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OFFICERS AND DIRECTORS

A discussion of liability under DGCL 102(b)(7)—Courts reaffirm that personal liability requires conduct constituting ''bad faith'' or worse; a showing of gross negligence is not sufficient.

Recent Delaware Decisions Temper Concerns Arising From Ryan v. Lyondell

By Robert S. Reder, Alan J. Stone, and Dean W. Sattler

A July 29, 2005 ruling by the Chancery Court of Delaware in *Ryan v. Lyondell Chemical Co.*[1] provoked a flurry of commentary denouncing the implications of this decision for personal liability of directors under Section 102(b)(7) of the Delaware General Corporation Law (''DGCL''). This class action lawsuit arose from the December 2007 acquisition of Lyondell Chemical Co. (''Lyondell'') by Basell AF (''Basell''). The plaintiff stockholders accused the Lyondell board of directors of failing to discharge its duties under the Delaware Supreme Court's seminal decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* [2] by neglecting to ''set its singular focus on seeking and attaining the highest value reasonably available to the stockholders'', even though the purchase price represented a 45% premium over the then-current market value of Lyondell's stock and the transaction was overwhelmingly approved by Lyondell stockholders. Plaintiffs also attacked the reasonableness of the seemingly customary deal protection devices negotiated as part of the merger agreement – including a no-shop clause with a ''fiduciary out'' to accept a superior proposal, subject to payment of a ''break-up'' fee equal to 3% of Lyondell's equity value (or 2% of its enterprise value)—under the familiar standard developed by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*[3]

The Lyondell directors argued that even if the Court concluded that their efforts in connection with the sale to Basell were insufficient under *Revlon* and the deal protection measures were objectionable under *Unocal*,

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

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

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

the directors were nevertheless entitled to summary judgment because, at worst, their actions constituted a breach of their duty of care from which they were absolved from personal liability under Lyondell's exculpatory charter provision adopted under DGCL Section 102(b)(7). Under this theory, to recover monetary damages from the Lyondell directors, the plaintiffs would have to prove that the board's failure to discharge its *Revlon* duties constituted a breach of its duty of loyalty, liability which cannot be eliminated under DGCL Section 102(b)(7). Vice Chancellor John Noble denied the defendant directors' summary judgment motion. Several commentators have expressed concern that Vice Chancellor Noble's rejection of the directors' DGCL Section 102(b)(7) argument potentially represents an unwarranted expansion of the range of conduct that could result in directors of Delaware corporations being held personally liable for their actions in connection with M&A transactions.

However, a series of subsequent Chancery Court decisions has helped to confirm that this concern was unfounded, as well as to clarify the relatively limited circumstances under which a director of a Delaware corporation might be subjected to personal liability for breach of fiduciary duty. First, in a letter opinion dated August 29, 2008, Vice Chancellor Noble, while declining to certify the *Lyondell* defendants' interlocutory appeal of his earlier decision, explained that his ruling was not as far-reaching as some commentators had feared. Then, within days, Chancellor William Chandler, in *McPadden v. Sidhu*,[4] and Vice Chancellor Leo Strine, in *In re Lear Corp. Shareholder Litigation*,[5] each addressed the scope of director liability in the context of an M&A transaction under DGCL Section 102(b)(7). These decisions went to great lengths to distinguish gross negligence (the level of misconduct required to establish a breach of the duty of care) from bad faith (a level of misconduct that can constitute a breach of the duty of loyalty) under Delaware law, and to drive home the point that only bad faith conduct will deprive directors of the protection of DGCL Section 102(b)(7).

In this article, we discuss the Chancery Court's rulings in *Lyondell*, *McPadden* and *Lear*, and parse the implications of these decisions for DGCL Section 102(b)(7) and the type of director conduct that may result in directors being deprived of its protections.

DGCL Section 102(b)(7)

DGCL Section 102(b)(7) provides that a Delaware corporation may include in its certificate of incorporation 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; [or] (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law ...'' This provision was added to the DGCL in the aftermath of the Delaware Supreme Court's 1985 controversial decision in *Smith v. Van Gorkom*,[6] which held that directors can be held personally liable for breaches of fiduciary duty in connection with their approval of an M&A transaction. The Delaware legislature, reflecting concerns in the business and legal communities that the *Van Gorkom* decision would make it difficult to attract qualified individuals to serve as directors of Delaware corporations, enacted DGCL Section 102(b)(7) to permit Delaware corporations to shield their directors from personal liability for damages arising as a result of a breach of their duty of care, but importantly, not for breach of their duty of loyalty or for actions not taken in good faith. Each of the corporations whose directors were the subject of the stockholder lawsuits in *Lyondell*, *McPadden* and *Lear* had adopted exculpatory charter provisions in accordance with DGCL Section 102(b)(7).

Ryan v. Lyondell Chemical Co.

Denial of Defendants' Summary Judgment Motion. The plaintiffs in *Lyondell* claimed that the process employed by the Lyondell board in approving the transaction with Basell was ''fatally flawed,'' citing, among other reasons, the facts that: (i) the board concluded its review of the transaction ''over the course of a mere seven day period'' in which the board ''could not possibly have informed itself as to the value of the Company and the wisdom of this transaction for the Lyondell stockholders,'' (ii) the board did not conduct a market check or otherwise shop Basell's offer and (iii) the deal protection devices included in the merger agreement were ''unreasonable and essentially 'locked up' this transaction for Basell by precluding other bidders from making an offer for the Company.'' The defendant directors, in support of their summary judgment motion, argued that they had in fact complied with their *Revlon* duties because the board knew ''the market . . . and the status of other potential acquirers, and it was reasonably confident, particularly given Basell's substantial initial offer, that another bid was unlikely.'' As for the *Unocal* claim, they argued that the ''sheer magnitude of the transaction premium'' and Basell's demands for a measure of deal certainty justified the deal protections included in the merger agreement.

The Court was clearly troubled by several aspects of the record (or, more precisely, the lack of a record) supporting the directors' summary judgment motion, and used unusually harsh language in referring to the Lyondell board as ''indolent,'' ''largely out of the loop'' and ''a passive conduit to the stockholders,'' and characterizing its process as ''hasty.'' On the other hand, the Court did acknowledge that the board ''was active, sophisticated and generally aware of the value of the Company and the conditions of the markets,'' ''was routinely advised of the financial outlook for the Company,'' received a long-range plan at least annually and ''was presented with detailed financial analyses of the Company and the Basell Proposal from both management and Deutsche Bank.'' Despite these findings, Vice Chancellor Noble denied the directors' summary judgment motion, ruling that ''[t]he Court cannot conclude on the limited record before it that, as a matter of undisputed material fact, the directors acted appropriately under the circumstances of this case.''

[4] *McPadden v.Sidhu*, C.A. No. 3310-CC (Del.Ch., Aug. 29, 2008).

[5] *In re Lear Corp. Shareholder Litigation*, C.A. No. 2728-VCS (Del.Ch., Sept. 2, 2008).

[6] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

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Addressing the directors' argument that they were entitled to summary judgment on the basis of Lyondell's exculpatory charter provision, the Court explained that *Revlon* duties are not unique fiduciary duties, but are rather ''a source of certain guidelines for the discharge of a director's fiduciary duties of care and loyalty in a sale scenario.'' Citing the Delaware Supreme Court's decision in *Stone v. Ritter,* [7] the Court cautioned that ''[w]here 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.'' One consequence of such a failure, the Court explained, is the loss of the protection of an exculpatory charter provision adopted under DGCL Section 102(b)(7).

Again referring to the paucity of information in the record before it, the Court stated that ''[t]he record, as it presently stands, does not, as a matter of undisputed material fact, demonstrate the Lyondell directors' good faith discharge of their *Revlon* duties.'' Because it was not able to determine from the record that the directors had acted in good faith, the Court determined that it could not award summary judgment to the directors on the basis of Lyondell's exculpatory charter provision.

*Denial of Defendants' Interlocutory Appeal***.** Undeterred, the defendant directors sought certification from Vice Chancellor Noble to appeal his ruling, contending that ''the Court committed reversible error by denying them the protection of Lyondell's exculpatory charter provision because . . . the Court improperly conflated possible violations only of the board's duty of care (i.e., gross negligence) with a violation of the good faith component of the duty of loyalty . . . (i.e., intentional dereliction or conscious disregard of fiduciary duties).'' Although he denied plaintiff's certification motion, the Vice Chancellor indicated (no doubt somewhat grudgingly) that ''the Court perhaps did not expound in sufficient detail upon its reasons for denying the directors the protection of Lyondell's exculpatory charter provision.''

Citing the Delaware Supreme Court's decision in the *Walt Disney Company Derivative Litigation,*[8] the Vice Chancellor confirmed that liability under DGCL Section 102(b)(7) ''is *not* predicated upon the breach of the fiduciary duty of care; rather, liability results from the separate and distinct duty of good faith.'' Then, perhaps to address the concerns raised by the commentators as much as the defendants' certification motion, the Vice Chancellor wrote that ''the reports of the death of Section 102(b)(7) (and the consequent possibility for the 'resuscitation' of a *Van Gorkam*-esque liability crisis) 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 DGCL Section 102(b)(7) provision defense in any other case.'' In fact, the Vice Chancellor explained that his earlier ruling did nothing more than ''assess the application (or potential application) of well-settled law under the peculiar and underdeveloped facts of this case.''

In applying the ''well-settled law'' concerning DGCL Section 102(b)(7) to the facts of *Lyondell*, however, the Vice Chancellor remained steadfast in his criticism of the Lyondell board's apparent handling of the merger with Basell. In this connection, he noted that even in light of the ''blowout'' premium offered by Basell, the board's two months of ''slothful indifference,'' despite knowing that the company was ''in play'', along with the board's apparent ''do nothing, hope for an impressive-enough premium, and buy a fairness opinion'' approach, raised a legitimate question whether the board, in bad faith, disregarded a known duty to act and failed faithfully to engage in the sale process in a manner consistent with the teachings of *Revlon* and its progeny.[9]

McPadden v. Sidhu

McPadden v. Sidhu arose from the approval by the board of directors of i2 Technologies, Inc. (''i2'') of a management buyout of its wholly-owned subsidiary Trade Services Corporation (''TSC''). The plaintiff brought a claim for damages arising from the alleged breach of fiduciary duty by the i2 directors, asserting that they approved the sale of TSC to members of TSC's management ''in bad faith for a price that defendants knew was a fraction of TSC's fair market value.''

Chancellor Chandler was nearly as critical of the i2 board's conduct as Vice Chancellor Noble had been of the Lyondell board's approach in approving the merger with Basell. Chancellor Chandler noted that the plaintiff had ''pleaded a duty of care violation [on the part of the i2 directors] with particularity sufficient to create a reasonable doubt that the transaction at issue was the product of a valid exercise of business judgment.'' Illustrating this point, the Chancellor noted (i) that TSC vice president Anthony Dubreville, who headed the winning management buyout group, was placed in charge of the TSC sale process despite the clear conflict of interest created thereby, (ii) the board's lack of oversight over the sale process, ''providing no check on Dubreville's half-hearted (or, worse, intentionally misdirected) efforts in soliciting bids for TSC'', and (iii) that the board did not question the valuation projections of TSC, which were produced in part by Dubreville.

Although Chancellor Chandler determined that the plaintiff demonstrated gross negligence on the part of the i2 directors in violation of their duty of care, the Chancellor dismissed plaintiff's claim based on the DGCL Section 102(b)(7) exculpatory provision contained in i2's charter. According to the Court, ''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. This sometimes fine distinction between a breach of care (through gross negligence) and a breach of loyalty (through bad faith) is one illustrated by the actions of the board in this case.''

The Court then sought to explain this ''sometimes fine distinction,'' with gross negligence being defined as ''conduct that constitutes reckless indifference or actions that are without the bounds of reason,'' while only

[7] *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[8] *In re Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. 2006).

[9] On September 15, 2008, the Delaware Supreme Court agreed to hear the plaintiffs' appeal of Vice Chancellor Noble's ruling. *See Lyondell Chemical Co. v. Ryan*, No. 401, 2008, C.A. No. 3176 (Del. 2008).

''the intentional dereliction of duty or the conscious disregard for one's responsibilities'' rises to the level of bad faith. And just in case the commentators on the first *Lyondell* decision remained skeptical as to the continued viability of DGCL Section 102(b)(7), Chancellor Chandler made it clear that ''[t]here is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.''

In re Lear Corp. Shareholder Litigation

The *In re Lear Corp. Shareholder Litigation* arose from the proposed acquisition of Lear Corporation (''Lear'') by Carl Icahn, a 24% stockholder. At the outset, Icahn offered to purchase Lear for $36 per share. Concerned that Lear stockholders would not approve this transaction, the board of directors of Lear agreed that if Icahn increased his offer by $1.25 per share, Lear would pay Icahn a $25 million termination fee (representing 0.9% of the total deal value) if Lear stockholders voted against the sweetened deal. The Lear stockholders did in fact vote down the transaction, and Icahn was paid the $25 million fee. Predictably, stockholder litigation ensued. The plaintiffs claimed that the defendant directors had acted in bad faith by approving an offer that they should have known would be rejected by Lear stockholders. The plaintiffs centered their complaint on their theory that ''directors who believe in good faith that a merger is good for the stockholders cannot adopt it if stockholder approval is unlikely.''

Vice Chancellor Strine granted the defendant directors' motion to dismiss, noting that ''[d]irectors are entitled to make good faith business decisions even if the stockholders might disagree with them.'' Citing the DGCL Section 102(b)(7) exculpatory provision contained in Lear's charter, Vice Chancellor Strine explained that to prevail, plaintiffs must ''plead facts suggesting that the Lear directors breached their duty of loyalty by somehow acting in bad faith for reasons inimical to the best interests of the Lear stockholders.'' Echoing the distinctions described by Chancellor Chandler in *McPadden*, Vice Chancellor Strine cited *Disney* for the proposition that to deny a director the protection of a DGCL Section 102(b)(7) exculpatory charter provision, ''a strong showing of misconduct must be made.''

Unlike the fact patterns in *Lyondell* and *McPadden*, Vice Chancellor Strine found that the plaintiffs' complaint did not ''come close to alleging that the board failed to employ a rational process in considering whether to approve the Revised Merger Agreement.'' In support of this proposition, he noted that the Lear board (i) received advice from two reputable financial advisors that the revised offer was fair to Lear stockholders, (ii) knew that no other bidder had come forward with a better offer after Icahn's interest was first announced or during the ''go shop'' period and (iii) held regular meetings and received advice from several relevant experts as to the revised offer. On this basis, the Vice Chancellor concluded that the Lear directors could not be found to have ''consciously and intentionally disregarded their responsibilities and thereby breached their duty of loyalty.'' To emphasize the high bar to director liability under DGCL Section 102(b)(7), he added that ''[i]n 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.''

Conclusion

The clear language employed by Vice Chancellor Noble in denying the interlocutory appeal in *Lyondell*, as well as the granting of motions to dismiss in favor of the defendant directors in *McPadden* and *Lear*, should be of significant comfort to directors of Delaware corporations involved in M&A transactions. These decisions clarify that the protections conferred by charter provisions adopted pursuant to DGCL Section 102(b)(7) still offer substantial protection to directors of Delaware corporations, even in situations where their actions are determined to be grossly negligent. Rather, it is only when a director acts in bad faith, or otherwise breaches his or her duty of loyalty, that the protections afforded by exculpatory charter provisions adopted under DGCL Section 102(b)(7) will be denied.

In fact, although Vice Chancellor Strine does not mention the initial *Lyondell* ruling in his *Lear* opinion, he does seem to indicate that he might have ruled differently. At the very least, directors and their advisors who are confronted with attractive, pre-emptive bids or other time-sensitive decisions should welcome his statement 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.''

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