CORPORATE, TAX & TRANSACTIONAL ALERT

5/18/17

Delaware Court of Chancery Focuses on Fiduciary Duty of Directors Appointed by Preferred Stockholders

By Terrence H. Link II, Partner
Connie A. Porter, Associate

In a recent Delaware Court of Chancery opinion filed April 14, 2017 in *The Frederick Hsu Living Trust v. ODN Holding Corporation*, the court held that it may be a breach of the directors' fiduciary duty to cause the corporation to sell off parts of its business to satisfy a liquidation preference expressed by preferred stockholders. The court noted that the board has a duty to the long-term interests of the stockholders and should not bow to short-term pressures.

In 2008, Oak Hill Capital Partners invested $150 million in Oversee.net through a holding company named ODN Holding Corporation. In return for their investment, Oak Hill received Series A Preferred Stock which carried a redemption right in 2013 and the right to appoint two directors. In 2009, Oak Hill invested another $24 million in common stock and obtained majority voting control. The board of directors was enlarged to eight directors and Oak Hill had the right to appoint three directors in total. However, several of the other directors had allegiances to Oak Hill.

At the time of Oak Hill's investment, Oversee.net (Company) was in growth mode, and made several acquisitions of related businesses. However, in 2011, complainants alleged that the Company altered its business plan and started seeking to accumulate cash that could be used for redemptions. To execute this new business plan, the directors caused the Company to change the management team. The new management team was offered bonuses tied to the redemptions. Starting in 2012, the Company started selling off lines of business for a fraction of what the companies had originally been purchased for. In March 2013, Oak Hill triggered its redemption demand and received $45 million of the $50 million in cash reserves. Over the next year, the Company continued selling its various businesses for far less than the businesses had been acquired for and in September 2014, the Company paid another $40 million in redemptions. Prior to the divestitures, the Company generated annual revenue of $141 million. In 2015, after the sales, the Company had a 92% decline, and generated annual revenue of $11 million. In December 2015, one of the founders of the Company filed suit.

The Plaintiff brought suit against the directors, alleging that the directors breached their fiduciary duty with the altered business plan initiated in 2011. Delaware law requires directors to manage the business and day-to-day affairs of a corporation. As managers of the corporation, directors owe two fiduciary duties – care and loyalty. The duty of loyalty requires that the best interest of the corporation and its shareholders be primary to any interest possessed by a director, officer, or controlling shareholder unless shared by the stockholders generally. It also requires the directors to act in good faith. A failure to act in good faith is demonstrated when the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation. The duty of loyalty requires directors to advance the best interests of the corporation, meaning that they must seek 'to promote the value of the corporation for the benefit of its stockholders.' The court clarified that when referencing the benefit of its stockholders, that this means "stockholders in the aggregate in their capacity as residual claimants, which means the undifferentiated equity as a collective without regard to any special rights."

In reviewing what duties are owed to preferred stockholders, the court pointed out that "the rights and preferences of preferred stock are contractual in nature." The fiduciary duties do not protect special preferences or rights. Although defendants argued that they did not have room to exercise discretion because the corporation had an obligation to fulfill its contractual commitment, the court stated that those contractual commitments did not remove the fiduciary obligations. "Even with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach."

The complaint alleged that if the board of directors had retained the businesses it divested, they would have generated greater long-term value for the benefit of the undifferentiated equity. Had the Company not sold the businesses it divested, the Company would not have had surplus or legally available funds, which means that there would not have been the ability or obligation to redeem the preferred stock. Further, had the board divested those businesses to raise funds after the redemption right ripened and compromised the Company's ability to generate long-term value for the benefit of the undifferentiated equity, "then the redemption provisions themselves recognize that a plaintiff could assert a claim for breach of fiduciary duty."

The duties of directors in Delaware corporations are substantial. Although the raiding of Oversee.net's assets to redeem the rights of a majority shareholder with preferred stock redemption rights might seem straightforward, foreseeing the consequences when drafting these rights and obligations is often more of a tangled web. If you need assistance in determining how a duty may play out or in drafting special preferred stock rights, please contact one of the attorneys below from Roetzel's Corporate, Tax and Transactional group.

Authors
Terrence H. Link II
tlink@ralaw.com

Connie A. Porter
caporter@ralaw.com

Additional Contact
Christopher P. Reuscher
creuscher@ralaw.com

Media Contact
Ashley McCool
amccool@ralaw.com