CLIENT ALERT

Important Guidance for Preferred Stockholders with Board Designees in M&A Exit Transactions; Delaware Court of Chancery Highlights Risks in Adopting Management Carve Out Plans

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In a recent decision involving a company sale that resulted in no payment to the holders of common stock, the Delaware Court of Chancery held, after trial, that the sale did not breach the directors' fiduciary duties even though, the court found, nearly the entire board was conflicted and the sale process was unfair. Although it applied the stringent unitary entire fairness test, the court found in favor of the defendant directors because the common stockholders properly received nothing as the common stock had no economic value at the time of the transaction. *In Re Trados Inc. S'hldr Litig.*, C.A. No. 1512-VCL (Aug. 16, 2013). The court held:

> "Despite the directors' failure to follow a fair process and their creation of a trial record replete with contradictions and less-than-credible testimony, the defendants carried their burden of proof on [the] issue [of entire fairness]. . . . [T]he common stock had no economic value before the Merger, making it fair for its holders to receive in the Merger the substantial equivalent of what they had before [i.e., zero]. The appraised value of the common stock is likewise zero."

In Re Trados was brought as a consolidated alleged breach of fiduciary duty action and appraisal proceeding challenging the 2005 sale of Trados Inc. for $60 million. Under the terms of the Trados charter, the holders of the preferred stock were entitled to a $57.8 million liquidation preference. Of the $60 million consideration provided for the sale, $7.8 million was paid to participants in a management incentive carve-out plan, and the remainder was distributed to the holders of preferred stock in partial payment of their liquidation preference.

In rendering its decision, the Chancery Court first determined the applicable legal standards governing the board's actions. It noted that the duty of loyalty "mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital." Fiduciary duties are owed to the holders of all capital stock, and preferred 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." Citing *LC Capital Master Fund, Ltd., v. James*, 990 A.2d 435 (Del. Ch. 2010), the court stated that "it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred."

The court then held that the stringent "entire fairness" standard of review applied because six of the seven directors were not disinterested and independent. It found that each of those six directors either received material personal benefits in the merger not equally shared by other stockholders, were fiduciaries of venture capital funds holding preferred stock, or held a close relationship with one of the funds.

The court separately assessed the transaction under both the "fair price" and "fair dealing" elements of the entire fairness test, and then measured the overall impact of the deal under a "unitary" test that considered whether the minority stockholders received the substantial equivalent in value of what they had prior to the transaction. The court concluded that the evidence

relating to fair dealing weighed in favor of the plaintiff. The court found that the sale process was initiated so that the venture funds could achieve an exit; that the design and effect of the management incentive carve-out plan incented management to conclude a transaction, but was detrimental to the interests of the common stockholders insofar as it did not proportionately incent management to reach for a level of consideration that would sufficiently exceed the preferred's liquidation preference and the plan's pay-out, so as to yield a payment to the common stockholders; that the board did not take any measures (such as formation of a special committee or obtaining a fairness opinion) to protect the interests of the common stockholders; and that the merger was not conditioned on approval of a majority of disinterested common stockholders. Notably, the court discussed the management incentive carve-out plan at length, and the effect the plan had of taking the $2.1 million of the $60 million total deal value that exceeded the preferred stockholders' $57.9 million liquidation preference and allocating it to the participants in the plan. In a footnote, the court noted that the plaintiff did not claim that the defendants breached their duty of loyalty by using the plan to reallocate consideration from the common to the preferred and management. Had the plaintiff pursued such a claim, according to the court, "it would have been difficult for the defendants to prove that the [plan] was fair."

In addressing fair dealing, the court declined to consider whether a typical VC-dominated exit maximizes overall societal wealth or whether common stockholders could be said to have implicitly consented to a structure that could encourage a relatively fast exit by VC investors that might yield little or no value to common stockholders. The court noted that boards cannot side-step the fiduciary duty analysis unless the duty is expressly abrogated in accordance with Delaware law, such as through a drag-along right, or through charter language that modifies the statutory regime under DGCL Section 141(a) that the business and affairs of a corporation be "managed by or under the direction of a board of directors."

The court found that the evidence on fair price was mixed. However, when considering the unitary determination of fairness, the court found that Trados did not have a reasonable prospect of generating value for the common stock. The evidence showed that while Trados could probably self-fund and avoid bankruptcy, it did not "have a realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference and cumulative return." The court's analysis was also strongly informed by its conclusion that the valuation opinion provided by the defendants' expert was methodologically sound and reasonably based on data relating to Trados' past and projected future performance, while it found the valuation opinion of the plaintiff's expert lacking in both regards. Based largely on the valuation opinions and related evidence, the court concluded that common stockholders received through the sale the substantial equivalent in value of what they had before the merger -- zero -- and the merger therefore satisfied the test of fairness. The court held that the fact that the directors did not follow a fair process does not constitute a separate breach of duty. While an unfair process can infect the price, resulting in a finding of a breach, that was not the situation here. The court found that the price was fair, given its conclusion that the common stock had no value at the time of the transaction.

The decision provides important guidance for funds holding preferred stock when planning for and executing M&A exit transactions. It is consistent with a 2009 decision on a motion to dismiss in the same case, which flagged the risks for preferred stockholders associated with forcing an exit transaction of an arguably viable business where little or no proceeds will flow to the common stockholders under the charter. Where the charter liquidation provisions assign no value to the common stock and there is no reasonable prospect of generating value for the common stock as a going concern, value need not be allocated to the common stock in a sale transaction. Where that is not the case, the considerations are more complex in light of the board's duties owed to the common stockholders.

In dictum, the court in its recent post-trial decision invited the investor community to try to address the issues through appropriate contractual arrangements, such as drag along rights, or by modifying the board's role under the charter. In order to structure around the fiduciary duty trap, drag along rights should be operable without board approval, and should be accompanied by a unilateral right of the preferred stockholders to trigger a sale process. Companies should nonetheless be aware that acquirers have often resisted relying on drag along mechanisms in the past because there are usually sufficient gaps in the drafting to render them vulnerable to attack or otherwise difficult to implement for a given transaction (such as transactions involving mergers or escrows, or where some stockholders receive different consideration). Since the earlier decision in this case on the motion to dismiss, some in the legal community have also advocated giving the preferred stockholders a put right as a way of forcing an exit. Unsurprisingly, this has not gained widespread adoption given the corporate law restrictions on share repurchases and tax and accounting complexities. In its discussion on fair process, the court also advocated the merits of other procedural protections, such as special committees, fairness opinions, and majority of the minority stockholder approval conditions. While these mechanisms should be considered, not every protection will be appropriate for every deal. For example, for transactions where the common stockholders do not receive any consideration, giving them a veto right may prevent the transaction from going forward.

Dictum in the recent post-trial decision also serves as an important caution for companies considering adoption of a management incentive carve-out plan. When adopting such a plan, boards should consider the impact it will have on the return to the common stockholders in light of the liquidation waterfall provisions under the charter. The court's critical focus on management incentive carve out plans may also serve as a magnet for plaintiffs' attorneys in future deals.

The decision also provides a reminder of the importance of obtaining a good valuation opinion, ideally contemporaneous with the time that an exit or sale transaction is being contemplated. The decision ultimately turned on a battle of the valuation experts. The court credited the defendants' valuation expert, who, it appears, put together a reasonably-constructed and supported valuation opinion. The court rejected the self-contradictory, result-oriented valuation opinion of the plaintiff's expert.

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