477 (Del. Mar. 25, 2009).

[5] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

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- *The duty of care* requires directors to be informed, prior to making decisions, of all material information reasonably available to them and to act with a level of care that ordinarily careful and prudent persons would use in similar circumstances.
- *The duty of loyalty* generally prohibits self-dealing by directors and requires that they act in good faith and in a manner they reasonably believe to be in the best interests of the corporation and its stockholders. A guiding principle of this duty is that when making decisions on behalf of the corporation, a director's own financial or other self-interest may not take precedence over the interests of the corporation and its stockholders. An integral component of the duty of loyalty is the obligation to act in good faith in the oversight of the corporation.[6]

Under Section 102(b)(7) of the Delaware General Corporation Law (DGCL), a corporation's certificate of incorporation may contain a provision eliminating the personal liability of a director for monetary damages for breaches of fiduciary duties, other than breaches of the director's duty of loyalty or acts or omissions not in good faith. In essence, Section 102(b)(7) allows a Delaware corporation to shield its directors from personal liability for conduct violating the director's duty of care (which conduct can constitute negligence or even gross negligence); Section 102(b)(7) does not, however, permit exculpation for breaches of the director's duty of loyalty, which encompasses the duty to act in good faith.

Ryan v. Lyondell Chemical Co.—Delaware Chancery Court (July 2008)

In *Ryan v. Lyondell Chemical Co.*, Vice Chancellor Noble reviewed the sale process employed by Lyondell's Board in connection with the sale of Lyondell to Basell AF. In the summer of 2006, Basell made an unsolicited offer to acquire Lyondell for a price of $26.50 to $28.50 per share. Lyondell rejected the offer as inadequate. Approximately one year later, Basell obtained the right to acquire an 8% stake in Lyondell and in May 2007 filed a Schedule 13D disclosing its intent to discuss various transactions with Lyondell. In response to the Schedule 13D, the Lyondell Board convened a special meeting, and although it recognized that the Schedule 13D signaled to the market that the company was ''in play,'' the Board decided to take a ''wait and see'' approach.[7]

On July 9, 2007, Basell made an offer to acquire Lyondell at $48 per share contingent on Lyondell signing a merger agreement by July 16, 2007 (one week later) and agreeing to a $400 million break-up fee. The Lyondell Board held a special meeting on July 10, 2007 where Basell's offer was discussed for fifty minutes. The Lyondell Board met again on July 11 for forty-five minutes and formally authorized negotiations with Basell. During negotiations, Lyondell requested various concessions from Basell, including an increase in price and a ''go-shop'' provision. Basell remained firm on their offer and agreed only to reduce the break-up fee from $400 million to $385 million. Subsequently, the Board received a fairness opinion from Deutsche Bank, its financial advisor, that Basell's offer of $48 per share was a fair price. The Board unanimously approved the merger on July 16, 2007. The merger was announced on July 17, 2007 and approved by stockholders on November 20, 2007.

The stockholder derivative suit alleged that the Board (1) failed to comply with its *Revlon*[8] duties, which require a Board that is undertaking a sale of the company to obtain the highest value reasonably available to its stockholders and (2) failed to comply with its *Unocal*[9] duties, which require deal protection measures to be reasonable in light of the circumstances. The director defendants argued (unsuccessfully) that any perceived shortcomings during the sale process constituted a breach of their duty of care, and was therefore exculpable under the Section 102(b)(7) provision in Lyondell's charter.

The court denied the directors' motion for summary judgment, finding that the record contained genuine issues of material fact as to whether the Board violated its duty of loyalty, specifically its duty of good faith. Critics found the decision troubling because the $48 per share price was a substantial premium to market (45% over the closing share price on the last trading day before the public became aware of Basell's interest in Lyondell), there were no allegations of self-interest, and 99.33% of the voting stockholders approved the merger. Further criticism of the decision expressed the view that any deficiencies in the Lyondell Board's conduct were merely a violation of the duty of care and should therefore be exculpable under Section 102(b)(7).

After the court's denial of summary judgment, the defendant directors sought certification to appeal. Although the court denied the appeal of summary judgment, the Vice Chancellor's later opinion in the case made clear that his original opinion was based solely on the limited evidence available at the summary judgment stage.[10]

Vice Chancellor Noble's later opinion in the case also elaborated on the distinction between the duty of care and the duty of good faith, stating that ''grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good

[6] ''Where 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.'' *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (citing *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)).

[7] *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176 - VCN, 2008 WL 2923427, *5 (Del. Ch. July 29, 2008).

[8] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

[9] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[10] ''Thus, the Court is not suggesting that the directors' conduct in this case *is* necessarily an example of bad faith, non-exculpable conduct, thus, exposing them to personal liability. Instead, the Court is saying that it *may be* such conduct, but that it is necessary to develop the record more fully in order to make that determination.'' *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176-VCN, 2008 WL 4174038, *4 (Del. Ch. Aug. 29, 2008). The court held that it was possible to draw a reasonable inference that the directors may have breached their fiduciary duties by consciously disregarding their known duties to act. Vice Chancellor Noble pointed to the following facts: the directors did not employ a strategy to maximize stockholder value; the directors did virtually nothing (pre- or post-signing) to confirm that a better deal could not be obtained; and the directors undertook virtually no negotiating with Basell on its offer.

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faith."[11] The Vice Chancellor continued to state that the distinction between gross negligence and non-exculpable bad faith ("that elusive something more") is significant in Delaware's jurisprudence and corporate statutory scheme because, for example, "director conduct amounting *only* to a violation of the duty of care, but otherwise taken in good faith" is exculpable under DGCL Section 102(b)(7) or indemnifiable under DGCL Section 145.[12]

The later opinion further explicitly addressed some of the concerns generated by the original decision — Vice Chancellor Noble stated that "the reports of the death of Section 102(b)(7) . . . in Delaware law are greatly exaggerated both with regard to the application of Lyondell's exculpatory charter provision in this case, and certainly with regard to the application of a Section 102(b)(7) provision defense in any other case."[13]

McPadden v. Sidhu—Delaware Chancery Court (August 2008)

In *McPadden v. Sidhu*, Chancellor Chandler reviewed the actions of the Board of Directors of i2 Technologies, Inc. in connection with a sale of its wholly-owned subsidiary, Trade Services Corporation (TSC), to a management team led by Anthony Dubreville, TSC's then vice president. The Board of i2 approved the sale of TSC to Dubreville for $3 million. Two years later, Dubreville sold TSC for over $25 million.

The stockholder plaintiff argued that i2's directors sold TSC in bad faith for a price that the defendant directors knew was a fraction of TSC's fair market value. The plaintiff alleged that various acts committed by the Board amounted to violations of the Board's fiduciary duties, including:

- placing Dubreville in charge of the sale process notwithstanding Dubreville's stated interest in acquiring TSC;
- the lack of engagement in oversight of the sale process, including the failure to solicit bids from TSC's direct competitors; and
- the use of projections prepared at Dubreville's direction.

The court found that the Board was grossly negligent; however, the grossly negligent conduct constituted a violation of the defendant directors' duty of care and was therefore exculpated by the Section 102(b)(7) provision in i2's charter. The exculpation clause thus shielded the directors from personal liability, and the court dismissed the plaintiff's complaint against the directors.[14]

Even though the i2 directors' actions were seemingly more egregious than the actions of the Lyondell directors, the court held that the plaintiff failed to sufficiently allege that the directors "acted in bad faith through a conscious disregard for their duties."[15] Chancellor Chandler stated that "it is quite clearly established that gross negligence, alone, cannot constitute bad faith. Thus, a board of directors may act 'badly' without acting in bad faith."[16] Using language that may have been directed towards Vice Chancellor Noble's *Lyondell* decision, Chancellor Chandler further opined that "[t]here is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith."[17]

In re Lear Corporation Shareholder Litigation—Delaware Chancery Court (September 2008)

In *In re Lear Corporation Shareholder Litigation*, stockholder plaintiffs brought an action against the Board of Lear Corporation for alleged violations of fiduciary duties in connection with the attempted sale of Lear to Carl Icahn. The stockholder plaintiffs argued that the directors acted in bad faith by agreeing to a termination fee of $25 million (.9% of the total enterprise value) in exchange for an increase in the per share acquisition price that the Board knew was not likely to be approved by stockholders.[18] The stockholders did, in fact, reject the deal, and Icahn was paid the $25 million termination fee. Thus, the gravamen of stockholders' complaint was that the directors' "conduct amounted to a bad faith abdication of fiduciary duties."[19]

Vice Chancellor Strine granted the defendant directors' motion to dismiss, holding that the complaint failed to state a non-exculpated claim for breach of fiduciary duty. The court pointed to the adequate process employed by an independent Board majority and the use of reputable financial, legal and proxy solicitation experts. The court held that the directors could not be found liable simply because a majority of stockholders did not agree with the terms of the sale.[20]

Directly addressing the pleading requirements for a breach of fiduciary duties claim, Vice Chancellor Strine stated that "it is critical that the complaint plead facts suggesting a fair inference that the directors breached their duty of loyalty by making a bad faith decision to approve the merger for reasons inimical to the interests of the corporation and its stockholders."[21] The court continued that "[w]here a complaint, as here, does not even create an inference of mere negligence or gross

[11] *Id.* at *2 (citing *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 65 (Del. 2006)).

[12] *Id.* at *3.

[13] *Id.* at *5.

[14] The court did not dismiss the complaint against Dubreville, TSC's then vice president. Although officers and directors owe the same fiduciary duties of care and loyalty to a corporation, an officer cannot seek protection from a Section 102(b)(7) exculpatory provision as Section 102(b)(7) is only available to directors. Thus, as an officer of TSC, Dubreville would not be exculpated and the complaint proceeded against Dubreville. *McPadden v. Sidhu*, 964 A.2d 1262, 1275 (Del. Ch. 2008).

[15] *Id.*

[16] *Id.* at 1263.

[17] *Id.* at 1274 (citing *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 66 (Del. 2006)).

[18] At the time the Board approved the terms of the merger agreement, the Board's advisors were not certain whether the stockholders would approve the deal or whether ISS (the proxy advisory service) would support the deal. *In re Lear Corp. Shareholder Litigation*, C.A. No. 2728 - VCS, 2008 WL 5704774, *5 (Del. Ch. Sep. 2, 2008).

[19] *Id.* at *7.

[20] The court noted the language used in the plaintiffs' brief regarding the Board's knowledge of defeat with respect to the merger — plaintiffs used words such as "almost certain," "near certain," and "all but inevitable." The court concluded that the plaintiffs' language conceded the possibility that the merger would be approved by the stockholders. *Id.* at *9.

[21] *Id.* at *1.

negligence, it certainly does not satisfy the far more difficult task of stating a non-exculpated duty of loyalty claim.''[22]

Vice Chancellor Strine identified ''what is arguably the hardest question in corporation law: what is the standard of liability to apply to independent directors with no motive to injure the corporation when they are accused of indolence in monitoring the corporation's compliance with its legal responsibilities?''[23] In response, the Vice Chancellor opined that the Delaware Supreme Court requires a ''strong showing of misconduct'' in order to ''hold a disinterested director liable for a breach of the fiduciary duty of loyalty for acting in bad faith.''[24]

In comments that appear to be in response to Vice Chancellor Noble's opinion in *Lyondell*, Vice Chancellor Strine stated that:

> Seizing specific opportunities is an important business skill, and that involves some measure of risk. Boards may have to choose between acting rapidly to seize a valuable opportunity without the luxury of months, or even weeks, of deliberation — such as a large premium offer — or losing it altogether. . . . Courts should therefore be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.[25]

Ryan v. Lyondell Chemical Co.—Delaware Supreme Court (March 2009)

When the Delaware Supreme Court handed down its eagerly awaited decision on March 25, 2009 in the controversial *Lyondell* case, the Court reversed the Chancery Court's decision and granted summary judgment in favor of the defendant directors. The Court noted that the Chancery Court decided that ''unexplained inaction'' by the Lyondell directors allowed for a reasonable inference that they may have consciously disregarded their fiduciary duties.[26] The Court held that at most, the record created ''a triable issue of fact on the question of whether the directors exercised due care,'' and concluded that there was no evidence ''from which to infer that the directors knowingly ignored their responsibilities'' or breached their duty of loyalty.[27]

The Court summarized the duty of good faith (citing the well-known decisions of *In re the Walt Disney Co. Derivative Litigation*[28] and *Stone v. Ritter*[29]) and concluded that even though the Chancery Court recognized the legal principles espoused in these cases, it mistakenly applied them to the record before it. The Court cited three factors that contributed to the Chancery Court's mistake.

First, the Chancery Court wrongly imposed *Revlon* duties[30] on the directors upon the filing of the Schedule 13D. The Court made clear ''that *Revlon* duties do not arise simply because a company is 'in play.' ''[31] Rather, the duty to seek the best available price arises ''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.''[32] The Court stated that the ''wait and see'' approach employed by the Lyondell Board during the two month period between the filing of the Schedule 13D and the commencement of negotiations with Basell was ''an entirely appropriate exercise'' of its business judgment.[33] The Court found that the Board's *Revlon* duties did not arise until the Board began negotiating the sale. The Court noted that the Chancery Court erred in focusing on the directors' two months of inaction, when it should have focused on the one week during which the directors considered Basell's offer. During that week, the directors met several times; Lyondell's CEO sought to negotiate more favorable terms; the Board evaluated Lyondell's value, the price offered and the likelihood of obtaining a better price; Deutsche Bank provided a fairness opinion on the share price; and the directors unanimously approved the merger.

Second, the Chancery Court erroneously concluded that *Revlon* and its progeny created ''a set of requirements that must be satisfied during the sale process.''[34] The Court made clear that no court can tell directors exactly how to satisfy their *Revlon* duty because directors ''will be facing a unique combination of circumstances, many of which will be outside their control.''[35] As the Court stated in *Barkan v. Amsted Industries, Inc.*,

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[22] *Id.*
[23] *Id.* at *10.
[24] *Id.*
[25] *Id.* at *11.
[26] *Ryan v. Lyondell Chemical Co.*, No. 401, 2008, 2009 WL 790477, *1 (Del. Mar. 25, 2009).
[27] *Id.*
[28] In *Walt Disney*, the Court stated that ''intentional dereliction of duty, a conscious disregard for one's responsibilities'' is treated as a nonexculpable and nonindemnifiable violation of the duty to act in good faith. *Id.* at *4 (citing *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 64 (Del. 2006)).
[29] In *Stone*, the Court adopted the standard set forth in *In re Caremark International Derivative Litigation* — '' 'Where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . 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 exists — will establish the lack of good faith that is a necessary condition to liability.' '' *Id.* (citing *In re Caremark International Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996)). Ten years later in *Stone*, the Court ''clarified any possible ambiguity about the directors' mental state, holding that 'imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.' '' *Id.* (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).
[30] *Revlon* duties, espoused in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, require a board to obtain the highest value reasonably available to the stockholders when it undertakes a sale of the corporate enterprise. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).
[31] *Ryan v. Lyondell Chemical Co.*, No. 401, 2008, 2009 WL 790477, *6 (Del. Mar. 25, 2009) (citing *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1151 (Del. 1989)).
[32] *Id.* (citing *In re Santa Fe Pac. Corp. Shareholder Litigation*, 669 A.2d 59, 71 (Del. 1995)).
[33] *Id.*
[34] *Id.* at *4. The Chancery Court synthesized *Revlon* and its progeny and held that directors must ''engage actively in the sale process'' and they must confirm that they have obtained the best available price either by conducting an auction or a market check or ''by demonstrating an impeccable knowledge of the market.'' *Id.* at *6 (citing *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176 - VCN, 2008 WL 2923427, *12, *19 (Del. Ch. July 29, 2008)).
[35] *Id.*

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" 'there is no single blueprint that a board must follow to fulfill its duties.' "[36]

Third, the Chancery Court erred by equating "an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith."[37] The Chancery Court "decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that 'known set of *Revlon* duties.' "[38] The Court noted that since there are no legally required actions that directors must follow to satisfy their *Revlon* duties, the Lyondell Board's failure to take any specific steps during the sale process could not have amounted to a conscious disregard of their duties. Significantly, the Court held that there is a "vast difference" between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard of those duties.

The Court opined that " '[d]irectors' decisions must be reasonable, not perfect,' "[39] and held that " '[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.' "[40] Noting that the Chancery Court denied summary judgment because the directors' "unexplained inaction" prevented it from concluding that the directors had acted in good faith, the Court found that if the directors failed to do all that they should have under the circumstances, they would have breached only their duty of care. The Court noted that the directors would have breached their duty of loyalty only if they "knowingly and completely failed to undertake their responsibilities."[41]

[36] *Id.* (citing *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989)).
[37] *Id.* at *4.
[38] *Id.* at *7 (citing *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176 - VCN, 2008 WL 2923427, *19 (Del. Ch. July 29, 2008)).
[39] *Id.* (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994)).
[40] *Id.* (citing *In re Lear Corp. Shareholder Litigation*, C.A. No. 2728 - VCS, 2008 WL 5704774, *11 (Del. Ch. Sep. 2, 2008)).
[41] *Id.*

The Court concluded that the Chancery Court reviewed the record from the wrong perspective. "Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price."[42] The Court held that viewing the record in light of this inquiry leads to only one possible conclusion — that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith.[43]

* * *

Vice Chancellor Noble's denial of summary judgment in *Lyondell* left directors justifiably concerned about increased exposure to personal liability for a violation of fiduciary duties; however, the Delaware Supreme Court has now made clear in its decision on appeal that the Chancery Court mistakenly applied the *Revlon* duties to the record before it. Directors should take comfort from the Delaware Supreme Court's *Lyondell* decision and the Chancery Court's opinions in *McPadden v. Sidhu* and *In re Lear Corporation Shareholder Litigation*, which all emphasize that Section 102(b)(7) continues to shield directors from personal liability for violations of the duty of care, even in instances of gross negligence.

[42] *Id.* (citing *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006)).
[43] The Court took note of the following factors: the directors met several times to consider Basell's premium offer; were generally aware of the value of their company and knew the chemical company market; they solicited and followed the advice of their financial and legal advisors and attempted to obtain a higher price even though all the evidence indicated that Basell had offered a "blowout" price. *Id.* The Court assumed, as it must at the summary judgment stage, that the "directors did absolutely nothing to prepare for Basell's offer, and that they did not even consider conducting a market check before agreeing to the merger." *Id.* Even so, the Court held that "this record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith." *Id.*