IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

HILLS STORES COMPANY and HILLS DEPARTMENT STORES COMPANY,

Plaintiffs,

v.

MICHAEL BOZIC, SUSAN E. ENGEL, THOMAS H. LEE, RICHARD B. LOYND, NORMAN S. MATTHEWS, JAMES L. MOODY, JR., and JOHN G. REEN,

Defendants.

Civil Action No. 14527

GAYLE DOLOWICH, IVAN J. DOLOWICH,and JOSEPH WEISS, On Behalf of Themselves and All Other Similarly Situated, and On Behalf of Hills Stores Company, a Delaware Corporation.

Plaintiffs,

v.

CHAIM Y. EDELSTEIN, JOHN W. BURDEN, III, MARK DICKSTEIN, MARK L. KAUFMAN, DAVID BRAIL, MARK D. BRODSKY, SAMUEL L. KATZ, DICKSTEIN PARTNERS, INC., MICHAEL BOZIC, SUSAN E. ENGEL, THOMAS H. LEE, RICHARD B. LOYND, NORMAN S. MATTHEWS,

Civil Action No. 14460

JAMES L. MOODY, JR., and JOHN G. REEN,

Defendants,

-and-

HILLS STORES COMPANY,

Nominal Defendant.

PETER M. FUSCO, On Behalf of Himself and All Other Similarly Situated, and On Behalf of Hills Stores Company, a Delaware Corporation,

Plaintiff,

V.

CHAIM Y. EDELSTEIN, JOHN W. BURDEN, III, MARK DICKSTEIN, MARK L. KAUFMAN, DAVID BRAIL, MARK D. BRODSKY, SAMUEL L. KATZ, DICKSTEIN PARTNERS, INC., MICHAEL BOZIC, SUSAN E. ENGEL, THOMAS H. LEE, RICHARD B. LOYND, NORMAN S. MATTHEWS, JAMES L. MOODY, JR., and JOHN G. REEN,

Defendants,

-and-

HILLS STORES COMPANY,

Nominal Defendant.

Civil Action No. 14787

MEMORANDUM OPINION

Argued: October 1, 1996
Decided: March 25, 1997

David C. McBride, Esquire and Martin S. Lessner, Esquire of YOUNG, CONAWAY, STARGATT & TAYLOR, Wilmington, Delaware; Alan R. Friedman, Esquire and Jonathan M. Wagner, Esquire of KRAMER, LEVIN, NAFTALIS & FRANKEL, New York, New York; Attorneys for Plaintiffs, Hills Stores Company and Hills Department Stores Company.

Joseph A. Rosenthal, Esquire, and John G. Day, Esquire, of ROSENTHAL, MONHAIT, GROSS & GODDESS, P.A., Wilmington, Delaware; Martin D. Chitwood, Esquire, Craig G. Harley, Esquire, and Christi A. Cannon, Esquire, of APPEL CHITWOOD & HARLEY, Atlanta, Georgia; Attorneys for Stockholder Plaintiffs.

Kevin G. Abrams, Esquire, Thomas A. Beck, Esquire, and Russell C. Silberglied, Esquire of RICHARDS, LAYTON & FINGER, Wilmington, Delaware; John D. Donovan, Jr., Esquire, Laurie R. Wallach, Esquire, and Robert G. Jones, Esquire of ROPES & GRAY, Boston, Massachusetts; Attorneys for Former Director Defendants.

BALICK, VICE CHANCELLOR

The plaintiff Hills Stores Company ("Hills Stores") is the corporate parent of the plaintiff Hills Department Stores Company ("Hills Department Stores"), a regional retailer operating 156 stores in eleven mid-Western and mid-Atlantic states. They seek to recover severance benefits in excess of $30 million that were paid to six former key executives and a consultant under agreements that provide those benefits in the event of an unapproved change in control ("employment agreements"). The defendants are former directors of Hills Stores and Hills Department Stores.

In June 1995, Dickstein Partners, Inc. ("Dickstein Partners") conducted a successful proxy contest to elect its slate of nominees as the Hills Stores' board.[1] The plaintiffs claim that the former directors breached their fiduciary duty by refusing to approve the change in control and other conduct at a special board meeting during the week before the election. They also claim that the amount of severance benefits paid was greater than provided in the employment agreements.

The former directors have filed a motion to dismiss for failure to state a claim upon which relief can be granted. To the extent that the complaint challenges defensive actions, the former directors must satisfy the enhanced scrutiny standard, which cannot be determined on a motion to dismiss. I also

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[1]The defendants' opening brief says that Dickstein Partners then owned 8.8% of Hills' voting stock.

conclude that the allegations of improper purpose and the contract claim are sufficient to survive the former directors' motion to dismiss.

The former directors also assert affirmative defenses based on the settlement agreement terminating Dickstein Partners' earlier consent solicitation and the court order approving the parties' settlement of an earlier case challenging the employment agreements ("Weiss judgment"). Because the plaintiffs are challenging the former directors' conduct after the settlements, I conclude that they do not bar the plaintiffs' claims.

PLAINTIFFS' ALLEGATIONS

The Hills Stores complaint includes three claims for relief: breach of fiduciary duty, unjust enrichment, and breach of contract. The complaints in the two pending derivative actions include essentially the same breach of fiduciary duty claim. The following is a summary of the plaintiffs' allegations.

On August 16, 1994, Dickstein Partners commenced a consent solicitation to remove four of the seven-member Hills Stores Board and replace them with Dickstein Partners' nominees.

On August 19, 1994, the former directors caused Hills Department Stores to enter into employment agreements providing substantial severance benefits in the event of an unapproved change in control.

On August 24, 1994, Joseph H. Weiss filed a derivative and class action in this court claiming that the former directors breached their fiduciary duty by entering into the employment agreements.

On September 23, 1994, Hills Stores and Dickstein Partners entered into a settlement agreement. Dickstein Partners agreed to terminate its consent solicitation and not to prosecute any claim with respect to the employment agreements.

On September 30, 1994, the parties to the Weiss case entered into a Memorandum of Understanding contemplating a stipulation of settlement.

On December 16, 1994, the parties entered into a Stipulation of Agreement of Compromise, Settlement and Release superseding the Memorandum of Understanding.

On February 1, 1995, Hills Department Stores adopted a Supplemental Executive Retirement Plan providing that all retirement benefits would be accelerated upon any change in control.

On March 20, 1995, this court entered a final order and judgment approving the parties' settlement of the Weiss action.

On May 3, 1995, Dickstein Partners made a proposal to purchase all shares of Hills Stores and thereafter commenced a proxy contest seeking to elect a new slate of directors. The former directors opposed the Dickstein Partners' slate, nominated themselves to continue as directors, and recommended that the stockholders reject the Dickstein Partners' nominees. The complaints in the derivative actions quote Dickstein Partners' proxy statement announcing its plan to acquire all of Hills Stores' outstanding stocks for $27 per share or to conduct an auction to obtain a higher price.

On June 16, 1995, the former directors convened a special board meeting, which continued until the annual stockholders meeting on June 23, 1995. After concluding from reports on the status of the proxy contest that the Dickstein Partners' nominees would be elected, the former directors took the following actions: established and funded trusts to provide for the immediate payment of the severance benefits, causing Hills Department Stores to breach certain loan covenants and impairing the plaintiffs' relationships with those lenders; purported to consider, but refused to approve, the change in control, giving the key executives an incentive to resign rather than inducing them to remain; and amended the agreements to provide for payments upon a change in control of Hills Stores as well as of Hills Department Stores, as originally drafted.

On July 3, 1995, the last business day before the results of the election were to be certified, defendant Reen provided the trustee with a schedule of payments that were greater in several respect than provided in the employment agreements.

On July 5, 1995, the parties to the employment agreements resigned their positions with the companies and received their severance benefits.

On July 20, 1995, it was announced that the Dickstein Partners' plan to acquire or auction the Hills Stores stock was abandoned because of the costs of the change in control.[2]

SUFFICIENCY OF CLAIMS

The former directors' motion to dismiss the claim that they breached their duty by refusing to approve the change in control ultimately rests on their interpretation of the employment agreements. Noting that their decision to oppose the Dickstein Partners' nominees is not challenged, the former directors maintain that approving the change in control after losing the election would have defeated the agreements' purpose and been a breach of contract. They contend that it necessarily follows that their decision not to approve the change in control was a proper exercise of business judgment.

The plaintiffs argue that one of the purposes of the agreements was to induce the key executives to remain after a change in control. The plaintiffs

[2]Dickstein Partners' failure to follow through with the stock purchase is the subject of litigation pending elsewhere.

point out that the agreements also protect the executives in the event of an approved change in control. Because the agreements define change in control to include a contested election, they maintain that the definition of "Approved Change in Control" must include the power to approve a change in control resulting from an contested election.

The plaintiffs' complaint alleges that the former directors' course of conduct demonstrates that they were not pursuing the interest of the corporation. The plaintiffs' allegation that the board purported to consider whether to approve the change in control after concluding that the Dickstein Partners' nominees would win suggests that the board's interpretation of the agreements then differed from the interpretation they argue now. Whatever the actual circumstances might prove to be, the court cannot conclusively interpret the contract at this stage of the proceedings without giving the parties an opportunity to offer evidence on the issue.

Even if the former directors' interpretation of the agreements is correct, or they had a good faith belief that it was, it is questionable how amending the agreements to apply to a change in control of Hills Stores or establishing trusts for the purpose of immediately paying the severance benefits were in the interest of the corporation.

The former directors argue that the amendment was simply to correct a clerical error in the agreements. But that is a matter of proof that cannot be decided on the face of the complaint. They argue that it was surely proper to provide for the performance of the agreements. But that does not answer the plaintiffs' allegation that establishing the trusts harmed the interest of the corporation by causing it to breach covenants with lenders and depriving the new board of an opportunity to persuade the key executives to remain with the corporation.

The former directors argue that the challenged acts cannot be considered defensive because the complaint alleges that they acted when they knew that the Dickstein Partners' nominees would win the election.[3] But the election of its slate was the first step in Dickstein Partners' plan to acquire or auction all shares of Hills Stores. If the former directors acted for the purpose of thwarting that plan, the board's acts could nonetheless be deemed defensive.[4] For these

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[3]The defendants point out that the former board was not financially interested because less than a majority, namely, three of the seven-member board, personally benefitted from the employment agreements.

[4]When a board provides severance benefits for a defensive purpose, its action is subject to enhanced scrutiny. MAI Basic Four, Inc. v. Prime Computer, Del.Ch., C.A. No. 10428, Hartnett, V.C. (Dec. 20, 1988), Mem. Op. at 3. The defendants misread Tate & Lyle PLC v. Staley Continental, Inc., Del.Ch., C.A. No. 9813, Hartnett, V.C. (May 9, 1988) and Nomad Acquisition Corporation v. Damon Corporation, Del.Ch., C.A. Nos. 10173, 10189, Hartnett, V.C. (Sept. 20,

reasons, it is likely that some or all of the defendants' conduct at issue in this case will be subject to enhanced scrutiny, which cannot be given on a motion to dismiss for failure to state a claim upon which relief can be granted.[5]

Even if the business judgment presumption applies, I would conclude that the allegations of improper purpose are sufficient to survive the defendants' motion to dismiss. Directors must always act in what they believe in good faith to be in the best interest of the corporation.[6] The plaintiffs allege that the defendants acted in bad faith. It may turn out that the plaintiffs' proof does not overcome the presumption that the former directors acted in good faith. But on a motion to dismiss, the court assesses the legal sufficiency of the complaint, not the probability of success. The plaintiffs have pled sufficient factually specific allegations to create a fair inference that in reacting to their defeat by the Dickstein Partners' nominees the former directors might have been motivated by concerns other than the best interest of the corporation and its stockholders.

1988) as holding otherwise.

[5]In re Santa Fe Pac. Corp. Shareholder Lit., Del.Supr., 669 A.2d 59, 72 (1995).

[6]Guth v. Loft, Inc., Del.Supr., 5 A.2d 503 (1939).

AFFIRMATIVE DEFENSES

The defendants assert affirmative defenses based on the plaintiffs' agreements to settle the Weiss case and the 1994 consent solicitation. A complaint is subject to dismissal under rule 12(b)(6) only when the existence of the defense clearly appears on the face of the pleading.[7]

COLLATERAL ESTOPPEL

The Weiss case included a claim that the board breached its fiduciary duty in entering into the employment agreements. As part of their settlement, the parties agreed to amend the employment agreements. The Weiss judgment includes the following provisions:

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> 7. All claims, rights, causes of action, suits, demands, matters and issues, known or unknown (except claims arising from any breach of the terms of the Stipulation), that arise now or hereafter out of, or relate to, directly or indirectly, or that are, were, or could have been asserted in connection with, the subject matter of the Action including, without limitation, claims
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> > (a) relating to or arising out of the Stock Repurchase Program, the Stockholder Rights Plan, the Employment Agreements (all as defined in the Stipulation), including any modifications to the Employment Agreements as provided for in the Stipulation, or any of the transactions or events

[7]Wright & Miller, Federal Practice and Procedure: Civil 2d § 1357.

described in the Complaint or the Amended Complaint in the Action; or

(b) relating to the fiduciary or disclosure obligations of any of the defendants (or persons to be released), or any public statements, announcements or other activities with respect to any of the foregoing,

that have been brought or could be brought by plaintiff, Hills, the stockholders of Hills, or any member of the Class, or the Class members' respective heirs, executors, administrators, successors, assigns or transferees, regardless of whether brought directly, individually, derivatively, representatively or in any other capacity against any of the defendants named in the Action or the respective present or former officers, directors, stockholders, employees, agents, attorneys, representatives, advisors, financial advisors, investments bankers, commercial bankers, lenders, accountants, insurers, trustees, affiliates, parents, subsidiaries (including the directors and officers of such affiliates, parents and subsidiaries), general and limited partners and partnerships, heirs, executors, personal representatives, estates, administrators, predecessors, successors and assigns of defendants or of any affiliate parent or subsidiary of any defendant are hereby compromised, settled and released.

....

9. Without affecting the finality of this Order and Final Judgment, this Court shall retain continuing jurisdiction for the purposes of implementing the Stipulation and the terms of this Order, including the resolution of any disputes that may arise with respect to the interpretation or effectuation of any of the provisions of the Stipulation.

While the defendants' motion to dismiss was pending in this court, a New York court purported to interpret the Weiss settlement agreement in an action by Hills Stores against Smith Barney, Inc., the former directors' financial advisor.[8] The New York court ruled that Hills Stores is barred from pursuing its claims by the broad language releasing all claims that relate to the employment agreements. The defendants contend that that ruling precludes the plaintiffs' claims in this case.

Since the settlement of a derivative or class action must be approved by the court, it follows that the court's final judgment and order must control. The Weiss settlement agreement includes substantially the same language releasing claims as the Weiss judgment. The court expressly retained jurisdiction to resolve disputes over the interpretation of its order. Considering this court's interest in the interpretation and effect of its orders approving settlements, I doubt it would give preclusive effect to a foreign court's interpretation of this court's order. Assuming that it would, there are several reasons why the New York court's interpretation does not preclude the plaintiffs' claim.

The New York court's ruling is based on language that is not in the Weiss judgment, but was in the parties' earlier memorandum of understanding,

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[8] Hills Stores Co. v. Smith Barney, Inc., N.Y.Supr., Index No. 122247/95, Crane, J. (April 3, 1996).

which was expressly superseded by the later settlement agreement. Since the language interpreted by the court is not included in the Weiss judgment, the New York interpretation cannot preclude the issue presented in this case.

Even if the New York court's ruling could collaterally estop this court's interpretation of its own order, there are two alternative reasons why it would not. Delaware gives a foreign judgment the same effect as would be given in the foreign jurisdiction.[9] The New York court's interpretation of the Weiss settlement agreement was an alternative ground for the court's holding that Hills Stores' claim was barred by its letter engaging Smith Barney. Thus, the court's interpretation of the settlement agreement was not essential to its judgment.[10] Moreover, the court interpreted the agreement as a matter of law. New York courts do not give preclusive effect to a ruling on an issue of law.[11] Having concluded that collateral estoppel does not apply, I now turn to the defendants' contentions that the Weiss judgment bars the plaintiffs' claims.

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[9]Columbia Cas. Co. v. Playtex FP, Inc., Del. Supr., 584 A.2d 1214, 1217 (1991).

[10]Koch v. Consol. Edison Co.of New York, Inc., N.Y. Ct. App., 468 N.E.2d 1, 4 (1984), cert. denied, 469 U.S. 1210 (1985); Restatement, Second, Judgments § 27 cmt. i (1982).

[11]American Home Assur. v. Intern. Ins. Co., N.Y. Ct. App., 641 N.Y.S.2d 241 (A.D. 1 Dept. 1996).

WEISS JUDGMENT

The defendants argue that the present claims are barred by the language of the Weiss judgment releasing all claims that arise thereafter relating to the employment agreements. The defendants interpret the Weiss judgment broadly by focusing on the reference to claims "...that arise now or hereafter out of, or relate to, directly or indirectly...." Those clauses refer to "the subject matter of the Action..." The Weiss action, insofar as is pertinent here, challenged the former directors' decision to enter into the employment agreements. The plaintiffs do not challenge that act. Rather, they claim that the former directors' later decision not to approve the change in control and other later acts violated their fiduciary duty.[12] The alleged breaches of fiduciary duty during the 1995 proxy contest occurred after the Weiss judgment. Since the plaintiffs' claims in this case do not arise from the same set of operative facts as the claims in the Weiss case, the Weiss judgment does not bar the plaintiffs' claims.[13]

The defendants argue that the Weiss judgment extinguishes a remedy for the alleged misconduct relating to the employment agreements in precisely the

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[12] Cf. Moran v. Household Intern., Inc., Del.Supr., 500 A.2d 1346, 1354 (1985)(it may be proper to adopt a defensive device but improper to use it in later circumstance).

[13] Nottingham Partners v. Dana, Del. Supr., 564 A.2d 1089, 1107 (1989).

same manner as damages claims for due care violations are extinguished under 8 Del. C. § 102(b)(7). The point is that the statute does not permit a charter to eliminate or limit liability for "any breach of the director's duty of loyalty" or "for acts or omissions not in good faith...." I see no reason why the public policy behind § 102(b)(7) should not also apply to settlement agreements. Thus, in overruling on an objection to a proposed settlement of a class action on the ground that it would grant directors immunity from liability for future breaches of fiduciary duty, this court ruled that the settlement would not be given that interpretation.

> Next, the Initiative's letter stated that settlement of the action would bar any and all "future" claims and causes of action. This statement is misleading, and falsely indicates that the settlement will permit Shearson to manage and operate the partnership in the future with complete immunity from litigation. In fact, the settlement terms, as confirmed at the argument on the application, contemplates a release of all existing and potential claims which arise out of the facts that were or could have been alleged in this litigation. It does not bar unit holders from asserting future claims based upon actions or inactions of the defendants occurring after this litigation. See Sternberg v. O'Neil et al., Del.Ch., C.A. No. 8592, Chandler, V.C., slip op. at 7-15 (Nov. 9, 1989).

In re Union Square Associates Securities Litigation, Del.Ch., C.A. No. 11028, Chandler, V.C. (Dec. 18, 1990), Mem. Op. at 13.

The defendants rely heavily on Hob Tea Room v. Miller as authority that a party to a settlement agreement may release further claims arising thereafter.[14] In October 1945, the parties in Hob Tea Room entered into a contract for the sale of all of the stock of a corporation. The contract arguably provided that the seller would be entitled to any later tax refund related to the time period before the date of sale. In December 1947, the parties settled other clams and gave each other general releases of any further claim pertaining to the original contract. In June 1948, the purchaser received a tax refund. The issue was whether the general release barred the seller's claim for a portion of the tax refund. Even though neither party had a tax refund in mind when they gave each other general releases, the court held that the release barred the seller's claim.

Hob Tea Room is consistent with the usual interpretation of language releasing any further claim arising thereafter as referring to claims based on past conduct or events that cause future injury or effects.[15] Hob Tea Room is not authority that one may grant a director immunity for future disloyal or bad faith acts.

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[14] Hob Tea Room v. Miller, Del.Supr., 89 A.2d 851 (1952).

[15] Sternberg v. O'Neil, Del.Ch., C.A. No. 8592, Chandler, V.C. (Nov. 9, 1989), Mem. Op. at 7-15.

HILLS-DICKSTEIN SETTLEMENT

The defendants argue that the plaintiffs' claims are barred by the settlement agreement between Hills Stores and Dickstein Partners. In that agreement, Dickstein Partners and its affiliates agreed to discontinue their 1994 consent solicitation. They further agreed that they

> shall not, alone or in concert with others, directly or indirectly, (i) institute, prosecute or pursue against (or in the right of) the Company (or, if applicable, the New Holding Company) (or any of the Company's or the New Holding Company's officers, directors, representatives, trustees, employees, attorneys, advisors, agents, affiliates or associates) any claim, action, complaint, cause of action, debt, demand or suit (individually a "Claim" and collectively, "Claims") with respect to (x) those certain employment agreements dated as of August 19, 1994, between Hills Department Store Company and certain executive officers of the Company or that certain consulting agreement dated as of August 19, 1994, between Hills Department Store Company and a consultant to the Company (or any changes thereto resulting from the settlement of any Claims arising therefrom)....

There are several reasons why that agreement does not bar the plaintiffs' claims. Dickstein Partners promised not to pursue "against (or in the right of)" Hills Stores or its directors any claim "with respect to" the employment agreements. That promise would not bar a claim by Hills Stores against its former directors unless the distinction between Hills Stores and Dickstein Partners as separate corporate entities were ignored. Moreover, a promise to grant directors immunity for future disloyal or bad faith acts would, for the reasons given above, be unenforceable.

ORDER

For the reasons stated in the memorandum opinion filed with this order, it is ordered that the defendants' motion to dismiss is DENIED.

Mar 25, 1997
Date

Bernard Balick
Vice Chancellor