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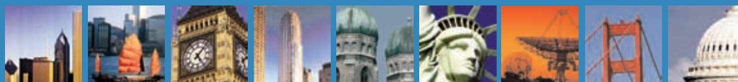
KIRKLAND & ELLIS LLP



Delaware Chancery Court Decisions Address Personal Liability of Directors in Change of Control Context

Introduction

In the last few months the Delaware Chancery Court has rendered three separate opinions addressing the fiduciary duties of directors of target companies in change of control situations. Each of these decisions addressed the issue of whether the actions of a board of directors in connection with a sale of a company breached the directors' duty of good faith so as to render the exculpation provision of the company's charter inapplicable to such actions. The consensus of the three opinions is that a director must engage in an intentional dereliction of duty or the conscious disregard of his responsibilities as a director — rather than mere gross negligence — to be deprived of protections of the exculpatory provision contained in the charter of most Delaware corporations.

The Lyondell Chemical Case

Of the three decisions, the troublesome one is Vice Chancellor Noble's decision in Ryan v. Lyondell Chemical Company, et al.[1] This decision arose out of the sale of Lyondell Chemical Company ("Lyondell" or "the Company") to Basell AF ("Basell"). The plaintiffs sued Lyondell, its directors, Basell and some of its affiliates claiming, among other things, that the directors breached their *Revlon*[2] duties to obtain the best price reasonably available for Lyondell in the sale of the Company. Specifically, the plaintiffs alleged that, despite the fact that the $48 per share price was a substantial premium to Lyondell's trading price before word of the deal leaked in the press, the directors breached their *Revlon* duties because:

- The sale took place over a very compressed timeframe (seven days);
- The Lyondell board (i) was not sufficiently engaged in the negotiation of the transaction, (ii) delegated this responsibility to Lyondell's CEO, (iii) did not negotiate vigorously enough with Basell with respect to either the price or the other terms and conditions of the transaction and (iv) engaged a financial adviser to advise the board with respect to the transaction only very late in the process;
- The Company did not conduct any sort of pre-signing market check or valuation of the Company even after the Company was effectively "put into play" by the filing of a Schedule 13D by an affiliate of Basell;
- The merger agreement did not contain a "go shop" provision but instead contained various deal protection provisions, including a "no shop" provision, matching rights and a $385 million termination fee;

1 Del. Ch. Ct., C.A. No. 3176-VCN (July 29, 2008).
2 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

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Lyondell's certificate of incorporation contained a customary exculpatory provision based on Section 102(b)(7) of the Delaware General Corporation Law that precluded an award of damages against a director for breach of the duty of care. The Delaware Supreme Court has made it clear, however, that bad faith conduct, as opposed to mere gross negligence, may breach a director's duty of good faith and thus his duty of loyalty to the corporation.[3] The Delaware Supreme Court has defined gross negligence to be reckless indifference to or a deliberate disregard of the whole body of stockholders or actions that are without the bounds of reason. The same court has defined bad faith conduct to be the intentional dereliction of duty or the conscious disregard of one's responsibilities.

The director defendants moved for summary judgment of the claims regarding breach of their *Revlon* duties, arguing that they could not be liable for damages due to the exculpatory provision in Lyondell's charter. The court denied the motion. The court first observed that the shortcomings in the sales process may not have been merely a case "where a board of directors simply botched a 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, despite *Revlon's* mandate." The court then held:

> With a record that does not clearly show the Board's good faith discharge of its *Revlon* duties, . . . whether the members of the Board are entitled to seek shelter under the Company's exculpatory charter provision for procedural shortcomings amounting to a violation of their known fiduciary obligations in a sale scenario presents a question of fact that cannot now be resolved on summary judgment.

The McPadden Case

The second decision, *McPadden v. Sidhu, et al.,*[4] by Chancellor Chandler, involved the sale by i2 Technologies, Inc. ("i2" or "the Company") of its wholly owned subisidiary, Trade Services Corporation ("TSC") for $3 million to a company controlled by a TSC vice president ("Dubreville"). Six months after the sale of TSC to Dubreville, Dubreville turned down an offer to acquire TSC for $18.5 million, but 18 months later he sold TSC for $25 million. The plaintiffs, shareholders of i2, sued the Company, its directors and Dubreville, alleging that the directors acted in bad faith by selling TSC to Dubreville at what they knew was a fraction of TSC's real value.

Among the allegations considered by the Chancery Court were the following:

- Approximately 2 ½ years before the sale of TSC to Dubreville, a competitor of TSC that was being sued by TSC for copyright infringement offered to buy TSC for up to $25 million, but the i2 board of directors did not pursue the offer;
- Dubreville allegedly took a number of actions to artificially depress the earnings of TSC, for the general purpose of misleading the i2 board as to the true value of TSC and for the specific purpose of creating artificially low financial projections for TSC;
- The i2 board allowed Dubreville to conduct the sale of TSC even after learning that he was interested in purchasing it;
- Dubreville undertook only limited efforts to sell TSC and did not contact the competitor discussed above that had earlier offered to purchase TSC for up to $25 million; and
- The i2 board knew that the fairness opinion delivered to the board in connection with the transaction was based on TSC projections prepared by or under the supervision of Dubreville and thus should have been inherently suspect as he was interested in buying TSC.

Despite the alleged shortcomings of the sale process, the Court dismissed the breach of fiduciary duty claims against the defendant directors because of the exculpatory provision contained in i2's certificate of incorporation. In reaching this conclusion, the Court, citing the relevant Delaware Supreme Court decisions, first observed that "the intentional dereliction of duty or the conscious disregard for one's responsibilities . . . must be treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith, a duty that the [Delaware Supreme] Court later confirmed was squarely within the duty of loyalty." The Court went on to conclude:

> Thus, from the sphere of actions that was once classified as grossly negligent conduct that gives rise to a violation of the duty of care, the [Delaware Supreme] Court has carved out one specific type of conduct — the intentional dereliction of duty or the conscious disregard for one's responsibilities — and redefined it as bad faith conduct, which results in a breach of the duty of loyalty. Therefore, Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason. The conduct of the Director Defendants here fits precisely within this revised understanding of gross negligence. . . . Because such conduct breaches the Director Defendants' duty of care, this violation is exculpated by the Section 102(b)(7) provision in the Company's charter and

3 In re Walt Disney Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); Stone v. Ritter, 911 A.2d 362 (Del. 2006).
4 Del. Ch. Ct., C.A. No. 3310-CC (Aug, 29, 2008).

therefore the Director Defendants' motion to dismiss for failure to state a claim is granted.

The Lear Corporation Case

The decision in In re Lear Corporation Shareholder Litigation,[5] by Vice Chancellor Strine, involved an offer by an affiliate of Carl Icahn ("Icahn") to acquire Lear Corporation ("Lear" or "the Company"). The board of directors of Lear had originally agreed to sell the Company to Icahn for $36 per share, which represented an approximately 46% premium to the price of Lear's stock before Icahn substantially increased his stake in the Company, which essentially put the Company "into play." The original merger agreement provided for a 45 day "go shop" period and termination fee of 2.4% of Lear's enterprise value if Lear terminated the Icahn transaction after the end of the go shop period to enter into a superior transaction.

After the original merger agreement was announced, the plaintiffs filed suit against the board of directors of Lear, claiming, among other things, that they breached their *Revlon* duties to obtain the best price reasonably available for the Company, and seeking a preliminary injunction. The motion was largely denied and the transaction was allowed to proceed.

However, Lear had trouble obtaining shareholder approval of the transaction based on the $36 per share price. Based on comments received from some shareholders and advice from its proxy solicitor and financial advisers, the Lear board concluded it would be necessary to increase the per share price to obtain shareholder approval. The Company thereafter entered into negotiations with Icahn, which eventually resulted in Icahn increasing the per share purchase price by $1.25, to $37.25. However, in exchange for this price increase, Icahn insisted on a termination of $25 million — representing 0.9% of the transaction value — if the Company's shareholders failed to approve the transaction. This is exactly what happened — the Lear shareholders failed to approve the merger agreement and the merger, and the Company paid Icahn the $25 million termination fee.

The plaintiffs thereafter amended their complaint to allege that the Lear directors acted in bad faith by approving a merger agreement knowing that the $1.25 per share increase in the merger consideration would likely be insufficient to obtain shareholder approval of the transaction but nevertheless agreeing to pay Icahn a $25 million termination fee if the shareholders rejected the deal. The Court, without ever referring to the *Lyondell Chemical Company* decision, rejected this argument, holding that the Lear directors were exculpated by the standard exculpatory provision contained in the Company's charter. First, the Court observed that "[f]or starters, the complaint does not come close to alleging that the board failed to employ a rational process in considering whether to approve the [amended] Merger Agreement." Then the Court observed that "the board was comprised of a super-majority of independent directors," thus rejecting any argument that the board could have breached its duty of loyalty. The Court went on to state: "Thus, the plaintiffs are in reality down to the argument that the Lear board did not make a prudent judgment about the" likelihood of shareholder approval of the revised deal, which, according to the Court, is "precisely the kind of argument precluded by the business judgment rule."

In rejecting the plaintiffs' argument that the Lear directors acted in bad faith, the Court first strongly cautioned against transporting a doctrine — i.e., the breach of the duty of good faith (and thus the duty of loyalty) — from the monitoring context, where such a breach requires a showing of "a sustained or systemic failure . . . to exercise oversight," to the "context where a discrete transaction was approved by the board." The Court went on to state:

> Courts should therefore be extremely chary about labeling what they perceive as deficiencies in the deliberation 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.

The Court concluded: "It would be inconsistent with the business judgment rule for this court to sustain a complaint grounded in the concept that directors act disloyally if they adopt a merger agreement in good faith simply because stockholders might (?), were likely (?), or were almost certain (?) to reject it."

Conclusion

Although the Chancery Court's decision in the *Lyondell Chemcial Company* case is arguably inconsistent with the other two decisions, this trio of cases helps to clarify the fiduciary duties of directors in the change-of-control context. More specifically, they clarify that only an intentional dereliction of duty by a director, or the conscious disregard of a director's responsibilities, can give rise to a breach of the duty of good faith that would not be exculpated by the exculpatory provision customarily included in the charters of Delaware corporations pursuant to Section 102(b)(7) of the Delaware General Corporation Law. Reading the three decisions together, one

5 Del. Ch. Ct., Cons. C.A. No. 2728-VCS (Sept. 2, 2008).

should conclude that shortcomings — even significant shortcomings — in a sale process will not result in a breach of the duty of good faith unless (i) those shortcomings are so extreme as to constitute an intentional dereliction or a conscious disregard of the directors' fiduciary duties and/or (ii) there are other facts, such as a lack of independence on the part of a majority of the directors, that strongly support the conclusion that the directors breached their duties of loyalty to the corporation and its shareholders. It is important to remember, however, that all three decisions focused on the duty of good faith subsumed within the duty of loyalty. It is possible that the conduct of the directors in one or more of the cases may have constituted a breach of the duty of care even if it did not constitute a breach of the duty of loyalty. ■

Meet The Authors

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Thomas Christopher focuses his practice on mergers and acquisitions, corporate governance, securities, restructurings and related matters. He represents principals and other parties in the purchase and sale of companies, subsidiaries, divisions, joint ventures and other assets. He specializes in representing public companies and over the years has advised numerous acquirers, targets and shareholders in both negotiated and unsolicited change-of-control transactions. Mr. Christopher also has extensive experience advising boards of directors and management of public companies regarding general corporate governance matters. In addition, Mr. Christopher has represented numerous special committees of boards of directors in connection with related party transactions. He is listed as a recommended lawyer for both mergers and acquisitions and corporate governance matters in the 2007 U.S. edition of *The Legal 500* and has been mentioned numerous times in the "Big Deals" column of *The American Lawyer*, including most recently in the November 2007 issue for his representation of Dade Behring Holdings, Inc. in connection with its approximately $7 billion acquisition by Siemens AG.

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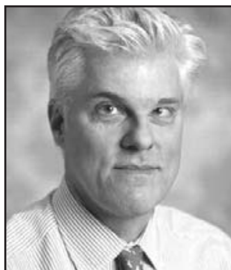

For more than two decades, Kirk Radke has focused exclusively on private equity clients. He is an internationally recognized leader in all aspects of the private equity practice. Mr. Radke has handled every type of private equity transaction including: acquisitions and recapitalizations, acquisition financing, growth equity investments, dispositions, fund formations, spinouts of institutional private equity units, carried interest programs and similar arrangements for private equity sponsors, strategic alternatives for private equity firms, including public capital markets transactions. Endorsed by clients for his "skills as both a dealmaker and a fund structuring specialist," and known as a "deal-getter and doer with a no-nonsense approach," Mr. Radke was selected as one of *Chambers USA, America's Leading Lawyers for Business* in Private Equity and Fund Formation from 2003 through 2008. He was also selected as a leading lawyer for Private Equity: Buyouts and Venture Capital Investment by *Chambers Global, The World's Leading Lawyers for Business* in 2006 and 2008.

Ellen Jakovic Joins Kirkland & Ellis

Kirkland & Ellis LLP recently expanded its Antitrust and Competition Practice Group with the addition of Ellen M. Jakovic, who joined the firm's Washington, D.C. office as a partner in February of 2008. Ms. Jakovic will take a lead role in Hart-Scott-Rodino (HSR) notification and antitrust clearance matters, a rapidly growing practice area for the Firm.

Ms. Jakovic comes to Kirkland from White & Case LLP, where she coordinated that firm's merger notification practice and advised clients on the antitrust aspects of complex international transactions and joint ventures. She is a leading member of the D.C. legal community, serving as President of the Women's Bar Association Foundation and The Barristers and serving on the Board of Governors of the D.C. Bar and the Board of Directors of the Bar Association of the District of Columbia.

Ms. Jakovic has an A.B., *magna cum laude,* from Harvard University and a J.D. from Harvard Law School.

About Kirkland's M&A Practice

Kirkland & Ellis LLP is a leading adviser to public companies on all types of mergers and acquisitions transactions, including tender and exchange offers, going private transactions, acquisitions and dispositions of subsidiaries, divisions and other assets and joint ventures. The firm is able to draw upon leaders in the areas of M&A, corporate governance, securities, tax, antitrust, intellectual property, ERISA and environmental law to provide our clients with comprehensive and innovative advice. We have experienced M&A teams in our domestic and European offices with the capability to execute complex domestic and multi-jurisdictional transactions. Our M&A practice is further bolstered by our extensive experience in corporate governance matters. We routinely counsel boards of directors and executive officers regarding significant transactions, takeover readiness, disclosure issues, Sarbanes-Oxley matters and internal investigations.

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ConAgra Foods (NYSE:CAG) in its $2.8 billion sale of the commodity and merchandising business of the ConAgra Trade Group to Ospraie Special Opportunities Fund (an affiliate of Ospraie Management) and other investors

Apax Partners, **Barclays Capital** and **The Tchenguiz Group**, as part of a private equity consortium, in their pending 1.6 billion sale of Somerfield to The Co-operative Group

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ACG Holdings in its $800 million merger with Vertis Holdings

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