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Roadblocks to Redemption: Delaware Chancery Court Makes Preferred Stock Redemptions More Challenging

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A recent decision in Delaware illustrates yet another difficulty investors face when using redemption of their stock as a liquidity strategy. In this case, a private equity fund, Oak Hill Capital Partners, and the directors of one of its portfolio companies (both outsiders and those designated by the fund) were sued for breach of fiduciary duty and other claims in connection with the redemption of preferred stock held by the fund. The court's refusal to dismiss the case creates the potential for a long and expensive court battle and ultimately the possibility of liability for Oak Hill and the directors.

On April 14, 2017, the Delaware Chancery Court declined to dismiss breach of fiduciary duty and other claims against a private equity fund and the directors of one of its portfolio companies (both outsiders and those designated by the fund) in connection with actions relating to redemptions of preferred stock held by the fund. This ruling adds to a number of other recent cases making redemption a more challenging liquidity strategy for private equity and venture capital firms.

In *The Frederick Hsu Living Trust v. ODN Holding Corporation, et. al.*, Vice Chancellor Laster allowed claims to proceed against Oak Hill Capital Partners, its director designees and other directors of ODN Holding Corporation for actions relating to redemptions of Oak Hill's preferred stock. The complaint alleged that Oak Hill lost faith in the company's ability to continue to grow, so instead caused the company to engage in a series of transactions designed to maximize the company's ability to redeem Oak Hill's shares of preferred stock rather than acting in the best long-term interest of all stockholders.

ODN sold a number of its divisions and business lines, including its "crown jewel," abandoned its historic high growth business strategy and restructured its operations. These changes resulted in a stockpiling of cash and reduction of annual revenue from $141 million to $11 million. At the same time, ODN's board of directors incented members of management to achieve the redemption of Oak Hill's shares by approving bonus agreements payable if the company redeemed at least $75 million of Oak Hill's preferred stock. Following these changes, ODN redeemed a total of $85 million of Oak Hill's preferred stock. The Oak Hill director designees abstained from the board votes approving the redemptions, but previously voted in favor of each of the business line sales and the company's restructuring.

A number of the court's conclusions in this decision will be troubling for private equity and venture capital firms that rely on redemption rights for liquidity. Notably:

- A board of directors does not generally owe fiduciary duties to holders of preferred stock, including when taking an action that circumvents the terms of the shares;
- A board of directors might breach its fiduciary duties if it causes the company to comply with the terms of preferred stock if breaching those terms would be more beneficial for the holders of common stock;
- Preferred stock without an accruing dividend is a fixed obligation and a board may breach its fiduciary duties by redeeming it in the short-term rather than growing the business over time, while at the same time reducing the present value of the preferred stock;
- Abstaining from a board vote may not shield a director from liability if the director "played a role in the negotiation, structuring or approval of the proposal;"
- Otherwise independent directors whose decisions favor the holders of preferred stock may be found to have acted in "bad faith" and thereby lose the benefit of the business judgment rule; and
- Where a controlling stockholder is present, a special committee of the board will not reduce the standard of review from entire fairness unless coupled with approval by a majority of the disinterested stockholders.

This ruling provides key takeaways for investors negotiating terms of preferred stock with redemption rights, as well as more generally for boards of directors of private equity and venture capital firm-controlled companies:

- The most effective approach to securing timely redemption is to include economic terms that incentivize the company, when considering what is best for the common stockholders, to redeem the preferred stock. Economic incentives, such as accruing dividends, can justify an earlier redemption of preferred stock given that the redemption amount will continue to increase the longer the preferred stock remains outstanding, potentially resulting in less value remaining for the holders of common stock.
- Particular care should be given to the decision-making process used by boards controlled by private equity or venture capital firms in connection with transactions with the firms or their affiliates that do not treat all stockholders in the same manner. Fiduciary standards for such transactions are likely to always be high and subject to an entire fairness review.