Wiped-Out Common Stockholders: Delaware Chancery Court Finds "Foul" But No "Harm" in the Sale of a Venture-Backed Company

BY J. D. WEINBERG AND DANIEL NAZAR

J. D. Weinberg is a partner, and Daniel Nazar is an associate, in the New York office of Covington & Burling LLP. Contact: jweinberg@cov.com.

On August 16, 2013, after a full trial, Vice Chancellor Laster of the Delaware Court of Chancery issued a detailed 114-page opinion in *In re Trados Incorporated Shareholder Litigation*, ruling that the Trados directors did not breach their fiduciary duties by approving a merger between Trados and SDL plc in which the Trados common stock would receive nothing. Laster held that, despite the failure of the directors to follow a fair process and their improper focus on the interests of the holders of preferred stock, the approval of the merger was entirely fair to the holders of common stock because the common stock had zero value at the time of the merger. The opinion contains a detailed analysis of the fiduciary duties of directors during an exit-motivated sale in which the preferred stockholders' contractual rights to liquidation preferences may conflict with the common stockholders' residual interest. The case provides useful guidance for directors in conducting a sale process for private investor-backed companies and helps clarify for buyers of such companies the risks involved where a properly structured sale process may not be utilized.

Background

Trados, a company which developed and marketed translation software, obtained multiple rounds of venture capital funding, and, as a result of these investments, VC firms held a majority of Trados' preferred stock and were entitled to designate four of Trados' seven directors.

Following a period of underperformance, the board decided in 2004 to replace the CEO and explore the possibility of a near-term sale. The board ultimately hired a new CEO who had prior success in turning around and selling technology companies. The CEO, as well as Trados' CFO, also served as directors on Trados' board. In order to incentivize management to pursue a sale, the board adopted a management incentive plan ("MIP") that would compensate management for achieving a sale of the company regardless of whether the common stock received any value in the sale.

Under the new CEO's leadership, Trados posted record revenue and record profit in the fourth quarter of 2004. At the same time, the CEO and the board continued to pursue a sale of the company, and in June 2005, the Trados board of directors approved a merger between Trados and SDL for $50 million in cash and $10 million in SDL stock. Of the $60 million received in the merger, $7.8 million went to management under the MIP and the remaining $52.2 million went to the preferred stockholders, while the common stockholders received nothing.

An individual who owned about 5% of Trados' common stock sought appraisal of his shares in the Court of Chancery and also sued the directors on behalf of the common stockholders, arguing that the directors had breached their fiduciary duties in connection with the sale.

Standard of Conduct and Review

Laster considered the standard of conduct applicable to the board's actions in considering and approving the merger. While directors have a fiduciary duty to take actions for the benefit of the stockholders, the Vice Chancellor noted that the special rights of preferred stockholders are contractual in nature and that a board owes no fiduciary duty to maximize the value of these special contractual rights.[1] Laster noted that under existing Delaware case law, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc. … of preferred stock."

Laster then considered the standard of review to apply while evaluating whether the directors met the standard of conduct, with a focus on actual conflicts of interest. The plaintiff successfully argued that six of the seven members of the board had personal interests in the merger which conflicted with their duty to maximize value for the common stockholders.

Management Directors. The Vice Chancellor found that the two management directors were interested in the merger because the personal benefits they would receive from a sale were material enough to influence their judgment in favor of the merger. Under the MIP, the CEO received $2.34 million and the CFO received $1.092 million in connection with the merger. The plaintiff also showed that the CEO negotiated for post-merger employment as an executive and officer at SDL.

VC Directors. Laster found that the plaintiff proved the three VC Directors faced a conflict of interest as "dual fiduciaries" because of their competing duties to the common stockholders and to their VC firms as preferred stockholders. In a previous ruling on a motion to dismiss, Chandler rejected the directors' argument that because the preferred stockholders did not receive their full liquidation preference, their interests were aligned with the common stockholders in achieving a higher price. While Laster agreed with Chandler, his opinion provided a more detailed analysis of the specific interests of VC firms.

Laster's opinion noted that the interests of VC firms may be aligned with common stockholders in a highly successful company where "everybody wins" or in a total failure where "everybody loses", but that their interests can diverge greatly in intermediate cases where a company is profitable but lacks growth opportunities. In such cases, the VC firms' interest in liquidating the company and achieving an exit can conflict with the common stockholders' interest in achieving value by either holding out for a better deal or continuing to operate under a growth strategy. As a result, the VC directors' duty to their VC firms conflicted with their duty to the common stockholders.

Outside Director. Laster also found that plaintiff proved that one of the two outside directors was interested in the transaction based on that director's indirect financial relationships with (i) the VC firm that nominated him to the board and (ii) the VC director designated by the same firm. Laster specifically noted that in a conflict of interest between the VC firms and the common stockholders, such "so-called 'independent directors'" nominated by VC firms would "have incentives to side with the VCs."

Because the board lacked a majority of disinterested and independent directors, Laster determined that, consistent with Delaware law, the board's actions would be evaluated under the entire fairness standard, which shifts the burden to the directors to prove that they engaged in fair dealing and obtained a fair price for the stockholders in the transaction.

Fair Dealing

Laster found that the evidence conclusively showed a lack of fair dealing by Trados' board. Importantly, Laster noted that there was no evidence contemporaneous to the merger which suggested that the directors had attempted to deal with the common stockholders in a procedurally fair manner and dismissed testimony by the directors at trial to depict their actions as having been fair to the common stockholders. Laster considered four different aspects of the deal process and concluded that the directors had acted in a manner unfair to the common stockholders in all of them.

Initiating Sale Proceedings. Laster evaluated the Board's original decision in 2004 to fire the CEO and pursue a sale and determined that the VC directors pushed for a sale without considering the perspective of the common stockholders. Rejecting contrary testimony given by the directors at trial that they had properly evaluated plans to continue operating the company and build value as an alternative to the sale, the court found that the VC directors had pushed for an exit and showed no interest in continuing to manage the company to increase value for the common stock, having "initiated a sale process and pursued the Merger to take advantage of their special contractual rights" as preferred stockholders.

Negotiating the Transaction. For purposes of fair dealing, Laster determined that the MIP "skewed the negotiation and structure of the Merger in a manner adverse to the common stockholders." The MIP provided that management would be paid first in a sale, and under the deal, the preferred stockholders were then to be paid up to their full liquidation preference. Of the $60 million received in the merger, $7.8 million went to management under the MIP and the remaining $52.2 million went to the preferred stockholders, while the common stockholders received nothing. Without the MIP in place, the preferred stockholders would have received their full liquidation preference of $57.9 million and the common stockholders would have received $2.1 million in the merger. Under the structure of the MIP, the company had to be sold for at least $66.5 million for the common stock to receive any value, and the common stockholders would have contributed disproportionately, in Laster's view, to the MIP even at a much higher sale price. Laster observed that at a $70 million sale price, 75% of the common stockholders' proceeds would go to the MIP while only 25% of the preferred stockholders' proceeds would fund the MIP.[2] In the case of the sale to SDL, Laster noted that the MIP reduced the amount the preferred stockholders ultimately received by 10%, while 100% of the money that would have gone to the common stockholders went to funding the MIP. While the management team held common stock and options which could have incentivized them to hold out for a higher price that would create value for the common stock, Laster considered those incentives to be defeated by the MIP's "cutback" feature. Under the cutback, the MIP payout would be reduced by any amount that management received for their common stock.

Laster found both the design and effect of the MIP as aligning management with the interests of the preferred stockholders and the CEO and CFO ultimately acting and voting in favor of the preferred stockholders' interests to be evidence that the board dealt unfairly with the common stockholders when negotiating the merger. The Vice Chancellor further noted the lack of evidence that the board even considered allocating some of the sale proceeds to the common stockholders.

Director Approval. While six of the seven directors, including the CEO and CFO, had personal incentives to vote in favor of the deal, Laster also found that the directors did not understand their duties to the common stockholders and noted that a "director's failure to understand the nature of his duties can be evidence of unfairness." While the directors testified at trial that they had considered the interests of all stockholders in approving the merger, their testimony also indicated that they did not see the conflict that existed between the interests of the preferred and common stockholders. According to the record before Laster, the directors failed to consider taking steps to ensure the fairness of the merger, such as forming a special committee to represent the interests of the common stockholders (which Laster noted could have allowed the directors the benefit of the more lenient business judgment review) or obtaining a fairness opinion, which apart from any value it may have provided, could have added to the process an outside analysis of alternatives to the merger and "improved the record" for the directors on fair dealing.

Stockholder Approval. The directors never considered conditioning the merger on the approval of a majority of disinterested common stockholders. Instead, the deal was conditioned on a simple majority vote, which was delivered by the preferred stockholders and certain "friendly" common stockholders. One such "friendly" stockholder was the CFO, who indicated having second thoughts prior to the vote but voted his common stock in favor of the merger after his share of the MIP was increased.

Fair Price

While Laster found for the plaintiff on the issue of fair dealing, he agreed with the directors that the common stock had no value at the time of the merger. Laster rejected the directors' position that the company's financial position was so dire that it faced bankruptcy and noted that it was realistic that the company could have funded its growth plan and continued to operate independently. However, Laster credited a defense expert's methodology and conclusion that Trados was worth approximately $51.9 million, less than the preferred stockholders' liquidation preference. Trados also owed an 8% dividend to the preferred investors which accrued as additional liquidation preference. Further, Trados faced industry consolidation that removed clients and potential buyers. As a result, Laster found that even if the company remained profitable, it faced significant risks and was unlikely to generate growth high enough to exceed the climbing liquidation preference amount and generate value for the common stock and the value of the common stock would have remained zero for the foreseeable future.

Laster concluded that while the directors did not follow a fair process, the board's decision to approve the merger was nonetheless entirely fair to the common stockholders because they had received a fair price, consistent with Delaware law that unfair process alone does not breach a director's fiduciary duties.

Appraisal Rights

While noting that the legal standard for fair value in an appraisal is the stock's ongoing value rather than its value in the context of a merger, Laster reiterated that the common stock had zero value and Trados had no realistic chance to grow fast enough to overcome the preferred stock's liquidation preferences. As a result, the plaintiff failed in his appraisal claim.

Conclusions

While the opinion found in favor of the directors, it contains several warnings for directors with financial interests in a sale. While the directors were ultimately found not to have breached their fiduciary duty, their actions in negotiating and approving the sale were found to be unfair dealing, and the question of director liability may have ultimately hinged on the company's value.

Throughout the opinion, Laster repeatedly noted the lack of evidence that the board considered the interests of the common stockholders during the sale process. While the failure to (i) structure the MIP to avoid making the common stockholders bear a disproportionate burden of the MIP's costs and shifting incentives, (ii) enact protective provisions such as the use of a well-functioning special committee or conditioning the merger on a majority vote of the disinterested common stockholders or (iii) solicit an independent review of the merger and alternatives by an outside advisor were each factors in the case, the Vice Chancellor also focused on the lack of evidence that the directors even considered taking such actions and the directors' failure to recognize the conflicts of interest presented by the merger. A Board represented by preferred stockholders in these situations should not only remain aware of the interests of common stockholders, but also take steps to demonstrate the considerations arising therefrom and have them documented. Laster's opinion makes clear that directors with financial interests in a sale need to focus on the process and not just the outcome.

Left unresolved by the opinion is whether VC funds can effectively contract around such fiduciary duties to the common stockholders. Laster noted that the VC investors in Trados did not attempt to contractually impose mechanisms for "side-stepping fiduciary duties", such as drag-along rights, or otherwise realigning the fiduciary duties of the directors, clarifying that his ruling "provides no opportunity for expressing a view as to the effectiveness of any such mechanism or realignment, and it does not intimate one." Practitioners may assume that such mechanisms may well provide relief from the applicability of the exacting review Laster undertook of the Trados' boards process, but Laster expressly avoided providing any comfort in that regard in *Trados*.

This case ultimately should be considered important reading for private investors and advisors, as it provides guidance on how directors may comply with their duties to all stockholders when seeking an exit where not everybody "wins" or "loses."

NOTES

1. In a footnote, Laster described the scholarly view of a "control-contingent approach," which theorizes a board elected by the preferred stock can promote the interests of preferred stock over the interests of common stock, as not consistent with his understanding of the role of fiduciary duties. The Vice Chancellor also rejected the theory that directors have a duty to maximize enterprise value, defined as the aggregate value of the common and preferred stock including the preferred stock's contractual rights, and noted that he read Delaware case law as not supporting the theory.
2. Laster noted that he made no determination of what would be a fair allocation of the cost of the MIP, observing only that at the boundaries, funding 100% of the MIP through proceeds otherwise payable to the preferred stock raised no fairness issues, while funding 100% of the MIP through proceeds otherwise payable to the common stock raised serious fairness issues, and that a range of intermediate allocations were possible.