Del. Dispatch: Clarification On Fiduciary Duties Of Controllers

By **Gail Weinstein, Philip Richter and Steven Steinman** (February 8, 2024)



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On Jan. 24, the Delaware Court of Chancery issued an important post-trial opinion in In re: Sears Hometown and Outlet Stores Stockholder Litigation that clearly set forth for the first time the fiduciary duties and standard of review applicable when a controller uses stockholder-level voting power to block actions the company's board has determined to be in the company's best interest.

The court held that Eddie Lampert, the controller of Sears Hometown and Outlet Stores Inc., had fiduciary duties, albeit of a limited nature, when he acted by written consent to amend the company's bylaws and remove two directors in an effort to block a plan, adopted by an independent committee of the board, to liquidate the company's unprofitable Hometown segment and continue its profitable outlet segment.

The court, applying enhanced scrutiny review, found that Lampert had complied with his fiduciary duties.

Key Points

Controllers have limited fiduciary duties when voting to block board actions.

The court, for the first time, clearly established that controllers have certain limited fiduciary duties when exercising their stockholder voting power to alter the status quo.

In this context, the court held, controllers have duties of good faith and due care that demand that they not harm the corporation or its minority stockholders intentionally or through grossly negligent actions. They do not have the higher-level duty that directors have to act affirmatively to promote what they believe is in the best interest of the corporation.

The court observed that there have been conflicting strains of Delaware authority as to whether controllers acting in this context have fiduciary duties. Some decisions assert that a controller can exercise stockholder-level rights free of fiduciary constraint, just as noncontrolling stockholders can. Other decisions assert that fiduciary duties do apply when a controller exercises stockholder-level rights, though they do not define these duties well.

Controllers have other fiduciary duties when influencing the board.

The court noted the other, more familiar, context in which a controller's actions implicate fiduciary duties, which was not at issue in this case. In this other context, Delaware authority has been clearer.

When a controller uses "its influence over the board and management to wield corporate power indirectly and cause the corporation to act," the controller, as it has "effectively

move[d] into the boardroom," becomes subject to the same fiduciary standards that apply to directors.

Enhanced scrutiny review applies.

The court also held, for the first time, that enhanced scrutiny review will apply to evaluate controllers' conduct when they exercise stockholder-level voting power to change the status quo.

Enhanced scrutiny, which is Delaware's intermediate standard of review, will apply, the court ruled, when a controller:

- May have had subtle conflicts — that is, no conflicts so stark, such as in a self-interested transaction, that they would give rise to stricter entire fairness review; and
- Also took action in areas traditionally reserved for the board.

Under the enhanced scrutiny standard, controllers bear the burden of proving that they acted in good faith, after a reasonable investigation, to achieve a legitimate objective, and that they used reasonable means to achieve the objective.

In this case, "While the actions [Lampert] took affected all stockholders equally, he had business agreements with the corporation [namely, certain related-party agreements entered into when the company was spun off from Sears Holdings Corp.] that could have skewed his judgment" — although these agreements tended to favor the company, the court noted. Lampert also acted in an area traditionally within the board's province, namely, deciding whether to liquidate a business.

Controllers can use stockholder-level powers to block board actions.

The decision confirms that a controller can intervene to block a board from pursuing its chosen course of action — subject to the limited fiduciary duties discussed above when the controller is affirmatively exercising voting power to change the status quo.

The court expressly rejected the plaintiffs' argument that such an intervention is inherently inequitable and always constitutes a breach of duty because it trespasses on the board's right to manage the affairs of the corporation.

Based on this decision, it appears that when a controller amends bylaws or removes directors — that is, changes the company's governance — to block a board's chosen course of action, the court will view the controller as having used its voting power to affirmatively change the status quo, even if the controller blocked the board action in order to preserve the company's operational status quo.

Lampert had, and complied with, limited fiduciary duties.

The court held that, as Lampert affirmatively exercised his voting power to change the status quo, he was subject to limited fiduciary duties. Under enhanced scrutiny review, he satisfied those duties.

The court found that Lampert acted in good faith, with the legitimate objective of blocking

what he believed, after a reasonable investigation, to be a value-destroying plan. He used reasonable means, as the bylaw amendment and director removals "were drastic but necessary" to achieve his objective, given that the board could not be convinced to drop its plan; was not open to negotiating alternative routes, such as Lampert's acquiring Homeland's inventory, Homeland itself or the entire company; and was moving unilaterally to implement its plan.

Limited fiduciary duties should not present a significant obstacle to controller actions.

We note that duties not to harm intentionally or through gross negligence should not present a significant obstacle to controller actions. These fiduciary duties are far more limited than those that apply to directors.

The court observed that, while some controller interventions involve "'bad guys' seeking with guile to protect or advance private interests," others simply involve a board and a controller having "differing, but plausible, conceptions of what constitutes right action in the circumstances."

Background

The Sears Hometown and Outlet Stores company was spun off from Sears Holdings Corp. in 2012 and became a separate, publicly traded entity. In the spin-off, the group of investment funds controlled by Lampert, which held a majority of Sears Holdings' common stock, received a majority of the Sears Hometown and Outlet Stores' common stock.

Lampert had been a largely supportive and passive investor, although the company had performed poorly. Neither Lampert nor any of his affiliates or close associates sat on the company's board of directors.

The company's Hometown segment, which represented about two-thirds of the company's assets and revenues, had been unprofitable for years — a bad business, in the board's view, and the outlet segment had recently become profitable after several years of unprofitability — a good business.

The committee endorsed a plan to liquidate Hometown and continue to operate the outlet branch. Lampert believed, and tried to convince the board, that this plan would destroy value. The board disagreed.

To avoid the board implementing the liquidation unilaterally, Lampert offered to buy the company for $2.25 per share. The board rejected the offer and ultimately countered by asking for $9.50 per share, which Lampert viewed as totally unrealistic.

Lampert suggested alternate routes, but the board rejected them. Lampert then effected the controller intervention.

Minority stockholders brought suit, claiming that Lampert had breached his fiduciary duties by using his stockholder voting power to block the liquidation plan. Vice Chancellor J. Travis Laster held that while Lampert did indeed have limited fiduciary duties, he had fulfilled them.

Discussion

Lampert believed the board's plan would be value-destroying.

Lampert believed that the committee was overestimating the proceeds that the Hometown liquidation could generate — as it would involve over 500 stores being liquidated over just eight weeks, while the company's valuation was based on its prior liquidations that had involved no more than 20 to 30 stores at a time and had taken place over a period of years.

Lampert also believed that the committee was underestimating the liabilities that would arise as a result of the liquidation, as it would cause the stores' dealer agreements to be breached, and thought that the committee was overestimating the performance of the outlet segment going forward. The outlet segment had just become successful after years of unprofitability; it might not have the necessary scale as a stand-alone entity, and it would have to assume all the liabilities arising from the liquidation.

Lampert's concerns intensified after he found no detailed analyses in the company's data room that addressed these critical issues.

Lampert acted by written consent to amend the bylaws and remove two directors.

The bylaw amendment required that a Hometown liquidation receive approval from 90% of the board at two separate board votes taken at least 30 business days apart. If the liquidation received the necessary votes at the first meeting, the board would be required to disclose the result to the stockholders.

The amendment thus did not prevent the board from pursuing the Hometown liquidation, but, as a practical matter, created a window during which Lampert could take additional actions to stop the liquidation before the second meeting. Lampert acknowledged at trial that he intended to not let the liquidation go through.

Lampert removed the two directors who, when he had met with the committee, were the most vocal supporters of the liquidation. He filled the resulting vacancies with two individuals whom he did not know personally but had been suggested to him by a friend who was a managing partner at a private equity firm. The court commented that "Lampert could be confident that [they] would support his interests, even without any direct ties between them."

Lampert sent a letter to stockholders announcing the bylaw amendment and removal of directors, and explaining his strong disagreement with the board's liquidation plan.

Consider these observations about Lampert's fiduciary duties.

The court found Lampert's true objective was not self-interested.

The board ultimately negotiated with Lampert for him to buy the company, given that Lampert had blocked the Hometown liquidation and the board believed it was not sustainable to continue with both segments. We note that if the court had viewed this end-stage transaction or some other self-interested transaction as Lampert's real or ultimate

objective, the court likely would not have concluded that he had complied with his fiduciary duties in blocking the liquidation plan.

The court emphasized that it was the committee that ultimately wanted Lampert to acquire the company, while Lampert's true objective all along was simply to block the liquidation plan that he believed was value-destroying.

The court agreed Lampert's liquidation analysis was correct.

Query to what extent the court's result was influenced by its view, which it expressly stated, that Lampert was correct that the liquidation plan would be value-destroying.

Certainly, a correct view is not required for a finding of compliance with fiduciary duties, but the court's view of the correctness, or lack thereof, of a controller's decision may influence the judicial result.

These factors may distinguish the case.

We see three potentially distinguishing features of this case.

1. Lampert had such a high level of expertise and experience, including specifically with liquidations, and the committee had apparently ignored some important real-world implications of the liquidation plan.

2. Lampert had been a largely passive investor in the company — and, indeed, in all the public companies in which he had invested. He had never before acted by written consent to amend bylaws or remove directors.

3. As the court noted, Lampert took action that was less drastic than he might have taken. His bylaw amendment did not prevent the liquidation plan, and regarding the board of directors, he removed only two directors, whom he did not replace with himself or individuals he controlled.

Practice Points

Controllers may have limited fiduciary duties when exercising stockholder voting power.

Based on this case, a controller has no fiduciary duties to the corporation and its minority stockholders when the controller:

- Decides not to sell its shares;
- Decides not to vote its shares;
- Acts to prevent dilution by the board of its control position; or
- Votes its shares against "a transaction that would alter the status quo."

However, a controller likely has limited fiduciary duties — that is, not to harm the corporation or its minority stockholders intentionally or through gross negligence — when the controller is:

- Deciding to sell shares; or
- Exercising voting power "affirmatively to change the status quo."

Of note, the decision seems to indicate that the court would view a controller's amending the bylaws or removing directors as exercising voting power affirmatively to change the status quo — even if the controller is seeking to preserve the company's operational status quo by blocking a board plan that would change the status quo.

Take appropriate care when voting to block board actions.

In Sears Hometown, although the controller had not prepared detailed analyses supporting his view, he had engaged in discussions with the committee, management and the board; understood the board's plan; and had sufficient information — including, from his own experience, about the perils of retail store liquidations, especially in a nonbankruptcy context, to make an assessment that was not grossly negligent.

Consider not fully blocking a board plan.

In Sears Hometown, the court viewed it as a factor in Lampert's favor that the bylaw amendment did not block the liquidation plan, although this provided Lampert with another opportunity to block it.

The court also noted that only two directors were removed, and they were replaced with individuals not closely associated with Lampert, although the court viewed them as likely to support the controller's interests.

Where a controller takes a series of actions, different levels of fiduciary duties may apply.

If, for example, a controller seeks to block a board plan and also seeks to buy the company, limited fiduciary duties may apply to intervening with the board plan, while buying the company would be subject to entire fairness.

In this situation, a controller should maintain a record that reflects that the objective to block the board plan is motivated by the controller's views about the plan, not by a desire to acquire the company.

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This article is part of a monthly column that delves into the most significant corporate law cases emerging from Delaware and offers practice points arising from recent court decisions.

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