Corporate and Securities Alert:
In re Trados: Important Lessons for Directors on Fiduciary Duties to Common Stockholders

Fenwick
FENWICK & WEST LLP

Overview

In a ruling issued August 16, 2013, the Delaware Court of Chancery applied the entire fairness test—the court's most stringent standard of review for evaluating director conduct—when considering whether directors of a corporation breached their fiduciary duties to common stockholders in approving a change of control transaction in which the common stockholders received no consideration. The dispute in *In re Trados Inc. Shareholder Litigation*,[1] arose from the sale of a venture-backed Delaware corporation, Trados, Inc., in which senior management received a portion of the merger consideration pursuant to a management incentive plan ("MIP") put in place when the company began looking for strategic exits, and preferred stockholders received gains on their investments (but less than their total liquidation preference), but common stockholders received nothing.

A Trados stockholder sued first to have his shares of common stock appraised and later sued the corporation's directors for breaching their fiduciary duties by approving the merger. Under the two-prong entire fairness standard of review, the court found that (a) the defendant directors had failed to implement a fair process but (b) the Trados common stockholders had received a fair price in the acquisition because the common stock had no economic value prior to the merger.

Notwithstanding the defendants' avoiding liability in *Trados*, the court's application of the entire fairness standard of review raises significant implications for venture capital-backed companies given what are often commonplace facts for startup companies: directors affiliated with VC investors, questions of independence regarding board directors in a closely-knit technology and business community, management incentive carve-out plans and transactions where preferred stockholders and common stockholders have divergent interests.

1 *In re Trados Inc. Shareholder Litigation,* Consol. C.A. No. 1512-VCL, mem. op. (Del. Ch. Aug. 16, 2013).

Background

As is typical with many technology startups, Trados had obtained several rounds of venture capital funding to finance a growth strategy that could lead to an initial public offering or other successful exit. Though the company's business was trending upwards under a new CEO, the record before the court indicated its VC backers, including their affiliates who were members of the Trados board, were dissatisfied and sought potential exit strategies. To that end, Trados' board put into place the MIP in 2004 to incentivize the management's pursuit of strategic exits.

In 2005, Trados was sold to SDL plc for approximately $60 million in cash and stock. In the sale, senior management, pursuant to the MIP, received the initial $7.8 million of merger consideration, and the preferred stockholders received the remaining $52.2 million of merger consideration (preferred stockholders had an aggregate liquidation preference of $57.9 million). The common holders received nothing, though they would have received $2.1 million in the acquisition if the MIP had not been put in place.

Fiduciary Duties Analyzed Under Entire Fairness Review

Corporate directors owe duties of loyalty and care. The *Trados* court distinguished between directors' duties to common stockholders and preferred stockholders, emphasizing obligations to the common holders. It stated:

> "[T]he standard of conduct for directors requires that they 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. In light of this obligation, 'it is the duty of directors to 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.'"[2] (Emphasis added.)

2 See *supra*, *In re Trados*, pp. 40-41 (citations omitted).

The Delaware court clarified that preferred holders with contractual rights, on the other hand, are not owed fiduciary duties on the basis of such rights.

Delaware's most stringent standard of review, the entire fairness test, applies to circumstances where actual conflicts of interest exist such that a transaction is not approved by a majority of disinterested directors. Once a plaintiff proves that such conflicts exist in the absence of procedural safeguards, the fiduciary defendants bear the burden to prove that the transaction was objectively the product of fair dealing and resulted in a fair price.[3] The two-prongs of the fair-dealing and fair-price analysis are considered separately, but ultimately determined as a whole.

In *Trados*, the entire fairness standard of review applied as the court found the plaintiff had proved that six of the seven directors were not disinterested and independent. The management directors were deemed conflicted on the basis that, under the MIP, they received financial benefits from the sale of the company not equally shared by other stockholders. The court found the VC-affiliated directors were not disinterested and independent due to their competing fiduciary obligations to their funds. The court also found that one of the two directors that Trados had deemed "independent"—neither of whom was part of management nor directly designated by the VCs—was also conflicted. Citing the "web of interrelationships that characterizes the Silicon Valley startup community,"[4] the court stated that such "independent directors" are often chosen by VCs with deep professional networks, and that such directors often have other motivations to side with the VCs. The court examined the history of the director's lengthy and close business relationship with one of the VC directors and his venture capital firm, and found that this business relationship "compromised his independence for purposes of determining the applicable standard of review."[5]

No Fair Dealing. Under the first prong of the entire fairness standard of review, the court found that the acquisition was not a product of a fair process. In conducting its analysis, the court evaluated how the transaction was initiated, examined the transaction's (including the MIP's) negotiation and structure and finally scrutinized the processes by which director and stockholder approvals were obtained.

Yet Fair Price. Notwithstanding the court's findings of an unfair process, it ultimately determined that the common stock price in the merger was fair. The court concluded that Trados' ability to generate value for the common stock required financing its business plan with internal and external cash, and the company could not have reasonably raised outside funds. Because the court found the common stock had no economic value prior to the merger, common stockholders received the substantial equivalent in the transaction—zero. Accordingly, the plaintiff could not recover on his breach of fiduciary duty claims.

Implications and Practice Considerations

Though the defendant directors avoided liability, the *Trados* decision carries significant implications for the venture capital and private equity communities, particularly with respect to distressed companies. We recommend directors and management consider the following best practices:

- **Be Mindful of Divergent Interests between Holders of Preferred Stock and Common Stock**

  When considering acquisitions, boards need to make a point of considering the potential fairness to, and impact on, common holders, especially in situations where the interests of preferred stockholders and common stockholders are not aligned.

- **Carefully and Clearly Document Board Considerations**

  Boards should carefully and clearly establish contemporaneous records of their consideration of rights of common stockholders, especially in situations where the interests of the common may diverge from preferred stockholders. Among other things, boards should carefully reflect in corporate records (1) pursuing purchase prices above the level at which common will participate, (2) analyses of inflection points for such participation and (3) comparisons of the "standalone" alternative to a merger or acquisition—considering the costs and viability of internal and external sources of funding that may permit the company to continue without such merger or acquisition and generate value for the common stock.

3 *Cinerama, Inc. v. Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156, 1163 (Del. 1995).

4 See *supra*, *In re Trados*, 66.

5 See *supra*, *In re Trados*, 68.

When faced with such transactions, boards should also keep in mind the potential effects of past optimistic reports from management and recent 409A valuations that establish positive valuations for common stock. Boards should consider how such records may potentially be used to cast doubts on later determinations of the actual viability of self-funding, executing business plans or the company's ultimate valuation. Board directors should also be mindful and careful when directing company management to focus on selling the company over other alternatives.

Lastly, when proceeding with such acquisition transactions, company boards should pay careful attention to the drafting of merger process minutes from start to finish. From initiation of discussions, negotiation of term sheets and setting deal structure, to solicitation of board and stockholder approvals, the preparation of corporate records requires careful consideration.

- **Consider Use of a Special Committee and Other Measures that Provide Indicia of Fairness**

  If it is likely that common holders will receive no consideration in a transaction, boards should carefully consider whether appointing a special committee may be warranted and, as noted below, whether truly independent directors are available to constitute such a committee.

  As noted in the *Trados* decision, obtaining a fairness opinion may be unduly burdensome and costly, particularly for an already distressed company. However, it may be worthwhile to clearly document in the record the advantages and disadvantages for obtaining such an opinion, considering among other things, costs, time pressures, realistic value and other factors.

  Although the *Trados* court did not state that a vote of a majority of disinterested common stockholders was actually required, boards should assess the practicality of conditioning the approval of the transaction on such a vote to improve the fairness analysis. Preferred holders may need to stand back from a portion of their liquidation preferences in order to obtain such a common vote, which often makes a disinterested common vote requirement an unpalatable alternative.

- **Consider How Independent "Independent Directors" Truly Are**

  The *Trados* court observed that the Silicon Valley startup community is a closely-knit web of professional and personal relationships. In a situation where entire fairness review may apply, boards needs to carefully examine whether "independent" board members may be characterized as being beholden to the VCs that control the board by virtue of their previous business relationships, history, affiliations and other contacts.

- **Carefully Consider Management Carve-out Plans**

  Management carve-out or incentive plans may later be characterized as evidence of unfair processes if not carefully considered, drafted and prepared. A board should be mindful of value implications (does the plan re-orient the economic interests of management or create a divergence of interests between management and common stockholders?) and valuation breakpoints of MIPs, as well as pay careful attention to the process of drafting, preparing and approving such plans. It may be worthwhile to have plan terms be designed and approved by persons that do not have direct interests in the outcome. Boards should also consider designing and structuring plans such that the costs are not entirely or disproportionately born by common stockholders.

- **Consider Use of Alternate Entities**

  Many of the issues raised in *Trados* could have been avoided or mitigated if the company was not structured as a corporation, but rather, for example, as a limited liability company where the only duties owed are contractual in nature. Entrepreneurs and investors should consider with their legal and tax advisors the viability of alternative structures to achieve their business and financial objectives.

For more information please contact:

Douglas N. Cogen, 415.875.2409; *dcogen@fenwick.com*
David W. Healy, 650.335.7266; *dhealy@fenwick.com*
Kee B. Kim, 415.875.2377; *kkim@fenwick.com*
Thomas S. Kang, 650.335.7690; *tkang@fenwick.com*

©2013 Fenwick & West LLP. All Rights Reserved.

THE VIEWS EXPRESSED IN THIS PUBLICATION ARE SOLELY THOSE OF THE AUTHORS, AND DO NOT NECESSARILY REFLECT THE VIEWS OF FENWICK & WEST LLP OR ITS CLIENTS. THE CONTENT OF THE PUBLICATION ("CONTENT") SHOULD NOT BE REGARDED AS ADVERTISING, SOLICITATION, LEGAL ADVICE OR ANY OTHER ADVICE ON ANY PARTICULAR MATTER. THE PUBLICATION OF ANY CONTENT IS NOT INTENDED TO CREATE AND DOES NOT CONSTITUTE AN ATTORNEY-CLIENT RELATIONSHIP BETWEEN YOU AND FENWICK & WEST LLP. YOU SHOULD NOT ACT OR REFRAIN FROM ACTING ON THE BASIS OF ANY CONTENT INCLUDED IN THE PUBLICATION WITHOUT SEEKING THE APPROPRIATE LEGAL OR PROFESSIONAL ADVICE ON THE PARTICULAR FACTS AND CIRCUMSTANCES AT ISSUE.