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Court of Chancery Fires Warning Shot Regarding Sales Process Issues

On July 29, 2008, the Court of Chancery decided *Ryan v. Lyondell Chemical Co.*, which arose from stockholder litigation filed in connection with Basell's acquisition of Lyondell Chemical during 2007. In denying the corporate directors' motion for summary judgment on several claims, the Court applied the familiar summary judgment standard and declined to give the benefit of any inferences to the directors, who were the moving parties. While unexceptional in this regard, the decision is likely to have far reaching impact in light of its extended discussion of the substantive law of directors' duties in agreeing to sell a company.

The Court concluded, after a detailed review of the factual record before it, that the director defendants' conduct raised serious questions about the discharge of the Board's duties under *Revlon*; that the "deal protection" measures approved as part of the transaction had not been justified by the Board as the product of a reasoned judgment based on reliable evidence; that the failure to become actively involved in the sales process was not an exculpated breach of the duty of care, but instead potentially a non-exculpated breach of the duty of good faith; and that the failure to disclose that management had provided the Company's investment banker with a weighted average cost of capital analysis which yielded a discount rate lower than that used by the Company's investment banker could have been material (although it was exculpated in the circumstances as a breach of the duty of care).

Though the court leaves open that possibility that the directors would ultimately prevail on the record it established after trial, in many ways, the decision reinforces the critical importance of having the Board involved in the sales process from the beginning, and of being able to demonstrate the Board's involvement in the corporate sales process as it unfolds.

The facts of the case, as described by the Court, suggested that, prior to advising his Board of Directors, and prior to the involvement of an investment banker, Lyondell's CEO held a number of discussions relating to the price of a potential transaction with a senior Basell officer, bidding up the price that Basell was willing to pay several times to the point where the price ultimately agreed upon represented a substantial (45%) premium over the pre-affected market price. Given time sensitivities imposed by the Buyer, the CEO took the premium price to his Board, and, in less than a week a definitive agreement was agreed to and executed by the parties.

In reviewing these facts, the Court repeatedly stressed the non-involvement of the Board in the process leading up to the final agreement on price; the after the fact hiring of the investment banker, who was effectively hired only to give a fairness opinion on an already negotiated deal and required to prepare its analysis in an extremely short time window; and the perceived lack of any active participation by the Board in the design and execution of the sales process until it was essentially over.

Although acknowledging that a Board may, based on a body of reliable evidence, determine to structure a sale to only one buyer, and was not required to conduct a pre-signing market check, the Court also stressed that, in doing so, the Board would be held to justify its conduct in the sense that it would be required to demonstrate that it had a sufficient quantum of market based knowledge on which reliably to conclude that it had signed up the best transaction reasonably available. Where the Board has no particular body of knowledge to fall back on in this regard, however, and relies primarily on industry knowledge in general, rather than more specific information relating to the market for control of the company, it risks a reviewing court concluding that it has failed its *Revlon* duties.

The Court also concluded, at least in the context of a motion for summary judgment, that the failure of the Board to become actively involved in the sales process could be viewed as a non-exculpated breach of the duty of good faith, rather than a breach of the duty of care. Relying on *Stone v. Ritter*, the Court held that the Board's inaction in the face of a known duty to act was not consistent solely with carelessness, but instead potentially a breach of the duty of good faith, which if true would not be subject to exculpation.

Turning to the deal protection measures, the Court addressed a matching right, a no shop with a fiduciary out, and a $385 million break up fee. Finding that the record showed only one attempt to lower the break up fee and allow some type of market canvass, which attempt was largely and quickly rejected by the buyer, the Court concluded that the perceived passivity of the Board rendered it unable to come forward with evidence in support of its motion that the deal protection measures were reasonable in the circumstances for purposes of meeting the standard for summary judgment. The Court also repeated the warnings of several recent cases that there is no formulaic set of deal protection measures which are entitled to automatic deference by the Court, notwithstanding the view of many corporate practitioners to the contrary.

Finally, in response to an argument that the overwhelming vote in favor of the transaction by the Lyondell stockholders served to raise the bar of the doctrine of ratification to protect the directors, the Court concluded that, on the current record, the disclosures were not sufficient to have the effect of extending the benefit of ratification to the transaction because the disclosures were lacking in one potentially material aspect. Specifically, in performing its discounted cash flow analysis, the Company's investment banker relied on two sets of projections, one from the Company and one based on street estimates. What the proxy failed to disclose, however, was that in supplying the banker with its projections, management also supplied a weighted average cost of capital calculation of 8.25%. The banker did not use this WACC, but instead applied discount rates in the range of 9.5%-11.5%, and no attempt was made to explain to stockholders why management's WACC was not utilized as a discount rate. While the Court reserved ultimate judgment on whether this omission was in fact material in the circumstances, it did find that there were sufficient questions relating to the potential materiality of the omitted information as to preclude application of the doctrine of ratification at this point in the proceedings.

The *Lyondell* opinion, although arising in the context of a motion for summary judgment, is perhaps more importantly a clarion call for Board involvement in all phases of a sale transaction. Deference to the advanced stages of the negotiation when the matter was first presented to the Board was simply not acceptable to the Court. Absent active *board* involvement in the design and execution of a sales process, all directors are at risk, especially given the Court's holding relating to exculpation. Moreover, the days when a CEO can negotiate a transaction and then present a prenegotiated deal to a board for approval are gone, and perhaps this is as much as any other written or implied message the key lesson from the case.