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PERSPECTIVE

Fiduciary vs contractual obligations

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TRANSACTIONS WITH BOIRON

ODN Holding provides useful guidance to boards of directors weighing fiduciary obligations against contractual obligations and to investors who take board positions on the companies in which they invest.

In *The Frederick HSU Living Trust v. ODN Holding Corporation*, the Delaware Court of Chancery dismissed a claim for unlawful redemptions and declined to dismissed claims of breach of fiduciary duty against ODN's directors and controlling stockholder.

In 2008, Oak Hill Capital Partners invested $150 million in ODN on terms that gave Oak Hill the right to redeem its preferred stock after five years following the initial investment. Pursuant to a 2009 amendment to the terms of the preferred stock, ODN contractually agreed to "take all reasonable actions," as determined by ODN's board of directors in good faith and consistent with its fiduciary duties, to raise capital to generate sufficient legally available funds to redeem the total number of shares required to be redeemed pursuant to Oak Hill's redemption request.

In 2009, Oak Hill became ODN's controlling stockholder. After two years of continuing its business strategy focused on growth and acquisitions, Oak Hill caused ODN to change its business strategy to accumulating cash to redeem Oak Hill's preferred stock.

Between 2011 and 2012, ODN sold two of its four business lines, and its annual revenue dropped by $52 million. By 2012, ODN's cash reserves doubled to $50 million, and the company formed a special committee to evaluate ODN's options for raising capital for redemptions. In February 2013, Oak Hill exercised its redemption right in full. After significant negotiations between Oak Hill and ODN's officers, the special committee recommended in favor of a $45 million redemption of Oak Hill's preferred stock. ODN's board of directors then approved the redemption and determined that ODN had sufficient surplus for the redemption.

In 2014, ODN's board of directors approved (i) a sale of another business line of ODN for $40 million, (ii) a sale of one of the three segments of its remaining business line, and (iii) a restructuring that involved terminating certain executives and other employees and terminating the lease for its headquarters. Those actions generated sufficient cash for another $40 million redemption of Oak Hill's preferred stock.

In 2016, Frederick Hsu, ODN's founder, filed a complaint claiming, among other things, unlawful redemptions and breach of fiduciary duty by ODN's directors and Oak Hill. In an opinion by Vice Chancellor Travis Laster, the court dismissed the claim for unlawful redemptions but allowed the claim for breach of fiduciary duty.

The court rejected the unlawful redemption claim under Section 160 of the General Corporation Law of the State of Delaware because ODN had sufficient "surplus," as required by the DGCL, to effect the redemption. Although ODN recorded on its balance sheet Oak Hill's preferred stock as a current liability after Oak Hill exercised its redemption right, ODN did not include the stock as a liability when it calculated ODN's surplus. The court found that ODN was not required to do so because Delaware courts have consistently held that preferred stock is equity, not debt, and the existence of a mandatory redemption right that has been exercised does not convert a holder of preferred stock into a creditor.

The court next focused its analysis on the common law limitations on redemptions. Under Delaware common law, a corporation's redemption is unlawful when the corporation is insolvent, meaning its liabilities exceed its assets or it is unable to pay its debts as they become due. After both redemptions were consummated, ODN had $23 million in assets, which exceeds the amount of its liabilities and was sufficient capital to pay its debts as they became due even though it was suffering an annual loss of $500,000. Thus, ODN was not insolvent pursuant to the balance sheet test or the cash flow test.

With respect to the breach of fiduciary duty claim against the directors, the court concluded that the plaintiff's pleading created a reasonable inference that all but one of the directors breached the duty of loyalty and that the breach should be evaluated under the entire fairness standard of review. A board of directors does not owe fiduciary duties to preferred stockholders when considering corporate actions that might trigger or circumvent the contractual rights of preferred stockholders. Instead, preferred stockholders are "owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock," in which case, a board of directors must promote the "value of the undifferentiated equity in the aggregate."

The court rejected the directors' argument that the fiduciary duty standard of conduct did not apply to the board of directors because it was constrained by the contractual obligation to redeem Oak Hill's preferred stock. Although the board of directors should consider the corporation's contractual obligations when making decisions, that consideration should be made with the goal of determining the actions that will generate the greatest benefit for the undifferentiated equity. The court indicated that the preferred stock did not include a cumulative dividend that would have increased the liquidation preference and steadily reduced the value of the common stock in the event ODN was not able to generate a sufficient return to pay off the preferred stockholders and return value for the common stockholders. Instead, before any contractual obligation to redeem the preferred stock was triggered, the board of directors approved the sale of two ODN's business lines to raise cash to satisfy a future redemption obligation, where retaining those business line would have resulted in greater long-term value for the common stockholders.

After determining that the entire fairness standard of review applied to the directors' decisions because the plaintiffs adequately pled that a majority of the directors were not disinterested and independent, the court concluded that the plaintiff adequately pled that the sale of ODN's assets was not entirely fair. The allegations supported a reasonable inference that ODN's assets were not sold at a fair price and that the board of director's decision to stockpile cash in favor of a redemption did not constitute fair dealing.

ODN Holding provides useful guidance to boards of directors weighing fiduciary obligations against contractual obligations and to investors who take board positions on the companies in which they invest. First, directors should put their fiduciary obligations ahead of all contractual obligations. In complying with their fiduciary duties, directors should consider the corporation's contractual obligations for the limited purpose of determining whether complying with those obligations is more beneficial to the company's stockholders than violating those obligations. If actions similar to those taken in *ODN Holding* are required to prevent a breach of an agreement that would result in greater harm or less benefit to the corporation than taking those actions, then the directors' fiduciary duties likely require them to approve taking those actions. Regardless of the circumstances, directors should always be focused on the corporation's long-term best interests.

Second, investors in preferred stock with a mandatory redemption right should consider negotiating for provisions that create an economic burden on the corporation for not redeeming the preferred stock. The economic burden increases the likelihood an independent and disinterested board of directors could take more drastic actions to redeem the preferred stock in lieu of suffering the economic harm of having the preferred stock outstanding. Although an early-stage investor likely will find it difficult to negotiate a provision that, upon failure of the corporation to redeem the preferred stock, grants to the preferred stockholder cumulative dividends, the right to force a sale of the corporation and drag-along the other stockholders and/or decreases the conversion price into common stock, *ODN Holding* has changed the legal landscape for investors and provides a good basis for seeking to negotiate a similar provision.

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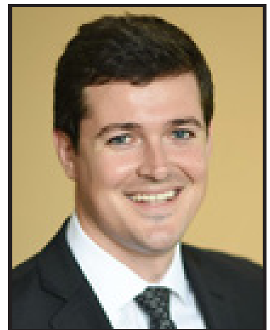

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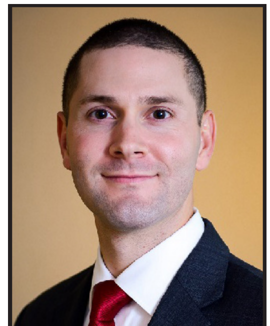

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