Frederic Hsu Living Trust v. ODN Holding Corp. (2017)

Key Takeaways

- A redemption right contained in a preferred stock is not a guaranteed right of payment. A holder of preferred stock is not a creditor of a corporation, even after the redemption right is exercised.
- A board of a Delaware corporation owes fiduciary duties to its common stockholders when considering how to handle contractual obligation owed to other parties, including holders of preferred stock. Under the doctrine of efficient breach, a corporation may decide that its most advantageous course is to breach a contract and pay damages.
- A board may be subject to claims for actions taken both <u>prior</u> to, and <u>after</u>, a redemption right is exercised:
  - Boards may be subject to claims of breach of the fiduciary duty of loyalty if, prior to a redemption right being exercised, they take actions to prepare for the redemption right which seek to maximize the value of the redemption right, rather than the value of the common equity. In this case, the company sold business lines to raise cash before there was any contractual obligation to redeem the preferred stock.
  - Following a redemption right being exercised, a board must still consider what is in the best interests of the common stockholders. If a company lacks "legally available funds," or if it would be in the interests of common stockholders to default on the payments, a company may not be able or necessarily obligated to make significant redemption payments.
- Fiduciary duty risks are heightened if the holder of the preferred stock is also the controlling shareholder of the company as additional claims may be made against the controlling shareholder for breach of the duty of loyalty. There is no exculpation for breaches of the duty of loyalty with respect to Delaware corporations.
- Directors appointed by holders of the preferred stock should recuse themselves not only with respect to decisions regarding the redemption of preferred, but also decisions that could be argued to be connected to the redemption (e.g., decisions to raise funds through asset sales)
- Procedural safeguards, such as special committees or actions taken by disinterested members of the board, should be put in place to maximize the likelihood of the "business judgment" rule applying. In this case, the Court determined that the higher "entire fairness" standard would apply. In some instances, both a special committee and approval of the "majority of the minority" may be needed for the business judgment rule to apply. It is also critical that any special committee members are totally independent.
- Be mindful of how employee bonuses are structured – in this case, bonuses were tied to the preferred holder receiving a certain amount of redemption proceeds, which the court focused on as potential evidence supporting a breach of duty as it forced executives to focus on the redemption right as opposed to the overall growth of the business.

Frederic Hsu Living Trust v. ODN Holding Corp. (2017) continued

Background

- Oversee.net was founded in 2000. By 2007, annual revenue exceeded $200 million.
- In 2008, funds sponsored by Oak Hill invested $150 million into shares of preferred stock of ODN Holding Corporation, a holding company for Oversee.net.
- Under the terms of the preferred stock, Oak Hill had a mandatory redemption right after five years, in 2013. Any redemption needed to be made "out of funds legally available therefor." If the funds legally available were insufficient, ODN was required to take all reasonable actions determined by the Board "in good faith and consistent with its fiduciary duties" to generate funds.
- In 2009, Oak Hill purchased shares of common stock in ODN and became its controlling stockholder.
- In 2011, ODN changed it growth oriented business strategy, sold two of its four lines of business and kept the resulting cash. Total annual revenue dropped from $141 million in 2011 to $89 million in 2012. There was also a change of management, which was alleged to be linked to the new business strategy that sought to maximize the value of the redemption right.
- In 2012, ODN approved bonuses for senior officers if ODN achieved a liquidity event (including a redemption of at least $75 million in preferred stock).
- In 2013, Oak Hill exercised its redemption right. ODN did not have sufficient funds to pay the full redemption price. It used as much of its cash as possible for redemption, sold a third line of business and developed a new business plan that involved various cost cuts and additional sales to fund additional redemption price.
- After these payments, ODN had redeemed a total of $85 million of the preferred and still owed $65 million.
- As a result of the business sales, ODN's annual revenues fell to $11 million.
- Frederick Hsu—one of ODN's founders and a holder of common equity—brought a suit against Oak Hill (as controlling shareholder), ODN's Board of Directors, and certain officers arguing:
  - the Board (and Oak Hill, as controlling shareholder) breached their fiduciary duties by seeking to maximize the value of Oak Hill's redemption right—by causing the company to sell assets and stockpile cash—rather than seeking to maximize the value of the corporation over the long-term,
  - that Oak Hill was unjustly enriched (which the Court noted could allow for ODN to claw back some of the redemption proceeds from Oak Hill).
- The Court considered that the "entire fairness" standard of review would apply whereby the defendants would need to prove that the transactions were entirely fair to the corporation and its shareholders. While the Board set up a "special committee" to negotiate with Oak Hill, questions were raised as to the independence of the committee. In addition, as Oak Hill was a controlling stockholder and given the broader facts, both an independent committee and a "majority of the minority vote" would have been required in order to seek restoration of the business judgment rule. In the end, the Court may have reached the same conclusions even if the "business judgement" standard of review applied given the absence of fiduciary duties owed to preferred stockholders in this case.
- Oak Hill and the other defendants sought to have the claims dismissed. The court rejected the motion to dismiss and made the findings noted above. The final decision of the court is still pending.

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