February 16, 2024

Delaware Court of Chancery Holds That Controllers May Owe Fiduciary Duties When Exercising Stockholder Rights

In *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation*, the Delaware Court of Chancery (in an opinion by Vice Chancellor J. Travis Laster) clarified that, when exercising stockholder rights to alter a corporation's status quo, controllers owe duties not to harm the corporation or its minority stockholders intentionally or through gross negligence. If a controller acts as a stockholder to impair the rights of directors or the minority stockholders, the court will apply enhanced scrutiny review, requiring the controller to show that he or she acted in good faith for a legitimate objective, had a reasonable basis for believing that action was necessary and selected a reasonable means for achieving the legitimate objective. Prior to this, it had been clear that controlling stockholders owe fiduciary duties when using their influence over the board and management to cause the corporation to act, but there were competing lines of authority regarding whether any duties were owed when controllers act solely as stockholders. Analyzing this open question, the *Sears* decision, which remains subject to appeal to the Delaware Supreme Court, held that controllers are subject to fiduciary constraints when exercising their stockholder rights to alter a corporation's status quo but reiterated that controllers do not owe fiduciary duties when they exercise the right to vote or sell stock to defend themselves from corporate actions and preserve the status quo. The decision further clarified that, unlike fiduciary duties owed by directors, controlling stockholders may continue to act in their own self-interest as opposed to promoting the best interests of the corporation, so long as they do not act intentionally or with gross negligence to harm the corporation or minority stockholders.

Background

Sears Hometown & Outlet Stores (the "Company") had two businesses, Hometown Stores and Outlet Stores, and was controlled by Eddie Lampert. Hometown Stores ran into severe financial difficulties, and the Company formed a special committee that was initially authorized only to explore possible transactions with Lampert, but later was also authorized to explore any bankruptcy-related transaction. Management and the special committee began to believe that a Hometown liquidation was the best option unless an appropriately priced deal could be reached with Lampert. But Lampert believed in earnest that liquidation would destroy value because of the overly optimistic expectations of management and the special committee on the liquidation proceeds. When the special committee and Lampert could not reach agreement on price, and liquidation looked imminent, Lampert acted by written consent to thwart it by (i) amending the company's bylaws so that a liquidation of the Hometown business would require 90% approval by the board of directors in two votes at least 30 business days apart (with interim disclosure of the initial vote to stockholders) and (ii) removing two special committee directors who had most vocally supported the liquidation plan. The Court of Chancery decision referred to these actions as the "Controller Intervention."

© 2024 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this publication may be considered attorney advertising. Past representations are no guarantee of future outcomes.

With only one remaining member, the special committee decided that the only viable way forward was to continue negotiations for a sale of the Hometown business or the entire Company. Lampert agreed to buy the Company, minus Outlet Stores, for $2.25 per share. He further agreed that Outlet Stores would be sold during an 84-day go-shop period, subject to a floor price and a matching right held by Lampert. During the go-shop, a third party purchased Outlet Stores for $121 million, $1 million over Lampert's matching right. Stockholders received $2.25 from Lampert for everything but Outlet Stores, and $0.96 from the purchaser of Outlet Stores, a 76% premium over the Company's trading price. Stockholders challenged the transaction.

Court's Reasoning

In a detailed analysis, the Court of Chancery analyzed separately (i) whether Lampert had breached the duties of loyalty or care he owed as a controller in connection with the Controller Intervention and (ii) the fairness of the sale of the Company.

The court reconciled competing lines of cases and clarified that controllers owe fiduciary duties when exercising stockholder-level powers to alter the company's status quo.

Under well-established Delaware law, controllers owe fiduciary duties when they use their "influence over the board and management to wield corporate power indirectly and cause the corporation to act." According to Vice Chancellor Laster, Lampert's written consent actions did not implicate that principle because he "only used his powers as a stockholder."

The court acknowledged "competing strains of authority" on whether Lampert, as a controller, owed fiduciary duties when acting through written consent or using other stockholder rights. The court explained that "[t]he three most familiar" stockholder-level rights "are the rights to sell, vote, and sue." Addressing the right to sell and the right to vote specifically, the court held that controllers do not owe fiduciary duties when they exercise these rights to defend themselves and preserve the status quo. Controllers do owe fiduciary duties, however, when they decide to sell their shares or vote them in favor of changing the status quo at the company. The attendant standard of conduct is that a controller who "seeks to change the status quo . . . cannot harm the corporation knowingly or through grossly negligent action."

Enhanced scrutiny applies where the stockholder takes action to impair the rights of directors or the minority stockholders.

Analyzing the actions taken in connection with the Controller Intervention, the court articulated that the applicable enhanced scrutiny standard requires fiduciaries to establish that they "(i) sought to pursue a legitimate end and (ii) selected an appropriate means of achieving it." Elaborating on this standard, the court explained that fiduciaries "must show that [they] acted in good faith for a legitimate objective and had a reasonable basis for believing that action was necessary." They also must show that they "selected a reasonable means for achieving [their] legitimate objective."

In taking the written consent actions to thwart the committee's plan to liquidate the Hometown Stores, Lampert identified a legitimate objective of "[p]romoting the long-term value of the corporation within the limits of the law for the ultimate benefit of its residual claimants." The court was satisfied that this was Lampert's true objective and that he had a reasonable basis to fear that the plan to liquidate Hometown Stores would compromise the Company's long-term health. The court further found that the written consent actions were a reasonable response to the threat posed by liquidation plan. Although the court acknowledged that Lampert might have achieved the same result through some lesser response (e.g., by removing only one director or only adopting the bylaw amendment), it found that he nonetheless made "a reasonable choice among debatable tactical alternatives."

The sale of the Company to Lampert and a third party was not entirely fair.

Turning to the two-part sale of the Company, the Court of Chancery applied the entire fairness standard because the transaction "involved Lampert acquiring the Company and eliminating the minority stockholders from the enterprise." Notably, the

Company did not employ *MFW* procedural protections, and therefore, the burden of proof remained with Lampert, as controller, to demonstrate that the sale of the company was entirely fair.

As to the first prong of the analysis, fair price, the Outlet Stores business was valued at market price, while the valuation of Hometown Stores turned on the amount of net proceeds that its inventory could generate and the related third-party liabilities. The valuation for the liquidation proceeds suggested that Lampert underpaid for Hometown Stores, and that his implied control premium in the transaction was high. Therefore, the court concluded that Lampert failed to pay a fair price in the transaction.

As to the fair process prong of entire fairness, the court evaluated the sale of Hometown Stores to Lampert and the sale of Outlet Stores to the third party as a single transaction. Although evidence about the fairness of the sale process was mixed, it fell "well short of a showing that would be necessary to overcome the fair price dimension." The court was concerned that Lampert's written consent actions—though they complied with enhanced scrutiny—left the one-member Special Committee unable to bargain at arm's length.

The court awarded the plaintiffs damages of $1.78 a share (about $18 million), equal to the gap between the court's valuation of the Company ($4.99) and the total price of the transaction ($3.21).

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Andre G. Bouchard
+1-302-655-4413
abouchard@paulweiss.com

Jaren Janghorbani
+1-212-373-3211
jjanghorbani@paulweiss.com

Andrew D. Krause
+1-212-373-3161
akrause@paulweiss.com

Kyle T. Seifried
+1-212-373-3220
kseifried@paulweiss.com

Laura C. Turano
+1-212-373-3659
lturano@paulweiss.com

Counsel Frances F. Mi, Legal Consultant Cara G. Fay and associate Matt Clarida contributed to this memorandum.

Our M&A Group

The Paul, Weiss M&A Group consists of approximately 40 partners and 125 counsel and associates based in New York, Washington, D.C., Wilmington, London, Los Angeles, San Francisco, Toronto, Tokyo, Hong Kong and Beijing. The firm's Corporate Department consists of more than 75 partners and roughly 300 counsel and associates.

Our M&A Partners

Matthew W. Abbott	Benjamin Goodchild	Andreas Philipson	Sarah Stasny
Edward T. Ackerman	Ian M. Hazlett	Austin S. Pollet	Laura C. Turano
William Aitken-Davies	Roger Johnson	Ravi Purohit	Krishna Veeraraghavan
Scott A. Barshay	Robert A. Kindler	Kenneth M. Schneider	Jeremy M. Veit
Angelo Bonvino	Andrew D. Krause	Robert B. Schumer	Michael Vogel
Ellen N. Ching	David K. Lakhdhir	John M. Scott	Samuel J. Welt
Ross A. Fieldston	Brian C. Lavin	Brian Scrivani	Steven J. Williams
Brian P. Finnegan	Xiaoyu Greg Liu	Kyle T. Seifried	Kaye N. Yoshino
Adam M. Givertz	Jeffrey D. Marell	Cullen L. Sinclair	Bosco Yiu
Neil Goldman	Judie Ng Shortell	Megan Spelman	Tong Yu