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Delaware Court of Chancery Clarifies Fiduciary Limitations on Controlling Stockholder's Exercise of Voting Power

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In a landmark decision,^[1] the Delaware Court of Chancery addressed, for the first time, the precise duties that a controlling stockholder owes, and the standard of review that will apply, when a controlling stockholder takes actions to block a board of directors’ desired course of action — such as by removing directors or enacting a bylaw requiring a unanimous vote for board action.

Specifically, the court held that when a controlling stockholder uses its voting power to change the status quo of the corporation, it owes the corporation and the minority stockholders fiduciary duties, albeit limited in nature. It must act with care and in good faith, but it need not take affirmative action to promote the best interests of the corporation. It also held that, in the factual context before it — that is an act taken to block board-level decision-making — a controlling stockholder’s actions will be reviewed under Delaware’s intermediate standard of review, enhanced scrutiny. This is a first of its kind decision that controlling stockholders, such as private equity funds, must heed before exercising voting rights to change the company’s status quo, such as seeking to block board-level action.

The court’s full opinion can be accessed [here](#). The high-level factual background and some of its major takeaways are below.

Background

The court aptly summarized the factual background of the decision as follows:

A controlled public company operated through two separate business segments. One was a bad business that steadily lost money. The other was a good business that had just achieved its first profitable year after four years of losses. A committee of independent directors endorsed a plan to liquidate the bad business and continue operating the good business... .

The company’s controlling stockholder believed that the liquidation plan would destroy value. He thought the liquidation could not generate the expected level of proceeds and would trigger additional third-party liabilities. He worried that the good business lacked scale and a track record.

The controller tried to convince the committee not to implement the liquidation plan. The committee persisted and set a hard deadline for moving forward. Perceiving no alternative, the controller used his voting power as a stockholder to adopt a bylaw amendment that prevented the board from implementing the liquidation plan The controller also removed the two committee members who he believed were the most insistent on the liquidation plan.

The court found that by taking action to change the status quo as to how the corporation was governed, the controlling stockholder assumed fiduciary duties to the company and the minority stockholders. It concluded that those duties were limited, however, to the duties of good faith and care. The stockholder did not assume the more stringent duty of acting affirmatively to promote the best interests of the corporation, to which directors are subject. The court also held that enhanced scrutiny review applied to the facts at issue here and that the stockholder's actions passed muster under that standard of review. Specifically, the court stated:

That the controller did not intend to harm the corporation and its stockholders. He believed in good faith ... that the liquidation plan could not achieve the committee's lofty expectations because the committee's advisors and management had failed to consider the extent of the third-party liabilities that the liquidation plan could trigger. Nor did the controller act in a grossly negligent manner. Although he did not prepare detailed analyses, he engaged in discussions with the committee, understood their plan, and had sufficient information — including about the perils of retail store liquidations — to make an assessment that was not grossly negligent. He also had the most to lose as a stockholder. When the controller exercised his stockholder-level voting power, he acted consistently with his fiduciary duties.

Some significant takeaways of the court's decision are below.

Takeaways

- **Controller Interference With Board Action Is Not *Per Se* Invalid.** The court confirmed that controlling stockholders are not statutorily prohibited from taking stockholder-level action to interfere with board-level decision-making, such as removing directors or enacting a bylaw requiring a unanimous vote for board action. The plaintiffs argued that because Section 141(a) of the Delaware General Corporation Law (DGCL) empowers the board of directors, not stockholders, to manage and oversee the business and affairs of a Delaware corporation, actions by a controlling stockholder to thwart board-level action are statutorily impermissible. The court disagreed, holding that majority stockholders can use their voting power to block the board's desired course of action and that such action is not prohibited as a matter of law.
- **A Controller Does Not Have Fiduciary Duties When Exercising Voting Power to Preserve the Status Quo.** The court also made clear that a controlling stockholder can use its voting power to maintain the status quo of the corporation without fear of judicial review. For example, a controller does not owe fiduciary duties when declining to sell its stock. Indeed, a stockholder, whether controlling or otherwise, is under no duty to sell its shares. This applies even where the sale would profit the minority stockholders. A controller can “say no” and maintain the status quo without becoming subject to court scrutiny. Likewise, a controller does not owe any duties when declining to vote or voting to maintain the status quo. A controller can refuse to vote in favor of, or affirmatively vote against, a transaction that would alter the status quo, even if a board of directors might

conclude that the transaction was in the best interests of the company and all stockholders. Because such decisions merely preserve the status quo, they are not subject to fiduciary review.

- **A Controller Has Fiduciary Duties When Exercising Voting Power to Change the Status Quo.** While a majority stockholder can use its voting power permissibly to preserve the status quo without fear of judicial scrutiny, a majority stockholder that seeks to use its voting power to change the status quo becomes subject to review for compliance with its fiduciary duties. Indeed, a controlling stockholder's decision to affirmatively sell implicates the controller's fiduciary duties, albeit to a limited degree. For example, consistent with the court's precedents, a controlling stockholder has and can be held to breach its fiduciary duties by knowingly or grossly negligently selling its stock to a corporate looter. Similarly, while a controller can vote no to a transaction without fear of judicial review, a controller owes limited duties when voting in favor of a transaction that alters the status quo.
- **Controller's Fiduciary Duties When Exercising Stockholder-Level Voting Power to Change the Status Quo Are Limited.** As explained by the court, a controlling stockholder's duties when exercising voting power to change the status quo are more limited than director's duties and controlling stockholder's duties when they cause the board to take certain actions on behalf of the corporation. As the court put it, "there are two separate contexts in which controller action can implicate fiduciary duties." The first context is where the controller uses its influence over the board to cause the corporation to take certain actions. The second is where the controller uses its stockholder-level voting power to make some type of change within the corporation, such as to its governance. In the first situation, "having effectively moved into the boardroom, the controller becomes subject to the *same* fiduciary standards that apply to directors." In the second, "a controlling stockholder owes fiduciary duties when exercising stockholder powers, but not the same duties a director owes." Rather, the controlling stockholders' duties are limited to not harming the corporation knowingly or through grossly negligent action.

Specifically, the court held when exercising stockholder-level voting power to change the status quo, "a controller owes a duty of good faith that demands the controller not harm the corporation or its minority stockholders intentionally" and a "duty of care that demands the controller not harm the corporation or its minority stockholders through grossly negligent action." "Directors, by contrast, must act affirmatively to promote the best interests of the corporation." "A controller need not meet that higher standard when exercising stockholder-level voting rights."

- **Enhanced Scrutiny Review Applies to a Controller's Exercise of Voting Power to Block Board Action.** It is well-settled Delaware law that entire fairness applies to any transaction in which the controlling stockholder is on both sides of the transaction or receives a nonratable benefit. It is also well-settled that enhanced scrutiny applies when directors take actions to intervene in elections or other issues involving corporate control. Until now, however, no Delaware case had ever decided what standard of review should apply to the reverse situation — where a stockholder exercises stockholder-level voting power to thwart board-level action. The court, here, holds that enhanced scrutiny applies given the subtle, situational conflicts that arise in such situations.

- **Enhanced Scrutiny Is a Reasonableness Test.** Under enhanced scrutiny review, a controller must demonstrate that it (i) sought to pursue a legitimate end and (ii) selected a reasonable means of achieving it. The first element has subjective and objective components. The controller must subjectively believe that a particular outcome is in the corporation's best interests. It must also have an objectively reasonable basis for that belief, obtained through a reasonable investigation. Under the second element, the controller must have chosen a reasonable means for achieving his proper objective — that is one that is proportional to the need for such action.
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[1] *In re Sears Hometown and Outlet Stores, Inc. S'holder Litig.*, C.A. No. C.A. No. 2019-0798-JTL (Del. Ch. Jan. 24, 2024).

Mike Swallow also contributed to this article. He is not admitted to practice law in any jurisdiction, and his bar admission is pending.

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