The Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

Delaware Court of Chancery Upholds *Trados* Transaction as Entirely Fair

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Tuesday September 3, 2013

Editor's Note: The following post comes to us from David J. Berger, partner focusing on corporate governance at Wilson Sonsini Goodrich & Rosati, and is based on a WSGR Alert memorandum. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

On August 16, 2013, the Delaware Court of Chancery issued a much-anticipated post-trial decision in *In Re Trados Incorporated Shareholder Litigation*, holding that the sale of Trados to SDL was entirely fair to the Trados common stockholders and that the Trados directors had not breached their fiduciary duties in approving the transaction.[1] The case involved a common fact pattern: the sale of a venture-backed company where (1) the holders of preferred stock, with designees on the board, receive all of the proceeds but less than their full liquidation preference, (2) the common stockholders receive nothing, and (3) members of management receive payments under a management incentive plan.

Background

In 2005, the board of directors of Trados, a translation software company, approved the sale of Trados to SDL plc through a merger. In the four years leading up to the transaction, Trados had received multiple rounds of venture capital financing and issued several series of preferred stock. Shortly before the sale, Trados was sharply in need of capital, due to significant downturns in its business. Its venture capital investors were unwilling to inject more cash into the business, so Trados obtained an infusion of venture debt, adopted a management incentive plan (MIP) so that it could recruit and retain new management, and hired a new management team, including a new CEO and CFO. Trados also hired an investment banker to explore strategic alternatives and shopped the company to several possible buyers. Trados' new management was able, at least in

[1] Wilson Sonsini Goodrich & Rosati represented the Trados directors in the later-filed fiduciary duty litigation in the case.

the short term, to “clean up” the business, beating budget estimates and increasing revenue, while also exploring strategic alternatives for the longer term. Trados was ultimately able to negotiate a sale to SDL on terms deemed favorable by the Trados board. In the sale to SDL, Trados received $60 million. The first 13 percent of the merger consideration, or $7.8 million, went to management under the MIP. The remaining $52.2 million was distributed to holders of the company’s preferred stock—less than their total liquidation preference of $57.9 million, although some of the preferred stockholders received some gain on their initial capital investment. The holders of common stock received nothing.

In 2005, a holder of 5 percent of Trados’ common stock challenged the sale, first seeking a statutory appraisal of the value of his shares and later challenging the sale as a breach of the Trados board’s fiduciary duties. His theory was that even though the preferred stockholders took a “haircut” on their liquidation preference, and some of the preferred stock was convertible and participating and thus would have shared in any conceivable upside with the common stock, the venture capital firms that held the preferred stock were eager to exit the investment and obtain liquidity, and thus pushed the deal through at the expense of the common stockholders, who received nothing in the sale. The plaintiff contended that Trados was on an upswing and should have continued in operation for the benefit of the common stockholders. The plaintiff alleged that entire fairness review applied because a majority of Trados’ seven-member board was interested in the transaction, in that two directors were members of management who received payments under the MIP and other benefits from the sale, including post-acquisition employment with SDL, and four of the directors were aligned with the preferred stockholders. In 2009, the Court of Chancery rejected the defendants’ motion to dismiss the fiduciary duty claims against the directors based on the alleged facts, but did dismiss the plaintiff’s claims for aiding and abetting against the buyer and its officers. The Court of Chancery later denied the defendants’ motion for summary judgment and the case went to trial.

The Court of Chancery’s Post-Trial Decision

The court found that the plaintiff showed at trial that a majority of the directors were interested in or had a conflict with respect to the transaction. As a result, the court reviewed the transaction under the stringent entire fairness standard, which requires defendant directors to show the fairness of the sale process and the transaction terms. The court’s observations about the board members appointed by the venture capital firms are particularly significant. Discussing at length academic commentary about the motivations of venture capitalists, the court first generally embraced the view that venture capital firms operate to receive “outsized” economic returns in a compressed time frame, stating that “VCs seek very high rates of return, usually ten-fold return of

capital over a five year period."[2] The court then concluded, based on the evidence, that the separate funds that invested in Trados, which were unaffiliated with each other, acted consistent with these motivations. As a result, the court determined that all of the Trados directors who were principals of these funds were conflicted because the funds supposedly wanted to exit their investments in Trados. The court also concluded that a fourth board member designated by one of the funds was not independent, even though he was not an employee of the fund. The court initially noted that this director was from Silicon Valley and that "[b]ecause of the web of interrelationships that characterizes the Silicon Valley startup community," independent directors of venture-backed companies "are often not truly independent of the VCs."[3] The court noted, however, that "the plaintiff could not rely on general characterizations of the VC ecosystem," and has to prove that the director was not independent.[4] The court then focused on that director's ownership of preferred stock as well as his history with one of the funds, which involved investing with the fund and serving as an executive of some of the fund's portfolio companies, and concluded that the director had "a sense of owingness" to the fund.[5]

Nonetheless, the court went on to find that the Trados directors had not breached their fiduciary duties because they proved that the transaction was entirely fair. The court was critical of the sales process, finding that the process had been initiated in order to obtain an exit for the preferred stockholders, that the MIP had been adopted to further the preferred stockholders' goals, and that the evidence failed to show that the board had considered the interests of the common stockholders or how to allocate proceeds in a way favorable to the common stockholders—for example, by (1) obtaining a fairness opinion, (2) funding the MIP further out of the proceeds of the preferred stock and allocating some proceeds to the common stockholders, or (3) using procedural protections such as an independent committee of directors or conditioning the transaction on approval by the disinterested common stockholders. However, noting that the entire fairness test is a "unitary" test based on price and process, the court concluded that the deal was entirely fair because the evidence showed that the economic value of the common stock at the time of the transaction was zero—i.e., exactly what the common stockholders had received.

It is also noteworthy that the Court of Chancery generally emphasized the contractual nature of preferred stock and the resulting limited fiduciary duties that a board can owe to holders of preferred stock versus common stock. The court embraced the view set forth in earlier Delaware case law that where directors can exercise discretion, they should generally prefer the interests of

[2] Op. at 59. The court noted that venture capitalists "will sometimes liquidate an otherwise viable firm if its expected returns are not what they (or their investors) expected." *Id.*

[3] *Id.* at 66.

[4] *Id.* at 67.

[5] *Id.* at 68.

common stockholders to those of preferred stockholders. The court also noted the absence of a drag-along provision or similar contractual right giving the preferred stockholders a right to force a sale of the company.

Key Takeaways

The decision highlights the difficulties that can arise under Delaware law in the venture-backed company context, particularly in a sale of the company where the common stockholders get little or no value for their stock. These difficulties are the result of many factors, including the narrow interpretation Delaware courts give to the rights of preferred stockholders and the possibility that designees of venture capital firms on boards may be found to be conflicted. Although the Trados directors were ultimately found not liable, the transaction was the subject of years of litigation—a nearly inevitable result once a court finds that a majority of the board is conflicted and therefore applies the entire fairness standard. Venture-backed companies should consult with their counsel to navigate and attempt to minimize these difficulties. The case does signal some paths to consider going forward, including using certain procedural protections in deals or contractual arrangements relating to liquidity events.