CLIENT MEMORANDUM

If the Price Is Fair, Ultimately Delaware Courts Don't Care

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A recent case out of Delaware, *In re Trados Incorporated Shareholder Litigation*,[1] highlights the tension between the duties owed by a board of directors to common stockholders and the rights of preferred stockholders who control the board of directors to effect a sale.

The underlying controversy in the case centers on the July 2005 sale of Trados Inc. ("Trados" or the "Company"), an enterprise software company. Trados obtained venture capital financing from several firms in multiple rounds beginning in 2000. In exchange, the venture firms received rights to designate directors to the Company's board. The Company's capital structure consisted of several classes of preferred stock, which were held by its venture capital investors, and one class of common stock. In addition, the board approved a management incentive plan that compensated certain members of the Company's senior management in the event of a sale, even if such a transaction yielded no return for holders of common stock. On the sale of the Company for $60 million in cash and stock, management received the first $7.8 million as a result of the management incentive plan, and the preferred stockholders received $52.2 million. The liquidation preference of preferred stock was $57.9 million. The common stockholders received no consideration for their shares from the sale of the Company.

[1] C.A. No. 1512-VCL (August 16, 2013).

One of the Company's common stockholders, individually and on behalf of a class of the other common stockholders, sued the directors in July 2008,[2] contending that they should not have agreed to the sale, but instead should have continued operating Trados on a stand-alone basis in order to maximize the value of the Company for the ultimate benefit of the common stock. The case initially garnered attention when the Delaware Chancery Court did not grant the defendants' motions to dismiss.[3] In that decision, the Court highlighted the fundamental issue for the board: what are the board's duties to common stockholders when the interests of preferred stockholders and common stockholders diverge. The Court noted that, in certain situations, a director could breach his or her fiduciary duties by improperly favoring the interests of the preferred stockholders over those of the common stockholders. In other cases, as in *Trados*, the facts may support pursuing a transaction that is beneficial to preferred stockholders, but not to common stockholders.

In this case, the Court began its analysis by noting that the duty of directors is not to maximize the value of the corporation as an enterprise, but to maximize the returns for the residual claimants (i.e., in most cases, the common stock). The Court determined that the members of the board could not rely on the more board-friendly business judgment presumption, as it was not a majority of independent and disinterested board members that approved the transaction. Instead, the Court found that six of the seven directors were not disinterested and independent: the three venture capital directors because of their venture capital firms' interest in receiving their liquidation preference, the two management directors because of the compensation they would receive from the sale as a result of the management incentive plan, and one of the supposedly independent directors due to his long history with one of the venture capital investor firms and his investment in preferred stock of the Company via another investment vehicle. Because of these conflicts of interest, the Court applied the entire fairness standard, which considers whether the transaction was the product of fair dealing and a fair price.

In respect of fair dealing, the Court found that the board did not even consider the possible outcomes from the perspective of the common stockholders or give serious consideration to any possible divergence of interest between the preferred and common stockholders. The Court also considered the management incentive plan, which it noted is common for venture capital-backed companies. In the case of *Trados*, the Court found that the cost of the management incentive plan was borne disproportionately by the common stockholders as opposed to the preferred stockholders. As such, the Court found the management incentive plan to be evidence of unfair dealing by the board to the common stockholders. The Court also highlighted that in making its decision, the board did not consider (i) forming a special committee to represent the interests of the common stockholders, (ii) obtaining a fairness opinion from the perspective of common stockholders or (iii) conditioning the sale of the Company on a vote of a majority of disinterested stockholders.

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2 The same plaintiff sued for appraisal of his shares immediately after the July 2005 sale. The actions were consolidated.

3 *See In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

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Both sides presented evidence of their valuation analysis of the Company to establish fair price. The Court accepted the discounted cash flow valuation presented by the board, which valued the Company at $51.9 million. Given the preferred stockholders' liquidation preference of $57.9 million, under the discounted cash flow analysis the common stockholders still would not have received any consideration. As a result, the Court found that the value of the common stock was zero, and therefore the transaction was fair in terms of price. Though the process of approving the sale of the Company was not fair, the price was deemed by the Court to be fair, and therefore the decision to approve the sale satisfied the entire fairness standard. As the Court noted, "[a]lthough the defendant directors did not adopt any protective provisions, failed to consider the common stockholders, and sought to exit without recognizing the conflicts of interest presented by the Merger, they nevertheless proved that the transaction was fair."

In short, *Trados* highlights the continuing need for private equity and venture capital sponsors to be thoughtful and careful in structuring and negotiating investments in their portfolio companies in connection with the ultimate sale of such companies, particularly in underwater transactions. Had the preferred holders negotiated exit rights upfront, such as a drag-along right and/or redemption rights, much of what was at issue in this litigation could have been avoided. Instead, although the preferred holders prevailed on a rigorous entire fairness analysis, the attendant costs and distractions of litigation were an undesirable by-product of not having such contractual (or charter) rights at the inception of their investment. Separately, the Court confirmed that preferred stockholders have no obligation – even without contractual disclaimers to such effect – to continue funding companies in which they are substantial equity holders nor to consent to funding from outside third parties, even when the company is in distress.

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