I. Venture Capital and Private Equity and the "Entire Fairness" Test: **In re Trados**

A. Introduction

On August 16, 2013, the Delaware Court of Chancery decided *In re Trados Inc. Shareholder Litigation*.[1] The issue in this case was whether directors of a corporation had breached their fiduciary duties to common stockholders by authorizing a sale of control in which the common stockholders received no consideration.[2] The court, reviewing the transaction for entire fairness, found no breach on the part of the directors despite their failure to follow a fair process, because "the common stock had no economic value before the Merger."[3] Therefore, the common stockholders received a fair price for their shares, and the transaction satisfied entire fairness.[4]

This article analyzes the court's opinion in *In re Trados* and discusses its implications for private equity and venture capital firms both as investors and as directors of portfolio companies. Part B reviews the background that led to the sale of Trados and the structure and results of the transaction. Part C then details the court's legal analysis of the case with particular focus on the rationale for the application of entire fairness review and subsequent treatment of that standard. Next, Part D discusses the implications of the decision for boards that are predominantly composed of venture capital or private equity fund appointees. Finally, Part E analyzes the implications for venture capital and private equity funds in structuring their investments, and Part F concludes with a brief recap of the important takeaways from *In re Trados*.

B. Background and Procedural Posture of *In re Trados*

Trados, a desktop translation software company, was formed in 1984, and by 1999 had achieved a strong presence in the desktop software market.[5] To initiate expansion into the enterprise software

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[1] 73 A.3d 17 (Del. Ch. 2013).
[2] *Id.* at 20.
[3] *Id.*
[4] *Id.*
[5] *Id.* at 21

market and situate the company for an eventual public offering, Trados obtained several rounds of venture capital funding from 2000 to 2003.[6] In exchange for funding, the investing venture capital firms received preferred stock in Trados and the right to designate one director each for a total of five of the seven Trados directors.[7] As a result of this capital structure, at the time of the disputed transaction the preferred stockholders (the venture capital firms) held a $57.9 million liquidation preference.[8] Additionally, three of Trados's directors were principals of the venture capital firms that appointed them, two were ostensibly independent and appointed by venture capital firms, and two were officers of Trados (the Chief Executive Officer and Chief Technology Officer).[9]

As Trados progressed following this funding, it became apparent to the venture capital firms that "while [they] might end up with an attractive software company, [their] ownership position makes it difficult to do much more than hope to recover a portion of invested capital."[10] Accordingly, the funds started seeking an exit strategy with particular focus on the mergers and acquisitions markets.[11] In line with this goal, the Trados board unanimously approved a management incentive plan ("MIP"), which would provide senior managers with proceeds from a sale of the company well above what they otherwise would otherwise receive as common stockholders.[12] Without this financial motivation, the board feared that "the management team 'may not have sufficient incentives . . . to pursue a potential acquisition of the Company, due to the high liquidation preference of the Company's preferred stock.'"[13] Specifically, the MIP provided Trados's managers "with an escalating percentage of sale proceeds depending on the valuation achieved," subject to a reduction according to the consideration that they also received as common stockholders.[14] This reduction meant that any consideration that management received in a sale would be as managers rather than stockholders, encouraging the managers to

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[6] *Id.* at 21–24.
[7] *Id*.
[8] *Id.*at 33.
[9] *Id.* at 21–24, 27, 45–54.
[10] *Id.* at 25.
[11] *Id.*
[12] *Id.* at 26, 28–29.
[13] *Id.* at 26.
[14] *Id.* at 28–29.

maximize the value of the MIP rather than attempting to produce value for the common stock.[15]

Following the implementation of the MIP, management pursued a sale, and a company called SDL agreed to acquire Trados for $60 million.[16] Under the MIP, Trados management received the first 13% of the consideration, amounting to $7.8 million.[17] The preferred shareholders received the remaining $52.2 million, leaving the common stockholders with nothing.[18] But for the MIP, the preferred stockholders would have received their full liquidation preference of $57.9 million, and the common stockholders would have received the remaining $2.1 million.[19]

Plaintiff Marc Christen, a Trados common stockholder, first brought an appraisal action seeking the fair value of his shares, which constituted approximately 5% of the outstanding common stock.[20] Following discovery associated with that action, Christen brought a second action alleging that Trados's directors breached their fiduciary duty of loyalty by selling the company instead of continuing to operate it "in an effort to generate value for the common stock."[21] Christen argued that by selling when it did, the board "unfairly favored the interests of the preferred stockholders over the common stockholders, and the common stockholders were stripped of the opportunity to share in the proceeds of a more profitable company sale."[22]

The directors asserted that their actions were protected under the business judgment rule and moved to dismiss the breach of fiduciary duty claim.[23] The Delaware Court of Chancery denied this motion, holding that the plaintiffs met their burden of rebutting the presumptions of the business judgment rule by "alleg[ing] facts that support a reasonable inference that a majority of the board was

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[15] *Id.* at 29.
[16] *Id.* at 31.
[17] *Id.* at 32.
[18] *Id.* at 33.
[19] *Id.* at 20.
[20] *Id.* at 34.
[21] *Id*. at 20, 34.
[22] Jonathan D. Gworek, *National Venture Capital Association Modifies Documents in Response to In Re Trados Case*, MORSE, BARNES-BROWN & PENDLETON, PC (Oct. 2010), http://mbbp.com/resources/business/inretrados.html; *see also In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *1–2 (Del. Ch. July 24, 2009).
[23] *In re Trados*, 2009 WL 2225958, at *4, *6–9.

interested or lacked independence with respect to the decision to approve the merger."[24] The court accepted the plaintiffs' theory that the board members were conflicted because their interests diverged from those of the common stockholders in deciding whether to sell the company or continue to operate it.[25] This decision to allow the case to move forward raised concerns amongst the venture capital community because it "suggest[ed] that a board of directors dominated by preferred stock investors may be in breach of its fiduciary duties to common stockholders by electing to sell the company when there is a reasonable probability that waiting until some later time might be in the best interests of the common stockholders."[26]

C. Delaware Court of Chancery Decision on the Merits

The case proceeded to trial, and the Delaware Court of Chancery issued its opinion on August 16, 2013. The court began its analysis by emphasizing the primacy of the interests of the common stockholders in corporate decisions.[27] It explained that any special rights of preferred stock are contractual, and that "[p]referred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock."[28] Therefore, directors are required to "strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants."[29]

After laying out the appropriate standard of director conduct, the court applied entire fairness review, the most stringent standard

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[24] *Id.* at *9.
[25] *Id.* at *7.
[26] Gworek, *supra* note 22.
[27] *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 41 (Del. Ch. 2013) ("[G]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc. . . . of preferred stock." (quoting Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. May 12, 1997))).
[28] *Id.* at 39–40.
[29] *Id.* at 40–41.

of review, to the directors' actions in selling Trados, because a majority of the board members were not disinterested and independent.[30] Specifically, the court found the two management directors to be conflicted because they received material financial benefits from the MIP not shared with other common stockholders, and one of the two "independent" directors to be conflicted due to "the web of interrelationships that characterizes the Silicon Valley startup community."[31] Regarding the directors who were venture capital fund principals, the court explained that funds investing in exchange for preferred stock face an "*inherent* conflict" with common stockholders in deciding whether to sell or continue operating a company.[32] This is because even in situations where continued operation of a company may maximize shareholder yield in the long run, preferred shareholders are likely to find immediate opportunities for sale or liquidation more attractive as these provide guaranteed returns to the preferred shareholders due to their liquidation preference. Continued operation, on the other hand, exposes the preferred shareholders to uncertainty and risk without a proportionate increase in their earning potential.[33]

Beyond these purely financial incentives to favor liquidation, the business model of venture capital funds consists of investments in multiple portfolio companies, each of which requires attention and resources.[34] Therefore, a fund might favor liquidation because, "[a]lthough the individual company may be economically viable, the return on time and capital to the individual venture capitalist is less than the opportunity cost."[35] Because the interests of venture capital funds diverge from those of the common stockholders in these scenarios, the court found all three fund principal directors to be conflicted.[36]

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[30] *Id.* at 43.
[31] *Id.* at 45, 54–55.
[32] *Id.* at 47.
[33] *Id.* at 49 (citing Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 993–94 (2006)).
[34] *Id.* at 51 (quoting Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 110 n.218 (2002)).
[35] *Id.* (quoting William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 507 (1990)).
[36] *Id.* at 54.

Entire fairness consists of two elements—"fair dealing and fair price."[37] While review of the two factors individually is often useful, the court underscored the "unitary," fact-specific nature of the inquiry.[38] Relying on this totality of the circumstances approach, the court ruled in favor of the directors, finding that they had failed to implement a "fair process" but that the Trados common stockholders had received a fair price in the acquisition because the common stock had "no economic value before the Merger."[39]

The court focused on two aspects of the transaction as indicative of unfair process—the MIP and the lack of board concern for the common stockholders in structuring the sale.[40] In addition to creating conflicts of interest for the manager directors, the court found that the MIP altered the dealings surrounding the merger to the detriment of the common stockholders.[41] First, it did so by reducing the management's merger compensation under the MIP by the amount the managers received as common stockholders such that they were "converted . . . from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred."[42] Second, the common stockholders paid a much higher proportion of their potential merger proceeds than the preferred stockholders to fund the MIP.[43] While the preferred stockholders received $52.2 million instead of their full liquidation preference of $57.9 million due to the MIP, a reduction of less than 10%, the common stockholders'

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[37] *Id.* at 56 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)).

[38] *Id.* ("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.").

[39] *Id.*at 20.

[40] 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*, SULLIVAN & CROMWELL LLP 4 (Aug. 29, 2013), http://sullcrom.com/siteFiles/Publications/SC_Publication_In_re_Trados_Incorporated_Shareholder_Litigation.pdf; *see also In re Trados*, 73 A.3d at 62.

[41] *In re Trados*, 73 A.3d at 61.

[42] *Id.* at 61–62.

[43] SULLIVAN & CROMWELL LLP, *supra* note 40.

proceeds were reduced by 100%—from $2.1 million to zero.[44] Further, the board made no effort to sell Trados in such a way as to provide proceeds to the common stockholders, either by negotiating for a higher price or by pursuing other transactions.[45] The directors "did not understand that their job was to maximize the value of the corporation for the benefit of the common stockholders, and they refused to recognize the conflicts they faced."[46]

With regard to fair price, the court, relying on discounted cash flow analysis, found that the pre-merger value of the common stock was zero and that it had no "reasonable prospect of generating value."[47] Trados needed cash to finance a business plan that would produce enough growth to create value for the common stockholders, but its venture capital investors refused to invest more, and this made it impossible to attract investments from other funds.[48] Further, even with funding, Trados's growth rate would have to exceed the preferred shareholders' 8% cumulative dividend to create yield for the common shareholders.[49] Thus, while Trados likely could have remained viable, it had dim prospects of adding enough value to overcome this dividend and the large liquidation preference.[50] Therefore, in receiving no consideration for the merger, "the common stockholders received the substantial equivalent in value of what they had before, and the Merger satisfie[d] the test of fairness."[51] While Delaware courts have validated past deals with a fair price "despite 'imperfections' in the process," this is the first case that has found entire fairness despite a seemingly complete lack of fair process.[52]

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[44] *In re Trados*, 73 A.3d at 60; SULLIVAN & CROMWELL LLP, *supra* note 40, at 4.
[45] *In re Trados*, 73 A.3d at 61.
[46] *Id.* at 62.
[47] *Id.* at 76–77.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.* at 76.
[52] John J. Cannon, III, In re Trados*: Directors Dodge a Bullet*, SHEARMAN & STERLING LLP 4 (Aug. 16, 2013), http://shearman.com/~/media/Files/NewsInsights/Publications/2013/08/CorpGovNewsletterWinter2013InTradosCannon.PDF (quoting Emerald Partners v. Berlin, No. 295, 2003, 2003 WL 23019210, at *28 n.94 (Del. Dec. 23, 2003)); *see also In re Trados*, 73 A.3d at 56.

D. Implications for Venture Capital and Private Equity Investors as Directors

The decision in this case made clear that preferred and common stockholders face an inherent conflict of interest "when a company has no common equity value but could potentially remain in business for some time."[53] Consequently, this conflict will likely trigger entire fairness review when the preferred stockholders also appoint a majority of the board.[54] While the court in *In re Trados* found entire fairness to be satisfied despite a seemingly complete lack of fair dealing, preferred-dominated boards should not find too much relief in this decision.[55] The court noted the importance of the particular facts of the case, and explained that unfair process can "infect the price" and lead to liability for directors.[56] In *In re Trados*, though, the price could not be "infected," because the common stock was valueless at the time of the transaction.[57]

Accordingly, *In re Trados* suggests that to avoid liability most effectively, "a conflicted board should actively consider the interests of common shareholders and ways in which the process might mitigate the conflict."[58] This deliberation should be clearly documented in board meeting minutes and other corporate records, and should demonstrate the following:

> (1) pursui[t of] purchase prices above the level at which common will participate, (2) analyses of inflection points for such participation and (3) comparisons of the "standalone" alternative to a merger or acquisition—considering the costs and viability of internal and external sources of funding that may permit the company to continue without

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[53] SULLIVAN & CROMWELL LLP, *supra* note 40, at 1.
[54] *Id*.
[55] Andrew M. Ray & Mark Michael Elliott, *In Re Trados Incorporated Shareholder Litigation: Confronting the Conflicts Facing Investment Fund Board Designees When a Portfolio Company is Sold*, BINGHAM MCCUTCHEN LLP (Oct. 9, 2013), https://www.bingham.com/Alerts/2013/10/In-Re-Trados-Incorporated-Shareholder-Litigation.
[56] *In re Trados*, 73 A.3d at 78.
[57] *Id.*
[58] SULLIVAN & CROMWELL LLP, *supra* note 40, at 1.

> such merger or acquisition and generate value for the common stock.[59]

Further, boards should consider the use of procedural protections such as a special independent committee, outside guidance regarding the fairness of the price,[60] and a majority of the minority voting condition.[61] Boards should be careful in appointing independent directors—for a special committee or otherwise—to ensure that they are truly independent and disinterested rather than just ostensibly so.[62] Additionally, MIPs should be designed to encourage managers to pursue transactions that benefit all shareholders, rather than just the preferred shareholders.[63] This ensures that the interests of management directors converge with the interests of both the common and preferred shareholders, mitigating the level of conflict.[64]

Lastly, as an alternative to these fairness and procedurally oriented solutions, boards should consider structural solutions as well.[65] If, rather than incorporating, Trados had formed as a limited liability company, which imposes only contractual duties, many of the issues in this case would not have arisen.[66]

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[59] Douglas N. Cogen et al., *Corporate and Securities Alert: In re Trados: Important Lessons for Directors on Fiduciary Duties to Common Stockholders*, FENWICK & WEST LLP (Sept. 16, 2013), http://fenwick.com/Publications/Pages/Corporate-and-Securities-Alert-In-re-Trados-Important-Lessons-for-Directors-on-Fiduciary-Duties-to-Common-Stockholders.aspx#; *accord* SULLIVAN & CROMWELL LLP, *supra* note 40, at 1.

[60] "A fairness opinion from a first tier Wall Street investment bank may not be cost-effective, but outside advice as to overall market conditions and the best timing to conduct a sale process can be helpful in demonstrating that the decision to put the company up for sale was the right one without regard to a fund's exit timeline." Ray & Elliot, *supra* note 55.

[61] *Id.*; *accord* Cannon, *supra* note 52, at 3; Cogen et al., *supra* note 59; SULLIVAN & CROMWELL LLP, *supra* note 40, at 1–2.

[62] Cogen et al., *supra* note 59.

[63] Ray & Elliot, *supra* note 55.

[64] *Id.*

[65] Cogen et al., *supra* note 59.

[66] *Id.*

E. Implications for Venture Capital and Private Equity Funds as Investors

The decision in *Trados* encourages venture capital and private equity funds to "side-step" fiduciary duties to their portfolio companies by negotiating for protective provisions, such as drag-along or forced sale rights, in their voting agreements.[67] The goal of these terms is to "grant preferred stock investors greater leverage in initiating a sale while at the same time minimizing the need to have the preferred stockholder board designees approve an action that presents a possible or apparent conflict."[68] To achieve this, drag-along rights allow preferred shareholding investors "to force common shareholders to vote for any transaction favored by [them]."[69] Thus, upon the triggering of these rights, a "forced sale" is effected without any action on the part of the board, insulating the directors from liability for breach of a fiduciary duty.[70]

Events surrounding the decision in *In re Trados* are instructive on this point. Following the court's denial of the directors' motion to dismiss in 2009, the National Venture Capital Association ("NVCA") revised its model form documents to include these types of provisions.[71] The revisions include a "sales right" provision, which permits the investors to "force the company to initiate a sales process" by requiring that it "take a number of affirmative steps towards the sale of the company."[72] The purpose of this provision is to allow the preferred shareholders to utilize their drag-along rights without having taken any action in their roles as

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[67] Lisa R. Stark, *Side-Stepping Fiduciary Issues in Negotiating Exit Strategies for Preferred Stock Investments after Trados*, BUS. L. TODAY, at 1, 2 (Sept. 2013), http://americanbar.org/content/dam/aba/publications/blt/2013/09/full-issue-201309.authcheckdam.pdf.

[68] Gworek, *supra* note 22.

[69] Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1331 (2013).

[70] Stark, *supra* note 67, at 2.

[71] Gworek, *supra* note 22.

[72] *Id.* These affirmative steps include "engag[ing] a banker, negotiat[ing] the terms and conditions for the sale of the company, keep[ing] the board abreast of material developments of the sale process, and call[ing] a meeting of the board to approve the sale and enter into definitive sale agreements." *Id.*

board members.[73] Further, in a situation where the board has the power to reject a sale forced by drag-along rights, and the board chooses to execute that power, the sales right "provides that . . . the [investors] would have the right to force the company to redeem all of their outstanding shares in an amount equal to their pro rata proceeds of the rejected transaction."[74] However, the NVCA revisions seek to avoid this situation by recommending the drafting of drag-along rights such that they can be exercised without board approval.[75]

F. Conclusion

In re Trados involved the familiar situation of venture capital or private equity firms investing in a company for preferred stock and board control, the company becoming stable and profitable yet unlikely to produce a large return for the investors, and the investors seeking an exit and implementing an MIP to motivate a sale.[76] When the merger consideration only satisfied the MIP and most of the preferred stockholders' liquidation preference, the common stockholders received nothing.[77] In the shareholder action for breach of fiduciary duty, the Delaware Court of Chancery held that a majority of the directors were conflicted (and that the venture capital fund principal directors were *inherently* conflicted) and that the transaction was thus subject to entire fairness review.[78] However, under the particular facts of the case, entire fairness was satisfied despite lack of fair dealing, because in receiving no consideration in the merger, the common stockholders received "the substantial equivalent of what they had before" as the common stock had no value before the transaction.[79] The court made clear, though, that unfair process can "infect the price" and lead to liability for

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[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *See* Daniel M. Bauer, *Fiduciary Duties in M&A Exit Transactions: Lessons from In re Trados*, PORTER WRIGHT MORRIS & ARTHUR LLP FED. SEC. L. BLOG (Sept. 23, 2013), http://fedseclaw.com/2013/09/articles/delaware-news/fiduciary-duties-in-ma-exit-transactions-lessons-from-in-re-trados; *see also supra* notes 32–35 and accompanying text.
[77] *See supra* notes 17–18 and accompanying text.
[78] *See supra* notes 30–32 and accompanying text.
[79] *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 76 (Del. Ch. 2013); *see supra* note 51 and accompanying text.

directors, so preferred stockholding directors should be sure to thoroughly consider the interests of the common stockholders in structuring exits and implement procedural protections to the extent feasible.[80] Additionally, in structuring the voting agreements for their portfolio companies, venture capital and private equity funds can largely insulate themselves from liability by negotiating for contractual provisions allowing them to dodge fiduciary duties.[81]

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[80] *See supra* notes 55–56 and accompanying text.
[81] *See supra* Part E.
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