Director Liability In Sale Process[1]

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Two recent Delaware Chancery Court decisions should allow directors of Delaware corporations (and their insurers) to rest more easily in that they confirm that claims of negligence (or even gross negligence) in the conduct of sale transactions can be dismissed before trial. These decisions are particularly important in view of a prior decision in which a different member of the Chancery Court declined to grant summary judgment in favor of the director-defendants and permitted a case to proceed to trial, thus requiring the taking of discovery and creating settlement value for the plaintiffs.

Background

After the Delaware Supreme Court's 1985 finding of director liability in *Smith v. Van Gorkom*,[2] some directors and potential directors of Delaware (or other) corporations began expressing reluctance about serving as directors. To help assure the continued availability of qualified directors, the Legislature of Delaware (and, soon thereafter, of other states) adopted §102(b)(7) of the Delaware General Corporation Law, which authorizes Delaware corporations to adopt provisions in their certificates of incorporation exculpating their directors from any potential liability for breaches of the duty of care, but not for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[3] As a result, in order for plaintiffs to collect damages for breach of the directors' fiduciary duties, they must demonstrate that the directors were not merely grossly negligent (the standard for a duty of care breach[4]), but rather were in bad faith or in knowing violation of law.

The terms "bad faith" and "knowing violation" suggest that the loss of exculpation protection of §102(b)(7) would require affirmative malfeasance on the part of directors. In the context of pretrial motions to dismiss or for summary judgment, it would seem impossible to plead such malfeasance with particularity absent extraordinary facts. Thus, §102(b)(7) has been quite effective in disposing of fiduciary duty-related claims at the pretrial stage.

The stakes for directors are rarely higher than in connection with a sale of the company. In a sale, particularly for cash consideration, the *Revlon* doctrine requires the company's directors to seek the highest price reasonably obtainable in the circumstances.[5] While initially some commentators construed this duty to require boards to conduct active auction processes, the courts soon clarified that such processes are not always necessary and, indeed, could be counterproductive in certain situations.

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[2] 488 A.2d 858 (Del. 1985)
[3] Delaware General Corporation Law (DGCL) §102(b)(7).
[4] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
[5] *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986).

In 1989, the Delaware Supreme Court held in *Barkan v. Amsted Industries Inc.* that "there is no single blueprint a board must follow to fulfill its [*Revlon*] duties" and that a sale may be permissible in the absence of a proactive sales effort where the board has "a body of reliable evidence with which to evaluate the fairness of the transaction" and the deal protection provisions of the sale, such as "no-shop" agreements, termination fees and "lock-up" options, are reasonable and not preclusive of a third-party bid.[6] Merger lawyers have long relied on *Barkan* in advising boards that they may enter into merger agreements without undertaking proactive solicitation efforts, which could harm the company by distracting management and employees (and possibly causing them to leave), or unnecessarily revealing confidential information to competitors. When combined with §102(b)(7), *Barkan* has served as a formidable cudgel to dispose of *Revlon* claims for damages at the pretrial stage.[7]

Meanwhile, in a series of decisions led by the *Caremark*[8] and *Disney*[9] cases, the Delaware courts introduced a substantial fissure in the protective bulwark of §102(b)(7) by finding that directors who fail to take action in the face of a known duty to do so can be deemed to have engaged in bad faith conduct. The notion that exculpation could be lost with respect to decisions that were made with purity of the heart - even if negligent or grossly negligent - led to concern within corporate boardrooms. While the potential loss of exculpation does not equate to a finding of liability - the plaintiff still needing to demonstrate that the duty of loyalty had, in fact, been breached - the benefits of early disposition of claims are not merely technical. The risk of time-consuming, distracting litigation and the fear of an adverse result can all work together to create substantial settlement value. They can also discourage qualified individuals from serving as corporate directors.

'Lyondell'

It was against this backdrop that director-defendants sought summary judgment from Vice Chancellor John W. Noble in *Ryan v. Lyondell Chemical Company*.[10] The *Lyondell* case arose in connection with the 2007 sale of Lyondell Chemical Co. to Basell AF, another chemicals concern, at a 40 percent premium to the market price of the company's stock. Lyondell did not solicit the transaction, but had substantial advance notice of Basell's interest in such a transaction - Basell had filed a Schedule 13D disclosing its intentions two months prior to the transaction.

The Lyondell board of directors met to discuss Basell's filing, but decided that no response was then necessary and awaited further actions on the part of Basell and, possibly, other parties. Surprisingly, Lyondell's board did not retain financial advisers or otherwise authorize any preparatory action in connection with the Basell filing. Lyondell's chief executive officer did, however, communicate with

[6] *Barkan v. Amsted Indus. Inc.*, 567 A.2d 1279, 1286 (Del. 1989).
[7] As a practical matter, §102(b)(7) has no impact on motions for injunctive relief.
[8] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996), holding that sustained or systematic failure of the board to exercise oversight constitutes a breach of the duty of loyalty and thus a failure to act in good faith.
[9] *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006), holding that an intentional failure by directors to act in the face of a known duty to act, demonstrating a conscious disregard for their duties, constitutes bad faith conduct.
[10] C.A. No. 3175-VCN (Del. Ch. July 29, 2008).

Basell's chief executive and principal shareholder, apparently without the knowledge of the company's board. In a meeting between Lyondell's chief executive officer and Basell's principal shareholder, Basell proposed an acquisition at a price that, over time through discussions, was increased twice (by a total of 20 percent), but subject to the condition that a definitive merger agreement would be signed within one week. Basell also required that Lyondell agree to a break-up fee of approximately 3 percent of the deal value.

Lyondell's board convened, considered Basell's proposal and retained a financial adviser. It also attempted to negotiate a higher price, a lower break-up fee and a "go-shop" period, but only obtained a minimal reduction in the break-up fee. After receiving advice from its legal and financial advisers (including with respect to the likelihood that any superior proposal would be made), as well as a fairness opinion, Lyondell's board agreed to Basell's terms.

Lyondell shareholders brought suit against the directors, claiming that they breached their *Revlon* duties. The directors sought summary judgment on the basis of §102(b)(7). But Vice Chancellor Noble denied the motion, notwithstanding the lack of any conflict of interest on the part of the Lyondell board with respect to the transaction.

While the court suggested that the "better inference" from the record likely supported the director-defendants,[11] the Vice Chancellor concluded that in the context of a summary judgment motion in which he was required to construe questions of fact favorably to the plaintiffs, such record (which he characterized as "limited" and "sparse") did not, "as a matter of undisputed material fact, demonstrate the Lyondell directors' good faith discharge of their *Revlon* duties - a known set of 'duties' requiring certain conduct or impeccable knowledge of the market in the face of Basell's offer to acquire the company." In particular, he found that the Lyondell directors had not carried the burden of showing that they had acquired sufficient information about the market to rely upon *Barkan* and thereby to justify their failure to take more proactive steps in furtherance of their *Revlon* duties. Thus, the court concluded, the availability of the exculpatory shelter of §102(b)(7) presented a question of fact that could only be resolved at trial.[12]

The defendants argued that the court improperly conflated the issue of "good faith" with the underlying *Revlon* analysis, and that the court did not address the existence of "good faith" and the discharge of the directors' *Revlon* duties independently. But the Vice Chancellor opined that the "good faith" question had been properly analyzed, and reaffirmed his view that the "rudimentary summary judgment record" fairly raised a question of whether "taking no discernible action to prepare for a possible sale of [Lyondell] in light of the 13D filing, and then, later, by doing nothing (or virtually nothing) actively to confirm that Basell's offer really was the 'best' deal reasonably available" could manifest a conscious disregard for the directors' known fiduciary obligations in a sale scenario.[13]

It is unclear, however, why the Vice Chancellor gave short shrift to the defense's argument that the Schedule 13D filing put the company "in play," and that the participation by the Lyondell board in negotiations with Basell (albeit during a short period of time) served to inform the board sufficiently to permit them to adopt a *Barkan* "passive sale" approach.

[11] *Lyondell*, slip op. at 39, 42 and 46.
[12] *Lyondell*, slip op. at 56.
[13] Letter, dated Aug. 29, 2008, from Vice Chancellor Noble to counsel, at p. 6.

'McPadden' and 'Lear'

The *Lyondell* decision was met immediately with concern that it weakened substantially the protections of §102(b)(7). But that concern was mitigated by two other Chancery Court cases that soon followed presenting similar facts and issues. *McPadden v. Sidhu*[14] involved the sale by i2 Technologies of a subsidiary to a company headed by an officer of that subsidiary who had run the sale process despite the board's knowledge that he wanted to buy the subsidiary. The directors allegedly engaged in little if any oversight in the process, and stood idly by while the executive did not contact the subsidiary's competitors, including one that had previously offered to acquire the subsidiary at a substantially higher price. This case seemed to present far more egregious potential breaches of fiduciary duty than in *Lyondell*.

The Chancellor described the §102(b)(7) jurisprudence under *Disney* as expressly permitting a board of directors to "act 'badly' without acting in bad faith."[15] Thus, even though the complaint alleged with particularity that the board's actions constituted gross negligence in violation of the duty of care, it did not allege facts supporting a claim that the directors had acted in bad faith through a conscious disregard for their duties. Accordingly, the Chancellor dismissed the claims against the i2 directors.[16]

The next week, Vice Chancellor Leo E. Strine Jr. decided *In re Lear Corporation Shareholder Litigation*.[17] *Lear* involved a proposed sale of Lear Corporation (a large supplier to U.S. auto makers) to an entity controlled by Carl Icahn (who owned a significant block of stock, but had no board representation). Although Lear had not been shopped, the acquisition agreement provided for a 45-day "go-shop" period that had been fully utilized. No other bidders surfaced during or after the go-shop period, despite the fact that Lear's large size and Mr. Icahn's commitment to vote in favor of a higher bid approved by Lear's board suggested that any other potential bidder would have been motivated to study the situation quickly.[18]

But Institutional Shareholder Services, the influential proxy advisory firm (ISS), and two other proxy advisers recommended against shareholder approval, and as the shareholder meeting approached it became clear that the vote was not likely to be successful at the agreed $36 per share price. Lear's financial advisers advised that a price increase of at least $1 would be required to obtain shareholder approval, while its proxy solicitor suggested that an increase of $1.50 to $2 per share could be needed in order to procure the desired recommendation from ISS. Based on this advice, a special committee of Lear's board negotiated with Mr. Icahn a price increase of $1.25 per share. As a condition, Mr. Icahn required a new termination fee of $25 million (approximately 0.9 percent of the deal value) that would be

[14] C.A. No. 3310-CC (Del. Ch. Aug. 29, 2008).
[15] *McPadden*, slip op. at 1.
[16] *McPadden*, slip op. at 26. However, Chancellor William B. Chandler III allowed the case to continue against the subsidiary officer who ran the auction and bought the subsidiary (and sold it two years later for over eight times the purchase price).
[17] Cons. C.A. No. 2728-VCS (Del. Ch. Sept. 2, 2008).
[18] Thus, 45 days, though a tight time frame, would likely have been sufficient to elicit any alternative proposals that were forthcoming (as compared with the facts of Vice Chancellor Strine's *NetSmart* opinion). See *In re NetSmart Techs. Inc. Shareholders Litigation*, 924 A.2d 171, 195 (De. Ch. 2007).

payable if Lear shareholders rejected the deal, regardless of whether an alternative bid was made. Such "naked" no vote breakup fees are unusual, although not unheard of.[19]

The price increase did not have its desired effect. ISS reiterated its negative recommendation of the deal, and Lear's shareholders voted it down. Notwithstanding that the fee clearly did not cause shareholders to vote in favor of the deal, Lear shareholders sued, claiming that the board acted in bad faith. The plaintiffs argued that since there was no realistic chance that shareholder approval of the transaction would be obtained, the grant of the $25 million fee was so devoid of care as to be disloyal.

Vice Chancellor Strine categorically rejected the plaintiffs' claim. Citing *Stone v. Ritter*[20] and *Disney*, the court held that the plaintiffs would need to "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]

In the court's opinion, actions viewed subjectively by the board to be in the best interests of the corporation and its shareholders cannot be characterized as disloyal simply because they entail a low probability of ultimate success. The Vice Chancellor commented further that courts should "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. In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."[22]

Conclusion

It is difficult to reconcile the opinions in *Lear* and *McPadden* with the court's decision in *Lyondell*. On the one hand, a technical interweaving of *Caremark* and *Disney* with *Barkan* and their collective application to the *Lyondell* facts as viewed by Vice Chancellor Noble, taken together with the rules of presumption applicable to motions to dismiss and for summary judgment, could arguably support the court's conclusion in that case. But by not requiring plaintiffs to show actual, subjective bad faith on the part of directors, the analysis essentially brings an alleged (but unproven) good faith failure to satisfy the requirements of *Barkan* into congruence with a bad faith breach of *Revlon*. And by doing so, it would appear to have the bizarre effect of giving plaintiffs in such cases a better hand against the directors where the record of their actions remains unclear than in cases where it is clear that the directors did things badly.

Directors can take comfort in that *McPadden* and *Lear* reaffirmed the requirement that plaintiffs demonstrate that there exists some evidence of subjective bad faith, or a suggestion of improper motive,

[19] *Williams v. Geier*, 671 A.2d 1368 (Del. 1996); *H.F. Ahmanson & Co. v. Great Western Financial Corp*., C.A. Nos. 15650, 15549, 15555-15557 (Del. Ch. June 3, 1997).
[20] 911 A.2d 362 (Del. 2006).
[21] *Lear*, slip op. at 2.
[22] *Lear*, slip op. at 26.

in order to overcome a §102(b)(7) defense at the pretrial stage. In a footnote to the *Lear* opinion seemingly aimed directly at this issue, Vice Chancellor Strine reminds us that the *Revlon* case itself involved a "strong sniff of disloyalty" in that the board favored one bidder over another, and that its principles must be considered in that context.[23] Accordingly, in his view, when a §102(b)(7) provision is applied together with a strong rationale for the decision taken (such as to secure a premium for stockholders), and in the absence of any alleged self-interested director bias or "illicit directorial motive," it is difficult for a plaintiff to pursue a breach of loyalty claim.[24]

Notwithstanding *McPadden* and *Lear*, boards are always well advised to establish the best structural and factual record possible before entering into a sale transaction. This includes retaining financial and legal advisers early in the process and holding frequent meetings of fully informed and actively participating directors.

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[23] The Vice Chancellor also noted that *Caremark* and *Disney* arose in connection with claims that the board had abrogated its duty to monitor the conduct of the company's management, and suggested that their direct application to sale transactions - which often do not involve the luxury of long deliberation - may be inapposite. *Lear*, slip op. at 25.

[24] *Lear*, slip op. at 26, fn 62.