Delaware Directors Potentially Liable for "Mishandling" Acquisition by Accepting "Blow-Out" Acquisition Offer

On July 29, 2008, the Delaware Chancery Court issued an important decision addressing directors' duties in the sale of a public company. The decision in Ryan v. Lyondell Chemical Co. threatens increased legal exposure for directors. That specter of liability also foreshadows changes in the process directors will follow and the terms they will require to conclude acquisition transactions.

The Challenged Transaction

Ryan v. Lyondell Chemical Co. challenged the $13 billion acquisition of Lyondell by Basell AF for $48 per share in cash. The deal price represented a 45% premium to Lyondell's undisturbed market price before announcement, and offered consideration that the court observed was "certainly . . . fair" to Lyondell's stockholders. The court noted that the price was well within—and in some cases significantly above—the range of valuations of the Company, including the discounted cash flow and other analyses performed by the directors' financial advisor.

The transaction was approved by the 11 member Lyondell board upon the recommendation of 10 non-management directors, whom the court held were "independent and not impermissibly motivated by self-interest." The Board was advised by independent financial advisors at Deutsche Bank. According to the court, "the structure of the deal was not coercive." The terms included what the court characterized as "typical" deal protections, including a "no-shop" provision, "matching" rights for the buyer, and a break-up fee equal to approximately 2% of Lyondell's enterprise value and 3% of its equity value. The merger agreement included "the requisite fiduciary out," and there was no voting agreement in the deal. Finally, the transaction "garnered the near unanimous support" of the Lyondell stockholders voting at the shareholder meeting following disclosures in the merger proxy statement that the court held were essentially adequate.

In spite of these facts, the court denied the directors' motion for summary judgment. The court held that the plaintiff-stockholders had raised triable issues that the directors' process was flawed because they had not conducted adequate pre- or post-signing "market checks" to scout out higher offers, and had inappropriately agreed to "deal protection" terms that could impede topping bids. The court refused to credit the directors' contention that they had accepted a "blow-out" offer made on "take-it-or-leave-it" terms. As a result, Vice-Chancellor Noble declined to extinguish the plaintiffs' "bad faith" claims, and held that the directors could be personally liable for damages to the stockholders.

The "Sale Process" Claims

On the defendants' motion for summary judgment on plaintiff's "sale process" claims, the court held that, when faced with an all cash offer, the directors of a Delaware corporation, must either (1) "engage in an active sale process" involving "auctioning the company to the highest bidder" or otherwise involving efforts designed to secure the "best price" for the company; or (2) amass a "reliable body of evidence against which to judge the adequacy and fairness" of the single bidder's offer. "The corollary to this is clear: When [a board] does not possess reliable evidence of the market value of the entity as a whole, the lack of an active sales effort is strongly suggestive of a . . . breach." The court held that the directors failed to show either an active sales effort by the Board or reliable evidence that the deal was so good that it could not be passed up without further negotiation or market checks:

- No Active Sales Process: Based on the record presented on summary judgment, the court held first that "there was no evidence of a proactive sales" process by the Lyondell Board of Directors. The Board did not conduct either a pre-signing market check or a post-signing market check, because the buyer offered a "blow-out" price to Lyondell's CEO and threatened no offer if the Board sought to negotiate further. As a result, the Board instructed Deutsche Bank not to test the market before signing the merger agreement and the deal did not provide for a post-signing "go-shop" period or any other post-signing market check.
- No Reliable Body of Value Evidence: The court also held that the Lyondell directors failed to demonstrate that they had a "reliable body of evidence" concerning the value of Lyondell with which to evaluate the adequacy of Basell's offer. First, the deal "materialized very quickly. The entire deal was negotiated, considered and agreed to in less than seven days." "The Board formally met to discuss the Basell Proposal for a total of no more than six or seven hours." Second, the Board "did not retain an investment banker or even ask management to prepare projections and valuations of the Company" until after the price of the deal had been negotiated by the CEO. Finally, "the Board did nothing (or virtually nothing, at least on this record) to study the market carefully or to prepare itself in anticipation of an offer for the Company."

In short, the "Lyondell Board was largely out of the loop until the very end of the process when it approved the deal the CEO had negotiated."

The "Deal Protection Device" Claims

The court in Lyondell also denied the directors' motion for summary judgment on plaintiffs' claims that the "deal protection" provisions of the merger agreement, while customary, were inappropriate. The court applied an "enhanced scrutiny" standard to the provisions, and held that, while the protections were typical and could even "be said to appear regularly, in one form or another in deals of this magnitude," the deal protections were nonetheless problematic in view of the directors' failure to shop the company. The court faulted, in particular, the existence of the "no-shop" provision (despite the "requisite fiduciary out") in view of the absence of pre- or post-signing "market checks":

> [W]here there is lingering doubt as to the Board's efforts to ensure that it had secured the 'best' transaction available to the Lyondell shareholders before it endorsed the transaction, the Court should also be skeptical of the wisdom of the Board's decision to grant considerable deal protections, simply as a matter of course, that limited its ability to discharge proactively its fiduciary obligations after the fact.

Potential Personal Liability of the Directors

In addition to faulting their handling of the sale process and the deal protections generally, the court held that the Lyondell directors could face potential personal liability as a result. Although presented as a classic "duty of care" case – in which stockholders challenge the reasonableness of directors' processes and business judgments, and for which directors are customarily "exculpated" from liability for monetary damages – the Lyondell court held that the summary judgment record permitted the inference of conduct that was not in "good faith." If proved, the absence of "good faith" would erase the protections of the Company's exculpatory charter provision:

> This may not be a case . . . where a board of directors simply botched the sale process in some careless or even grossly negligent manner; instead, this is a board of directors that appears never to have engaged fully in the process to begin with . . . Thus, the "good faith" aspect of the duty of loyalty may be implicated, which precludes [an exculpation] defense . . .

Some Practical Takeaways from Lyondell

The Lyondell decision is replete with lessons for targets and bidders (financial and strategic) alike, among them are:

- Target Boards Will Take Notice: The potential for personal liability highlighted by Lyondell will not go unnoticed by directors of Delaware and non-Delaware corporations alike. The threat of personal liability under the circumstances set forth in Lyondell is likely to trouble directors of target companies. Directors will take heed of Lyondell and adjust their conduct based on its example.
- Lyondell May Lead to More Auctions: In Lyondell, the court criticized the directors for accepting a "blow-out" price in the absence of "market checks" that worked as auction surrogates. The decision suggests that the safest course for a target board is to choose between a robust pre-signing market check, even a full blown auction, or an aggressive "go-shop" after execution of an agreement. Particularly given the threat of personal liability for failing to conduct an adequate process that smokes out alternative proposals, target boards are likely to seek competitive bids. The threat of personal liability that Lyondell raises also provides them with leverage to push back against bidders resisting market checks.
- Deal Protections Must be Tailored to the Circumstances: Deal protections should not be adopted reflexively, but should be tailored to the circumstances. "Standard" no-shop provisions and "typical" 3% break-up fees may not be considered standard or typical depending on the circumstances. Any deal protections will need to be explained in the context of the deal as a whole and not by reference to "market" terms or general deal term precedents.
- The Tradeoff Between Market Checks and Deal Protections: Above all, absent a robust pre-signing market check, deal protections should be limited—and bidders can expect the Chancery Court, at least, to scrutinize carefully stringent deal protections. The Chancery Court's decision in Lyondell appears designed to shift the cost-benefit calculus for aggressive bidders seeking bullet-proof deals, and the Chancery Court can be expected to hold the line on this front.
- "Go-Shops" Help: The Lyondell court tacitly endorsed the "go-shop" as an effective device for use in a post-signing market check and implicitly criticized the Lyondell Board for its failure to obtain a "go-shop." In Lyondell, even the passage of some four months between the public announcement of the proposed merger and the shareholder vote without the emergence of a competing bid—combined with a market 3% break-up fee,—was not viewed by the court as a sufficient post-signing market check. In view of Lyondell, expect "go-shops" with tiered break-up fees to persist, and to be used more frequently, both in financial and strategic deals.
- Settlement Values/Indemnities Will Increase: Acquisitions of public companies almost inevitably attract stockholder litigation. If Lyondell's threat of personal liability is heeded by directors, target boards are likely to insist on more robust buy-side indemnification, and will no doubt be strong proponents of early settlements. Customarily, buyers have considered that they "own" post-closing liabilities of directors because they succeed to the target's indemnity obligations. But if directors are personally liable for conduct that is allegedly not in "good faith"—i.e. a claim that is not indemnifiable—they are likely to insist upon pre-closing settlements. The "disclosure only" settlement that has been a feature of many recent transactions will also be influenced by Lyondell. Following other recent decisions from the Chancery Court, the Lyondell court held that, if a shareholder wishes to press a duty of disclosure claim for alleged defects in the merger proxy, it must do so through a motion to

enjoin the closing of the deal. The increased prospect of an injunction against closing will make bidders more willing to settle.

- The Dilemma of the Unsolicited "Blow-out" Offer: The Lyondell court's decision puts in stark relief the dilemma created by an unsolicited "blow-out" offer. Under these circumstances, as the court noted, in addition to facing a risk of personal liability (for all of the reasons discussed in the decision) for accepting the all cash premium offer, "the Board recognized the risk that failing to pass along such a premium offer likely would have subjected them to a host of lawsuits from disgruntled shareholders." At a minimum, under these circumstances, directors face a risk of reputational harm from failing to accept the blow-out offer. Lyondell offers no satisfactory answer to this dilemma.
- The Rules May be Different for Troubled Companies: At certain points in Lyondell, the Chancery Court intimates that the result was affected, in part, by the absence of any need to sell Lyondell or raise capital and the fact that the Company was not on the block and did not need to be: "This case presents a somewhat novel factual scenario for application of sale of control jurisprudence. Lyondell was neither in financial distress nor actively seeking a sale of assets, an investment of capital, strategic partnerships, or any other type of transaction before announcing the Merger." Robust pre-signing market checks and/or lax deal protections may not be as necessary in the case of a company that must be sold.

If you have any questions, please contact your regular Ropes & Gray attorney.