

The Delaware Supreme Court Puts to Rest the Conflation of Bad Faith and Due Care Arising Out of *Ryan v. Lyondell Chemical Co.*

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On March 25, the Delaware Supreme Court reversed and remanded the Delaware Chancery Court’s decision in *Ryan v. Lyondell Chemical Co.*, a decision that, if it had been allowed to stand, had the potential to conflate violations of due care with bad faith in the context of a board’s evaluation of potential mergers.¹ Although not entirely unexpected, given that the Supreme Court agreed to hear the case on an interlocutory appeal, the Court’s opinion is certainly welcomed by merger and acquisition professionals, as few recent decisions by the Delaware Court of Chancery have sparked more immediate commentary.² Indeed, despite a 45% premium, a series of meetings held during the week preceding the board’s vote on the merger, and the board having retained a financial advisor who not only advised the board but also rendered a fairness opinion, the Chancery

Court found material issues of fact that could give rise to a claim of “bad faith” because the board failed “to engage in a more proactive sale process.”³ Given the material issues of fact, the Chancery Court rejected the directors’ Delaware General Corporation Law section 102(b)(7) defense on a motion for summary judgment, despite finding no disclosure violations, no self-dealing or illicit motive and no other “general duty of loyalty claims.”⁴

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Given the skepticism expressed by the Chancery Court about the plaintiff's chances of ultimately prevailing, *Lyondell* could have been read as nothing more than a decision where the court felt constrained by the standards applicable to any summary judgment motion. Indeed, the Chancery Court suggested as much in a clarified opinion denying the directors' interlocutory appeal.⁵ Nevertheless, the decision created the potential for enormous uncertainty for directors faced with the difficult decisions inherent in the sale of a company.⁶ That uncertainty would only be heightened by the fact-intensive nature of the bad-faith inquiry and the potential for personal liability even for a disinterested, independent board that would flow from the absence of section 102(b)(7) protection on a *Revlon* claim.⁷

As discussed below, the Delaware Supreme Court firmly rejected the Delaware Chancery Court's decision that "unexplained inaction" permits a reasonable inference that the directors may have consciously disregarded their fiduciary duties.⁸ While noting that "[a]t most, this record creates a triable issue . . . on the question of whether the directors exercised due care. There is no evidence . . . from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty."⁹ Consequently, the Delaware Supreme Court found the directors were entitled to summary judgment on their section 102(b)(7) defense.¹⁰ The clarity of the Court's instruction that there is a "vast difference" between conduct that might give rise to a due care claim and that which constitutes an "intentional dereliction of duty"¹¹ restores a measure of certainty as to the protections afforded a disinterested, independent board in determining whether or not to accept a merger proposal or in deciding between competing proposals.

Background of the Merger

Netherlands-based chemical company Basell AF first expressed interest in acquiring Lyondell Chemical Co. in April 2006 at an introductory meeting between Lyondell's Chairman and Chief Executive Officer, Dan F. Smith, and the Chairman and President of Basell's corporate parent,

Leonard Blavatnik. As the price Mr. Blavatnik proposed at that time was inadequate, those discussions were unfruitful.

A year later, Access Industries—a New York-based industrial group owned by Mr. Blavatnik and which had bought Basell in 2005—acquired an 8.3% interest in Lyondell and filed a Schedule 13D with the Securities and Exchange Commission, which signaled to Lyondell's board of directors (the Board) that Basell may wish to engage in further discussions.¹² The Board convened a special meeting to discuss the filing.¹³ At the time, Lyondell was "a financially strong and viable company. It was not in financial distress; it was not looking to raise capital; it was not looking to spin-off one of its divisions; and it was not otherwise 'for sale' or 'on the auction block.'"¹⁴ Consequently, the Board concluded that "no immediate response [to the Schedule 13D] was required and that it would await the reaction of the market and Lyondell's major shareholders to Blavatnik's move."¹⁵ The Board also "decided to wait and see if any suitors would express an interest in the company in light of the 13D's signal to the market that Lyondell was 'in play.'"¹⁶

The market did in fact react to the 13D filing. One private equity investor contacted Mr. Smith to see if Lyondell management would be interested in a management-led buyout.¹⁷ That investor was "flatly rebuffed" because Mr. Smith "viewed such transactions as fraught with inherent conflicts of interest for both management and the Board."¹⁸ Shortly thereafter, Mr. Smith pursued negotiations with Basell, and, at one point, suggested to Basell's Chief Executive Officer, Volker Trautz, that a price of \$48 per share would be "justified."¹⁹ The Board, however, was largely unaware of these contacts.²⁰ According to the Chancery Court, "despite the signals sent to the market by Blavatnik's 13D filing . . . (and Smith's apparent anticipation of a transaction), the Board was indolent, making no effort to value the Company or to assess what options might be on the table *if* Basell (or another acquirer) made a move to acquire Lyondell."²¹

Without participation or input from the Board, Mr. Smith continued to negotiate with Mr. Blavatnik. Eventually, Mr. Smith suggested that Mr. Blavatnik make his "best" offer for the compa-

ny.²² On July 9, 2007, Mr. Blavatnik offered \$48 per share if the Board would sign a merger agreement by July 16, 2007, and agree to a \$400 million break-up fee.²³

Mr. Smith then took Mr. Blavatnik's proposal to the Board. The Board hired financial advisors and met several times over the next week, for a total of six or seven hours.²⁴ The Board also sought several concessions from Mr. Blavatnik in the merger agreement.²⁵ Mr. Blavatnik agreed to reduce the break-up fee to \$385 million, but otherwise refused to improve the terms of the deal.²⁶

Ultimately, the Board approved the premium transaction. As is typical in such situations, the merger agreement provided for a 3% termination fee, a no-shop clause, and matching rights for Basell.²⁷ The Board also agreed to pull Lyondell's shareholder rights plan as to Basell's proposal.²⁸

The Chancery Court's Decision

As usually happens after the announcement of any significant corporate transaction, litigation quickly ensued. Lyondell shareholder Walter E. Ryan brought a putative class action challenging the decision of the Board to accept the premium offer.²⁹ Despite the premium price and overwhelming shareholder approval, the plaintiff asserted breach of fiduciary duty claims, alleging, among other things, that neither the process the Board undertook to consider Basell's offer nor the deal protection measures to which the Board agreed were designed to maximize shareholder value as required by *Revlon*.

The Board moved for summary judgment on the plaintiff's claims, which the court denied in part and granted in part.³⁰ While the court granted summary judgment for the directors as to the plaintiff's disclosure claims and claims that the Board was conflicted or acted with improper motive, it denied the motion as to plaintiff's *Revlon* claims. The court concluded that issues of fact existed as to whether the directors acted with "bad faith" or "conscious disregard" of their duties, in doing "nothing (or virtually nothing) to confirm the superiority of the price but, nonetheless, [providing] Basell a full complement of deal protections."³¹ In so concluding, the court denied

the directors, at least at the summary judgment stage, the protection of Lyondell's section 102(b)(7) charter provision.³²

In rejecting the directors' argument that plaintiff, at best, stated a claim for breach of the duty of care, the Chancery Court began its analysis by acknowledging that plaintiff was required to "demonstrate that the Board either failed to act in good faith in approving the Merger or otherwise acted disloyally."³³ The court concluded, however, that "the Board's failure to engage in a more proactive sale process may constitute a breach of the good faith component of the duty of loyalty as taught in *Stone v. Ritter*."³⁴ The court explained that, in *Stone*, the "Delaware Supreme Court held that 'the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. [Rather, the duty] also encompasses cases where the fiduciary fails to act in good faith.'"³⁵ As described by the court, "[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."³⁶

The court went on to explain its denial of summary judgment stating: "[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—a known set of 'duties' requiring certain conduct or impeccable knowledge of the market in the face of Basell's offer to acquire the Company."³⁷ The court's August 29, 2008 opinion denying interlocutory appeal best summarizes its reasoning:

[O]n the summary judgment record before the Court, it appeared that: (1) the directors knew, based on the filing of a Schedule 13D with the Securities and Exchange Commission in May 2007, that the Company was "in play"; (2) despite having that knowledge, the directors did nothing (or virtually nothing) to prepare or to develop a strategy—consistent with the principles of *Revlon* and its progeny—for maximizing shareholder value in connection with a possible sale of the Company; (3) the directors did nothing (or virtually nothing)

pre-signing to confirm that a better deal could not be obtained; (4) the directors did nothing (or virtually nothing) to negotiate on Basell's offer; and (5) the directors did nothing (or virtually nothing) post-signing to verify that a better deal could not have been obtained.³⁸

Based on these facts, the Chancery Court ruled that “there exists apparent and unexplained director inaction despite their knowing that the Company was ‘in play’ and their knowing that *Revlon* and its progeny mandated certain conduct or impeccable knowledge of the market in pursuit of the best transaction reasonably available to the shareholders in a sale scenario.”³⁹

The Delaware Supreme Court's Reversal and Remand Clearly Delineate the Difference Between Gross Negligence and Bad Faith

In reversing and remanding with instructions that summary judgment be entered for the directors on their section 102(b)(7) defense, the Delaware Supreme Court held that there is a clear distinction between conduct necessary to sustain a finding of gross negligence and conduct necessary to support a finding of bad faith.⁴⁰ Indeed, as the Delaware Supreme Court noted, “[b]ecause the trial court determined that the board was independent and was not motivated by self-interest or ill will, the sole issue is whether the directors . . . breached their duty of loyalty by failing to act in good faith.”⁴¹ The Court began its analysis by noting that it had addressed the “range of conduct that might be characterized as bad faith” in *In re Walt Disney Co. Derivative Litigation*, where it held that “bad faith encompasses not only an intent to harm but also intentional dereliction of duty. . . .”⁴²

While not necessarily faulting the Chancery Court's decision to “obtain a more complete record,” the Delaware Supreme Court found that “the trial court reviewed the existing record under a mistaken view of the applicable law.”⁴³ According to the Court, at least three flaws underlie the Chancery Court's analysis: (i) an imposition of *Revlon*

duties before the Board either decided to sell or before a sale became inevitable; (ii) an assumption that *Revlon* created a fixed set of requirements that the Board had to satisfy in order to demonstrate that it obtained the highest price reasonably available; and (iii) equating an imperfect sales process with a knowing disregard of duty constituting bad faith.⁴⁴ These errors led to an improper denial of summary judgment given the Chancery Court's acknowledgment that the Lyondell Board was “‘active [and] sophisticated,’” with a general awareness of both the “‘value of the Company and the conditions of the markets in which the Company operated.’”⁴⁵

With regard to the “two months of slothful indifference” so criticized by the Chancery Court, where the Board failed to take any action following Basell's filing of a Schedule 13D, the Delaware Supreme Court found that *Revlon* duties do not arise “simply because a company is in play.”⁴⁶ Rather, the Court found that having conducted a special meeting and declining to either take any defensive measures or put up the company for sale, the Board's decision to take a “‘wait and see’ approach” was an “entirely appropriate exercise of . . . business judgment.”⁴⁷

In terms of the Board's failure to conduct an auction, conduct a market check or demonstrate “an impeccable knowledge of the market,”⁴⁸ the Court commented that while it might have been permissible to seek additional evidence on a duty of care claim, the analysis is “very different” when a court is determining whether directors “acted in good faith.”⁴⁹ Reiterating that “there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties,” the Supreme Court held that the “directors' failure to take any specific steps during the sales process could not have demonstrated a conscious disregard of their duties.”⁵⁰ The Court went on to declare that “[i]nstead 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.”⁵¹ Finding that the record “leads to only one possible conclusion,” the Court reversed and remanded “for entry of judgment in favor of the Lyondell directors.”⁵²

Conclusion

If it had been allowed to stand, the Chancery Court's liberal interpretation of bad faith would have substantially undermined the very purpose of section 102(b)(7), which was enacted in response to the seminal Delaware Supreme Court case, *Smith v. Van Gorkom*.⁵³ Significantly, although the board in *Van Gorkom* was far less active than the Lyondell Board, the conduct of the *Van Gorkom* directors only gave rise to a claim of gross negligence—not bad faith. Recall that in *Van Gorkom*, the board approved a merger that, as in *Lyondell*, had been negotiated by the Chief Executive Officer. The board held a single two-hour meeting that consisted of an oral presentation from the CEO; a statement from the company's president that he supported the merger and believed the offer was adequate; a statement from the chief financial officer that, although he had not participated in the negotiations and had not performed a valuation of the company, the price offered was "at the beginning of the [fair] range"; and legal advice about the need for a fairness opinion (the board did not have one). The directors did not read the merger agreement, and did not provide for a market check. Based on these facts, the Delaware Supreme Court concluded that the directors acted with gross negligence and awarded damages to the plaintiffs.

To that end, *Van Gorkom* acts as a measuring stick for what level of board involvement deserves section 102(b)(7) protection. The Chancery Court's overly broad interpretation of "bad faith" in *Lyondell* would have transformed conduct plainly within the *Van Gorkom* realm of grossly negligent acts [conduct that section 102(b)(7) was designed to address] into conduct that loses section 102(b)(7) protection. In unequivocally declaring that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties,"⁵⁴ the Delaware Supreme Court's reversal of *Lyondell* should put the lid back on a Pandora's Box of potential personal liability for directors and ensure that they retain the flexibility necessary to respond appropriately in considering change of control transactions.

NOTES

1. *Lyondell Chemical Co. v. Ryan*, 2009 WL 790477 (Del. 2009), opinion revised and superseded, 2009 WL 1024764 (Del. 2009) ("*Lyondell III*").
2. See, e.g., Jeff Lipshaw, *Reactions to Ryan v. Lyondell*, Legal Profession Blog, http://lawprofessors.typepad.com/legal_profession/2008/07/reactions-to-ry.html (July 31, 2008) (raising questions regarding decision); Professor Francis Pileggi, *Ryan v. Lyondell: Chancery Denies Interlocutory Appeal*, Delaware Corporate and Commercial Litigation Blog, <http://www.delawarelitigation.com/2008/08/articles/chancery-court-updates/ryan-v-lyondell-chancery-denies-interlocutory-appeal> (noting that the *Lyondell* decision "generated a substantial amount of commentary by experts and practitioners alike").
3. *Ryan v. Lyondell Chemical Co.*, 2008 WL 2923427 at *11 (Del. Ch. 2008), cert. denied, 2008 WL 4174038 (Del. Ch. 2008), and appeal granted, stay granted, 2008 WL 4294938 (Del. 2008), and decision rev'd, 2009 WL 1024764 (Del. 2009) ("*Lyondell I*").
4. *Lyondell I* at *9 n.51 (referring to the plaintiff's loyalty claims, other than those based on *Revlon*, as "general duty of loyalty claims").
5. *Lyondell III* at *1.
6. See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45, Fed. Sec. L. Rep. (CCH) P 98063 (Del. 1994) ("[A] court should not ignore the complexity of the directors' task in the sale of control. There are many business and financial considerations implicated in investigating and selecting the best value reasonably available.>").
7. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182, Fed. Sec. L. Rep. (CCH) P 92525, 66 A.L.R.4th 157 (Del. 1986) (requiring that a board in a change of control transaction seek the "highest price for the benefit of the stockholders").
8. *Lyondell III* at *1.
9. *Lyondell III* at *1.
10. *Lyondell III* at *7.
11. *Lyondell III* at *3, *7 (discussing *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 37 Employee Benefits Cas. (BNA) 2756 (Del. 2006)).
12. *Lyondell I* at *5.
13. *Lyondell I* at *5.
14. *Lyondell I* at *1.
15. *Lyondell I* at *5. Although the Chancery Court opinion did not consider the issue, because *Lyondell* had a shareholder rights plan in place, which permitted the Board to act in a deliberate manner, the decision to "stop, look, and listen" should not have been viewed as problematic. See *Lyondell I* at *8.
16. *Lyondell I* at *5.

17. *Lyondell I* at *5.
18. *Lyondell I* at *5.
19. *Lyondell I* at *5.
20. *Lyondell I* at *5.
21. *Lyondell I* at *5.
22. *Lyondell I* at *6.
23. *Lyondell I* at *6.
24. *Lyondell I* at *14.
25. *Lyondell I* at *7.
26. *Lyondell I* at *7.
27. *Lyondell I* at *8 & n.31.
28. *Lyondell I* at *8.
29. Basell's \$13 billion cash offer at \$48 per share constituted a 45% premium over the closing share price on the day before the public became aware of Basell's interest in the company, which the court recognized was a "substantial premium to market." *Lyondell I* at *1 & n.3. No higher offers came forward and Lyondell's "stockholders voted overwhelmingly" in favor of the merger. *Lyondell I* at *1.
30. *Lyondell I* at *3.
31. *Lyondell I* at *3.
32. On August 29, 2008, the court denied the directors' petition for interlocutory appeal and further clarified its July 29, 2008 ruling. *Ryan v. Lyondell Chemical Co.*, 2008 WL 4174038 (Del. Ch. 2008) ("*Lyondell II*"). On September 15, 2008, the Delaware Supreme Court agreed to hear an interlocutory appeal. *Lyondell Chemical Co. v. Ryan*, 2008 WL 4294938 (Del. 2008).
33. *Lyondell I* at *11.
34. *Lyondell I* at *11.
35. *Lyondell I* at *19 (quoting *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).
36. *Lyondell I* at *19 (quoting *Stone*, 911 A.2d at 370).
37. *Lyondell I* at *19.
38. *Lyondell II* at *1 (footnotes omitted).
39. *Lyondell II* at *4. The court's application of "bad faith" extended the reach of *Stone* and *Disney* into new territory. Reaction was swift. Shortly after *Lyondell* was decided, in another decision issued by the Delaware Court of Chancery in the *Revlon* context, the court rejected the applicability of the *Stone* and *Disney* "conscious disregard" definition of bad faith. In *In re Lear Corp. Shareholder Litigation*, 2008 WL 5704774 (Del. Ch. 2008), the plaintiff, like the plaintiff in *Lyondell*, argued that the board acted with "no care" and therefore with "bad faith" in approving a merger. The Chancery Court dismissed plaintiff's claim, explaining that "not all situations governed by *Revlon* have the strong sniff of disloyalty that was present in the original case." *Lear* at *11 n.62. The court went on to stress that when a *Revlon* case involves no allegations of "illicit directorial motive and the presence of a strong rationale for the decision taken (to secure the premium for the stockholders)," it should be difficult to sustain a disloyalty claim. *Lear* at *11 n.62. See also *McPadden v. Sidhu*, 964 A.2d 1262, 1263 (Del. Ch. 2008) ("Though what must be shown for bad faith conduct has not yet been completely defined, it is quite clearly established that gross negligence, alone, cannot constitute bad faith. Thus, a board may act badly without acting in bad faith.") (footnotes omitted).
40. *Lyondell III* at *7 (remarking that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties").
41. *Lyondell III* at *3.
42. *Lyondell III* at *3. The court went on to point out that in *Stone*, in determining what might constitute bad faith in the context of an oversight or "Caremark claim," the court "clarified any possible ambiguity about the directors' mental state, holding that imposition of liability [for bad faith] requires a showing that the directors knew they were not discharging their fiduciary obligations." *Lyondell III* at *4; see also *In re Caremark Int'l. Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (holding that to establish a claim for failure of oversight, a plaintiff must show "an utter failure to attempt to assure a reasonable information and reporting system exist").
43. *Lyondell III* at *4.
44. *Lyondell III* at *4.
45. *Lyondell III* at *5. The court also noted that there was no dispute that the Board had a basis to believe no higher bidders would emerge and that none did so during the four months between the announcement of the merger and the stockholder vote. *Lyondell III* at *5.
46. *Lyondell III* at *6.
47. *Lyondell III* at *6.
48. *Lyondell III* at *6.
49. *Lyondell III* at *6-7.
50. *Lyondell III* at *7 (emphasis added).
51. *Lyondell III* at *7.
52. *Lyondell III* at *7.
53. *Smith v. Van Gorkom*, 488 A.2d 858, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985) (overruled on other grounds by *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009)).
54. *Lyondell III* at *7.