# Fiduciary Duty Obligations to Common Stockholders:

## Management Carve-out Plans

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In an economic climate such as the current one, venture-backed companies often implement management carve-out plans as an incentive to retain key employees through an acquisition. In the recent case *In re Trados, Incorporated Shareholders Litigation*, C.A. No. 1512-CC (Del. Ch. July 24, 2009), the Delaware Court of Chancery addressed claims against the members of the board of directors by a common stockholder of Trados Incorporated (the "Company") as a result of such a plan.

The former stockholder alleged that the directors of the Company breached their fiduciary duty when the Board approved a merger of the Company pursuant to which only the preferred stockholders and certain members of management received any consideration, leaving the holders of common stock with no consideration at closing. The Court denied the defendants' motion to dismiss with respect to the breach of fiduciary duty claim and stated that in a situation in which the "interests of the common stockholders diverge from those of 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."

The plaintiff claimed that the transaction occurred to benefit preferred stockholders by triggering the large liquidation preference and providing the preferred stockholders with an exit to the detriment of the common stockholders. Four of the Company's directors were designated by preferred stockholders. During 2004, the Company's board began the process of seeking a buyer for the Company, including engaging an investment banker and hiring a new CEO who indicated that he had been hired to assist the Company in achieving an acquisition event. At the time the new CEO was hired in April 2004, the Company was not profitable and had minimal cash to continue operating the business on an on-going basis.

The investment banker identified potential buyers for the Company, engaged in discussions with these entities, and received a proposal for a $40 million acquisition in July 2004. The Company did not accept this proposal indicating it was too low. In December 2004, after Board discussions related to the concern that the executive officers may not be properly motivated to remain with the Company to assist in the potential sale, the Board adopted a management incentive plan (the "MIP"), pursuant to which certain members of the management team of the Company would receive compensation upon an acquisition.

The consideration to be received by management was based upon a graduated scale, depending upon the acquisition price (management was to receive 6% if acquisition price was $30–$40 million, 11% if $40–$50 million, 13% if $50–$90 million, 14% if $90–$120 million and 15% if at or above $120 million).

During the fourth quarter of 2004 and into 2005, the Company's financial performance improved dramatically. The Company was able to reduce spending and receive additional cash through debt financing. At the February 2005 Board meeting, management presented to the

Board significantly improved results — including record revenue and profit from operations in the fourth quarter of 2004. Despite improved performance, the Company continued down the path of an acquisition. In January 2005, a subsequent offer was presented to the Board for $60 million and in April 2005, the Company executed a letter of intent for a merger of $60 million.

As a result of the merger, the holders of preferred stock received approximately $52 million (not their entire liquidation preference of $57.9 million) and pursuant to the terms of the MIP, certain members of management received the remaining consideration. The plaintiff alleged that "there was no need to sell [the Company] at the time because the Company was well-financed, profitable and beating revenue projections" and that "in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing [the Company] as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment."

The Plaintiff's argument was based on the claim that the preferred stockholders' interests diverged from the interests of the common stockholders, while the defendants claimed that the plaintiff ignored the "obvious alignment" to obtain the highest price possible for the Company because at the $60 million consideration price, the preferred stockholders had not received their entire liquidation amount back. However, the Court did not agree with the defendants and instead remarked that the merger triggered a $52 million payout to the preferred stockholders of their $57.9 million preference, while the common stockholders "lost the ability to ever receive anything of value in the future for their ownership interest in [the Company]. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred."

The Court denied the defendant's motion to dismiss with respect to the breach of duty claim. As a result of this case, boards should be cognizant of the potential impact a management incentive plan may have on holders of common stock and should make sure to consider the potential impact of the timing of an acquisition event on such equity holders.

For more information on management carve-out plans, please contact **Mary Beth Kerrigan**.