

CLIENT ALERT

Delaware Court of Chancery Finds That Controlling Stockholders Have Limited Fiduciary Duties When Exercising Influence on Corporate Decision-Making

February 7, 2024

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On January 24, 2024, the Delaware Court of Chancery issued a ruling deciding—as a matter of first impression—the fiduciary duties owed and the standard of review that will apply when a controlling stockholder exercises its voting power to influence corporate decision-making. The ruling has important implications for private equity sponsors.

In re Sears Hometown & Outlet Stores, Inc. S'holder Litig., No. 2019-0798-JTL, 2024 WL 262322 (Del. Ch. Jan. 24, 2024), [available here](#), involved a public company that was controlled by billionaire Eddie Lampert. Neither Mr. Lampert nor any of his affiliates was a member of the company's board of directors. The company operated through two business segments. A special committee of its board of directors had endorsed a plan to liquidate one segment and continue operating the other. Mr. Lampert strongly opposed the liquidation plan, because he thought the plan was overly optimistic and did not take into account certain serious risks. Mr. Lampert expressed his concerns to the company, but the special committee was not convinced and decided to move forward anyway. At that point, Mr. Lampert, in his capacity as the majority stockholder of the company, adopted a bylaw that would create certain procedural hurdles for (but not expressly prohibit) the liquidation. Mr. Lampert also removed and replaced two of the three directors serving on the special committee, viewing them as the two biggest proponents of the liquidation plan. Minority shareholders challenged Mr. Lampert's intervention.

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The Court held that when a controlling stockholder takes action to change the status quo, it owes limited fiduciary duties to the corporation and the minority stockholders. The Court looked to Delaware precedent analyzing a controller's decisions with respect to selling and voting its shares. The Court noted that a controlling stockholder does not owe fiduciary duties when refusing to sell its shares or voting against a proposed transaction. However, the Court noted that controllers have been found to owe a limited duty when selling their shares, which is to not knowingly or recklessly harm the corporation by selling to a looter. Thus, the Court determined that a similar limited duty also should apply when a controller votes its shares to change the status quo, which is to not knowingly or recklessly harm the corporation through its actions. The Court said that, in exercising its voting powers as a stockholder, a controller need not meet the higher standard applied to directors, who must act affirmatively to promote the best interests of the corporation.

The Court also held that the controlling stockholder's actions to change the status quo are subject to the "enhanced scrutiny" standard of review, which requires the controller to demonstrate (and bear the burden to prove) that it (i) sought in good faith to pursue a legitimate objective and (ii) selected a reasonable means of achieving that objective.

The *Sears* holding is not solely applicable to publicly listed companies and applies to non-listed entities as well. The case highlights the following considerations for sponsors:

- **How to Determine the Status Quo:** In the Court's ruling, the imposition of these limited but enforceable fiduciary duties and the enhanced scrutiny standard of review turn on whether the action maintains or changes the "status quo." Although the facts of this case were relatively straightforward, it is easy to envision more complicated scenarios where it may be more difficult to determine precisely what constitutes the "status quo." As with any newly announced standard, the precise contours of its application will need to be refined in future litigation.
- **Interaction with Other Agreements:** Sponsors routinely enter into contractual agreements that grant them the right to take certain actions (such as appoint or remove directors), and may affect board decision-making when exercising those contractual rights. There is a strong argument that the exercise of contractual rights does not constitute a stockholder-level action that should trigger a higher standard of review, and further, that the contractual right to exercise those powers constitutes part of the "status quo." However, it is unclear how the Delaware courts will interpret such behavior. For example, the standard of review that would be applicable if a sponsor chose to appoint a director to fill a vacancy to sway the board's decision as to a specific matter is unclear following the *Sears* decision.
- **Carefully Document the Reasoning for Stockholder Action:** Under the enhanced scrutiny standard of review, a controller must demonstrate that it had a legitimate reason for taking the action. To do this, a controller must show both that it subjectively believed that a particular outcome is in the company's best interests and that it had an objectively reasonable basis for that belief. Here, the Court found Mr. Lampert credibly believed that the liquidation was not in the best interests of the company, based on his experience with other liquidations. The Court

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noted that Mr. Lampert “did not have a detailed slide deck or report documenting his beliefs,” but found he did not need it because he was a credible witness. Nonetheless, such documents may be helpful to corroborate witness testimony.

- **Consider How to Tailor Stockholder Action:** Under the enhanced scrutiny standard of review, a controller must also show that it chose a reasonable means for achieving that legitimate objective. To do that, a controller must show that the action it took was proportional to the need. Here, Mr. Lampert made multiple efforts to persuade the special committee, and only took action after concluding the special committee was moving forward unilaterally. Further, the action taken was less drastic than it might have been: the bylaw amendment was tailored to the liquidation, and only two directors were replaced rather than the entire board. Thus, when controllers decide to take action, it will be important to consider whether a more narrowly tailored action would be sufficient to neutralize the perceived threat.
- **Multiple Actions in a Series:** After Mr. Lampert took action to block the board’s liquidation plan, he then negotiated a transaction to buy the company. The Court held that limited fiduciary duties applied to interfering with the board’s plan, but consistent with Delaware precedent determined that the sales transaction was subject to the more stringent “entire fairness” standard of review. The outcome likely would be different in a scenario where the Court thought a controller’s concerns about a board’s plan were pretext, and the real objective motivating the decision to block the plan was to force the company into a transaction with the controller.

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