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An Unremarkable Case: Good Faith After *Lyondell*

By Blake Rohrbacher

Some may consider the Delaware Supreme Court's recent opinion in *Lyondell Chemical Co. v. Ryan*[1] to be a remarkable departure from the Delaware courts' prior cases. But the opinion, issued on March 25, 2009, was largely a faithful application of settled precedent. Most importantly, *Lyondell* reaffirmed the definition of bad faith set forth by the Court in its *Disney*[2] opinion and confirmed that *Disney*'s bad-faith standard applies in the transactional context. This article describes the decision and discusses its implications.

Background

Basell AF wanted to buy Lyondell Chemical Company.[3] After a few unsuccessful overtures, in May 2007, Basell filed a Schedule 13D with the Securities and Exchange Commission indicating an interest in entering into a transaction with Lyondell. Lyondell's board met to consider the Schedule 13D, recognizing that it had put the company "in play," and decided to await the market's reaction—which turned out to be nothing. No real bidders came forward until July 2007, when Basell offered Lyondell a "blowout" price with a short fuse. Basell demanded that the deal be approved in a single week and mostly refused to negotiate on key aspects of its "best price" offer. The Lyondell directors had general knowledge of Lyondell's value, solicited advice from financial and legal advisors, and considered the possibility that Lyondell's stockholders would receive a better deal. After several meetings, they unanimously approved the merger, which was later approved by more than 99 percent of the voted shares.

The Court of Chancery, focusing on the two-month period (between the May 2007 filing of the Schedule 13D and the July 2007 decision of the board to negotiate the sale to Basell) of relative inaction by the Lyondell directors, held that a question of fact was raised regarding the directors' good faith that could not be decided on summary judgment.[4] After the Lyondell directors sought and received permission to pursue an interlocutory appeal, the Supreme Court reversed and remanded with instructions to enter judgment in favor of the defendant directors.[5]

The Supreme Court's Opinion

The linchpin of the Supreme Court's decision was the fact that Lyondell's certificate of incorporation contained an exculpatory provision under 8 *Del. C.* § 102(b)(7). The Lyondell directors were therefore not liable in damages for a breach of their duty of care, and the plaintiff had to plead a breach of their duty of loyalty to obtain any damages.[6] But the Court of Chancery had determined that the Lyondell board—made up of accomplished businesspeople—was independent and disinterested.[7] As has become increasingly common,[8] the plaintiff tried to get around this hurdle by arguing that the Lyondell directors had failed to act in good faith. For the Supreme Court, then, "the sole issue [was] whether the directors [were] entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith."[9]

Although the Court of Chancery denied summary judgment because it found the factual record incomplete, the Supreme Court held that the Court of Chancery had "reviewed the existing record under a mistaken view of the applicable law."[10] The Supreme Court stated that "[t]hree factors contributed to that mistake."[11]

First, the Supreme Court followed precedent in holding that no *Revlon* duties arose during the two-month period following the filing of the Schedule 13D; *Revlon* duties arose only during the week in which the directors began negotiating the sale of the company.[12] That is, the "duty to seek the best available price applies only when a company

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embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."[13] The import of this unremarkable statement[14] was that the two-month period following the Schedule 13D was no longer relevant for purposes of deciding whether the Lyondell directors had acted in bad faith.[15] Since the Lyondell directors had made no decision to sell Lyondell at that time, the fact that Lyondell had been put "in play" by Basell's Schedule 13D was irrelevant. The Court of Chancery's analysis had "focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basell's offer."[16] The Supreme Court's narrowing of the legally relevant timeframe was significant—even the Court of Chancery had "acknowledged that the directors' conduct during those seven days might not demonstrate anything more than lack of due care."[17]

The opinion then turned to what the Supreme Court considered the Court of Chancery's second mistake, reading "*Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process."[18] The Supreme Court first repeated *Revlon*'s statement that there is "only one *Revlon* duty—to '[get] the best price for the stockholders at a sale of the company'"[19] and then repeated *Barkan*'s statement that "'there is no single blueprint that a board must follow to fulfill its duties.'"[20] The Court held that no "court can tell directors exactly how to accomplish [the goal of achieving the best sale price for the stockholders], because they will be facing a unique combination of circumstances, many of which will be outside their control."[21] Because the issue before the Court was not due care, but only whether the directors had failed to act in good faith, the Supreme Court held that judgment was mandated in the directors' favor.

Finally, the Supreme Court disagreed with the Court of Chancery's equating "an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith."[22] The Court relied for this analysis on the language from *Disney* that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.'"[23] Because *Revlon* imposes no legally prescribed steps for directors to follow, the Court stated that the Lyondell "directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[24] That is, only if the directors "knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."[25] Since the Lyondell directors had been found to be disinterested and independent, "the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price."[26]

The Court then held that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith because they had, among other things, met several times to consider Basell's offer, been generally aware of Lyondell's value, solicited and followed the advice of their financial and legal advisors, attempted to negotiate a higher offer, and approved the too-attractive-to-pass-up merger agreement.[27]

Lyondell and Good Faith

The Supreme Court in *Lyondell* was faithful to the letter and spirit of its prior decisions on good faith. Most prominently, *Lyondell* followed the three-factor analysis set forth in *Disney*, which required plaintiffs claiming a failure to act in good faith to show an (1) intentional (2) failure to act (3) in the face of a known duty to act.[28] In applying these three factors, *Lyondell* demonstrated how the courts will apply *Disney*'s bad-faith standard in the transactional context.

First, it is clear that the Supreme Court meant what it said in *Disney*—plaintiffs cannot prove that directors failed to act in good faith without showing that the directors' inaction was *intentional*.[29] While *Lyondell* did not describe the requirement using the term "scienter," as the Court did last year in *Wood v. Baum*,[30] it made its point nonetheless: "Only if [the directors] *knowingly and completely failed* to undertake their responsibilities would they breach their duty of loyalty."[31] "[T]he inquiry should have been whether those directors *utterly failed to attempt* to obtain the best sale price."[32]

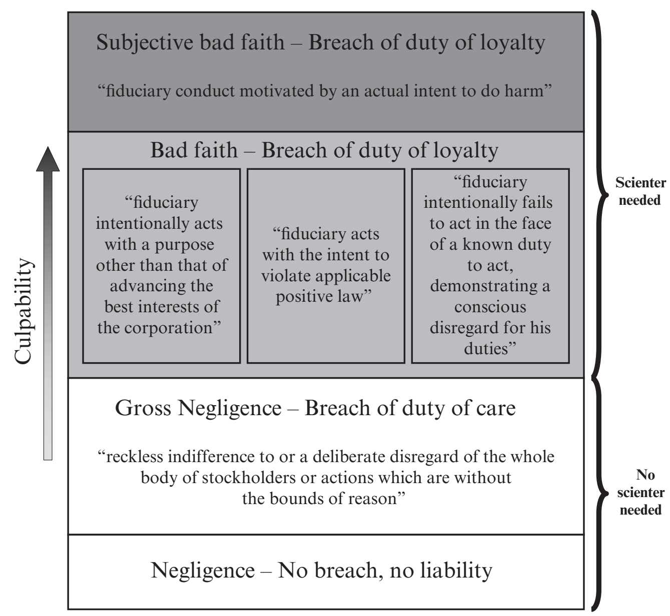
The second bad-faith factor requires plaintiffs to show a failure to act. *Lyondell* arose in a transactional context, and the Court made a key observation here: the plaintiff had not claimed that the directors did *nothing* during the week in which their *Revlon* duties applied; he merely claimed that the directors did not do *enough*. But not acting enough is not the same as completely failing to act. As the Supreme Court stated, "if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."[33] *Lyondell* confirmed, just as *Disney* and *Stone*[34] had held, that to fail to act in good faith, fiduciaries must completely "fail to act"[35]—thereby maintaining the important distinction between the duty of care and the duty of loyalty.

The last *Disney* factor, a source of some confusion, was also clarified somewhat in *Lyondell*. The requirement that directors must have intentionally failed to act "in the face of a known duty to act" has been discussed colloquially in the *Caremark* context by *Stone* and others as a "red flag." A "red flag" in the oversight context is some specific fact or facts known to the directors that should prompt the directors to take some action in response.[36] But it has been less clear what this requirement means in the transactional context. Directors' sole duty to act in the *Revlon* context is to get the best sale price for the stockholders.[37]

The *Lyondell* Court refused to carve that duty into disparate elements, noting that "the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[38] Both *Disney* and *Lyondell* refer to a "known duty to act," as opposed to a "fiduciary duty," which may explain why the *Lyondell* Court was unwilling to carve up *Revlon* duties into specific action items.[39] The sole *Revlon* duty is to get the best sale price, so that alone was the directors' known duty to act.[40] As long as the directors *attempted* to pursue that goal, they could not have been liable for bad faith.

Taken as a whole, *Lyondell*'s faithful reading of *Disney* confirmed that *Disney*'s bad-faith standard applies the same in the transactional context as in the oversight context. Bad faith is already hard to show in the oversight context,[41] where one might conceivably catch directors sleeping on the job. It may be (and should be) even harder in the transactional context, where disinterested directors are constantly taking actions. It is for that reason that the Court of Chancery in *Lear* made the statement, adopted in *Lyondell*, that, "'[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.'"[42] The *Disney/Stone* standard of bad faith applies in the transactional context, but the requirement that directors must completely "fail to act" makes bad-faith claims harder to prove. Any allegations of *inadequate* action will constitute only an exculpated breach of the duty of care, so a plaintiff must prove that disinterested directors did absolutely nothing in a context where they typically do many things.

The effect of *Lyondell*, therefore, was to reaffirm the culpability framework that had existed before the opinion and to establish its broader application in all contexts. That framework, including definitions set forth by the Delaware courts, is depicted in the below diagram:[43]



Conclusion

While practitioners of all stripes may debate what *Lyondell* means for stockholder litigation, it should be clear that *Lyondell*'s unremarkable holdings do not change the status quo.[44] The presence of a § 102(b)(7) exculpatory provision will continue to prevent monetary damages for breaches of the duty of care, but plaintiffs can still seek injunctions when directors breach their duty of care in a *Revlon* situation.[45] While plaintiffs may have a hard time making out a bad-faith claim against independent, disinterested directors, such claims have always been difficult to prove. In other words, stockholder litigation will proceed as it always has, but, thanks to *Lyondell*, both counsel and the courts will have a clearer path to follow.

Notes

1. 970 A.2d 235, 2009 WL 1024764 (Del. Mar. 25, 2009).

2. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

3. A fuller recitation of the factual record may be found in the Supreme Court's opinion. *See Lyondell*, 2009 WL 1024764, at *1–2.

4. *See Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427, at *19 (Del. Ch. July 29, 2008), *rev'd*, 2009 WL 790477 (Del. Mar. 25, 2009).

5. *Lyondell*, 2009 WL 1024764, at *7.

6. *See id.* at *3.

7. *Ryan*, 2008 WL 2923427, at *10.

8. *See* Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* 87 (Harvard John M. Olin Discussion Paper Series No. 630, 2009), available at *http://ssrn.com/abstract=1349971*.

9. *Lyondell*, 2009 WL 1024764, at *3.

10. *Id.* at *4.

11. *Id.*

12. *Id.* at *6.

13. *Id.*

14. This holding was consistent with *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1151 (Del. 1989), which had held that *Revlon* duties do not arise merely because a company is "in play."

15. *Lyondell*, 2009 WL 1024764, at *6. Like the Supreme Court, this article uses the terms "bad faith" and "failure to act in good faith" interchangeably. *See id.* at *3 n.8.

16. *Id.* at *6. Furthermore, "inaction" may not have been the proper term. The directors considered the Schedule 13D and "decided to take a 'wait and see' approach"—a decision the Supreme Court termed "an entirely appropriate exercise of the directors' business judgment." *Id.*

17. *Id.*

18. *Id.* at *4.

19. *Id.* at *6 (quoting *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986)) (alteration in original).

20. *Id.* (quoting *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989)).

21. *Id.*

22. *Id.* at *4.

23. *Id.* at *7 (quoting *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006)).

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* (holding that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties'" (quoting *Disney*, 906 A.2d at 67)).

Some have recognized that the relationship between gross negligence and recklessness makes the bad-faith analysis more difficult. *See, e.g.*, Strine, Hamermesh, Balotti & Gorris, *supra* note 8, at 89 n.242; *cf.In reLear Corp. S'holder Litig.*, 967 A.2d 640, 652 n.45 (Del. Ch. 2008). The phrase "conscious disregard" arguably makes the analysis even more difficult since "conscious disregard" derives from the recklessness and gross negligence standards. *See, e.g.*, *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) (stating that conduct evidencing a "conscious disregard" was "once classified as grossly negligent"); *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (holding that "gross negligence means 'reckless indifference to or a deliberate disregard of the whole body of stockholders'"). More emphasis of the three *Disney* factors, and less of "conscious disregard," might make the bad-faith analysis simpler.

29. *See also, e.g.*, *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007) ("[T]o find [the directors] liable for breach of fiduciary duty absent the exculpation clause, one would have to consider whether their failure to realize the impropriety of the options grants rose to a level of gross negligence, the higher threshold used by our law to analyze due care claims for several policy reasons that are well understood. But because they are protected by the exculpation clause, the directors can only be held liable if they act with a state of mind that is disloyal to their obligations to the corporation. In this context, that would likely require a finding that the compensation committee knew that the options violated the stock option plan and that the options were being accounted for in a manner that was improper, or that their failure to obtain that information resulted from their knowing abdication of their directorial duties. In other words, it is precisely by the careful use of equitable principles to analyze director conduct that directors are protected from liability in a situation when they did not act with scienter." (footnotes omitted)).

30. *See Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) ("Where, as here, directors are exculpated from liability except for claims based on 'fraudulent,' 'illegal' or 'bad faith' conduct, a plaintiff must also plead particularized facts that demonstrate that

the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper.").

31. *Lyondell*, 2009 WL 1024764, at *7 (emphasis added).

32. *Id.* (emphasis added).

33. *Id.*

34. *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006).

35. Of course, liability may also be imposed for actions. That is, a director acts in bad faith if he or she "intentionally acts with a purpose other than that of advancing the best interests of the corporation" or "acts with the intent to violate applicable positive law." *Disney*, 906 A.2d at 67.

36. *See, e.g.*, *Stone*, 911 A.2d at 370 (describing "red flags").

37. *Lyondell*, 2009 WL 1024764, at *6.

38. *Id.* at *7.

39. A "known duty to act" appears to have a specific trigger (here, the directors' decision to negotiate the sale of Lyondell) and a specific goal (here, to obtain the best sale price). Fiduciary duties, on the other hand, are omnipresent and apply during the entire length of a director's term.

40. Outside the single-bidder situation in *Lyondell*, however, it is possible that other known duties to act may arise in the *Revlon* context—for example, the receipt of a topping bid may give rise to a duty to consider and evaluate the bid.

41. *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (calling such a claim "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment").

42. *Lyondell*, 2009 WL 1024764, at *7 (quoting *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654–55 (Del. Ch. 2008)) (second and third alteration in original).

43. A partial list of authority for the various portions of the diagram follows.

Subjective bad faith: *Disney*, 906 A.2d at 64.

Bad faith: *Disney*, 906 A.2d at 67; *Lyondell*, 2009 WL 1024764, at *7.

Gross negligence: *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled in part on other grounds by Brehm v. Eisner*, 744 A.2d 244 (Del. 2000); *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008).

Negligence: *Aronson*, 473 A.2d at 812.

Culpability: *Disney*, 906 A.2d at 64, 66.

Scienter needed: *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008); *Lyondell*, 2009 WL 1024764, at *7.

No scienter needed: *Disney*, 906 A.2d at 64; *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007).

44. Indeed, a working paper posted before *Lyondell* was decided anticipated almost exactly the key language in the *Lyondell* opinion. Vice Chancellor Strine and his fellow authors wrote that "there is nothing new about recognizing that a conscious failure to make a good faith effort to comply with the required duty of care is categorically distinct from a mere failure to fulfill that duty in a specific circumstance." Strine, Hamermesh, Balotti & Gorris, *supra* note 8, at 91. The *Lyondell* Court wrote, "Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price." *Lyondell*, 2009 WL 1024764, at *7.

45. *See, e.g.*, *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 542 (Del. 1996) ("While section 102(b)(7) and charter provisions adopted thereunder will leave stockholders without a monetary remedy in some instances, they remain protected by the availability of injunctive relief.")

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