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Client Alert

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Delaware Court Addresses Preferential Treatment of Preferred Stock over Common Stock in Merger

On August 16, 2013, the Delaware Court of Chancery issued a highly anticipated post-trial opinion in *In re Trados Inc. Shareholder Litigation*, C.A. No. 1512-VCL, mem. op. (Del. Ch. Aug. 16, 2013). The case arose from the sale of a venture capital-backed company in which all of the merger consideration was allocated to the preferred stockholders, in satisfaction of their liquidation preference, and senior management, pursuant to a compensation plan, leaving nothing for the common stockholders. In his 114-page ruling, Vice Chancellor J. Travis Laster applied the entire fairness test, which is Delaware's most stringent standard of review. He found that, "despite the directors' failure to follow a fair process," the defendants met their burden because the common stock had no economic value prior to the merger. As a result, the common stockholders received substantially the equivalent of what they had before.

Background

The litigation arose from the 2005 sale of Trados Incorporated ("Trados"), which was a Delaware corporation backed primarily by venture capital ("VC") firms. The VC firms held various series of preferred stock with a liquidation preference payable in the event of a merger. Almost all of the company's directors were members of senior management or affiliated with the VC firms.

Throughout the sale process, the record indicated that the VC firms' board designees were focused on possible exit opportunities. Also during the sale process, the board adopted a management incentive plan that would pay bonuses to senior management equal to a specified percentage of the proceeds realized in any sale transaction. The bonuses would be reduced, however, by any payments to the senior management for their equity ownership, which was in the form of common stock.

In the sale, a third-party buyer agreed to acquire Trados for $60 million. The merger consideration was allocated as follows: $7.8 million was paid to senior management; and the remaining $52.2 million was paid to the preferred stockholders. At the time, the aggregate liquidation preference of the preferred stock was $57.9 million. Nothing was paid to the common stockholders in the merger.

The plaintiff initially sought appraisal for his common stock. After conducting discovery, he filed a second complaint on behalf of all Trados common stockholders alleging that the directors breached their fiduciary duty of loyalty in approving the merger. In a 2009 decision, the Court of Chancery refused to dismiss that complaint. *See In re Trados Inc. S'holder Litig.*, C.A. No. 1512-CC, mem. op. (Del. Ch. July 24, 2009) ("*Trados I*"). Chancellor William B. Chandler III held that the plaintiff sufficiently alleged that a majority of the board was not disinterested and independent. He further stated that, in a transaction in which the consideration was paid solely to the preferred stockholders, "it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders." After Chancellor Chandler's retirement, the case was assigned to Vice Chancellor Laster, proceeded to trial, and resulted in his post-trial opinion addressing both the breach of fiduciary duty claims and the appraisal petition.

Post-Trial Opinion

At the outset, the court observed that Delaware law requires that directors "strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants." The court also contrasted the rights of common and preferred stock, noting that the latter is generally contractual in nature. Citing to prior Delaware decisions, the court also stated that directors must "pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred."

In turning to the plaintiff's fiduciary duty claims, the court determined that a majority of the company's board of directors was not disinterested and independent. With respect to the VC funds' board designees, the plaintiff met its burden of showing that "(i) the interests of the VC firms in receiving their liquidation preference as holders of preferred stock diverged from the interests of the common stock and (ii) the VC directors faced a conflict of interest because of their competing duties [to their affiliated funds and the company's common stockholders]." Based on the record at trial, the court found that the VC designees "wanted to exit [the investment], consistent with the interests of the VC firms they represented." As a result, the court held that the merger must be reviewed for "entire fairness," which is a two-pronged test that looks for "fair dealing" and "fair price."

Fair Dealing. In applying the entire fairness standard, the court found that the merger was not a product of fair dealing. In so doing, the court focused on the initiation and structure of the merger as well as how it was approved.

- *Initiation.* The court found that the merger was initiated so that the VC funds could "devote personal resources to other, more promising investments and by returning their funds' invested capital plus a modest return." The court further stated that the funds' board designees "did not make this decision after evaluating Trados from the perspective of the commons stockholders, but rather as holders of preferred stock with contractual cash flow rights that diverged materially from those of the common stock and who sought to generate returns consistent with their VC funds' business model."

- *Structure & Negotiation*. The court held that the implementation of the management incentive plan was evidence of unfair dealing. The plan was structured so that, if the merger consideration exceeded the preferred stock's aggregate liquidation preference, the bonuses would be funded by proceeds otherwise payable to the common stockholders. The court found "no evidence… that the Board ever considered how to allocate fairly any incremental dollars above the liquidation preference."

- *Manner of Director Approval*. The court found that the board never considered the interests of the common stockholders in approving the transaction. Vice Chancellor Laster also stated that "[g]iven the directors' intelligence, educational background and experience, I believe they fully appreciated the diverging interests of the VCs, senior management, and the common stockholders" and yet chose not to form a special committee or take other steps to evidence fair dealing.

Fair Price. Notwithstanding the court's determination that the merger did not satisfy the "fair dealing" prong, it concluded that the merger was fair. It found that "Trados likely could self-fund, avoid bankruptcy, and continue operating, but it did not have a realistic chance of generating a sufficient return [for its common stockholders] to escape the gravitational pull of the large liquidation preference and cumulative dividend" of the preferred shares. Thus, "[t]he common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before." As a result, the plaintiff was not entitled to recover based on his fiduciary duty claims. The court likewise concluded that the fair value of the common stock for purposes of the plaintiff's appraisal petition was zero.

Implications

Trados was a much-awaited opinion among the venture capital and private equity communities as well as distressed companies. It addresses a common issue involving competing classes and series of stock. The decision confirms that directors' duties will generally run to the common stockholders. As *Trados* noted, "[a] board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights."

Trados provides some helpful doctrinal guidance to practitioners in advising directors and stockholders. In addition to addressing the nature of the directors' duties when facing common and preferred stockholders, the court's fair price analysis focused on whether the company had "a reasonable prospect of generating value for the common stock." This should be a helpful guidepost to future boards in evaluating similar transactions.

Nevertheless, practical problems in these situations will continue to arise. A transaction in which all or most of the merger consideration is paid to preferred holders or creditors will always carry a heightened risk of common stockholder litigation. The claims in any such litigation are likely to be exacerbated when the directors are affiliated with the preferred stockholders, which is often the case. Plaintiffs generally will claim that those directors were interested by receiving a benefit not shared generally with the common stockholders. This was a similar issue in Vice Chancellor Laster's recent decision in *Carsanara v. Bloodhound Technologies* in which he found that directors who were affiliated with investment funds were interested in various financing rounds.

Importantly, *Trados* does not require that a board continue to operate a company until it makes a profit for the common stockholders. Likewise, it does not foreclose a sale that only benefits preferred stockholders or creditors. In fact, Delaware decisions such as *NACEPF v. Gheewalla*, 930 A.2d 92 (Del. 2007), *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), and *Blackmore Partners, L.P. v. Link Energy LLC*, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005), give wide latitude to directors who manage distressed or insolvent companies.

VC and private equity-backed companies can take a few steps to minimize the risk reflected in the *Trados* litigation. First, these companies should consider adding "outside" directors who are independent of the preferred stockholders and management. To be effective, however, the independence of these directors should be vetted carefully. Prior Delaware decisions have generally held that social relationships and immaterial business dealings are not sufficient to strip an outside director of his or her independence. The *Trados* court, however, expressed concern about "the web of interrelationships that characterizes the Silicon Valley startup community" and noted that independent directors "on VC-backed startup boards 'are often not truly independent of the VCs.'"

Second, boards should focus on procedural safeguards and indicia of fairness. Vice Chancellor Laster suggested that the merger might have been reviewed under the business judgment rule if the board had formed a special committee of disinterested and independent directors. He also suggested that, while not legally required, conditioning the merger on the approval of the common stockholders would have been "helpful affirmative evidence of fairness." In addition, the Vice Chancellor focused on the absence of a fairness opinion supporting the board's decision that the transaction provided fair value for the company.

It is not clear whether *Trados* will have a larger impact on the VC and private equity industries. As noted above, these investors may become increasingly likely to include outside directors on the boards of their portfolio companies. Many of the issues in *Trados* also could have been mitigated or avoided entirely if the company was structured as an alternative entity. For tax reasons and general "comfort" with conventional VC investment documents, VCs prefer investing in corporations through preferred stock. Delaware's alternative entity statutes, however, embrace the "freedom of contract," allowing companies to disclaim common law fiduciary duties and establish procedural mechanics to approve conflicted transactions. *Trados* may cause more investors to explore limited liability companies and limited partnerships. Trados may also cause VC and private equity investors to address exit transactions more frequently in a company's organizational documents. In *Trados I*, for example, the court noted that the defendants did not argue that they had a duty to pursue a transaction that would trigger the preferred stockholders' liquidation preference. Likewise, Vice Chancellor Laster noted that "[t]he VC contracts in this case did not attempt to incorporate any mechanism for side-stepping fiduciary duties (such as a drag-along right if the VC funds sold their shares)." Thus, VC funds may start negotiating more strongly for specific rights to compel an exit opportunity.

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