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Delaware Court of Chancery Finds Private Equity Controller's Preferred Redemption Entirely Fair

The Delaware Court of Chancery recently held in *The Frederick Hsu Living Trust* v. *Oak Hill Capital Partners* that a controlling stockholder and its board designees did not breach their fiduciary duties in connection with the controlling stockholder's preferred stock redemption. The court determined that Oak Hill and its representatives satisfied the most exacting standard of review in Delaware—"entire fairness"—by demonstrating that retaining cash was the company's best strategy, because the company's business was in significant decline and alternative uses of the cash would not have created additional value for the common stockholders. The case stands for the premises that (1) where a controlling stockholder has a preferred stock redemption option, a court will apply the lens of entire fairness to the actions of the stockholder and its board designees, even as those acts relate to ordinary-course management decisions that may affect the stockholder's ability to redeem, and (2) that a controller may nevertheless prevail under an entire fairness review on the right record.

In *Hsu*, the company's majority stockholder, Oak Hill Capital Partners,[1] held preferred stock with an optional redemption right exercisable five years after its investment. Over time, and in light of changing market conditions, the company sold off various non-growth assets of the company at prices that were not disputed at trial and ultimately used accumulated cash to honor Oak Hill's pre-existing redemption right. The court held that the sale transactions (and the ensuing retention of the cash in the company) conferred a unique benefit on Oak Hill, because the accumulation of cash had the effect of maximizing the company's ability to redeem Oak Hill's preferred shares. The Court therefore held that the entire fairness standard of review applied not just to the redemption, but to the management of the company prior.

After voluminous discovery and a ten-day trial, the court concluded that the "Oak Hill deal team did not behave like people who were happy to build up a cash balance, redeem part of their Preferred Stock, and then write off the rest of Oak Hill's investment." Rather, the court concluded that the Oak Hill professionals "spent countless hours working with the Company to enhance the value of Oak Hill's investment. . . . Oak Hill wanted *both* a return of capital *and* to make the Company a success."

Ultimately, the court determined that the business was in decline due to unrelated "industry headwinds" and "relentless competition", there were no alternative acquisition or growth opportunities available, and the "common stock would have ended up worthless" regardless of whether accumulated cash was invested or not. While acknowledging the "lottery-like possibility" that alternative uses of company capital "might have achieved outsized success and created value for the common," the court held that "Oak Hill, the board, and the management team were not obligated to take a long-shot bet." To the contrary, the court found

[1] Paul, Weiss served as counsel to Oak Hill Capital Partners in the *Hsu* litigation.

Oak Hill's status as the majority stockholder to be "a counterbalancing incentive not to harm the value of the common stock" and "a final contextual factor that supports the economic fairness" of the company's strategy. Because the defendants proved redemption "was the best use of the Company's cash" that "inflicted no harm on the common stockholders," the defendants' actions were entirely fair.

The decision reminds us that successfully exercising redemption rights consistent with fiduciary duties owed to a company and its minority stockholders can be challenging exit events for private equity sponsors or other controlling stockholders. And it underscores that it is not just the exit event, but conduct preceding that event (even by years) that may be subject to judicial scrutiny. The court's holding nevertheless affirms that a controller can survive an entire fairness review in the right facts and circumstances.

For the court's opinion, click here.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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