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A Cautionary Tale For Investors

Personal economics should not take precedence over fiduciary duties

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A venture-backed company faces difficult conflict of interest issues when its investors and their board representatives lose patience with management and want to sell the company at a time when the common stockholders will get little or nothing.

This produces predictably strong disagreements between the investors — who are seeking an exit in short order to salvage some return for their limited partners — and the company's founders and other common stockholders — who believe that the company will turn around with just a little more time.

The situation becomes especially risky for the investor-appointed directors where the preferred stockholders have no contractual right to force a sale of the company and they make the mistake of using their board positions to accomplish the sale. The recent decision of the Delaware Chancery Court in the case of *In re Trados Incorporated Shareholder Litigation*, 2009 WL 2225958 (Del. Ch. July 24, 2009), serves as a warning to investors who face this very common dilemma.

The plaintiff in *Trados* was a common stockholder and charged that the board, a majority of which was appointed by the preferred stockholders, had approved a sale of the company at a price that resulted in the payment of a large liquidation preference to the preferred stockholders and multi-million dollar bonuses to management, but left nothing for the common stockholders at a time when the company seemed to be turning the corner.

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Background

Trados Incorporated had developed an innovative translation software program and provided a range of translation services to multinational corporations. It started out as a German company but re-incorporated in Delaware in 1994 in order to position itself to go public.

After moving to the United States, it raised capital by issuing four rounds of preferred stock to various private equity funds over a number of years. Four of the seven Trados board members were appointed by the preferred stockholders. Two of the remaining directors were executives of the company, and the third had no apparent ties to the investors or management.

By 2003, however, the preferred stockholders were becoming increasingly impatient with the company's underperformance and the amount of time being consumed on company matters. In April 2004, the board began discussing a sale of the company and shortly thereafter hired a new CEO to improve the company's performance and engaged an investment bank to assist in finding potential buyers.

After a failed attempt to sell the company, the board became concerned that management might not have sufficient incentive to stay with the company and pursue a successful sale because the high liquidation preference of the preferred stock would render their stock options and other equity incentives worthless.

The board adopted a management incentive (or so-called carve out) plan to pay a bonus to management if the company were sold. The higher the sale price, the more generous the bonus.

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Trados' financial condition improved markedly in the last quarter of 2004. Ultimately, the company sold for $60 million in June 2005.

Preferred stockholders received approximately $52 million, and management received $8 million under the carve-out plan. No return was realized by the common stockholders.

Shortly after the sale, one of the common stockholders petitioned for an appraisal of his shares and later filed suit against the directors claiming, among other things, that they had breached their fiduciary duty of loyalty to the common stockholders by favoring the interests of the preferred stockholders, either at the expense of the common stockholders or without properly considering the effect of the sale on the common.

Breaches Of Fiduciary Duty

The court rejected defendants' motion to dismiss plaintiff's fiduciary duty claims and held that the plaintiff had alleged sufficient facts to support a reasonable inference that the four board members appointed by the preferred stockholders were "interested" directors because they were all owners or employees of investors.

The court concluded that a reasonable inference could be drawn from the pleadings that a majority of the board lacked the

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requisite independence with respect to the decision to sell the company.

Where the board of directors is confronted with a discretionary decision involving the special rights and preferences of the preferred stockholders, the directors are obligated by their fiduciary duties to prefer the interests of the common over the preferred.

Based upon that principle and under the plaintiff-friendly rules applicable to a motion to dismiss, the court held that the plaintiff had pleaded sufficient facts to support a reasonable inference that the investor-appointed directors had breached their fiduciary duties by improperly favoring the interests of the preferred stockholders over the common. The result was that the common received no consideration for their shares.

The court pointed out, however, that its decision does not necessarily mean that there is a breach of fiduciary duties in every sale where the common stockholders receive nothing. The court specifically mentioned that the company was not under a compulsion to sell in that it had cash and financing sufficient to continue to operate and that the preferred stockholders did not have the contractual right to force a sale of the company.

Lessons To Learn

The *Trados* case is a cautionary tale for private equity and venture capital investors. It illustrates the risks of letting investor economics overshadow the special duties of the board in the context of a fundamental decision such as a sale of the company and the precautions that should be taken where there are significant conflicts of interest.

Private equity investors can take a number of steps, both in structuring their investment and during the sale process, to minimize the risk of liability:

- **Right to Force a Sale:** There would have been no director fiduciary duty issues in *Trados* if the preferred had bargained for a contractual right to force a sale of the company (typically after some appropriate time period) or had a drag-along right to force the other stockholders to join in any sale approved by the requisite vote of the preferred. When exercising a right to force a sale or drag along other stockholders, an investor acts as a stockholder and not as a director, and generally can act in the investor's own self interest and without fiduciary duties to other stockholders.
- **Decision by Disinterested Directors or Common Stockholders**: If the seventh member of the board were disinterested, the board could have addressed the conflict of interest issue by appointing him as a one person committee to decide if and when to sell the company. This is not a position that many independent directors would relish but it may be the only viable alternative to deal with the substantial conflict of interest issues facing an investor-dominated board.

  If a committee is appointed, counsel should carefully review the applicable indemnification provisions and the relevant directors and officers liability policies to ensure that there is adequate coverage for committee members.

  Where there are no disinterested directors or where the appointment of a committee is impractical, another alternative would be to condition the sale on the approval of a majority of the common stockholders.
- **Pay Attention to the Written Record:** The board minutes should reflect that the directors have been advised by counsel of their fiduciary duties under the circumstances and that full and fair consideration was given to the interests of the common stockholders. This includes the reasons for the sale, the adequacy of the purchase price and the timing of the sale. Directors should avoid statements and particularly e-mails and other writings that indicate that they are acting in the interests of the preferred stockholders and not taking into account the interests of the common.

- **Separate Your Roles:** Investor directors should be careful to distinguish their role as a director from their role as a representative of an investor-stockholder. Board meetings are not the forum to express approval or disapproval as an investor. If management and other board members need to understand where an investor stands as a stockholder, have these conversations outside of the board room.

These cautions and procedural steps are not ones that will always be greeted with enthusiasm by private equity and venture capital investors. But there is one fate worse than suffering through the inconvenience of procedures to address conflicts of interest—suffering through months and years of interrogatories, document production requests, depositions, motions, briefs and a lots of quality time with your favorite defense counsel. ■