

Delaware Court of Chancery Defines Controlling Stockholder Fiduciary Duties: *In Re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation*

Client Alerts

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When do controlling stockholders, exercising their voting power or selling stock, owe fiduciary duties to a Delaware corporation and its minority stockholders? This thorny question in corporate law may have a new answer following a new landmark decision by the Delaware Court of Chancery.

On January 24, 2024, the Court of Chancery of the State of Delaware (Vice Chancellor Laster) issued a Post-Trial Opinion^[1] finding that Edward Lampert (Lampert), former controlling stockholder of Sears Hometown and Outlet Stores, Inc. (the Company), had violated his fiduciary duties as controlling stockholder in the course of negotiating his purchase of the outstanding equity of the Company from the minority stockholders in a 2019 take-private sale. Although the concept that a controlling stockholder may owe fiduciary duties to minority stockholders is not a new one, with this opinion, the court introduced a new framework that will help determine when fiduciary duties are owed by a controlling stockholder and better define the boundaries of such fiduciary duties going forward.

In particular, the court held for the first time that even when exercising voting power, a controlling stockholder has fiduciary duties not to harm the corporation either intentionally or through grossly negligent action. In the voting context, however, the controlling stockholder need not meet the same standard as a director to show that it affirmatively acted to promote the best interests of the corporation. The Chancery Court further held that even though Lampert did not violate his fiduciary duties through his exercise of voting power to adopt certain bylaw amendments and remove certain directors from the board, he separately violated those fiduciary duties by subsequently negotiating an unfair price for a conflicted take-private transaction with the Company.

Background

A Struggling Company Considers a Transaction for Two Business Units: In the wake of well-documented and long-standing financial struggles, in late 2018 the Company began to consider various options to maximize stockholder value, including liquidating its “Sears Hometown and

Hardware” segment (the Hometown Business), which was rapidly losing money, and proceeding with its “Sears Outlet Segment” (the “Outlet Business”), which was by far the more profitable segment, as a standalone business.

Controlling Stockholder Lampert Looks to Buy the Entire Company, But Parties Don’t Agree on Price: Lampert, previously a generally passive investor despite his controlling interest in the Company, believed that the Company’s board of directors of the Company (the Board) was significantly overestimating the proceeds and underestimating the costs of a liquidation of the Hometown Business and significantly overestimating the likelihood of success of the Outlet Business as a standalone business. Lampert therefore made efforts to negotiate his own acquisition of the outstanding equity of the Company, which was a desired outcome of the Board. The Board appointed a three-member special committee of independent directors (the Special Committee) to engage in negotiations with Lampert. However, the vast difference between Lampert’s valuation of the Company (with an initial offer of \$2.25 per share, representing a fairly standard premium to the Company’s prevailing trading price) and the Special Committee’s valuation of the Company (\$9.50 per share) led negotiations to break down between the parties.

Lampert Takes Action to Make a Transaction More Difficult: Believing that he was being stonewalled by the Board/Special Committee, and that the Board would soon initiate what was certain to be a disastrous liquidation of the Hometown Business, Lampert took action. Acting by written consent as a stockholder, Lampert (i) amended the bylaws of the Company in a manner that would make the proposed liquidation subject to onerous process requirements (two separate Board votes, 30 days apart, each approving the liquidation by 90%) and (ii) removed the two members of the Board (and of the Special Committee) that he believed were responsible for standing in the way of the transaction.

Lampert Buys Hometown Business: Following these actions, negotiations resumed afresh with a new one-member Special Committee. Although Lampert had intended to wholly own both the Hometown and Outlet Businesses, Lampert agreed to allow the Board to shop the Outlet Business to third parties, resulting in an agreement for the sale of the Outlet Business to an unrelated private equity buyer and the sale of the Hometown Business to Lampert. Both the sale of the Outlet Business to the private equity buyer and the sale of the Hometown Business to Lampert closed on October 23, 2019. The final consideration received by the stockholders of the Company was \$3.21 per share.

Minority Stockholders Object about the Price Lambert Paid: Following the announcement of the transaction, various minority stockholders filed suit against Lampert (along with various other defendants), challenging the terms of the deal, including both the bylaw amendment and director removal and the price and process related to the transaction.

Defining the Fiduciary Duties of a Controlling Stockholder

This case helps bring greater clarity to when a controlling stockholder owes fiduciary duties to minority stockholders and the applicable standard of conduct. The court drew a distinction between when the stockholder uses its controlling corporate power to cause the corporation to act and when there is an exercise by the stockholder of stockholder rights.

While long-established Delaware precedent holds that when a controlling stockholder wields influence in such a manner that he or she is essentially operating as a *de facto* member of the board, such stockholder becomes subject to the same fiduciary standards that apply to the board of directors,^[2] the court determined that this was **not** what occurred in this case. Instead, the court determined that Lampert's actions—amending the bylaws and removing directors—were the exercise of his powers of a stockholder. Despite this, the court still determined that Delaware law imposes fiduciary duties on a controlling stockholder in the exercise of such stockholder powers—although “not the same duties a director owes.”^[3]

The exact boundaries of these duties had not been previously defined by Delaware courts, but in this case, the court presented the following definitional framework for the fiduciary duties of a controlling stockholder when the stockholder exercises stockholder rights. While a controlling stockholder has no obligation to vote in favor of a transaction that would “alter the status quo,” **if a controlling stockholder is exercising voting power to affirmatively change the “status quo,” such stockholder owes (a) a fiduciary duty of loyalty requiring that such stockholder “not intentionally harm the corporation or its minority stockholders” and (b) a fiduciary duty of care that requires that such stockholder not harm the corporation or its minority stockholders through “grossly negligent action.”**^[4]

As determined by the court, since Lampert was exercising his powers to “change the status quo” through the amendment of the bylaws and replacement of directors, these fiduciary duties of loyalty and care applied.

Intervention by Lampert Did Not Breach Fiduciary Duties

The court first found that the actions Lampert took pursuant to his stockholder voting rights before the take-private transaction (i.e., the bylaws amendment and removing two of the members of the Board and the Special Committee) did **not** constitute breaches of his fiduciary duties as a controlling stockholder exercising stockholder rights.

The court determined that the appropriate standard of review here was “enhanced scrutiny,” requiring Lampert to have acted in good faith towards a legitimate objective with a reasonable basis for thinking that such actions were necessary, and by using reasonable means to accomplish such objective.^[5] Enhanced scrutiny is an intermediate standard that is less deferential than the business judgment rule, but not as exacting as the entire fairness standard (as discussed below).

Here, the court specifically cited the fact that the Board was incorrect in its estimates of the likely valuation of the liquidation of the Hometown Business (and assertions of the probability of success of the Outlet Business as a standalone business); that Lampert had made several other attempts to convince the Board to take other courses of action; and that Lampert's actions did not technically prevent the Board from pursuing its objectives (only made such objectives difficult) as facts weighing in Lampert's favor.^[6] In sum, the court viewed Lampert's interventions as a "drastic, but necessary"^[7] course of action that was taken to neutralize the threat of the Board implementing a liquidation that was potentially disastrous to all stockholders. Therefore, his actions cleared the bar of enhanced scrutiny and did not (in and of themselves) breach any duties.

Impact of Intervention Did Breach Fiduciary Duties

As the court noted, if Lampert's only action was to amend the bylaws and remove directors, then the case would be over. However, the court was required to evaluate Lampert's actions in the sale of the Company and specifically examined Lampert's sale process and sale price for the conflicted, take-private transaction. Because Lampert stood on both sides of the sale of the Company, the court applied an entire fairness standard in its review of whether Lampert complied with his fiduciary duties in his negotiation of the transaction. While the court held that the actions that Lampert took that directly intervened in the sale process did not violate his fiduciary duties as a controlling stockholder, the court found that the ramifications of these interventions "fatally undercut" the ability of the Board to negotiate a fair transaction, resulting in a price for the deal significantly below the fair value that could have been obtained in an arms-length transaction. As a result, the transaction was deemed not to be entirely fair to the minority stockholders.

In evaluating the fair price aspect of entire fairness review, the court interacted extensively with various methods of valuation for the Hometown Business and the Outlet Business, including valuations provided by Lampert himself during the course of his financing discussions with potential lenders for his acquisition of the Hometown Business, and determined that a fair per share price would be somewhere in the range of \$4.79 - \$5.62. Even assuming the most conservative valuation at the low end of that range, the difference between the actual final per share price of \$3.21 was too large for the court to find that Lampert had paid a fair price, even after taking into account the concept of a controller premium/minority discount.^[8]

In evaluating the fair dealing aspect of entire fairness review, the court also focused on the process and, in particular, on the amendment of the bylaws and removal of directors. In particular, Lampert's actions in amending the bylaws and removing Board/Special Committee members effectively "boxed in" the Special Committee by removing from the table the principal alternative to Lampert's proposed transaction. Although Lampert acted within his rights as a stockholder, and although the remaining member of the Special Committee took appropriate action to attempt to negotiate an arms-length transaction, the balance of power following Lampert's actions did not allow for a fair deal to be negotiated because of the extreme asymmetry of negotiation leverage.^[9]

Although the court found that Lampert did not act in bad faith and did not breach his fiduciary duties by amending the bylaws and removing two Board/Special Committee members, he did in fact breach his fiduciary duties by negotiating unfair transaction terms in a process that had been undermined by these actions. Although the court emphasized that Lampert appears to have “sincerely believed” that the transaction was fair, the court focused on the fact that entire fairness is an objective standard, and the subjective state of mind of the fiduciary is not part of the equation. Here, Lampert appears to have had plenty of opportunity to understand that he was significantly undervaluing the Hometown Business--including according to the very valuation that he was using to secure financing for the transaction. The net result was that Lampert was required to pay \$18 million to the minority stockholders.

As a whole, this case is important not only for the court’s consideration of Delaware precedent for the standard of conduct and review as applied to the “controller intervention,” but also for its evaluation of the transaction under the entire fairness standard.

Two Takeaways:

- 1. Controller Actions Will be Subject to Further Stockholder Litigation from both Public and Private Companies and the Enhanced Scrutiny Standard Will Invite such Litigation:** While the case focused on the actions of a public company, fiduciary duties apply to both public and private Delaware corporations. Many private and closely held companies should consider how any action changing the “status quo” could increase the risk of a suit by the minority stockholders. Furthermore, because the enhanced scrutiny standard applied in this case is fact-intensive and more likely to survive a motion to dismiss, defending any actions may be more time-consuming and costly than previously assumed.
- 2. What the Court Didn’t Focus on—What Triggers a Change in the “Status Quo”:** The disputes in the case—removal of directors, amendment of bylaws and a change in control—are central to the overall governance of a company, potentially some tertiary decisions could trigger a change in the status quo and implicate controller fiduciary duties. For example, amendments to the company’s certificate of incorporation regarding the number, manner of election, or classification of directors, issuance of stock under stock exchange rules or re-incorporating in a new state are all changes to the “status quo” and could be implicated in the decision if there is an impact to minority stockholders.

Footnotes

[1] In re: Sears Hometown and Outlet Stores, Inc. S’holder Litig., C.A. No. 2019-0798-JTL (Del. Ch. Jan. 24, 2024).

[2] *Id.* p. 50

[3] *Id.* p. 52

[4] *Id.* p. 60

[5] *Id.* p. 69

[6] *Id.* p. 71

[7] *Id.* p. 73

[8] *Id.* p. 104

[9] *Id.* p. 112

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