Transaction Procedure Insights

Delaware Court of Chancery Denies Summary Ruling in Favor of Directors Who Approved Merger, Based on Accusations of a Breach of Duty of Good Faith

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The Lyondell Chemical Company board of directors received an unsolicited—but very attractive—tender offer for its publicly traded stock. However, even after negotiating an even greater price increase, deliberating over the offer, and receiving a fairness opinion from a prominent investment banker, the board can be second-guessed by dissenting shareholders. In this case, the Delaware Court of Chancery held that a substantial price premium to market price attained by the target company's board of directors did not necessarily satisfy the board's duty to find the best possible price available.

Introduction

In *Ryan v. Lyondell Chemical Co.*,[1] the Delaware Court of Chancery set a new precedent concerning the actions of directors during a change of control sale. The Court denied summary judgment in favor of a board of directors accused of a breach of good faith. Board members may face an allegation of a violation of their fiduciary duties during a change of control merger, despite securing a premium price and having overwhelming shareholder approval.

This discussion summarizes and explores (1) the factual background of the case, (2) the plaintiff's claims and reasoning, (3) the defendant's position and defense, (4) the Delaware Chancery Court's decision on summary judgment, and (5) conclusions from the case.

Factual Background of the Case

Prior to the proposed acquisition by Basell AF ("Basell"), Lyondell Chemical Company ("Lyondell") was a publicly traded company that manufactured chemicals and plastics. Lyondell was a financially viable company, not looking to raise capital, and not otherwise for sale.

In April of 2006, Basell expressed interest in purchasing Lyondell. Basell was turned down due to an inadequate offer price. In May of 2007, Basell filed a Schedule 13D disclosing that it had purchased 8.3 percent of Lyondell's shares, making Basell the second largest shareholder.

After the filing of the Schedule 13D, the Board of Directors of Lyondell ("the Board") decided to take a passive approach to surveying the market for potential offers, noting that the Schedule 13D indicated that Lyondell was "in play." As a reaction to the Schedule 13D filing, the share price of Lyondell increased from $33 to $37 the same day.

One potential suitor also came forward with the idea of a management-led leveraged buyout. The offer was refused by Lyondell CEO Dan F. Smith ("Smith"). The refusal cited potential conflicts of interest for management and the Board.

After no other offers emerged, Smith engaged in talks with Leonard Blavatnik ("Blavatnik"), the chairman and president of the company that owned Basell, concerning the possible purchase of Lyondell. In the early stages of the negotiation, Smith acted independently and did not seek guidance from the rest of the Board.

On July 9, 2007, Smith secured an offer from Blavatnik of $13 billion cash, or $48 per share. The offer was (1) a 45 percent price premium to the share price of Lyondell prior to the Schedule 13D filing and (2) a 20 percent price premium to the share price before the announcement of the merger. The offer was considered to be fair—if not exceptional.

The original offer also came with deal protections of a $400 million break-up fee, a "no shop" clause, and matching rights. Another stipulation of the Basell offer was that the Board must decide to accept the offer within seven days.

After receiving the offer, Smith called a Board meeting to discuss the situation. The Board approved Smith (1) to continue talks with Blavatnik and (2) to secure a formal offer.

The Board met multiple times over the week to discuss the offer, but met for a total of only seven hours. The Board was aware that the conditions of the Basell offer put them in a tight situation with respect to their fiduciary duties. Consequently, the Board requested (1) a price increase from Basell, (2) a "go shop" clause allowing them to seek potential buyers for a period of 45 days, and (3) a reduction of the break-up fee during the "go shop" period and after.

Knowing that the offer was well above market price, and that there were no other current competing offers, Basell rejected all of the concessions other than a small reduction in the break-up fee (reduced from $400 million to $385 million) as a show of good faith.

During the week of negotiating, the Board commissioned investment bank Deutsche Bank to provide a fairness opinion concerning the Basell deal. Deutsche Bank performed several valuations using both (1) optimistic projections provided by Lyondell management and (2) more conservative projections provided by equity analysts.

Using the optimistic projections, a value range of $37 to $47 per share was concluded to be a fair price, using a discounted cash flow (DCF) analysis. The optimistic projections also resulted in a fair price range of $44.75 to $51.50 per share, using a leveraged buyout (LBO) analysis. Using the more conservative projections, price ranges of $30 to $39 per share and $32.25 to $38.50 per share were concluded to be fair, using the DCF and LBO methods, respectively.

Deutsche Bank concluded (1) that the $48 per share offer price was indeed fair and (2) that it was unlikely that a better offer would present itself in the near term. Deutsche Bank also identified 20 other companies that would potentially be interested in acquiring Lyondell. However, Deutsche Bank was specifically instructed by Lyondell not to attempt to solicit any competing offers.

Considering the fairness opinion provided by Deutsche Bank, the substantial price premium offered, and the absence of any competing offers, the Board unanimously approved the merger at $48 per share with the significant (but in line with industry norms) deal protections. The Board approved the merger on July 16, 2007, and it was announced the following day.

The merger was voted on by the shareholders on November 20, 2007. And, it was approved by an overwhelming margin (99.33 percent voted for the merger, while only 0.44 percent voted against the merger).

The Plaintiff's Claims

The plaintiff in this case is Walter E. Ryan, Jr. ("Ryan"), a Lyondell shareholder. The accusations put forward by Ryan included:

1. general duty of loyalty claims against the Board,
2. the Board's obligations in a sale of control, the process undertaken in such a sale, and the Board's breach of the duty of loyalty specifically relating to shortcomings under Revlon[2] (the "Revlon Claims"),
3. deal protection measures that were unreasonable under the given circumstances ("Deal Protection Claims"),
4. disclosure claims against the Board, and
5. aiding and abetting claims against Basell.

All claims other than the Revlon Claims and Deal Protection Claims were dismissed under summary judgment.

The relevant accusations in this case (the only accusations not granted summary judgment in favor of the defendants) were the Revlon Claims and Deal Protection Claims. Delaware corporate law has set a precedent known as the Revlon Duties. The Revlon Duties require a board of directors to set its singular focus on attaining the highest reasonable value for the stockholders, when confronted with a sale of the company.

The other principal relating to this case, previously established in Delaware corporate law (addressed in *Unocal*[3] and *Omnicare*[4]), requires deal protection measures not be preclusive or coercive and must be reasonable in light of the circumstances.

There were several arguments outlined by the plaintiff as to why the Board failed to meet its Revlon Duties.

- The Board acted in a passive manner concerning the merger. After Basell filed a Schedule 13D and indicated possible interest in a control change, the Board adopted a wait and see approach. The Board assumed that any interested parties would see the filing as an indication that Lyondell was "in play." The Board took no action to retain an investment banker or prepare a business valuation until an offer was made by Basell.
- The short time frame in which the Board made a decision brought into question its "best effort." Only six to seven hours over a seven day period were documented as the amount of time spent discussing the merger. Such a short time frame would make it difficult for the Board to adequately evaluate the situation.
- There was no meaningful market check, either before or after the deal signing. The Board made no proactive attempt at a market check before agreeing to the merger. The Board specifically instructed Deutsche Bank not to solicit any competing offers. The post-signing market

check was hindered by strict deal protections including a "no shop" clause, matching rights, and a $385 million break-up fee.

- The entire negotiation process was dominated by Smith, with little interaction with the Board before the final proposal was made. The best efforts of the Board come into question again with this passive involvement.

The Deal Protection Claims brought into question the Board's approval of strict deal protections in light of a questionable sales process. The deal protections were not untypical for a merger of similar size and nature. However, the inadequate pre-signing market check raised the question of reasonableness.

If a proper valuation and market check is not carried out prior to the signing of a merger, then deal protections including a "no shop" clause may not be appropriate for the target company.

The Board's Defense

The Board (the "Defendants") motioned for a summary judgment on all claims, a decision by the Court to dismiss the case without going to trial. Under the summary judgment standard, the Court must draw all reasonable inferences in favor of the party not moving for summary judgment.

It was the duty of the Defendants then to prove that there was no reasonable dispute concerning the Board's process in seeking the best value for Lyondell shareholders.

The Board's intentions were not deemed to be contrary to those of the stockholders. However, the Board's Revlon Duties were in question as to whether they put forth their "best" effort to maximize stockholder value.

The Board argued that its actions were appropriate for the following reasons.

- The offer from Basell was a "blowout" price, at 45 percent above the market value prior to the Schedule 13D filing. Smith attained this price through negotiation, resulting in a significant increase from the original proposal.
- The market was aware that Lyondell was "in play" after the filing of the Schedule 13D by Basell. No superior offers came forward between the Schedule 13D filing and the Basell offer. After the offer was made, the "blowout" price may have deterred other bidders.
- The Board hired Deutsche Bank to offer a fairness opinion. Multiple valuations considering different scenarios concluded the offer price of $48 per share was in the upper range of the company's value. Deutsche Bank gave the opinion (1) that the offer was a fair price and (2) that it did not foresee a better offer from another potential acquirer.
- The merger was almost unanimously approved by the shareholders. Although it is the Board's duty to provide guidance, the overwhelming approval indicates that most shareholders thought that the offer was favorable.
- A further attempt to negotiate the deal conditions or a failure to act in a timely manner may have caused Basell to retract the offer, ultimately reducing shareholder value.

The Board also argued that the Deal Protection Claims were justified because the premium price received warranted greater deal protections. The deal protections were not uncommon in a merger of this size and nature.

Also, the Board did try to negotiate the deal protections with Basell, requesting a 45-day period to seek other potential buyers and a reduction in the break-up fee. Basell refused the requests (other than a $15 million reduction in the break-up fee). And, the Board had no other choice but to accept the deal protections or risk losing the premium offer.

In addition to the defenses listed above, the Board argued that it should be protected from monetary damages by a Section 102(b)(7) defense. Section 102(b)(7) found in Lyondell's charter stated, "A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." ("102(b)(7) Defense")

In light of this charter, the Court would have to rule that the Defendants acted with such negligence that they breached their duty of loyalty by failing to carry out their fiduciary obligations in good faith.

The Court's Ruling

With regard to all claims except for the Revlon Claims and Deal Protection Claims, summary judgment was granted in favor of the Board of Lyondell. Summary judgment was also granted in favor of the Basell defendants with regard to aiding and abetting claims.

The Board's motion for a summary judgment with regard to the Revlon Claims and the Deal Protection Claims was denied by the court.

Although the Board was denied summary judgment, the Court remained skeptical that Ryan's claims were viable in a trial proceeding. In a summary judgment, the benefit is given to the nonmoving party, in this case the plaintiff.

However, the ruling to deny summary judgment did open the door for the directors to face a trial despite attaining an attractive offer.

The Court ruled that it could not dismiss the Revlon Claims against the Board under summary judgment, after giving the plaintiff the "benefit of all reasonable inferences." The Court's decision was based on the opinion that the Board did not put forth "a reasonable effort to create value for the Lyondell stockholders."

- The Court was unimpressed with the seven hours spent deliberating over the merger, half of which was spent reviewing the final offer.
- The Court believed that the Board should have been proactive after the filing of the Schedule 13D, seeking a valuation of the company, performing a thorough market check, hiring an investment bank, and forming a strategy for receiving potential offers.
- The Court criticized the Board for being passive in the negotiating process. Smith dominated almost all negotiations and the Board merely "ceremoniously" approved the final offer.
- The Court also doubted the meaningfulness of a post-signing market check because of the deal protections.

The Court also ruled that it could not dismiss the Deal Protection Claims against the Board under summary judgment. Although the Chancery Court concluded that the deal protections were not coercive, the court could not conclude under summary judgment that the deal protections were reasonable under the given conditions.

Although the deal protections were deemed by the Chancery Court to be typical in mergers of this size and nature, the lack of an appropriate market check prior to the deal signing rendered the protections unreasonable.

With respect to the Section 102(b)(7) Defense, the Chancery Court ruled that the Board potentially breached its duty of loyalty by failing to carry out its fiduciary obligations in good faith. This meant that the Board's actions throughout the merger may have been so inadequate that it went beyond a breach of their duty of good care and breached the good faith aspect of their duty of loyalty.

In making this judgment, the Chancery Court referred to *Stone v. Ritter*[5] where the Delaware Supreme Court held that "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."

Summary and Conclusion

The ruling to deny summary judgment in favor of Lyondell's board of directors sets a new standard for the required actions of directors in a change of control sale. A denial of the Board's motion for summary judgment came despite:

1. negotiating a purchase offer that represented a 45 percent price premium to the market price,
2. commissioning a well respected investment bank to perform a fairness opinion,
3. no conflicts of interest,
4. the threat of the offer being withdrawn if not acted upon quickly,
5. an absence of competing offers,
6. a charter provision protecting directors from a breach of fiduciary duties, and
7. overwhelming shareholder support for the offer.

The Chancery Court was skeptical that the claims made against the Board would be credible in a trial proceeding. However, if the Board was found guilty for a violation of its Revlon Duties, breaching its duty of good faith and consequently its duty of loyalty, the individual members of the Board could be held personally accountable for monetary damages.

There is no uniform protocol for a board of directors to follow in order to meet its Revlon Duties in a merger and acquisition situation. This lack of guidelines leaves directors vulnerable to shareholder lawsuits.

There are procedures that a board can take towards meeting its Revlon Duties including: (1) staying informed as to the value of the company by conducting regular valuations in anticipation of possible merger and acquisition activity, (2) seeking legal and financial advice as soon as a potential suitor becomes apparent, (3) actively overseeing all aspects of the sales process and involving all directors, (4) actively seeking competing offers both before the signing of an agreement and after, (5) analyzing the situation in which deal protections are being applied, (6) fulfilling fiduciary duties despite a fear of an offer being retracted, and (7) developing a response strategy in preparation for an unexpected offer.

This case is now on appeal to the Delaware Supreme Court.

Notes:

1. *Ryan v. Lyondell Chemical Co.*, No. 3176-VCN, Del. Ch. 2008 WL 2923427 (Del. Ch. 2008)
2. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del.1986).
3. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
4. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).
5. *Stone v. Ritter*, 911 A.2d 362 at 370 (Del. 2006).

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