When Nothing is Fair: *In re Trados* and the Fiduciary Duties of Investor Directors

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In a legal opinion dated August 16, 2013, the Delaware Court of Chancery delivered its long anticipated, post-trial decision in *In re Trados Incorporated Shareholder Litigation*, holding that a conflicted board of directors' decision to approve a merger transaction in which common stockholders received no consideration was entirely fair to the corporation and its stockholders. The court's decision serves as an important reminder of certain best practices to be followed by boards of directors while also leaving some uncertainty as to the contours of "entire fairness" scrutiny under Delaware law.

Background

Founded in 1984, Trados Inc. ("*Trados*" or the "Company") grew a successful business on the shoulders of its proprietary document translation software, generating nearly $14 million of annual revenue by 2000. After operating for 16 years without the benefit of significant outside investment, Trados sought venture capital financing in order to further spur growth and potentially position itself for an initial public offering. Beginning with an initial financing in March 2000, the Company proceeded to raise a total of $26.6 million from three venture capital firms over the course of two and a half years, issuing seven different series of preferred stock, some of which were "participating preferred" (meaning that once the applicable liquidation preference of the preferred shares was paid in full, the preferred stockholders shared pro-rata in any remaining distributions payable to holders of common stock) and all of which carried 8% cumulative dividends.

In the years that followed the venture capital financings, Trados experienced slow albeit steady growth. Dissatisfied with the Company's trajectory, the Trados board of directors hired a new CEO in July 2004 and established a management incentive plan (the "MIP") that reserved a portion of the proceeds from the eventual sale of the Company for designated senior managers. Shortly after this shift in leadership, the Company's performance improved with the business reporting record revenues and record operating profits in early 2005.

Despite this positive momentum, the Company's board of directors voted to sell the Company to SDL plc ("SDL"), a publicly traded software company, in June 2005 for $60 million. At the time of the sale, the total liquidation preference on the Company's preferred stock was $57.9 million, including accumulated dividends. After paying 13% of the total deal consideration to management under the MIP and addressing various indemnification claims post-closing, the Company's preferred stockholders ultimately received aggregate proceeds of $49.2 million, well below their total liquidation preference. Consequently, Trados common stockholders received nothing for their shares in connection with the sale of the Company. Despite the fact that designees of the Company's preferred stockholders constituted a majority of the Trados board, the separate approval of the Company's disinterested and independent directors was not obtained. The Trados board also did not condition the closing of the transaction on obtaining the separate vote of a majority of the Company's disinterested common stockholders.

Initial Court Decision and its Immediate Aftermath

In the wake of the sale of Trados, a holder of 5% of the Company's common stock filed two lawsuits, one seeking appraisal of his shares of stock and the other alleging breach of fiduciary duty by the Company's board of directors. In the latter lawsuit, the plaintiff claimed that the defendant directors had voted to sell the company at a time of profitable, strong performance and, in doing so, they had unfairly favored the interests of the preferred stockholders over the common stockholders, depriving the common stockholders of the opportunity to share in the proceeds of a sale of the company for a higher price at some later date. The defendant directors sought to dismiss the plaintiff's claim by relying on the "business judgment rule", a well-established tenet of Delaware corporate law that provides wide latitude to a corporation's board of directors in its stewardship of the business enterprise.

In evaluating the merits of the case, the court emphasized that the rights of preferred stockholders are contractual in nature and that when the interests of common and preferred stockholders diverge and discretionary judgment is to be exercised, it is the duty of the board of directors to prefer the interests of common stockholders to the special rights and preferences of preferred stockholders. In *Trados*, the board of directors made the discretionary decision to sell the Company in a transaction that triggered the liquidation preferences of the preferred stockholders despite the fact that the preferred stockholders held no separate rights to force a sale of the Company (i.e. through a negotiated "drag-along" provision) and despite an upswing in the Company's performance that gave hope to a sale at a higher price in the future. In addition, the court stressed that a majority of the Trados board of directors was self-interested in voting in favor of a sale of the Company by virtue of several directors' affiliations with the Company's venture capital investors. Accordingly, the court rejected the defendant directors' motion to dismiss the case and held that the directors would need to satisfy the burden of proving that the sale of Trados to SDL was entirely fair to the corporation and its stockholders.

The court's initial decision in *Trados* was met with some alarm by venture capital investors and legal practitioners as investor directors worried about potentially being held liable for voting in favor of a corporate sale at a price below the corporation's liquidation preferences that resulted in no proceeds being payable to common stockholders. Based on the wording of the *Trados* decision, such liability could even arise in situations where investor directors simply voted in favor of a sale transaction in which previously negotiated liquidation preferences were honored. The ensuing confusion over the status of Delaware fiduciary duty law and related best practices for directors led the National Venture Capital Association (the "NVCA") to modify its model financing documents to include commentary and drafting options to protect investor directors in such situations. Most notably, the NVCA model Voting Agreement was modified to provide for a "sale rights" provision pursuant to which a certain percentage of investors (the "Electing Holders") could force the corporation to initiate a sales process (i.e. engagement of an investment banker, negotiation of the terms of a sale of the corporation, etc.) without ever directly participating in the process at the board level. This new provision also anticipated scenarios where a board of directors ultimately rejected a proposed sale of the corporation, requiring in such instances that the corporation redeem all of the Electing Holders' shares in an amount equal to their pro rata proceeds of the rejected corporate sale.

August 2013 Court Decision

Despite misgivings about how the Trados board of directors had initiated and negotiated the SDL transaction and the manner by which director and stockholder approval of the transaction had been obtained, the *Trados* court recently concluded in a post-trial decision that the Company's directors had not breached their fiduciary duties in approving the sale of the Company because the Company's common stockholders received the economic value of their shares in connection with the transaction. In its decision, the court stressed that the timing of the approval of the SDL transaction (after the announcement of record profits) and the Trados board's failure to obtain the approval of a disinterested and independent majority of the board – or a majority of the Company's disinterested common stockholders – demonstrated that the

board had dealt with the Trados stockholders in a fundamentally unfair manner from a procedural standpoint. Nonetheless, the court found expert witness testimony regarding the value of the Company at the time of the SDL transaction credible. Despite recent improved performance, legitimate questions surrounding the long term viability of the Company remained and overshadowed the imperfect process followed by the Trados board. Accordingly, the Court concluded "that Trados would not be able to grow at a rate that would yield value for the common [stockholders]. Trados likely could self-fund, avoid bankruptcy, and continue operating, but it did not have a realistic chance of generating sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividend" held by the Company's preferred stockholders.[1]

As such, the consideration paid to the Trados common stockholders for their shares of stock – nothing – was fair.

Best Practices and an Open Question

The facts of *Trados* illustrate a situation where the timing of preferred stockholders' need for liquidity does not correspond with a corporation's ability to achieve an ideal liquidity event (either due to current market conditions or otherwise). Such situations are far from rare in the world of venture capital-backed companies. Accordingly, investor directors should be mindful of the following issues in the course of carrying out their fiduciary duties as board members:

1. Be aware of investor director conflicts of interest. *Trados* exemplifies the inherent conflict of interest between common stockholders and preferred stockholders in situations where a corporation's common stock has no value in the context of a sales transaction (in the case of *Trados*, due to the liquidation preferences/accrued dividends of the Company's preferred stockholders) but the corporation nonetheless has the financial wherewithal to self-fund its business plan and continue to operate. In situations where designees of the corporation's preferred stockholders comprise a majority of the board of directors, such a conflict of interest may cause the board's actions to be reviewed under the onerous entire fairness standard. While not an implication of director liability in and of itself, withstanding entire fairness analysis can be a drawn out and expensive undertaking for directors and their investment firms.

2. Process is important. The *Trados* court criticized the process by which the Company's board of directors approved the SDL transaction, finding that the Trados common stockholders were not dealt with in a procedurally fair manner. In the context of a proposed sale of a corporation, the board of directors should take pains to consider the interests of common stockholders and create a process that gives voice to common stockholder considerations. This can include (i) establishing an independent, special committee of the board of directors to review and approve the terms of a proposed sale, (ii) obtaining a fairness opinion from an investment bank or a qualified, third party valuation firm and/or (iii) conditioning the closing of the sale on the vote of a majority of disinterested common stockholders. Documenting these steps in the form of corporate minutes is also important. Following these procedures may allow investor directors to avail themselves of the protections of the business judgment rule and the more deferential level of judicial review that comes with it.

3. Does fair price trump faulty process? Delaware corporate law has long held that satisfying entire fairness analysis is a two-pronged effort and that defendant directors must establish that their approval of a transaction was fair as to both price and process.[2] However, notwithstanding the identified deficiencies of the approval process related to the SDL transaction, the *Trados* court ultimately found that the transaction was entirely fair to the Company and its stockholders because the Company's common stockholders received the economic value of their shares in connection with the transaction (in the case of *Trados*, nothing). The Trados court stressed that its analysis was one of entire fairness and that while price and process may be evaluated separately, the overall test cannot be bifurcated and all aspects of the issue of fairness must be examined as a whole. Still, the court's holding in *Trados* begs the question as to whether the twin prongs of the entire fairness test are truly given equal weight. While process can undeniably

impact price, one is left to wonder whether there are scenarios where a court will find that an investor director has breached his fiduciary duties by approving a transaction that is fair as to price but unfair as to process. Still, pending further clarification of this issue, investor directors are cautioned against unduly relying on the *Trados* court's emphasis on fair price; meeting the requirements of the entire fairness test is invariably a fact sensitive analysis and adhering to well-established approval procedures remains the prudent course of action.

For further information on this topic, please contact **Scott R. Bleier**.

Footnotes.

1. An open question remains as to whether the court's determination of fairness would have been swayed by evidence that Trados was reasonably likely to generate cash in the future that was sufficient to overcome the liquidation preferences of the Company's preferred stockholders. In such a scenario, it's unclear whether the court would have still have ruled that it was fair to approve the SDL transaction rather than waiting for a more profitable liquidity event – one in which the common stockholders would share in the proceeds – in the future.

2. "The concept of fairness has two aspects: fair dealing and fair price. [Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983).