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Delaware Court of Chancery Holds that a Minority Stockholder may be a Controlling Stockholder Where it has Control and Influence over a Board at the Time of a Transaction

In *Calesa Associates, L.P.,* v. *American Capital, Ltd.*, the Delaware Court of Chancery denied a motion to dismiss breach of fiduciary duty claims against a 26% stockholder and members of a company's board of directors, holding that the plaintiffs raised reasonable inferences that a majority of the board was under the influence of, or shared a special interest with, the stockholder, such that it was a controlling stockholder.

Background

In 2007, American Capital, Ltd. ("ACAS") invested $8.9 million in Halt Medical, Inc. ("Halt"). Through its initial investment, ACAS was granted two seats on Halt's five-seat board of directors (the "Board") and a right to block any subsequent *pari passu* investment in Halt. According to the Plaintiffs' complaint, which the Court must presume is true for purposes of this motion to dismiss, the parties' relationship deteriorated thereafter. First, for some time, ACAS allegedly did not invest in Halt and purportedly misled Halt as to whether it would provide funding. During that time, certain of Halt's minority stockholders provided a bridge loan to Halt. Then, in 2011, when Halt eventually obtained a third-party loan secured by its intellectual property, ACAS supposedly covertly purchased the note and the secured interest. Later that year, ACAS used its blocking right to prevent Halt from receiving another third-party investment, and the Board was allegedly forced to accept a $20 million loan from ACAS at a 22% interest rate, pursuant to which ACAS gained another seat on the Board. By the fall of 2013, Halt owed ACAS $50 million under the note. Despite initially indicating that it would extend the note, ACAS purportedly demanded repayment in full by year's end.

With no viable alternatives, Halt entered into another financing transaction with ACAS (the "Transaction"), pursuant to which Halt would form a merger subsidiary and be merged into it. Through the merger, all issued and outstanding shares of Halt's preferred stock and warrants to purchase common or preferred stock were cancelled. Halt's common stock was unaffected. The parties also entered into a note purchase and exchange agreement pursuant to which ACAS would loan Halt up to $73 million and new shares of preferred and common stock were issued to ACAS and other investors. A management incentive plan was also adopted, under which a percentage of a subsequent sale of Halt would be paid to certain employees. Following the Transaction, ACAS's equity position in Halt increased from approximately 26% to 66% and it had four ACAS-designated seats on the seven-seat Board. The minority stockholders' equity positions were diluted. The Transaction documents disclosed that three of the seven directors on the Board were affiliated with ACAS entities that intended to finance the Transaction. Two of those directors also served as either an officer or director of ACAS. The third director was a CEO of a portfolio company in which ACAS had allegedly invested $66 million. All three directors were appointed to the Board by ACAS. Finally, Halt's CEO, also a director, had his salary doubled prior to the Transaction, became eligible to participate in the incentive plan and continued as CEO after the Transaction. Stockholders were given one day to review and execute the Transaction documents, which spanned almost 300 pages.

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ANALYSIS

Subsequently, minority stockholders of Halt filed an action against ACAS and certain current and former Board members (the "Defendants") in the Court of Chancery. The Plaintiffs alleged that ACAS breached its fiduciary duties, owed as a controlling stockholder, to the minority investors by forcing Halt to enter into the Transaction, which resulted in a dilution of equity in ACAS's favor and an unfair extraction of value from the minority stockholders. The Plaintiffs also alleged that the director Defendants breached their fiduciary duties by approving the Transaction. Defendants moved to dismiss for failure to state a claim.

The Court of Chancery denied Defendants' motion to dismiss the breach of fiduciary duty claims, holding that Plaintiffs had adequately pled claims for breach of fiduciary duty under Court of Chancery Rule 12(b)(6):

- *The Court ruled that Plaintiffs pled facts supporting a reasonable inference that ACAS was the controlling stockholder of Halt:* A "stockholder is controlling, and owes fiduciary duties to the other stockholders, 'if it owns a majority interest in or *exercises control* over the business affairs of the corporation.'" The Court acknowledged that ACAS's exercise of its duly obtained contractual rights to the detriment of Halt did not show control, but ruled that the Plaintiffs "pled sufficient facts to support a reasonable inference that a majority of the Board was not disinterested or lacked independence from ACAS, such that ACAS was a controlling stockholder at the time of the Transaction."
    - First, the Court found that the Plaintiffs adequately alleged that the three directors who were affiliated with ACAS entities that intended to finance the Transaction were interested in the Transaction because they stood to gain a personal benefit from it that was not equally shared by the stockholders. The Court also found that the Plaintiffs had adequately alleged that the two directors who served as either an officer or director of ACAS were not independent because they were dual fiduciaries, but did not address the Plaintiffs' argument that the third director was beholden to ACAS because it had invested $66 million in his company.
    - Second, the Court ruled that the Plaintiffs had adequately alleged that the fourth director, the CEO of Halt, was beholden to ACAS because he faced a decision between supporting the Transaction, on terms highly favorably to ACAS and allegedly unfair to the minority stockholders, or rejecting the Transaction, which, given the $50 million due to ACAS, was tantamount to voting for Halt's collapse and losing his source of income.

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