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Private Equity Firm Proves Strategy was Entirely Fair

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In *The Frederick Hsu Living Trust v. Oak Hill Capital Partners III, L.P., et al.*, the Delaware Court of Chancery doubled down on the importance of evaluating fair dealing and fair pricing as a whole in the context of board members' fiduciary duties. Oak Hill Capital Partners, a private equity firm, owned ODN Holding Corporation, a holding company for Oversee.net. Oak Hill owned a majority of the company's common stock and all of its Series A preferred stock. Oak Hill's holdings gave it control over the company at both the stockholder and board levels.

Frederick Hsu had co-founded the company, and was the second largest holder of its common stock after Oak Hill. According to the Delaware Court of Chancery's opinion, Hsu maintained that Oak Hill and its representatives on the board breached their fiduciary duties by causing the company to accumulate cash in anticipation of a redemption pursuant to certain terms of the preferred stock (the redemption right), rather than investing it in the company's business to promote long-term growth. At trial Hsu initially proved that the cash-accumulation strategy conferred a unique benefit on Oak Hill by creating a pool of funds that the company would be required to use to redeem Oak Hill's shares of preferred stock as soon as the redemption right ripened. Therefore, because the strategy conferred a unique benefit on the company's controlling stockholder, the defendants had the burden at trial of proving that the pursuit of the cash-accumulation strategy was entirely fair.

As is well known, the concept of fairness has two basic aspects—fair dealing and fair price—which must be examined as a whole to determine entire fairness. The fair dealing dimension of the entire fairness inquiry examines the procedural fairness of the decision, transaction, or result being challenged. The court found the defendants fell short on this dimension of the analysis. The reasons appear to be that Oak Hill directed management's actions and the lack of board approval of the cash accumulation strategy. Nevertheless, and noting that Hsu challenged only the cash accumulation strategy but not the decision to redeem shares or the prices at which assets were sold, the court found the lack of process was not fatal. The court noted that although the two aspects—fair dealing and fair price—may be examined separately, they are not separate required elements of a two-part test.

The fair-price dimension of the entire fairness inquiry examines the substantive fairness of the decision, transaction or result being challenged. In the traditional formulation, it relates to the economic and financial considerations of the transaction being challenged, including all relevant factors: assets, market value, earnings, future prospects and any other elements that affect the intrinsic or inherent value of a company's stock. The defendants proved at trial that the cash-accumulation strategy was entirely fair. The defendants proved by a preponderance of the evidence that the company's value declined not because of the cash-accumulation strategy, but rather because of industry headwinds and relentless competition, most notably from Google, Inc.

The defendants also proved by a preponderance of the evidence that even if the company had reinvested its net income, it could not have generated a return sufficient to create value for the holders of common stock. Oversee's common stock would likely have ended up worthless with or without the cash-accumulation strategy. The record also showed that although Oak Hill had an interest in achieving a return of capital with respect to its preferred stock, Oak Hill's additional ownership of a majority of the common stock gave it an incentive to create value for the common stockholders. While the court could envision "some lottery-like possibility" that reinvested cash could have produced some outsized success, it noted that company leadership and Oak Hill as the controlling shareholder were not obligated to take the long-shot bet.

Proving entire fairness is often difficult. This decision should provide some comfort to controlling groups that it can be done in certain circumstances.

For more information on this opinion, please contact Steve Quinlivan, Ashlee Germany, Timothy Joyce, Jennifer Cooke-Yin, Jennifer Moyer, Jack Bowling, Scott Gootee, Patrick Respeliers, Jonathan Vessey or the Stinson LLP contact with whom you regularly work.

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