

***In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation***

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On January 24, 2024, the Delaware Court of Chancery issued a significant post-trial opinion in *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation* (“Sears”). The Court held that controllers exercising their voting power to “change the status quo” owe fiduciary duties.<sup>1</sup> These duties include a duty of loyalty not to “harm the corporation or its minority stockholders intentionally,” and a duty of care not to take “grossly negligent action.”<sup>2</sup> These duties are not as high as those owed by a director, who must “act affirmatively to promote the best interests of the corporation.”<sup>3</sup>

The Court also sketched a framework for judicial review of controller interventions under “enhanced scrutiny,” Delaware’s intermediate standard of review.<sup>4</sup> Although the Court did not explicate what kind or level of controller intervention would be enough to trigger enhanced scrutiny, the *Sears* controller’s efforts to thwart a transaction favored by the board were substantial and explicit, including unilaterally amending the bylaws and removing two special committee members from the board.

**I. Summary of the Case**

*Sears* involved a controlled company. One stockholder controlled over 50% of Sears’ stock (the “Controller”). The Controller had historically been hands-off with the business, but became more involved when a special committee of the board

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<sup>1</sup> — A.3d —, 2024 WL 262322, at \*25 (Del. Ch. Jan. 24, 2024).

<sup>2</sup> *Id.* at \*1.

<sup>3</sup> *Id.* at \*1.

<sup>4</sup> *Id.* at \*29-30.



proposed a liquidation plan for a failing business segment. The Controller believed that the liquidation plan advanced by the special committee “would destroy value.”<sup>5</sup> As a result, he first “tried to convince the committee not to implement” the plan.<sup>6</sup> When that failed, the Controller acted by written consent to adopt a bylaw amendment that required a 90% board vote at two meetings held thirty days apart and notice to the stockholders to approve a liquidation.<sup>7</sup> “Those procedural requirements did not technically foreclose the liquidation plan, but they ensured that the controller had a window to act,” and the “controller candidly acknowledged at trial that he had no intention of letting the liquidation plan become reality.”<sup>8</sup> The Controller also acted by written consent to remove the two board members he believed were most supportive of the liquidation plan and filled their board seats with two individuals “affiliated with one of his financial backers.”<sup>9</sup> Having prevented the liquidation, the Controller continued to negotiate with the sole-remaining committee member on an “end-stage transaction that eliminated the minority stockholders’ interests in the company.”<sup>10</sup> The end-stage transaction was not conditioned “on a majority of the minority vote,” nor could the board “terminate the agreement to accept a superior proposal.”<sup>11</sup>

The Court held that the Controller’s actions, which rested on his voting power, though permissible under the DGCL must also be tested in equity. To that, the Court held that when a controller uses its voting power to change the “status quo” the controller owes “limited but enforceable duties” that largely parallel the duties owed when a controller decides to sell its stock.

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<sup>5</sup> *Id.* at \*1.  
<sup>6</sup> *Id.*  
<sup>7</sup> *Id.* at \*16  
<sup>8</sup> *Id.* at \*1.  
<sup>9</sup> *Id.*  
<sup>10</sup> *Id.* at \*2.  
<sup>11</sup> *Id.* at \*19.

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 all stockholders. But when exercising voting power affirmatively to change the status quo, a controlling stockholder owes a fiduciary duty of loyalty which requires that the controller not intentionally harm the corporation or its minority stockholders, plus a fiduciary duty of care that requires that the controller not harm the corporation or its minority stockholders through grossly negligent action.<sup>12</sup>

The Court then considered what standard of review should apply. The Court noted that past decisions do not identify a standard of review for a controller using its control to sell or vote its shares. As such, the Court turned to the standards of review typically applied to director action. The Court held that enhanced review made sense here, where the Controller sought to amend bylaws and remove directors—actions that touched on voting rights and corporate control.

Research has not revealed any decisions applying enhanced scrutiny to a controller's unilateral action to amend bylaws or remove directors, but using enhanced scrutiny makes sense in that context. The ability of a controller to exercise its stockholder power in that setting presents the obverse of director action in the same context. Enhanced scrutiny applies when directors amend bylaws or otherwise intervene in elections or voting contests touching on corporate control. Enhanced scrutiny also should apply when a controller does something comparable. If enhanced scrutiny applies to one set of fiduciaries (directors) when they take action that affects the rights of a stockholder majority, it also should apply to a different fiduciary (controller) who

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<sup>12</sup> *Id.* at \*26.



takes action to impair the rights of the directors or a stockholder minority.<sup>13</sup>

Having determined the standard of review, the Court applied it to the Controller’s conduct and determined that the Controller did not breach his fiduciary duties even if enhanced scrutiny were applied. At trial, the Controller proved that he “acted in good faith for a legitimate objective and had a reasonable basis for believing that action was necessary.” The Controller also proved that he “selected reasonable means for achieving his legitimate objective.”

If “the story ended there and the company had continued in the status quo that existed before the controller intervened, then judgment would be entered in favor of the defendants.”<sup>14</sup> But following his acts of intervention, the Controller proceeded to negotiate a transaction to eliminate the minority stockholders as an alternative to the liquidation plan the Controller had thwarted. The Court applied the entire fairness test and determined that the Controller had failed to establish entire fairness.<sup>15</sup> The Court ordered the Controller to pay, as damages, the difference between the transaction price and the “true” value of the company.

## II. Key Takeaways

***Controllers using voting power to change the status quo will trigger fiduciary duties of loyalty and care.*** These duties are less exacting than the duties owed by directors, but include the duty not to act to intentionally harm the company or to act in a grossly negligent manner. In evaluating the Controller’s opposition to the liquidation plan, the Court outlined the beginnings of a legal framework where a controlling stockholder “does not owe any enforceable duties when declining to

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<sup>13</sup> *Id.* at \*30.

<sup>14</sup> *Id.* at \*2.

<sup>15</sup> *Id.* at \*3.

vote” or “sell” stock, “or when voting against a change to the status quo.”<sup>16</sup> But a controller who “face[s] a subtle conflict” and “sell[s]” or “vote[s]” stock “to change the status quo” may be subject to “limited but enforceable duties.”<sup>17</sup> The contours of what acts change the “status quo” and the duties owed by the controller” remain to be seen.

***Controller intervention may trigger enhanced scrutiny, Delaware’s intermediate standard of review.*** The Court was willing to apply standards of review to a controller’s actions that are similar to those used when directors act. The Court held that the enhanced standard of review was appropriate where a controller took affirmative action to amend bylaws and replace board members—actions that touched on voting contests or corporate control. For other controller interventions, different standards of review may apply depending on the type and degree of intervention.

***What level and type of controller intervention triggers enhanced scrutiny or some other standard is to be determined.*** Whether a controller’s conduct triggers “enhanced scrutiny” will be a contested issue in future litigation. The Court held that the actions taken by the Controller triggered enhanced scrutiny. The Court also emphasized the analogy between directors and controllers and that similar fact scenarios should trigger similar enhanced judicial review. But the Court did not specify other specific controller actions that may trigger enhanced scrutiny. Nor did the Court provide specific examples of what types of controller intervention might be subject to review under the business judgment rule or other standard, or how those standards would be applied to a controller when exercising stockholder rights.

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<sup>16</sup> *Id.* at \*23, 25.

<sup>17</sup> *Id.* at \*2, 23, 25.

*Sears provides guidance to controllers on when fiduciary duties and enhanced scrutiny are triggered.* The full impact *Sears* will have in litigation against controllers remains to be seen, including how it may impact the kind of claims plaintiffs assert, the scope of those claims, and the ability of defendants to obtain an early dismissal of those claims. However, *Sears* provides guidance to controllers and their counsel in structuring transactions. Controllers may seek legal advice from litigators, as well as transactional lawyers, while negotiating deals.

*Whether Delaware Supreme Court adopts this new framework remains to be seen.* *Sears* is the first Delaware decision stating that a controller’s exercise of stockholder powers to change the “status quo” should be subject to “enhanced” judicial scrutiny. It remains to be seen whether the *Sears* framework will be adopted by the Delaware Supreme Court or other members of the Court of Chancery.