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corporate alert

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Recent Delaware Case Law Sheds Light on Directors' Potential Exposure to Personal Liability in Cash Sale Transactions

The current instability of the marketplace and collapse of credit sources will likely encourage strategic buyers to acquire competing firms at discounted prices, as well as entice distressed businesses to seek out potential sale opportunities. In the haste to finalize a deal, however, it is important for corporate directors to be aware of recent developments under Delaware law in order to ensure that they satisfy their fiduciary duties to the company and its shareholders, in addition to minimizing their own exposure to personal liability during the sale process.

Recent Developments Regarding the Risk of Personal Liability of Corporate Directors

Last July, a decision by the Delaware Chancery Court in *Ryan v. Lyondell Chemical Company* (July 29, 2008) ("*Lyondell I*") created alarm in the corporate community by expounding on the watershed *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* ("*Revlon*") decision, which requires corporate directors, when contemplating a cash sale of the company, to perform their fiduciary duties in a manner that maximizes the sale price reasonably available for shareholders. The court in *Lyondell I* suggested that, despite securing a substantial premium for shareholders, a board's failure to execute its *Revlon* duties in good faith would constitute a breach of the board's duty of loyalty to the company. Such a breach could subject individual directors to personal liability given that any exculpatory or indemnification provisions benefitting directors in the company's charter would no longer apply under Delaware law. Not surprisingly, the fact that *Lyondell I* also suggested that a board's mere negligent actions or omissions could constitute a breach of the duty of loyalty and subject its directors to personal liability caused an outcry among many legal commentators and corporate executives.

Soon after *Lyondell I*, however, the Delaware courts released three subsequent opinions (*Ryan v. Lyondell Chemical Company* ("*Lyondell II*"), *McPadden v. Sidhu* and *In re Lear Corporation Shareholder Litigation*), which allayed these initial concerns by suggesting that, in order to support a finding that corporate directors breached the duty of loyalty in a cash sale scenario, it must be demonstrated that the directors acted in conscious disregard of their *Revlon* duties or otherwise executed their *Revlon* duties in a seriously flawed manner.

In a final attempt to dispel the fear and confusion raised by *Lyondell I*, the Delaware Supreme Court's recent *Ryan v. Lyondell Chemical Company* (March 25, 2009) ("*Lyondell III*") decision reversed *Lyondell I* and asserted the following principles under Delaware corporate law:

- Corporate directors generally will not be personally liable in a cash sale scenario unless they demonstrate bad faith by consciously disregarding their duties under *Revlon* (a much higher bar than the negligence standard suggested by *Lyondell I*);
- A board's *Revlon* duties are not triggered until the company decides to engage in a sale or at such point when a sale is inevitable. A board may even "just say no" to a merger offer or adopt a "wait-and-see approach" prior to such point in time; and
- *Revlon* does not create a set blueprint of procedures that a board must adhere to in order to avoid liability; whether or not the board breaches its *Revlon* duties will be a specific question of fact reviewed on a case-by-case basis.

"Best Practices" for Board Members to Minimize Risk of Personal Liability

Despite the reassuring *Lyondell III* decision, *Lyondell I* illustrates the potential exposure that directors can face when negotiating the sale of their company. Though *Lyondell III* made it clear that there is no single method or set of required procedures to follow when negotiating and consummating a cash sale, the following guidelines provide a series of suggested "best practices" for board members, in order to minimize their risk of personal liability:

Stay Informed

Once aware of potential buyers, the board should seek to determine the value of the company, so as to have determined an acceptable sale price when entering negotiations. Also, if the company has discussed the possibility of engaging in a cash sale, the board should evaluate the potential for additional buyers and strategies for future negotiations.

Avoid the Bystander Role

Though an executive officer may be in the best position to negotiate and lead negotiations, the board should remain active in the negotiation process and avoid delegating all negotiating powers to the company officers. Remaining active in the negotiation process will help demonstrate the board's good faith effort to satisfy its *Revlon* duties.

Seek Greener Pastures When Practicable

In a cash sale scenario, the *Revlon* decision requires the board to seek out the maximum value for company shareholders, whether by considering multiple suitors or negotiating the best possible price-per-share with a single bidder. This is important for the board to consider, even in situations where a potential buyer puts forth a seemingly unbeatable offer. To minimize the risk of personal liability, board members should make a concerted effort to obtain a buyer's best offer and verify that market for other potential buyers. In addition, though "no shop" provisions and break up fees are often standard, the board should be certain to have apprised itself of other potential buyers and their likelihood of making a competitive offer before locking away the ability to seek maximum value for shareholders.

Avoid Rash Decisions

Though deadlines will vary from deal to deal, it is important for the board to take the necessary time to weigh the benefits and disadvantages of a cash sale and to determine whether the deal terms are right for the company and its shareholders. To further demonstrate the board's careful consideration, make sure to keep careful minutes and records of all board meetings where the deal is discussed.

Do Not Rely on Corporate "Insurance"

To provide additional protection to the directors, the board should attempt to negotiate indemnification provisions for the individual directors in merger agreements with potential buyers. Such indemnification will provide an additional safety net to individual directors.

Obtain Periodic Counsel to Review Fiduciary Duties

Because the fiduciary duties the board owes to the company and its shareholders are most often determined by the courts, such duties are not static and can change as frequently as cases are decided by the courts. In addition, the application of fiduciary duties varies greatly by jurisdiction. To ensure that the board is apprised of additional duties or changes to existing duties, as well as how best to execute them, the board should seek counsel on a regular basis to obtain up-to-date reports and training sessions on the subject.

What You Should Do

If you would like further information regarding corporate governance matters and board duties, or if you would like to arrange for a complimentary "refresher course" on fiduciary duties for your board members, please contact any of the members of Venable's Business Transactions practice group.

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