Recent Ruling a Caveat to Private Equity Investors

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When negotiating investments in target companies, a private equity firm will almost assuredly attempt to negotiate the best possible deal for itself and its investors. Any professional that has been a part of such negotiations and transactions understands that in addition to the valuation of the target company and the size of the investment, private equity firms can negotiate director seats, board observer rights, dividends, warrant protection, management services agreements, the right to buy additional securities at a fixed price in the future, and redemption rights. A recent opinion by the Delaware Chancery Court, however, may force some private equity firms to give pause before using their clout over company management to "cash-in" on these negotiated terms.

In *The Frederick Hsu Living Trust v. ODN Holding Corporation*, plaintiff Frederick Hsu, a common stockholder of ODN Holding Corporation (the Company), makes a variety of claims against the defendants, including claims of breach of fiduciary duties against certain officers and directors of the Company related to the redemption of Preferred Stock by Oak Hill Capital Partners (Oak Hill), a private equity firm that had invested in Oversee.net through the Company five years prior to the redemption. The complaint also alleges a breach of fiduciary duty against Oak Hill itself.

Ruling on a motion to dismiss and after giving the required benefit of all reasonable inferences to the plaintiff, the Delaware Court of Chancery declined to dismiss several of the counts against the defendants, including the claim of a breach of fiduciary duties against Oak Hill and certain of the Company's directors (including the directors nominated by Oak Hill) and officers.

THE FACTS

As the alleged illicit conduct occurred over a several year period, the facts related to the case are somewhat complicated, but can be simplified as follows. In 2008, Oak Hill purchased $150 million of Preferred Stock in Oversee.net through the Company (the parties formed the Company in order to facilitate the investment), and in 2009 purchased an additional $24 million of Common Stock in the Company from Lawrence Ng, who co-founded Oversee with Mr. Hsu. Following such investments, Oak Hill owned over a majority of the voting stock of the Company and had the right to nominate three of the Company's eight directors. Additionally, as part of the Preferred Stock purchase, Oak Hill negotiated the right to redeem the Preferred Stock in 2013 for $150 million (the original purchase price of the Preferred Stock) if the Company had the funds available to do so.

Following the investment, the Company's historic business strategy did not immediately change. From 2009 to 2011 the Company continued to focus on growth and completed at least three acquisitions. However, in 2011 the Company's strategy changed abruptly, and it is alleged that the change of strategy was made at the behest of Oak Hill in order to hoard cash so that Oak Hill could exercise its redemption right in early 2013 and exit its initial investment in the Company. This new strategy seemed to work in Oak Hill's favor. In two separate redemptions in 2013 and 2014 Oak Hill received $85 million in exchange for a portion of its Preferred Stock, but the redemptions left the Company a shell of its former self, achieving annual revenue of $11 million in 2015, down 92% from the $141 million in annual revenue achieved in 2011 prior to the strategy change. Virtually all of the Company's value was paid out to Oak Hill so that it could exercise a right that it had negotiated during its Preferred Stock investment five years earlier.

THE RULING

While the Company's actions, including the redemption described above, were approved by the Company's Board of Directors, and therefore would normally be protected from challenge by the business judgment rule, the Court held that the Company did not have a majority of disinterested directors and that a majority of the directors were actually beholden to Oak Hill (the majority stockholder) for various reasons. As a result of the lack of a majority of disinterested directors, the Court was forced to use the heightened "entire fairness" standard to analyze the actions of the Board as opposed to the Board deferential "business judgement" standard. When Courts use the "entire fairness" standard, the defendants must show that the challenged actions, which include the Company's change in business strategy, the negotiation of the redemption with Oak Hill and the actual redemptions, were "entirely fair" (fair with respect to both process and price) to the common stockholders. Although the defendants can shift the burden to the plaintiffs if either an independent committee of directors or the disinterested stockholders approved the actions in question, the defendants failed to do so. Thus, the Court ruled that the actions of the Board, which included a majority of directors tainted by their relationship to Oak Hill and thus not independent were not "entirely fair" and the breach of fiduciary duty claims would be litigated at trial, which will be costly, lengthy and may have an adverse effect on the reputation of Oak Hill and the management of the Company.

ANALYSIS

Must a private equity investor, then, be worried that it is opening itself up to breach of fiduciary duty claims every time it exercises a negotiated provision of its investment? The answer is assuredly "no," but all directors of a company, whether independent or not, need to be cognizant of their fiduciary duties to the company and its stockholders and be sure to abide by the applicable provisions of Delaware law on the matter, which state, in part, that a corporation has essentially a contractual obligation to its preferred stockholders but the directors owe a fiduciary duty to the common stockholders. Therefore, the company cannot favor the interests of preferred stockholders over the interests of the common stockholders, in spite of a clear contractual obligation to the preferred stockholders. Here, the Court states that the Board treated Oak Hill as a secured creditor and not as a preferred stockholder and placed the interests of Oak Hill above the interests of the common stockholders, which is contrary to Delaware law. Although it will be interesting to see if the defendants at trial can successfully rebut the claims made against them, as a practical matter, the fact that the plaintiff's claims have survived to this point is already a loss for the defendants.

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