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# Controlling Stockholder Cannot Advance its own Self-Interest at Expense of Minority Stockholders

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*In Carr v. New Enterprise Associates, Inc.*, C.A. No. 20170381-AGB (Del. Ch. Mar. 26, 2018), the Delaware Court of Chancery, in denying in part and granting in part a motion to dismiss, reaffirmed the principle that a controlling stockholder, when acting outside its capacity as a stockholder, cannot use the corporation to advance the controlling stockholder's self-interest at the expense of minority stockholders. In the context of defendants' motion to dismiss, the court found that it was reasonably conceivable that the controlling stockholder of American Cardiac Therapeutics, Inc. ("**ACT**") and its conflicted board of directors had breached their duty of loyalty to ACT's minority stockholders by approving a sale of a warrant to a third party that included an option to acquire ACT, allegedly at an unfairly low price, in order to incentivize the third party to also acquire and invest in the controlling stockholder's other portfolio companies.

The case arose out of a dispute between a co-founder of ACT and New Enterprise Associates, Inc., and its subsidiaries and affiliates ("**Defendant**" or "**NEA**"), a large venture capital firm and the controlling stockholder of ACT. The central allegations in plaintiff's complaint were that (1) the preferred stock offering that enabled NEA to become ACT's controlling stockholder had been approved by a conflicted board and significantly undervalued ACT; and (2) NEA had orchestrated the potential sale of ACT to Abbott Laboratories ("**Abbott**") on the cheap as part of a strategy to optimize the value of NEA's portfolio by inducing Abbott to also acquire Topera and invest in VytronUS, both of which were NEA portfolio companies. Plaintiff claimed that the preferred stock offering impermissibly diluted ACT stockholders and allowed NEA to gain control of the corporation for less than fair value, and that NEA used its resulting control of ACT to sell the warrant to Abbott at an unreasonably low price in order to facilitate the Topera and VytronUS transactions for NEA's benefit. In addition to NEA, plaintiff named as defendants six individual directors of ACT who were serving at the time of the challenged transactions (collectively, the "**Director Defendants**").

With respect to the preferred stock offering, the court found that plaintiff stated a claim for breach of fiduciary duty against the Director Defendants because, under the entire fairness standard – which applied because four of the six directors were interested in the transaction – plaintiff had alleged sufficient facts to call into question the fairness of both the process and price of the preferred stock offering. In addition, plaintiff's claim that NEA aided and abetted the board's breach of its fiduciary duty by approving the preferred stock offering survived the motion to dismiss. Because one of ACT's directors also was a partner of NEA, his alleged knowing participation in the board's breach of its fiduciary duty with respect to the preferred stock offering could be imputed to NEA. The court found that plaintiff had pled sufficient facts to show that NEA deployed its board designee to exploit conflicts of interest on the ACT board and to facilitate the preferred stock offering at an unfairly low price, which gave NEA control of ACT.

Plaintiff's complaint also alleged NEA breached its fiduciary duty as the controlling stockholder of ACT with respect to sale of the warrant by engaging in self-dealing. Generally, a controlling stockholder has the right to act in its own self-interest when it is acting solely in its capacity as a stockholder, but this right must yield when a corporate decision implicates a controller's duty of loyalty. *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 440-42 (Del. 1996). NEA's alleged self-dealing came in the form of portfolio optimization by selling the warrant on the cheap to Abbott in order to incentivize Abbott to undertake a transaction favorable to NEA with respect to two of its other portfolio companies, Topera and VytronUS. In essence, plaintiff alleged that NEA prioritized its fund's overall rate of return to the detriment of ACT's stockholders, which would be a breach of the duty of loyalty under Delaware law.

The controlling stockholder's act of engaging in "a form of portfolio optimization" — that is, "prioritiz[ing] its fund's overall rate of return over maximizing value for [ACT's] shareholders" — is "precisely the kind of behavior that controllers may not engage in under Delaware law," the court wrote.

Plaintiff's complaint also stated a claim for breach of fiduciary duty against the individual Director Defendants regarding the warrant transaction. Plaintiff rebutted the business judgment presumption by pleading facts indicating that the Director Defendants had breached their duties of care and loyalty. With respect to the duty of care, the ACT board had not pursued an unsolicited, potentially superior offer or leveraged it to extract a higher price from Abbot in the warrant sale. Additionally, the board did not engage a financial advisor, or implement any formal process for sale of the warrant. Taken together, the board's inaction suggested gross negligence by the ACT board. With respect to the duty of loyalty, the business judgment rule was rebutted because Plaintiff pled facts showing that at least half of the ACT board was not disinterested or independent. ACT itself admitted that two of the directors were interested, and the court found that a third director was interested as well because of his position as CEO of an NEA-controlled company. These conflicts were relevant because NEA was allegedly motivated to accept less than fair value for its shares of ACT in order to benefit from Abbott's acquisition of Topera and investment in VytronUS.

Applying the entire fairness standard, the court further found that the facts alleged by the plaintiff supported a reasonable inference that neither the price nor the process relating to the sale of the warrant were fair. As to price, the court noted that the sale price under the warrant was significantly less than the price implied for ACT in a stock offering that was effected three months before the warrant sale. As to process, the court observed that the board likely was not independent due to ties to the controlling stockholder and its affiliates, had not engaged in any "formal process" to consider the transaction, and had not pursued the unsolicited, potentially superior offer that ACT had received while considering the sale of the warrant.

Kenneth Carr, etc., v. New Enterprise Associates, Inc., et al., memorandum opinion 180326



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