

**UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS**

ROBERT F. BOOTH TRUST, derivatively on)
behalf of nominal defendant SEARS HOLDINGS)
CORPORATION,)

No. 1:09-cv-05314

Plaintiff,)

Hon. Ronald A. Guzman

v.)

WILLIAM C. CROWLEY, EDWARD S.)
LAMPERT, STEVEN T. MNUCHIN,)
RICHARD C. PERRY, ANN N. REESE,)
KEVIN B. ROLLINS, EMILY SCOTT, and)
THOMAS J. TISCH,)

Defendants,)

and)

SEARS HOLDINGS CORPORATION,)

Nominal Defendant.)

**PLAINTIFFS' MEMORANDUM OF LAW
IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS**

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TABLE OF CONTENTS

PRELIMINARY STATEMENT.....1

FACTS.....2

A. Section 8 Prohibits Interlocking Directors on The
Boards of Competing Companies.....2

B. Sears’ Apparel and Automotive Businesses.....3

C. Defendants Crowley and Reese are Interlocking
Directors in Violation of Section 8.....3

D. Sears and its Board Knew That Sears’ Interlocking Directors
Were a Conflict of Interest and Illegal.....4

1. Aylwin Lewis’ Employment Agreement With Sears
Prohibited Him From Joining the Board of a Competitor.....4

2. Sears’ Severance/Non-Compete Agreements
Prohibit Sears Executives From Working for
Sears Competitors, Including “AutoZone”.....4

3. The Company’s Own Codes of Conduct Prohibit
Conflicts of Interest and Competition With Sears.....6

E. Lampert Dominates, Controls and Influences the Sears Board.....6

ARGUMENT.....7

A. Demand Is Excused Because Defendants’ Violations of Section 8
Were *Per Se* Illegal, Cannot Be Ratified By Shareholder Vote,
And Were Not a Valid Exercise of Business Judgment.....8

1. The Board’s *Ultra Vires* Acts
Excuse Demand as a Matter of Law.....9

2. Defendants Were Grossly Negligent,
Acted Intentionally and/or In Bad Faith.....10

B. The Board Lacks Independence Because It Is
Controlled, Dominated and Influenced By Lampert.....13

CONCLUSION.....15

Plaintiffs respectfully submit this opposition to the motion of Defendants William C. Crowley (“Crowley”), Edward S. Lampert (“Lampert”), Steven T. Mnuchin (“Mnuchin”), Richard C. Perry, Ann N. Reese (“Reese”), Kevin B. Rollins, Emily Scott, and Thomas J. Tisch (“Tisch”), to dismiss this action under Rules 12(b)(6) and 23.1(b)(3).

PRELIMINARY STATEMENT

Defendants’ motion should be denied because the Complaint adequately alleges why a pre-suit demand on the Sears board is futile and thus excused.

The board of Sears Holdings Corporation (“Sears” or the “Company”) nominated Defendants Crowley and Reese for re-election to the Sears board of directors in 2009 and recommended that shareholders vote for them. ¶59.¹ This action was *ultra vires* – literally, “beyond the powers” of the board – and illegal under Section 8 of the Clayton Act (“Section 8”), 15 U.S.C. § 19, which prohibits a director from simultaneously serving on the boards of competing companies. *See Protectoseal Co. v. Barancik*, 484 F.2d 585, 589 (7th Cir. 1973). Crowley cannot serve both as a Sears director and as a director, as he does, of AutoZone, Inc. (“AutoZone”) and AutoNation, Inc. (“AutoNation”), because they compete with Sears in the auto parts and repair business. Similarly, Reese cannot serve as a Sears director while she sits, as she does, on the board of Jones Apparel Group, Inc. (“Jones Apparel”), a competitor of Sears in the area of apparel, footwear and accessories. Under Delaware law, the board’s illegal and *ultra vires* acts are void, and because a majority of the current Sears board committed the challenged *ultra vires* acts, any pre-suit demand on them is excused. *See In re InfoUSA, Inc. Shareholders Litig.*, 953 A.2d 963, 988 (Del. Ch. 2007) (“demand will be excused if a majority of the board

¹ Citations to “¶__” refer to Plaintiffs’ Complaint, dated Oct. 13, 2009 [DE 45]. Citations to “Decl. Ex. __” refer to the Declaration of Kenneth J. Vianale and the exhibits attached thereto, filed concurrently herewith. On a motion to dismiss, the Court may take judicial notice of public disclosures, filed with the Declaration and/or referenced in the Complaint, without converting Defendants’ motion into one for summary judgment. *See* Fed. R. Evid. 201; *Hecker v. Deere & Company*, 556 F.3d 575, 582-83 (7th Cir. 2009) (affirming the application of a “liberal standard” in noticing material outside of the complaint); *Pugh v. Tribune Co.*, 521 F.3d 686, 691 n.2 (7th Cir. 2008) (taking judicial notice of “documents in the public record, including publicly reported stock prices”).

that allegedly pursued the *ultra vires* action remains on the defendant board at the time demand is made”). In addition, Defendants lack independence precisely because of their *ultra vires* acts, thus excusing demand for a second independent reason.

Defendants’ argument that the Complaint must show intent, bad faith, or gross negligence is incorrect because Delaware law dispenses with the futile exercise of making a pre-suit demand on the same board that committed the challenged *ultra vires* acts, regardless of the mental state of the individual board members who engaged in the *ultra vires* acts. Nevertheless, the Complaint, together with Sears’ own public filings adequately show that the board acted with intent, bad faith and/or gross negligence. Accordingly, any pre-suit demand is excused.

FACTS

A. Section 8 Prohibits Interlocking Directors on The Boards of Competing Companies

Section 8 prohibits a person from serving as a director or officer of two or more corporations if: (a) the combined capital, surplus and undivided profits of each of the corporations exceeds \$26,161,000; (b) each corporation is engaged in commerce; and (c) the corporations are competitors with certain threshold competitive annual sales.² Although Section 8 contains certain exemptions, none apply here. ¶¶1, 69, 74. The U.S. government has twice sued Sears, Roebuck & Co. (“Sears Roebuck”), now a Sears subsidiary, and its directors for Section 8 violations.³

² Defendants state in a footnote on page 4 of their brief that in order to establish competition under Section 8 a court “may” apply the standards of reasonable interchangeability, cross-elasticity and other factors that were used by one trial court in Maryland. *American Bakeries Co. v. Gourmet Bakers, Inc.* 515 F. Supp. 977, 980 (D. Md. 1981). Defendants fail to point out, however, that the Seventh Circuit expressly rejected that kind of complex analysis. *Protectoseal Co. v. Barancik*, 484 F.2d 585, 588-89 (7th Cir. 1973) (stating that Congress did not intend “the legality of an interlock to depend on the kind of complex evidence that may be required in a protracted case arising under §7 [of the Clayton Act]”); *see also TRW, Inc. v. The Federal Trade Commission*, 647 F.2d 942, 946-47 (9th Cir. 1981) (citing *Protectoseal* and holding that the purpose of Section 8 would “not be well served by requiring proof of high cross-elasticity of demand between competing products or low-friction interchangeability of use”). In any event, Defendants raise matters of proof which are not at issue on this motion.

³ *See U.S. v. Sears, Roebuck & Co.*, 112 F. Supp. 336 (S.D.N.Y. 1952) (shortly after the government sued, John M.

B. Sears' Apparel and Automotive Businesses

On March 24, 2005, Kmart Holding Corporation (“Kmart”) merged with Sears Roebuck to form Sears. ¶6. Since merging with Kmart, Sears operates in three business segments – Kmart, Sears Domestic and Sears Canada – and for fiscal 2008 broke down its segment sales as follows: Kmart (\$16.219 billion); Sears Domestic (\$25.315 billion); Sears Canada (\$5.236 billion). ¶23. The Sears Domestic segment operates 929 broadline stores of which 856 are full-line stores located across all 50 states and Puerto Rico. ¶25.

According to Sears, its full-line stores, in all three of its business segments, offer a wide array of products including “apparel, footwear and accessories for the whole family.” ¶25. These areas of business compete with Jones Apparel, which offers similar products. ¶30-37. In addition, Sears sells a variety of auto parts and accessories in all three business segments and online. ¶¶38-39. Sears also services and repairs cars at its Sears Auto Centers. ¶40. Sears operates 782 Auto Centers in association with its full-line stores, 27 Auto Centers out of its Essentials/Grand Stores and 30 free standing and independently operated Auto Centers. ¶38. These areas of business compete with AutoZone, ¶42-45, and AutoNation, ¶47-52.

C. Defendants Crowley and Reese are Interlocking Directors in Violation of Section 8

Defendants Crowley and Reese are “interlocking” directors within the meaning of Section 8. ¶2. Crowley is a member of the Sears Finance Committee and also sits on the boards of AutoZone, a competitor of Sears in the area of automotive parts and accessories, and AutoNation, a competitor of Sears in the area of automotive service and repair. ¶2, 38-52.⁴

Hancock, a Sears Roebuck director, voluntarily resigned from the board of Bond Stores, Inc.); *U.S. v. Sears, Roebuck & Co.*, 111 F. Supp. 614 (S.D.N.Y. 1953) (granting summary judgment against Sears Roebuck and Sidney J. Weinberg, a director of both Sears Roebuck and The B.F. Goodrich Company, for violating Section 8).

⁴ Defendants do not and cannot challenge the fact that Sears competes with Jones Apparel, AutoNation and AutoZone. ¶22-52. In fact, Defendants implicitly concede that Sears competes with all three companies when they state as their sole factual defense to this action (not implicated on this motion) that the “properly defined ‘competing sales’ attributable to Sears are below the *de minimus* threshold set forth in section 8.” Joint Initial Status Report, dated Nov. 3, 2009, at 5 [DE 47]. Of course, such a limited defense is difficult to reconcile with Sears’ admissions

Reese is Chair of the Sears Audit Committee and also sits on the board of Jones Apparel Group, a competitor of Sears in the area of apparel, footwear and accessories. ¶2, 22-37.

D. Sears and its Board Knew That Sears' Interlocking Directors Were a Conflict of Interest and Illegal

1. Aylwin Lewis' Employment Agreement With Sears Prohibited Him From Joining the Board of a Competitor

Following the 2005 merger, Sears had ten directors: Aylwin B. Lewis ("Lewis"), Alan J. Lacy, Michael Miles, Donald J. Carty, Julian C. Day, along with Defendants Lampert, Crowley, Reese, Mnuchin and Tisch. ¶6. On March 30, 2005, Sears filed a Form 8-K signed by Crowley (as Sears' CFO), publicly announcing that Lewis had become a Sears director and had signed a five-year Amended and Restated Employment Agreement. *See* Decl. Ex. A, at 1. Section 14 of that agreement prohibited Lewis, while a Sears employee and for one year thereafter, from becoming an "officer, director, shareholder, consultant, independent contractor, employee, partner, or investor, with any Competing Enterprise" Decl. Ex. A (exhibit 10.1 at 9). "Competing Enterprise" meant: "(i) American Retail Group, Inc., Carrefour SA, Fleming Companies, Inc., Kohl's Corporation, The May Department Store Company, J.C. Penny Company, ShopKo Stores, Inc., Target Corp., The Home Depot, Inc., Toys R Us Inc., TJX Companies, Inc., and Wal-Mart Stores and (ii) an entity or enterprise whose business is in direct competition with a business that the Company [Sears] hereafter acquires and which reports directly to [Lewis] during his employment" *Id.* Crowley signed Lewis' employment agreement for Sears, as Executive Vice President, Finance and Integration. *Id.* at 16.

2. Sears' Severance/Non-Compete Agreements Prohibit Sears Executives From Working for Sears Competitors, Including "AutoZone"

Sears' public filings state that Sears directly competes with "AutoZone." On April 26,

in its public filings that, at least with respect to AutoZone, they are in direct competition. Nevertheless, Defendants' limited challenge presents a question of fact subject to discovery.

2005, Sears filed a Form 8-K announcing that the board's Compensation Committee – then made up of Defendants Lampert, Reese and Tisch, Decl. Ex. G at 77 – adopted two forms of “Executive Severance/Non-Compete Agreements.” Decl. Ex. B. Both severance agreements required executives to keep Sears' business confidential and prohibited them from working for a Sears competitor for one year after the executive left Sears. *Id.* In particular, Section 6 of the Severance/Non-Compete agreements prohibited Sears executives from working for any “Sears Competitor” listed on an “Appendix A” to the agreements. Decl. Ex. B (exhibits 10(c) at 3, and 10(d) at 3). The Appendix A named 33 companies as Sears competitors, grouped by industry, as follows: Retail/Department Stores (7); Discount Stores (3); Specialty Stores (15); Home/Product Services (5); and Other (3). Decl. Ex. B (exhibits 10(c) and 10(d) at Appendix A). Among the prohibited competitors listed is “**AutoZone, Inc.**” *Id.* (emphasis added).

Section 6 of the agreements also prohibited Sears executives from “(A) engag[ing] in any retail business . . . that consists of selling . . . **auto parts and/or apparel products** . . . with combined annual revenue in excess of \$500 million” Decl. Ex. B (exhibit 10(c) at 4) (emphasis added). Under Section 6, Sears could modify the agreement to include “emergent Competitors in Sears existing lines of business and Competitors in lines of business that are new for Sears” *Id.* Finally, Section 6(f) required Sears executives to acknowledge that Sears would suffer “irreparable harm” from any breach of the agreement by the executive. *Id.*

In later SEC filings, Sears kept the same basic Severance/Non-Compete form, with the same prohibitions against working for competing companies set out in Section 6 of the earlier agreements.⁵ Sears filed these Severance/Non-Compete Agreements with its Annual Report on Form 10-K for: (1) its fiscal year ended February 2, 2008; and (2) its fiscal year ended January

⁵ These later-filed agreements refer to an “Appendix A” containing the names of each “Sears Competitor.” *See* Decl. Ex. C (exhibits 10.16, 10.17, 10.18 and 10.19 at ¶4(b)) and D (exhibit 10.27 and 10.28 at ¶4(b)). Sears did not file with its fiscal 2008 and 2009 Form 10-K the “Appendix A.” Counsel confirmed orally with the SEC that the “Appendix A” for these filings is “not available.”

31, 2009. Decl. Exs. C and D.⁶ All of the Defendants named herein signed these annual reports. Decl. Exs. C at 106 and D at 100.

3. The Company's Own Codes of Conduct Prohibit Conflicts of Interest and Competition With Sears

The Code of Conduct for the Board of Directors of Sears Holding Corporation, expressly states that a director must “avoid conflicts of interest” which include “other duties, responsibilities or obligations that run counter to his or her duty to the Company.” Decl. Ex. E. It also states that “Directors may not compete with the Company,” or use corporate opportunities for their own benefit or that of another. *Id.*

Sears' Code of Conduct for employees states that Sears “is subject to complex antitrust laws designed to preserve competition among enterprises and to protect consumers” Decl. Ex. F, at 4. It states that employees are “expected to comply with these laws at all times,” and warns them not to “discuss with competitors any Company pricing, plans, or other competitive marketing information” *Id.* The Code of Conduct advises employees that “monetary violations for antitrust violations can be high” and that if employees “have any questions about potential antitrust implications, [they should] consult with [Sears'] Law Department.” *Id.* The Sears Code of Conduct contains an “Introduction” from Lampert as Chairman of the Board.

E. Lampert Dominates, Controls and Influences the Sears Board

Defendant Lampert is Chairman of Sears and owns 54% of Sears through his ownership and control of ESL Investments, Inc. (“ESL”), a Connecticut-based private hedge fund. (¶¶7-8). ¶8. As a result of his majority stake, Lampert controls Sears and its board. ¶8. According to Sears' annual report filed with the SEC on March 17, 2009, Lampert has “*substantial influence* over many, if not all, actions to be taken or approved by [Sears'] shareholders, including the

⁶ These agreements also state that it would constitute a conflict of interest for a Sears executive to have a “relationship” with any Sears competitor, *Id.* (¶4(a)(iv)), and that the executive agrees Sears would be irreparably harmed if the non-compete or conflict of interest sections were violated, *Id.* (¶5).

election of directors and any transactions involving a change of control.” ¶8 (emphasis added). Lampert also owns, through ESL, a substantial part of AutoZone (43.67%) and AutoNation (45%), and placed Crowley – who is President and Chief Operating Officer of ESL – on the boards of all three competing companies. ¶7-8. Defendants Tisch and Mnuchin are limited partners in one of the ESL Companies and another affiliate of ESL Investments, Inc. Decl. Ex. G at 69, 76. Crowley is President and Chief Operating Officer of ESL. ¶7.

In March 2009, an eight-member Sears board nominated and endorsed Reese and Crowley for re-election. ¶¶58-59. In August and September 2009, when these derivative actions were filed, the Sears board still consisted of seven of the eight directors that in March 2009 had nominated and endorsed Crowley and Reese for re-election. ¶¶4, 60.

ARGUMENT

The test for determining when a shareholder may bring a derivative action without having to make a pre-suit demand is set forth in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), and its progeny. A pre-suit demand will be deemed futile when the plaintiff alleges particularized facts that, if true, would raise a “reasonable doubt” as to whether the directors: (i) are disinterested and independent; or, (ii) exercised proper business judgment in approving the challenged transaction. *Aronson*, 473 A.2d at 814-15; *Grobot v. Perot*, 539 A.2d 180, 186 (Del. 1988); *Grimes v. Donald*, 673 A.2d 1207, 1217 n.17 (Del. 1996) (stating that the “concept of reasonable doubt is akin to the concept that the stockholder has a ‘reasonable belief’ that the board lacks independence or that the transaction was not protected by the business judgment rule;” “Reasonable doubt can be said to mean that there is a reason to doubt”).

Demand is excused here for two reasons. First, the Sears board committed *ultra vires* acts when it nominated and endorsed two illegal interlocks, ¶67, acts which cannot, under any scenario, be held a proper exercise of business judgment. Accordingly, there is “reason to

doubt” that the directors exercised proper business judgment because they violated Section 8, and particularized facts are alleged to demonstrate a “substantial likelihood of director liability.” *Aronson*, 473 A.2d at 815 (“in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists”). Second, Lampert dominates the Sears board to such an extent that the board nominated and endorsed an illegal interlock (Crowley) to the detriment of Sears and for the benefit of Lampert. ¶66. Accordingly, there is “reason to doubt” the board’s independence.

A. Demand Is Excused Because Defendants’ Violations of Section 8 Were *Per Se* Illegal, Cannot Be Ratified By Shareholder Vote, And Were Not a Valid Exercise of Business Judgment

In nominating and endorsing Crowley and Reese for re-election, the board committed *ultra vires* acts – ones that were illegal *per se*. ¶¶4, 67. That is because Section 8 “prohibits corporations from choosing, and natural persons from serving as, directors in violation of Section 8’s substantive requirements.” *TRW, Inc. v. FTC*, 647 F.2d 942, 949 (9th Cir. 1981). The board’s actions were also contrary to public policy because Section 8 “reflects a public interest in preventing directors from serving in positions which involve either a potential conflict of interest or a potential frustration of competition.” *Protectoseal Co. v. Barancik*, 484 F.2d 585, 589 (7th Cir. 1973); *see U.S. v. Sears*, 111 F. Supp. at 615 (“What Congress intended by § 8 was to nip in the bud incipient violations of the antitrust laws by removing the opportunity or temptation to such violations through interlocking directorates”).

Here, a pre-suit demand is excused because the board’s actions were *ultra vires* and there is “reason to doubt” that the board’s actions were the product of a valid business judgment. *Grobot v. Perot*, 539 A.2d 180, 186 (Del. 1988) (pre-suit demand is futile when particularized facts “raise a reasonable doubt as to . . . whether the directors exercised proper business judgment in approving the challenged transaction.”); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.

1984) (“*Absent an abuse of discretion*, [a board’s business] judgment will be respected by the courts”) (emphasis added). Because the board had neither authority nor discretion to nominate Crowley and Reese, their acts are void, *ultra vires* and excuse any pre-suit demand.

1. The Board’s *Ultra Vires* Acts Excuse Demand as a Matter of Law

Delaware law is clear that “the business judgment rule may not be invoked to shelter unauthorized actions of a board of directors.” *California Public Employees’ Retirement System v. Coulter*, 2002 WL 31888343 at *10 (Del. Ch. Dec. 18, 2002). Nor could Sears’ shareholders ratify a board’s illegal, fraudulent or void acts. See *Toebelman v. Missouri-Kansas Pipe Line Co.*, 130 F.3d 1016, 1022 (3d Cir. 1942); *Keenan v. Eshleman*, 2 A.2d 904, 909 (Del. 1938); *Kerbs v. California Eastern Airways, Inc.*, 90 A.2d 652, 655 (Del. Ch. 1952).⁷

In these circumstances – when a board acts *ultra vires* – a pre-suit demand “will be excused if a majority of the board that allegedly pursued the *ultra vires* action remains on the defendant board at the time demand is made.” *In re InfoUSA, Inc.*, 953 A.2d 963, 988 (Del. Ch. 2007). Here, seven out of the eight directors who pursued the *ultra vires* acts remained on the board when Plaintiffs’ complaints were filed in August and September, 2009. ¶¶4, 58, 67. Accordingly, demand on the current Sears board is excused.

Defendants nevertheless argue that even if the acts complained of were *ultra vires* or unlawful, there are “no facts in the Complaint that would show that any defendant *knowingly* and *intentionally* engaged in *ultra vires* conduct or that any defendant *knowingly* and *intentionally*

⁷ An “*ultra vires*” act is one which a corporation, regardless of shareholder approval, cannot lawfully accomplish. See *Central Transportation Co. v. Pullman’s Palace Car Co.*, 139 U.S. 24, 59-60 (1891). With respect to “void” and “voidable” acts, the Chancery Court in Delaware recently explained:

The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent or gifts or waste of corporate assets. The practical distinction . . . is that voidable acts are susceptible to cure by shareholder approval while void acts are not.

Void acts are not ratifiable “because the corporation cannot, in any case, lawfully accomplish them.” Void acts are “illegal acts or acts beyond the authority of the corporation.” *Nevins v. Bryan*, 885 A.2d 233, 245 (Del. Ch. 2005) (footnotes omitted). In any event, the result of the shareholder vote here was a foregone conclusion given Lampert’s 54% majority share ownership of Sears.

caused the corporation to violate the law.” Def. Mem. at 12. But Defendants misread the only authority they cite to support this argument, *Meltzer v. CNET Networks*, 934 A.2d 912, 914-915 (Del. Ch. 2007), which states: “to the extent a director knowingly backdated a stock option in violation of the company’s charter, that director’s action is *ultra vires* and is not the product of valid business judgment.” *Id.* at 914. Thus, the court in *CNET* was simply stating that “knowingly” backdating options is *ultra vires* and, as such, an *ultra vires* act is “not the product of business judgment.” *Id.* It was not stating, as Defendants suggest, that the commission of an *ultra vires* act must be done “knowingly” to fall outside the protections of the business judgment rule. *CNET* confirms that any *ultra vires* act (e.g., knowingly backdating options, nominating interlocking directors in violation of Section 8, etc.) cannot be the product of a valid business judgment, by definition, regardless of the actor’s state of mind. *Id.* Indeed, *CNET*, 934 A.2d at 914 n.7, relies on the very same language from *InfoUSA* cited above, which contains no mention of a mental state.⁸

2. Defendants Were Grossly Negligent, Acted Intentionally and/or In Bad Faith

As shown above, Defendants’ acts were illegal *per se*, void, and beyond the protection of the business judgment rule. Because a majority of the board committed these acts, no further analysis is required to excuse demand. Nevertheless, Defendants argue that a pre-suit demand is not excused unless Plaintiffs allege that Defendants acted with intent, gross negligence or in bad faith. Def. Mem. at 11-13. While this analysis is unnecessary, the allegations and evidence of

⁸ The decision in *Aronson*, and the Seventh Circuit’s analysis of that decision, confirm that allegations of mental state regarding *ultra vires* acts are not necessary to excuse demand. As the Seventh Circuit explained:

Under *Aronson*, “the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors...” 473 A.2d at 815. However, demand may be excused if “in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, [resulting in] a substantial likelihood of director liability,” *id.*, or if the directors exhibited “gross negligence” in breaching their duty of care. *Brehm*, 746 A.2d at 259 (citing *Aronson*, 473 A.2d at 812).

In re Abbott Labs. Deriv. Shareholders Litig., 325 F.3d 795, 808 (7th Cir. 2003) (emphasis added).

Defendants' intent, gross negligence and bad faith are substantial.

Defendants intentionally nominated and endorsed Crowley and Reese as directors, even though their service would plainly violate Section 8's prohibition against interlocks. ¶¶58-59. At the very least, Defendants were grossly negligent in failing to properly inform themselves of the illegality of nominating and endorsing them. *See Aronson*, 473 A.2d at 812 ("directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them"). Defendants do not challenge the sufficiency of the claims alleged in Counts I to III, and they admit directly or implicitly that Sears competes with AutoZone, AutoNation and Jones Apparel. Nor do they challenge the allegation that the board's actions were *ultra vires*. It could therefore only have been "gross negligence" that led Defendants to nominate and endorse individuals in violation of the antitrust laws.⁹

Defendants did nothing to inform themselves of Section 8's prohibition against interlocking directors, or, more likely, recklessly ignored the statute. For example, there is no question that Defendants knew Crowley served on the boards of AutoNation and AutoZone (an acknowledged Sears competitor) and that Reese served as a director of a competing apparel company, Jones Apparel, but apparently did nothing to discern the illegality of either nomination. *See In re Nuveen Fund Litig.*, Nos. 94-C-360, 94-CV-5416, 1996 WL 347012 at **5-6 (N.D. Ill., June 11, 1996). Defendants ignored every red flag pointing to the illegal interlocks and ignored their own duty of loyalty, which when followed, protects against such conflicts of interest. *See generally Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del.

⁹ Defendants argue that because the Complaint alleges that the Nominating Committee reviewed the background and qualifications of Crowley and Reese, the board must have properly informed itself. Def. Mem. at 11. But this allegation shows only that Defendants *had to know* that Crowley and Reese sat on the boards of competing companies and that they thus knew of or recklessly ignored the requirements of Section 8. It does not suggest that the board "properly informed" itself of the illegal nature of the interlocks. Indeed, Plaintiffs are not complaining that Crowley and Reese are unqualified professionally or lack experience, but rather, that they cannot under Section 8 serve as Sears directors while they serve on the boards of competitors. Where, as here, Defendants do not challenge the sufficiency of the alleged wrongs, they cannot argue that they nevertheless properly informed themselves of their own wrongdoing.

1993); 5 P. Areeda & D. Turner, ANTITRUST LAW § 1300, at 359 (1980) (dual directorate implicates duty of loyalty).

Defendants knew that working for a competitor of Sears was prohibited. Indeed, Defendants signed Sears' Form 10-K for the fiscal year ended January 28, 2006. That filing incorporated by reference the Company's form of Severance/Non-Compete Agreement which expressly identified "AutoZone" as a competitor of Sears. Decl. Ex. H at E-3. The board's Code of Conduct also expressly forbids a director from competing with the Company, and Sears' Code of Conduct warns employees not to discuss any company business with "competitors," and reminds them to abide by the antitrust laws, and to contact the Law Department if they "have any questions about potential antitrust implications." Decl. Exs. E and F.

Additional facts further support the inference that the directors acted knowingly and/or in bad faith. First, the board's actions were not isolated, one-time acts. The board repeatedly nominated Crowley and Reese for re-election in 2006, 2007, 2008 and 2009. ¶¶6, 7, 14. And Sears Roebuck (Sears' subsidiary) has been the subject of *two* government actions to enjoin unlawful director interlocks. Second, the board's counsel in this case even issued a "Client Alert" on Section 8 months before Defendants nominated Crowley and Reese for re-election, Decl. Ex. I, making clear that avoiding Section 8 interlocks is a basic board duty. Finally, none of the directors could have missed the fact that Crowley sat on the board of AutoZone while he was also Chief Financial Officer of Sears, Decl. Ex. D at 14 – something that the Company's code of conduct and basic fiduciary duties prohibit. There thus appear to be two sets of rules: one for Sears' employees, and one for Lampert's board. Employees must inform themselves of, obey and observe the antitrust laws, and not work for "competitors." But directors have no qualms about letting Crowley sit on the board of an acknowledged competitor like AutoZone – a company controlled by Lampert. ¶8 (43.67% ownership). That is *not* good faith director

action.¹⁰

B. The Board Lacks Independence Because It Is Controlled, Dominated and Influenced By Lampert

Plaintiffs have sufficiently alleged that Lampert controls the Sears board and dominates and influences that board – to the detriment of Sears and for the benefit of Lampert – in violation of the board members’ duty of “care, attention and sense of individual responsibility.” *Aronson*, 473 A.2d at 816. The board has advanced Lampert’s self-interest by allowing Crowley, a close colleague and a director of two companies that Lampert largely owns and which compete with Sears, to also serve on the Sears board. Accordingly, any pre-suit demand is excused.

Lampert owns 54% of Sears and controls the Company and its board. ¶8. Sears has admitted in its public filings that Lampert has “*substantial influence* over many, if not all, actions to be taken . . . including the election of directors” *Id.* (emphasis added). *See Rales v. Blasband*, 634 A.2d 927 (Del. 1993) (the ultimate inquiry on independence is whether the interested party was “in a position to exert *considerable influence* over” a director) (emphasis added). Indeed, Lampert controls and owns significant stakes in AutoZone (43.67%) and AutoNation (45%), both competitors of Sears. ¶¶8, 38-52. Serving as a director on all three companies – and also serving as a top officer at Lampert’s ESL hedge fund – is Crowley. ¶7. Also, Defendants Tisch and Mnuchin are “limited partners in one of the ESL Companies and another affiliate of ESL Investments, Inc.” Decl. Ex. G, at 69, 76. Accordingly, a majority of the board (four of seven directors) are closely affiliated with Lampert’s ESL. Lampert thus exerts his domination and influence over an idle and complacent Sears board by having its members nominate, endorse and allow to remain on the board, for the benefit of Lampert and to

¹⁰ Defendants rely on Sears’ Certificate of Incorporation to argue that a culpable mental state must be alleged when seeking money damages. Def. Mem. at 13-15 (Exhibit A). Of course, the Complaint seeks injunctive relief, not money damages, a position Defendants outright acknowledge. Def. Mem. at 13 (the “Complaint does not . . . seek [money] damages”). Accordingly, Sears’ Certificate of Incorporation is irrelevant and the appropriate portions of pages 13 through 15 of Defendants’ brief should be ignored. *See Abbott*, 325 F.3d at 809-11 (finding the exemption clause in the company’s certificate of incorporation inapplicable where a breach of loyalty is alleged).

the detriment of Sears, the illicit interlock, Crowley. ¶66. This is far more robust than what Defendants describe as “[m]ere directorial approval of a transaction.” Def. Mem. at 9. Also, given Lampert’s stake in all three companies, Defendants incorrectly argue that Lampert does not benefit personally from the illegal interlock Plaintiffs complain about, Def. Mem. at 7, because Lampert benefits as a shareholder of all three companies, to the detriment of Sears, when his hand-picked colleague sits on all three boards.

Accordingly, where one person (Lampert) has “substantial influence” over the election of the board and where the board engages in acts personally beneficial to Lampert, detrimental to Sears and contrary to their “care, attention and sense of individual responsibility,” reasonable doubt exists as to the independence of these directors. In the words of the Delaware Supreme Court, the Sears directors lack independence because there is a “reasonable belief” that their decision to nominate and endorse Crowley was based on “extraneous considerations or influences” and not on “the corporate merits of the subject before the board.” *Aronson*, 473 A.2d at 816. *See also Grimes v. Donald*, 673 A.2d 1207, 1216-17 n.17 (Del. 1996) (demand is normally excused when, *inter alia*, “a majority of the board is incapable of acting independently for some other reason such as domination or control” and that “reasonable doubt is akin to the concept that the stockholder has a ‘reasonable belief’ that the board lacks independence”).

Directly on point is *In re Penn Central Sec. Litig.*, 367 F. Supp. 1158 (E.D. Pa. 1973), where shareholders of Great Southwest Corporation (“GSC”) brought a derivative suit against GSC and its board for, among others, Section 8 violations. The plaintiffs alleged that a pre-suit demand was excused because a single entity – like ESL and Lampert here – held a majority stake in GSC, controlled the board and dominated it such that an affiliate of the majority shareholder, and illicit interlock, came to serve as a GSC director. *Id.* at 1163-64 (quoting paragraph 7(c) of the complaint). In analyzing the adequacy of these allegations, the Court explained as follows:

A majority shareholder, particularly one owning a very substantial majority of the corporation's stock, has complete control of the selection of directors. The fact of Pennco's position as an overwhelmingly dominant shareholder is sufficient to support a conclusion that Pennco dominates the GSC board, whoever its members might be, and therefore that a demand on those directors to sue the stockholder that put them in their positions would be futile. What a judge said long ago in another case applies with equal force here: "Every sensible man, out of a court of justice, knows [that a demand under the circumstances] would never be complied with." *Young v. Alhambra Min. Co.*, 71 F. 810, 812 (N.D. Ill. 1895), *quoted in* 3B Moore's Federal Practice 23.1.19 at 23.1-255 (2nd ed., 1969).

Id. at 1165 (alterations in original). Similarly, it would be futile to demand that Lampert and his hand-picked co-directors sue themselves for carrying out Lampert's decision to have Crowley serve as a Sears' director for Lampert's benefit, Sears' detriment and in violation of Section 8.

CONCLUSION

For the foregoing reasons, the Court should deny Defendants' motion to dismiss.¹¹

Dated: December 7, 2009

Respectfully submitted,

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¹¹ Should the Court find any pleading deficiency, Plaintiffs respectfully request leave to replead. *See* Fed. R. Civ. P. 15(a)(2). Leave to replead should be granted because Plaintiffs have never sought leave to amend, and were only informed of the merits of Defendants' motion to dismiss upon its filing, despite having unsuccessfully requested such information earlier. In addition, and as explained above, there are substantial facts in the public record, which can be promptly incorporated into an amended pleading, sufficient to support demand futility. Under the circumstances, there is no "undue delay, bad faith, dilatory motive, prejudice, or futility." *General Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1085 (7th Cir. 1997).