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Securities Alert

Delaware Court Issues Important Trados Decision Delineating Director Duties in Sale of Venture-Backed Company

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The Delaware Chancery Court issued its long-awaited post-trial decision last month in *In re Trados Incorporated Shareholder Litigation*. In the decision, the court affirmed that directors designated by the venture capital preferred stockholders owed fiduciary duties only to the common stockholders, subject to the contractual rights of the preferred stockholders. The court found on the evidence presented at trial that the directors who were designated by the preferred stockholders had interests that conflicted with the interests of the common stockholders. Because they were conflicted, the directors lost the protection of the “business judgment rule,” which presumes that the directors are acting in the best interests of the company and its stockholders, and instead the directors were judged by the strict “entire fairness” standard. Under that test, the directors were affirmatively required to prove at trial that the process they followed was fair and that the price paid to the common stockholders ($0) was also fair. Here, the directors proved the price was fair and escaped liability, but only after years of litigation.

A Daunting Task

The requirement that the directors prove entire fairness seemed like a daunting task given that the common stockholders received nothing from the sale of the company and given the court’s pretrial observation that this “was the worst possible outcome for the common shareholders.”

The Living Dead

The case arose in the not too uncommon scenario of a venture-backed “living dead” investment, which lies in the middle ground between the clear winners that yield strong returns and the losers where the investment is lost. In the case of Trados, a privately-held software company in the desktop translation market, the venture capital backers who held the preferred stock finally decided not to continue funding and to exit the investment to free up their time and capital for more highly valued projects. They replaced management and, in order to focus new management on a sale, put a “management incentive plan” into place pursuant to which management would receive up to 15% of the sale price. The company was soon sold, but once management was paid some $8 million of the proceeds, the remaining $52 million was not even enough to pay out the preferred stockholders’ liquidation preference, leaving nothing for the common stockholders.

The Litigation and Decision

Common stockholders then brought suit challenging the fact that they received nothing. The directors were forced to endure years of litigation and trial. The court, in its decision, stressed that directors owe their fiduciary duties to the common stockholders, not the preferred, whose rights are contractual. Because the majority of the directors who orchestrated the sale were connected with the preferred stockholders as their designees or, in the case of the two management directors, stood to receive millions from the management plan, they were necessarily conflicted, giving rise to the stringent entire fairness test.

Vice Chancellor Travis Laster, writing for the court, first found that the *process* pursued by the directors was not fair to the common stockholders because it was initiated by the preferred stockholders’ desire to exit the investment and was pursued without ever considering the interests of the common stockholders. The court explained that the company could have appointed a special committee of unconflicted directors to look after common stockholders’ interests, sought a fairness opinion from an independent financial advisor or required a majority of the disinterested common stock to approve the deal.

Notwithstanding that the court found the directors failed to follow a fair process, the court nevertheless focused on *price*. The court found that the directors had proven at trial that the $60 million sale price was in fact fair. Here, the court credited the directors' valuation expert, who employed a discounted cash flow analysis, and discredited the plaintiff's expert's valuation as "unreliably high" and as having "gamed" the analysis. Lastly, the court found that waiting it out and not selling would not have been any better for the common stockholders because the company would never have grown at a rate large enough to outpace the preferred stockholders' ongoing cumulative 8% dividend and thus it was unrealistic to suppose that a sale would ever have resulted in anything for the common.

Lessons from *Trados*

The leading takeaway from *Trados* is that the directors of a company facing a sale in which the common stockholders will receive nothing must proceed cautiously. The directors must be careful to consider the interests of the common stockholders, including perhaps by establishing a special committee for that purpose. Another structural solution hinted at by the court would be for preferred investors to insert into the deal documents the right to force the initiation of a sales process.

Also of note is the fact that the *Trados* court concluded that the directors did not breach their fiduciary duties because, even if the process was not fair, the price was. In the past, many observers of Delaware law believed that both process and price would need to be fair for directors to escape liability. The court could have found that because the process was not fair, the directors breached their fiduciary duties. At least here, the court did not do so. In that sense, the holding of *Trados* was especially helpful to defendants.

Are We Done?

Unhappy with the defendants' trial tactics, shifting testimony and evasive responses to discovery requests, the court invited the plaintiff to submit an application for fees and costs. If the application is granted, will the defendant directors qualify for either indemnification by the company or exculpation from liability?

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