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Delaware Court of Chancery: Controlling Stockholders Have Fiduciary Duties When Voting to Change the "Status Quo"

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February 7, 2024 - In a pathfinding decision, the Delaware Chancery Court has specified the standards of conduct and review that apply to a controlling stockholder's exercise of its voting rights to block board action. [1]

The post-trial opinion, delivered by Vice Chancellor J. Travis Laster on January 24, 2024, ruled that Edward Lampert, as the controlling stockholder of Sears Hometown and Outlet Stores, Inc. (the "Company"), acted consistently with his fiduciary duties in removing board members and amending bylaws in order to prevent a liquidation he deemed harmful to the Company. However, the court went on to find that Lampert's conduct nevertheless rendered his subsequent acquisition of the Company unfair.

Background

The case arose out of Lampert's acquisition of all shares in the Company that he did not already own. The Company operated two businesses, one unprofitable and the other profitable. When Lampert expressed interest in a strategic transaction with the Company, the board formed a special committee of three directors independent of Lampert to negotiate with him (the "Special Committee"). It asked Lampert to pay multiple times the price per share that he had offered and threatened that the Company would liquidate the unprofitable business if it could not agree on a transaction with him. Lampert determined that the Special Committee was motivated by inflated expectations of proceeds from such potential liquidation, ignoring the significant liabilities that a liquidation would entail.

In response, Lampert acted by written stockholder consent to remove from the board the two Special Committee members he believed were most ardently advocating a liquidation and to amend the Company's bylaws to make it procedurally more difficult for the board to effect a liquidation (the "Controller Intervention").

The remaining Special Committee member believed a transaction with Lampert to be the only viable alternative and continued to negotiate with him. The parties reached an agreement on the acquisition by Lampert of all shares of the

Company that he did not already own, subject to a right of the Company to actively shop the profitable business to third parties with a minimum floor price a third party would have to pay, Lampert's right to match any offers up to a certain threshold, and the stockholders receiving their pro rata share of any incremental value the Company would realize above the floor (the "Go-Shop"). The profitable business was then acquired by a third party, closing simultaneously with Lampert's acquisition of the Company itself.

The Controller Intervention was not a Breach of Fiduciary Duty

The court established that "*when exercising stockholder-level voting power, a controller owes a duty of good faith that demands the controller not harm the corporation or its minority stockholders intentionally. The controller also owes a duty of care that demands the controller not harm the corporation or its minority stockholders through grossly negligent action.*" [2] The court clarified, however, that a controller need not affirmatively promote the best interests of the corporation (as directors must do) by exercising its stockholder-level voting rights. Therefore, "*[a] controller does not owe any fiduciary duties when declining to vote*" or when voting to preserve the corporation's "*status quo*". [3] Delaware law had hitherto been inconclusive, with some authorities suggesting that a controller owed no fiduciary duties when exercising stockholder-level voting power and others holding that it did, but without spelling out details.

Having established the applicable standard of conduct, the court found that Delaware had not established a standard of review for a controller's exercise of stockholder voting power. It then reviewed the Controller Intervention under Delaware's intermediate standard of review, given that in seeking to prevent a liquidation, Lampert "*invaded the space typically reserved for the board of directors*" and faced a "*subtle conflict*", because one of his affiliates had business agreements with the Company. [4] Therefore, Lampert had to show that "*he acted in good faith for a legitimate objective and had a reasonable basis for believing that action was necessary*", and that "*he selected a reasonable means for achieving his legitimate objective.*" [5] The court found that Lampert had met the test, since he believed in good faith that the liquidation could not fulfill the Special Committee's "*lofty expectations*" and acted on an informed basis to prevent it, after discussing with the Special Committee and understanding its plan. [6]

The Controller Intervention Rendered the Controller's Subsequent Acquisition of the Company Unfair

The court reviewed Lampert's acquisition of the Company under the entire fairness standard, Delaware's highest level of judicial scrutiny, because he, as the controlling stockholder, acquired the Company and eliminated the minority stockholders, and did not condition such acquisition upon both the approval by a committee of disinterested and independent directors and the vote by a majority of the minority stockholders. Under the entire fairness standard, Lampert had to prove that the transaction was the result of fair dealing and reflected a fair price.

This he failed to prove. The court found that while the Go-Shop ensured that the price the Company achieved for the profitable business was fair, holding that "*there is no reason to engage in [any] valuation exercise when a market-tested price exists*" [7], Lampert failed to prove that the price allocated to the unprofitable business was fair since the estimates management used to quantify liquidation liabilities were too low. The court found that the process was not entirely fair either, since the Controller Intervention "*had tilted the playing field*" in favor of Lampert, as shown by the absence of meaningful negotiation over the value of the unprofitable business. Interestingly, the court explained that while the Special Committee was by definition composed of directors unperturbed by the risk of being removed from the board, the controller's removal of members of the committee nonetheless constituted evidence of an unfair process. [8]

Takeaways

- **A controlling stockholder can exercise its voting rights unrestricted to maintain the "status quo".**
  -While the court neither defined "status quo" nor expressly decided whether or not the Controller Intervention constituted a change of the Company's "status quo", it generally used the term to refer to the situation that existed before the controller intervened. [9] Therefore, identical corporate action might change the status quo in one case but preserve it in another.

-The court listed as examples for maintaining the "status quo" where a controlling stockholder (i) declined to sell its shares, even if such sale would benefit the minority, [10] (ii) refused to vote in favor of, or affirmatively voted against, a strategic transaction, even when the board had concluded that such transaction was in the best interests of the stockholders, [11] or (iii) adopted a bylaw amendment increasing the quorum requirement for board meetings and requiring unanimous board action to prevent the incumbent board from diluting its stake. [12]

- **When voting to change the "status quo", the controller must not harm the corporation knowingly or through grossly negligent action.** The court cited as examples for changing the "status quo" where a controlling stockholder (i) sold its shares, [13] or (ii) adopted a bylaw unanimity requirement to block a transaction it had previously committed in writing to support, seeking to implement a different transaction in its own best interest. [14]
- **The court reviews a controller's vote to change the "status quo" by adopting bylaw amendments and changing the board composition under the enhanced scrutiny standard.** The controller must show that he 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 his legitimate objective.
- **Wider Delaware adoption of the new framework remains open.** It remains to be seen whether the Supreme Court of the State of Delaware or other Chancery Court judges adopt this new framework for judicial review of controlling stockholder voting and if so, how future decisions delineate what constitutes a change of a corporation's "status quo".

For more information about this case, please contact Chuck Samuelson, Shahzeb Lari, or Alexander Rahn.

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1. In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation, C.A. No. 2019-0798-JTL, 2024 WL 262322. ↩
2. Id. at 2. ↩
3. Id. at 57, 62. ↩
4. Id. at 3. ↩
5. Id. at 69. ↩
6. Id. at 4. ↩
7. Id. at 5. ↩
8. Id. at 110. ↩
9. Id. at 4. ↩
10. Id. at 53 (citing Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987)). ↩
11. Id. at 59 (citing Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996)). ↩
12. Id. at 60 (citing Frantz Mfg. Co. v. EAC Indus. Inc., 501 A.2d 401 (Del. 1985) (quoting *"the sale process agreement had defined the status quo, and the controller breached its duties by intentionally using its stockholder power to change it, knowingly harming the company in the process"*)). ↩
13. Id. at 54 (citing Ford v. VMware, Inc., 2017 WL 1684089, at *9–13 (Del. Ch. 2017) (explaining a controller breaches its fiduciary duties when knowingly selling its shares to a looter)). ↩
14. Id. at 61 (citing Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. Feb. 26, 2004), aff'd, 872 A.2d 559 (Del. 2005) (finding the amendments sought to "*disable[] the [company] board from protecting the company from his wrongful acts.*")). ↩

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