SULLIVAN & CROMWELL LLP

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In re Trados Incorporated Shareholder Litigation

Delaware Court of Chancery Finds Conflicted Board Did Not Breach Fiduciary Duty in a Change of Control Transaction that Satisfied Fair Price But Did Not Satisfy Fair Process

SUMMARY

In an opinion issued on August 16, 2013, the Delaware Court of Chancery (Vice Chancellor Laster) found that the board of directors of Trados Incorporated ("Trados"), consisting of a majority of directors who had conflicts of interest arising out of their affiliations with venture capital firms that invested in Trados through preferred shares, did not breach its fiduciary duty in approving a change of control transaction in which common shares received no consideration; and all consideration was paid first to fund a management incentive plan adopted to promote a sale and second to preferred stockholders to satisfy the liquidation preference of the preferred shares. Specifically, the court concluded that the entire fairness standard of review applied, and that, while the board did not satisfy the fair process prong of the standard, the zero consideration satisfied the fair price prong of the entire fairness standard.

The *Trados* decision has the following implications for directors and venture capital and other investors holding preference shares with liquidation preferences:

- Parties should recognize the conflict of interest that arises between preferred stockholders and common stockholders when a company has no common equity value but could potentially remain in business for some time. On boards with a majority of directors designated by preferred stockholders, this conflict of interest is sufficient to elevate the standard of review to the rigorous entire fairness standard.
- In evaluating a change of control transaction with a common-preferred conflict, a conflicted board should actively consider the interests of common shareholders and ways in which the process might mitigate the conflict. That deliberation should be memorialized in the minutes. Although helpful, the board is not required to employ procedural protections for the holders of common

stock such as a special committee of directors independent from the preferred stockholders, a fairness opinion from a bank engaged by the special committee or a vote of a majority of the stockholders unaffiliated with the holders of the preferred stock.

- In sales or similar transaction, directors must conclude that the transaction consideration exceeds what they expect the corporation otherwise would generate for stockholders over the long term.[1]
- In evaluating the adoption of a management incentive plan in the context of pursuing exit opportunities, the board should consider both the impact of such a plan on the incentives of management directors as well as the funding allocations of the plan. The board's decision to fund the management incentive plan ahead of the preferred stockholders' liquidation preference and any consideration that would otherwise have been received by the common stockholders and its approval of the management incentive plan without explicit consideration of the impact on common stockholders were both indicative of an unfair process.
- Although dicta, the *Trados* decision summarizes the fact that Delaware law does not require that directors fulfill the wishes of stockholders or a subset of stockholders and that the duty to manage the corporation may not be delegated to stockholders.
- A board that approves a change of control transaction that satisfies the fair price prong, even if it does not satisfy the fair process prong, can nonetheless be found not liable for breach of fiduciary duty. However, boards should not rely on this being the case in all situations, as the entire fairness standard is applied to a heavily facts-specific analysis; furthermore, whether this holding will be adopted by other Chancery Court judges or by the Delaware Supreme Court remains to be seen.

BACKGROUND

Trados produced desktop translation software. A majority of its stockholder voting rights were controlled by venture capital ("VC") investors, who had also designated a majority of the directors on the board. The VC investors invested through convertible preferred shares that had liquidation preferences payable upon a change of control transaction, voted with the common shares on an as-converted basis and had other customary VC negative control rights.

Over time, Trados faced challenges in achieving its business plans. In 2004, the board replaced the CEO and engaged a financial advisor to advise Trados about its strategic alternatives. At that time, the new CEO also presented several potential stand-alone alternatives to the board. Although stand-alone alternatives may have permitted Trados to remain solvent, none appeared to offer a clear opportunity for achieving any meaningful returns for the VC firms or any meaningful (if any) common equity value. The VC-designated directors favored an immediate sale of the company, and each VC investor also declined to invest additional capital to alleviate the company's liquidity crunch (later resolved through a third-party loan) and fund the potential organic growth plans. After initially rejecting a $40 million proposal from SDL, Trados later agreed to be acquired by SDL for $60 million, of which the first $7.8 million was paid to management under a management incentive plan (the "MIP"), and the remaining $52.2 million (less an indemnification holdback) was paid to the holders of the preferred stock, whose liquidation preference was $57.9 million. The common stockholders received nothing. The plaintiff, who owned 5% of the common shares, alleged that Trados's directors had breached their fiduciary duties in approving the transaction and sought appraisal.

THE COURT'S DECISION

Vice Chancellor Laster's opinion has implications for investors and boards, structuring investments, exits, and processes.

A. *Structure of Investment*

The court found that, in connection with approving a transaction in which proceeds were distributed through a waterfall with liquidation preferences paid to holders of preferred shares, directors designated by holders of the preferred stock have an inherent conflict of interest in relation to their fiduciary duties to act in the best interests of the "residual owners" (the common stockholders).[2] The inherent conflict arises because, as a result of the liquidation preference, holders of preferred stock "sometimes gain less from increases in firm value than they lose from decreases in firm value,"[3] such that the preferred stockholders' tolerance for the risk of achieving stand-alone business plans deviates from the risk tolerance profile of the common stockholders. When a board is dominated by directors designated by VCs, the existence of a liquidation preference may "affect the choice between (i) selling or dissolving the company and (ii) maintaining the company as an independent private business."[4] The resulting conflict in this case tainted six of seven directors on the board and subjected the board's decisions to the entire fairness standard of review.[5]

This heightened standard of review applies notwithstanding that the liquidation preference is a contractual right of the preferred shares embedded in the company's charter and that the common stockholders are on notice of the preferred stockholders' rights or potential rights at the time they invest. This is the case because the standard of review adheres to the approval of the change of control at the board level, not just the investor level. In dicta, the court noted that it may be possible to circumvent, through *ex ante* planning, the tension between preferred stockholders and common stockholders, and the attendant heightened standard of review, by mechanisms meant to avoid implicating the board's fiduciary duties. These mechanisms could include, for example, building into a company's charter or a stockholders agreement an affirmative right for the preferred stockholders to cause a sale of the whole company without the need for board approval (such as by implementing drag-along rights). However, the court did not rule on this issue and in many cases such a broad affirmative right will not be practical.

B. *Structure of Sale Process*

Due to the directors' conflicts of interest, the court reviewed the board's decision to approve the sale transaction under the entire fairness standard of review. Notably, the court found that although the process was not fair (in that there appeared to have been little, if any, thought given to the interests of common stockholders), the price was fair and that the directors therefore did not breach their fiduciary duty in approving the transaction. *Trados* confirmed that in certain circumstances, it is possible for directors to meet the entire fairness standard even if the transaction fails to satisfy the fair process prong, though the Court states that “the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.”[6] This holding emphasized that the unitary determination of fairness rests on “whether the minority stockholder shall receive the substantial equivalent in value of what he had before” the change of control transaction.[7]

The court especially considered two components of the sale process as evidence of an unfair process. One was the MIP, which raised two concerns: First, the MIP contained a cut-back feature whereby the management team gave up all benefits from its other equity holdings, including common stock and options to acquire common stock, to the extent of any payments under the MIP. This “converted the management team from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred.”[8] Second, the MIP was disproportionately funded by the common stockholders. With a liquidation preference of $57.9 million and the MIP taking the first $7.8 million, the preferred stockholders received $52.2 million instead of their full liquidation preference, a reduction of nearly 10%. However, the common stockholders, who in the absence of the MIP would have received $2.1 million, instead received zero, a reduction of 100%. The board apparently did not evaluate whether the $2.1 million of consideration above the liquidation preference should have been allocated to the MIP ahead of the common stockholders from the perspective of the common stockholders; the court noted that “there is no evidence in the record that the [b]oard ever considered how to allocate fairly any incremental dollars above the liquidation preference.”[9] The court goes on to say that “once the consideration topped the preference, thereby implicating the rights of the common, the additional dollars were not fairly allocated. All of the additional dollars went to management and the preferred. The common would not receive anything until the deal price exceeded the preference by more than the MIP payout”,[10] which would require a deal value of $66.5 million.

The second procedural issue that the court considered as evidence of an unfair process was the absence in the record of any meaningful consideration by the board of the interests of the common stockholders during the board’s evaluation of the proposed transaction. The board also did not consider alternatives to the funding allocation for the MIP as between the preferred stock and the common stock. Depositions and testimony also suggested that the VC-designated directors failed to understand that they had duties to the common stockholders or to recognize their conflicts of interest. In light of that, the board unsurprisingly did not employ any procedural protections for the holders of common stock such as a special committee of directors independent from the preferred stockholders, a fairness opinion from a bank engaged by the special committee or a vote of a majority of the stockholders unaffiliated with the holders of the preferred stock. The court acknowledged that these procedural protections were not required, especially given the size of the company and the cost of the measures, but noted that the absence of a majority of the minority condition precluded the directors from having an affirmative defense to claims the process was unfair.

C. *Valuation Methodology and Fair Price*

Notwithstanding the deficiencies in the process, the court found that the consideration received by the common stockholders – zero – was a fair price and that the appraised value of the shares was also zero. The court found that while Trados "likely could self-fund, avoid bankruptcy, and continue operating, […] it did not have a realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividend,"[11] and therefore, the common stock "had no economic value before the [m]erger, and the common stockholders received in the [m]erger the substantial equivalent in value of what they had before."[12] In reaching this conclusion, the court considered valuation studies produced by two experts. Consistent with recent trends in Delaware cases, the court questioned multiple assumptions made by the valuation experts and ultimately ascribed greater weight to a DCF analysis than to the comparables analyses. Among other reasons, the court pointed to challenges in identifying true comparables and addressing the impact of synergies in comparable transactions.

IMPLICATIONS

Trados's primary lesson is the importance of directors having an unrelenting focus on the interests of common stockholders and the very limited extent to which directors should consider the non-contractual interests of preferred stockholders in structuring transactions.

It has long been true that investors are usually better served by protecting their rights at the investor – rather than board – level and the *Trados* decision is an example of the fiduciary complexities that can arise when boards act.

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ENDNOTES

[1] See *In Re Trados Incorporated Shareholder Litigation*, C.A. No. 1512-VCL, slip op. at 35-36 (Del. Ch. Aug. 16, 2013) [hereinafter *Slip Op.*] ("Equity capital, by default, is permanent capital. […] When deciding whether to pursue a strategic alternative that would end or fundamentally alter the stockholders' ongoing investment in the corporation, the loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term.").

[2] Consistent with other recent cases, such as *In Re Morton's Restaurant Group, Inc. Shareholders Litigation*, the court acknowledged that while there is nothing inherently problematic with investors who are focused on exit opportunities, because of the standardized nature of VCs' investment in preferred stock with liquidation preferences, VCs typically have divergent economic incentives from those of the common stockholders. It is due to this divergent economic incentive that directors appointed by VCs have a conflict of interest.

[3] *Slip Op*. at 56.

[4] *Id.*

[5] In this case, the directors' conflicts of interest were not sanitized by the presence of outside directors on the board because one of the outside directors had meaningful ties to a VC investor. He had a long history with the VC, including having helmed a company in which the VC invested, working with the VC on other companies, and serving as the CEO of another company in which the VC was an investor (and on whose board the VC's designee to the Trados board also served). This web of interrelationships led the court to find "a sense of 'owingness' that compromised [the director's] independence" (*Slip. Op.* at 69). VC-backed portfolio companies often have VC-sourced "outside" directors who may have other ties to the VC. The court's finding that those ties may compromise the independence of "outside" directors, while not novel, is a reminder that when establishing a portfolio company board, VC investors should consider the pros and cons of including "outside" directors without assuming the "outside" directors will sanitize decisions in which the VC investors' director designees have a conflict of interest.

[6] *Slip Op*. at 69-70 (internal quotation marks omitted).

[7] *Id.* at 108.

[8] *Id.* at 80.

[9] *Id.* at 77.

[10] *Id.*

[11] *Id.* at 110.

[12] *Id.* at 111.

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