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Delaware's Most Recent Thinking on the Preferred-Common Conflict: *Hsu* v. *ODN Holding Corp.* and *In re Appraisal of GoodCents Holdings, Inc.*

Delaware Court of Chancery Addresses the Rights of Preferred Stockholders in the M&A Context

SUMMARY

In two recent decisions, the Delaware Court of Chancery addressed the differing rights of preferred and common stockholders in the M&A context. On April 14, 2017, in *Frederic Hsu Living Trust* v. *ODN Holding Corp.*,[1] the Court refused to dismiss claims that a private equity fund and the directors of one of its portfolio companies breached their fiduciary duties to common stockholders by selling certain of the company's business lines and assets in order to fund a mandatory redemption of preferred stock. The case, while decided on a limited record in the context of a motion to dismiss, illustrates the primacy—and power—of director duties to holders of common stock as compared to the contractual obligations owed to holders of preferred stock. Separately, on June 7, 2017, in *In re Appraisal of GoodCents Holdings, Inc.*,[2] the Court determined that common stockholders who had received no consideration in a 2015 merger were entitled to a pro rata share of the merger proceeds; in reaching that conclusion, the Court interpreted the company's certificate of incorporation—which established a liquidation preference for the company's preferred stockholders—as guaranteeing only a voting right, not a liquidation preference, in the event of a merger. Though the case centered on an issue of contractual interpretation—and its implications are therefore limited—the outcome favored the holders of common stock over the holders of preferred stock.

FREDERIC HSU LIVING TRUST v. *ODN HOLDING CORP.*

In 2008, Oak Hill Capital Partners invested $150 million in internet technology company Oversee.net. Together, Oak Hill and Oversee.net established ODN Holding Corporation ("ODN") as a holding company to facilitate the investment. In return for its investment, Oak Hill received preferred stock, which included a mandatory redemption right and terms that required ODN's Board of Directors to take "all reasonable actions . . . in good faith and consistent with its fiduciary duties" to generate sufficient funds to facilitate the redemptions.[3] However, the redemption right was only enforceable to the extent ODN had "legally available funds" to make the redemption.[4] In 2009, Oak Hill purchased common shares in ODN sufficient to give Oak Hill control over a majority of ODN's voting power.

In 2013 and 2014, ODN redeemed a total of $85 million of Oak Hill's preferred stock. According to the plaintiff, a common stockholder of ODN, this redemption was only made possible because, rather than managing ODN to maximize its long-term value for the benefit of the common stockholders, the directors operated the company so that it would be in the best position to redeem the maximum amount of preferred stock as soon as possible after the redemption right vested. To this end, beginning in 2011, Oak Hill allegedly caused ODN to shift from a growth-oriented strategy to one focused on amassing cash reserves. To effect this strategy, ODN allegedly sold all but two of its business lines for pennies on the dollar, abandoned its historic high-growth business strategy, and restructured its operations. Additionally, ODN's Board of Directors in 2012 incentivized members of management to generate funds for redemption by approving bonus agreements that were triggered by the redemption of at least $75 million of Oak Hill's preferred stock. Collectively, ODN's actions resulted in a reduction of annual revenues from $141 million to $11 million.

In March 2016, the plaintiff sued Oak Hill, ODN's Board of Directors, and certain of ODN's officers, claiming (among other things) that ODN, aided and abetted by Oak Hill, had breached its fiduciary duties to the common stockholders "by seeking in bad faith to benefit Oak Hill by maximizing the value of Oak Hill's redemption right, rather than by striving to maximize the value of the corporation over the long-term . . . ."[5] In considering the defendant's motion to dismiss the complaint, the Court addressed the scope of the fiduciary duty owed to the common shareholders in light of Oak Hill's contractual redemption right. The Court also addressed the appropriate standard under which to evaluate ODN's business decision to honor Oak Hill's redemption right.

The Court refused to dismiss the complaint. In allowing the case to proceed, Vice Chancellor Laster discussed the tension between the directors' fiduciary duty to maximize value for all stockholders and the company's contractual obligation to generate sufficient funds to facilitate the redemption of the preferred. Vice Chancellor Laster determined that, despite the contractual obligation owed to the preferred stockholders—to use funds legally available for redemption of preferred shares and, if insufficient, to "take all reasonable actions (as determined by [ODN's] Board of Directors in good faith and consistent with its

fiduciary duties) to generate, as promptly as practicable, sufficient legally available funds . . . "—the fiduciary duty owed to ODN's common stockholders required the directors to consider whether, in the long term, the company would have been better off breaching its contract with the preferred stockholders and facing the repercussions, as opposed to taking the actions it did to generate cash to fund the redemption. To this end, Vice Chancellor Laster noted that "[e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach."[6] The Court determined that the plaintiff had adequately alleged facts at the pleading stage to support the inference that the Board pursued a "de facto liquidation" of ODN at "seemingly fire-sale prices" purely to benefit the preferred stockholder,[7] when in fact it "could have grown [ODN's] business, gradually redeemed all of the Preferred Stock, and then generated returns for its common stockholders."[8] In other words, even though the preferred stockholders clearly were entitled contractually to a preference, that fact did not end the analysis because the contractual obligation was not absolute; rather, directors must always consider the fiduciary duty to "strive to maximize value for the benefit of the residual claimants,"[9] which in this case meant that the directors might have had a duty to cause ODN to breach its contractual obligations to the preferred stockholders, or at least to operate the business so that the redemption obligation could be satisfied, in accordance with its terms, over a longer period of time.

Notably, in reaching its decision, the Court determined that entire fairness review (where the defendant must prove that the process and outcome were fair), rather than business judgment review (where the plaintiff must prove that the board's action was not rational), was the appropriate standard to evaluate ODN's decision to generate cash for the redemption. The Court applied the entire fairness standard because it determined that the preferred stockholder, Oak Hill, was a controller and that the eight-member Board of Directors—consisting of three Oak Hill directors, four outside directors, and ODN's CEO, who stood to receive a large financial bonus for achieving the redemption—was under the influence of Oak Hill and not independent.[10] Applying this standard, the Court concluded that the plaintiff had alleged sufficient facts in the complaint for one to "reasonably infer[] that the directors acted to maximize the value of Oak Hill's Preferred Stock rather than seeking to promote the long-term value of [ODN] for the benefit of the undifferentiated equity, and that the resulting transactions were unfair to [ODN]'s common stockholders."[11] Therefore, the Court allowed claims of breach of fiduciary duty to proceed against the directors, officers, and Oak Hill itself (both as the controlling stockholder of ODN and as an alleged aider and abettor of the Board's alleged breach).

IN RE APPRAISAL OF GOODCENTS HOLDINGS, INC.

In *GoodCents*, the preferred stockholders of the target company, GoodCents Holdings, Inc., were entitled to a $73 million preference that, under the company's certificate of incorporation, was to be triggered in the event of a "liquidation, dissolution or winding up of the corporation."[12] The certificate of incorporation went on to state that "[w]ithout the affirmative vote of the [preferred stockholders], the corporation shall

not . . . effect any merger or consolidation . . . unless the agreement or plan of merger . . . shall provide that the consideration payable to the stockholders of the corporation . . . shall be distributed to the holders of capital stock of the corporation in accordance with [the provisions] above."[13]

GoodCents underwent a merger in 2015, pursuant to which the company was valued at only $57 million. The company concluded that the merger triggered the preferred stockholders' liquidation preference and, as a result, the preferred stockholders received all of the proceeds of the merger, and the common stockholders received none. The common stockholders filed a petition for appraisal, arguing that the merger did not trigger the liquidation preference in the certificate of incorporation, which they claimed provided the preferred stockholders with only a class vote or blocking right in the event of a merger. As such, the common stockholders asserted in their appraisal action that the fair value of the company at the time of the merger should have been allocated pro rata among the common stockholders and the preferred stockholders on an as-converted basis. The question for the Court was whether the company's certificate of incorporation guaranteed to the preferred stockholders a liquidation preference in the event of a merger, as the company believed, or merely a voting right with respect to a merger, as the common stockholders argued.

The Court agreed with the common stockholders. Vice Chancellor Montgomery-Reeves explained that the "plain meaning" of the relevant passages of the certificate of incorporation was that (i) GoodCents could not enter into any merger without the approval of the preferred stockholders, but that (ii) the preferred stockholders' voting right as to the merger "falls away" in the event that the merger includes a liquidation preference.[14] The Court clarified that the certificate of incorporation "unambiguously" granted the preferred stockholders only "a voting right," and did not mean that whenever GoodCents entered into a merger, the preferred stockholders would be entitled to their liquidation preference.[15] In concluding that the merger did not trigger the preferred stockholders' liquidation preference, the Court also referred back to the provisions of the certificate of incorporation that expressly referenced the triggering of the liquidation preference in the event of liquidation, dissolution, or winding up, noting that a similar reference to a merger was "noticeably absent."[16]

IMPLICATIONS

The *Hsu* and *GoodCents* decisions highlight the contractual nature of duties owed to the holders of preferred stock. *Hsu* illustrates the overriding responsibility of corporate fiduciaries to always consider ways in which their decisions can optimize outcomes for the residual claim holder: the common stock. For its part, *GoodCents* underscores the importance of precise drafting in the terms of preferred instruments.

Hsu is also relevant to a trend in recent Delaware case law relating to financially distressed corporations. In those cases, the courts have concluded that directors never owe fiduciary duties to

creditors—even in the context of insolvency, when a director's fiduciary obligations shift from maximizing value for common equity holders to maximizing the value of the corporate enterprise for all constituents. In light of decisions such as *Hsu*, until a corporation is insolvent, the Board's focus should be solely on maximizing value for common equity holders—including by potentially defaulting on a contractual obligation—if the net result is that the corporation would remain solvent.

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ENDNOTES

[1] 2017 WL 1437308 (Del. Ch. Apr. 14, 2017).

[2] 2017 WL 2463665 (Del. Ch. June 7, 2017).

[3] 2017 WL 1437308, at *25.

[4] *Id.*

[5] *Id.* at *1.

[6] *Id.* at *24.

[7] *Id.* at *36, *40.

[8] *Id.* at *35.

[9] *Id.* at *20.

[10] *Id.* at *33-34.

[11] *Id.* at *36.

[12] 2017 WL 2463665, at *2.

[13] *Id.* at *3.

[14] *Id.* at *4.

[15] *Id.* at *5.

[16] *Id.*

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