In re Trados: Directors Dodge a Bullet

By John J. Cannon, III

Vice Chancellor J. Travis Laster's August 16 post-trial opinion in *In re Trados Inc. Shareholder Litigation*[1] (hereinafter, "In re Trados") has attracted a significant amount of attention. Much as both the Chancery and the Delaware Supreme Court did in the Disney/Ovitz case[2] of the mid-2000s, the *In re Trados* court portrays an extremely deficient board process in vivid and unflattering detail, while ultimately finding — perhaps reluctantly — in favor of the defendants. *Disney* and *In re Trados* differ substantially on the factual circumstances (*Disney* involved an employment contract with a senior executive under which extraordinary severance amounts were paid when the executive's brief tenure with the company was terminated; *In re Trados*, a merger in which common shareholders received no consideration) as well as the standard of review applied by the courts to the actions in dispute (*Disney* considered whether the actions were protected by the business judgment rule; *In re Trados*, whether the challenged merger could withstand "entire fairness" review). However, in addition to the similarity of the respective defendant directors escaping liability seemingly by the skin of their teeth, *In re Trados* like *Disney* provides an example of how not to manage a board process in a manner designed to avoid disruptive litigation (if not actual liability).

In re Trados: The Facts and Holdings

Facts

Trados Inc. ("Trados") was a privately held company that produced translation software. In 2000, Trados obtained funding from various venture capital ("VC") investors. The VC investors received preferred shares with liquidation preferences payable upon a change-of-control transaction, voting rights identical to common shares on an as-converted basis and other customary VC negative control rights (including the right to veto a change-in-control transaction). Additionally, certain of the VC investors received the power to designate representatives to the Trados Board of Directors (the "Board").

The VC investors collectively controlled a majority of the voting power on an as-converted basis and the power to elect the majority of directors on the Board. The Board was composed of three VC employees, two members of management and two ostensibly independent directors.

Faced with financial setbacks, in July 2004 the Board approved hiring a new CEO. Later that year, the Board approved a management incentive plan (the "MIP") that would incentivize senior executives to pursue a sale of Trados even if it yielded nothing for common shareholders. The Board also rejected an initial $40 million acquisition proposal from SDL plc as it considered the offer too low.

After commencing his employment in August 2004, the CEO advised the Board of its options: to invest additional capital in Trados and reposition its core business for growth or to focus on a potential sale or merger transaction. Although the stand-alone alternative may have permitted Trados to remain solvent, it did not appear to offer a clear opportunity for achieving any meaningful returns for the VC investors or any meaningful (if any) common equity value. Further the VC investors, who each preferred the merger alternative, declined to provide additional capital to ameliorate Trados' financial situation. Under the new CEO, Trados secured a third-party loan allowing it to slightly improve its financial situation. Nonetheless merger discussions with SDL re-commenced in November 2004.

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1 *In re Trados Inc. S'holder Litig.*, C.A. No. 1512-VCL, slip op. (Del. Ch. Aug 16, 2013)

2 *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005)

In June 2005, Trados agreed to be acquired by SDL for $60 million in cash, of which the first $7.8 million was paid to management under the MIP and the remaining $52.2 million (less an indemnification holdback) was paid to the holders of the preferred shares, whose liquidation preference was $57.9 million. The common shareholders received nothing.

The plaintiff, who owned 5% of the common shares, sought appraisal and subsequently sued the directors both individually and on behalf of the class of common shareholders, alleging that Trados' directors had breached their fiduciary duties to the common shareholders in approving the merger.

Holdings

Six of the seven members of the Board were conflicted (the three VC representatives, the two management members participating in the MIP and one "independent" director with an economic interest in the deal and close ties to one of the VC firms), so the "entire fairness" standard of review applied (i.e., fair dealing and fair price).

Despite the Board's failure to satisfy the "fair dealing" prong, the court found that the common stock was worthless at the time of the merger and had no realistic prospect of having value in the reasonably foreseeable future and, therefore, the defendants satisfied the "fair price" prong and, on the whole, the Board met its burden under the entire fairness standard.

The Board did not breach its fiduciary duty in approving the merger even though (a) common shareholders received no consideration, and (b) the entirety of the merger consideration was used to, first, fund the MIP adopted to encourage the sale of Trados, and, second, to satisfy the liquidation preference of the preferred shares.

Practical Lessons

Among the practical lessons to be learned from In re Trados:

Fiduciary Duties Are Owed to the Common Shareholders and Not to the Preferred Shareholders. In certain ranges of company values, the interests of holders of preferred stock (who are effectively contractual claimants) and those of common shareholders (as residual claimants — "the ultimate beneficiaries of the firm's value…"[3]) in a potential sale of the company will be in conflict. The court reaffirmed, however, that in such circumstances the directors' fiduciary obligations continue to be owed exclusively to the corporation and the common shareholders.[4]

Preferred Shareholders Can Protect Themselves by Contract. The court's observations concerning the respective interests and rights of preferred and common shareholders suggest that preferred investors would be well advised to minimize the scope of board discretion (and hence decisions that are subject to fiduciary responsibility to the common) by designing comprehensive contractual provisions giving the holders of preferred the power and authority to force exit transactions (e.g., through "drag-along" rights) without the necessity of board approval.

A Conflicted Board Needs to Demonstrate a Process that Considers the Interests of Common Shareholders. If a board is composed of a majority of directors who have interests in conflict with those of the common shareholders (including in any of the various ways analyzed by the court in *In re Trados* and discussed below), its actions will no longer be reviewed under the deferential business judgment rule standard but instead will be subject to entire fairness review. As a consequence, a board so constituted should take extra care to address the conflicts (perhaps through the procedural safeguards discussed below) and take into consideration the interests of the common shareholders, including the question of whether pursuing a long-term independent business strategy could generate value for the common shareholders that is not being delivered through the proposed sale of the company.

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3 *In re Trados*, C.A. No. 1512-VCL, slip op. at 40

4 The court nevertheless acknowledged that preferred shareholders are owed fiduciary duties "…when they do not invoke their special contractual rights and rely on a right shared equally with the common stock." *Id.* at 38

Such consideration of common shareholders' interests should be reflected in minutes or other documentary evidence of board deliberations and information reviewed by the directors.

Procedural Safeguards Can Help. Delaware courts have held that certain procedural safeguards can mitigate conflicts and thereby either (at best for the directors) maintain the protections of the business judgment rule[5] or (at worst) shift to plaintiffs the burden of proving that a transaction was not entirely fair. Among such safeguards are a fully empowered special committee of disinterested directors and majority of the minority shareholder approval (in a case like In re Trados, separate approval by unconflicted common shareholders).

The Nature of Director Conflicts. The *In re Trados* court devoted considerable space to a discussion of the conflicts faced by most of the Trados directors. In circumstances like those found in *In re Trados*, the conflicted directors include not only the employee designees of venture capital firms (who are likely to be fiduciaries of funds holding the preferred and thus face "the dual fiduciary problem identified in *Weinberger v. UOP*, Inc.…"[6]) but also members of management on the board, to the extent their personal interests are aligned with the preferred, as well as nominally independent directors if they stand to materially personally benefit from a challenged transaction and/or have personal and business relationships with interested parties that create a sense of obligation ("owingness," in the court's parlance)[7] to them. In this regard, the court found that one of the two "independent" directors, who indirectly held Trados preferred stock and had a long-standing relationship with one of the venture capital firms (including serving as CEO of another startup backed by that firm), was conflicted. The court's discussion in *In re Trados* of director conflicts and the "web of interrelationships that characterizes the Silicon Valley startup community"[8] may well lead venture capital firms to reconsider their criteria for selecting ostensibly independent board members. More broadly, the case may cause private company shareholders to take a more public company approach to board composition.

MIP Design Considerations. In analyzing the impact of the MIP, the court viewed the plan as creating conflicts for the management directors while also "[f]or purposes of fair dealing…skew[ing] the negotiation and structure of the merger in a manner that was adverse to the common shareholders."[9] The court's critical observations concerning the MIP's design and impact (effectively, taking $2.1 million in value from the common shareholders) should cause practitioners to carefully consider the design of similar incentive arrangements in companies pursuing liquidity transactions in which there are potential conflicts between the interests of preferred and common shareholders and where the likely deal values could result in a disproportionately adverse impact on the common. Even though there may not be any objectively fair allocation of MIP costs between common and preferred shareholders, at the very least the directors approving such a plan should be able to demonstrate that they took the interests of the common shareholders fully into account in the MIP's design and implementation.

Delaware Law Issues

In addition to the observations above, we also present some additional observations regarding the court's legal reasoning in In re Trados:

- *Entire Fairness Without Fair Dealing*? The court took pains to apply a "unitary definition of fairness" under which it balanced the fair dealing and fair price analyses rather than requiring the satisfaction of both "prongs." As a result, the defendants were able to successfully prove the "entire fairness" of the transaction in

5 S*ee, In re MFW S'holders Litig.*, C.A. No. 6566-CS, slip op. at 7 (Del. Ch. May 29, 2013)

6 *In re Trados*, slip op. at 51 (referencing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983))

7 *Id.* at 50

8 *Id.* at 66

9 *Id.* at 78

effect solely on the basis of "fair price."[10] Although Delaware courts have emphasized that entire fairness review requires a holistic, non-bifurcated analysis of whether the transaction is the "product of both fair dealing *and* fair price",[11] and in the past have concluded that a transaction was entirely fair despite "imperfections" in the process,[12] we are not aware of another case in which a Delaware court has concluded that the defendants satisfied entire fairness despite what appeared to be an almost total absence of fair dealing.[13]

- *No Fair Dealing But No Breach of Fiduciary Duty*. It also is interesting that the court concluded that, because of the fair price, there was no breach of fiduciary duty. In analyzing the facts of the case, one could readily instead conclude (contrary to the *In re Trados* court's holding) that there were ample breaches of fiduciary duty — of care, loyalty and perhaps (whether as an independent obligation or as a component of the duty of loyalty) good faith — but that there were no damages proven by the plaintiffs (given that the court held that the common stock was worth zero) and that accordingly there was no liability. Moreover, the weight of authority in Delaware is that proof of a breach of fiduciary duty is a necessary condition for rebutting the presumptive protection of the business judgment rule,[14] although such a rebuttal does not establish substantive liability *per se*.
- *Absence of Damages Rather than No Breach*? Other Delaware courts have held in the past that entire fairness was not satisfied — and consequently a fiduciary breach giving rise to substantive liability was proven — on the basis of the fair dealing prong of the standard even where the price was fair.[15] Rather than holding as in *In re Trados* that a fair price precluded a finding that a transaction was not entirely fair, they found a breach but concluded that there were no actual damages. Consistent with the equitable powers of the Delaware Chancery Court discussed below, such courts may have awarded only nominal damages or none at all, but in any event the absence of actual damages did not lead the courts to conclude that no breach had occurred.

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10 "Although the defendants did not adopt any protective provisions, failed to consider the common stockholders, and sought to exit without recognizing the conflicts of interest presented by the Merger, they nevertheless proved that the transaction was fair." *Id.* at 107

11 *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified on other grounds*, 636 A.2d 956 (Del. 1994)

12 *Emerald Partners v. Berlin*, 840 A.2d 641 (Del. 2003) (unpublished opinion, text available at 2003 Del. LEXIS 42, at *100 n.94 and 2003 WL 23019210, at *28 n.94) (Del. Dec. 23, 2003) ("In short, the process imperfection identified here was not of sufficient gravity to preclude a finding of fair dealing in this merger.")

13 "The evidence pertinent to fair dealing weighed decidedly in favor of the plaintiff. Indeed, there was no contemporaneous evidence suggesting that the directors set out to deal with the common shareholders in a procedurally fair manner." *In re Trados*, slip op. at 70

14 *See*, *e.g. In re Walt Disney*, 906 A.2d at 52; *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. 2007) ("a showing that the board breached either its fiduciary duty of due care of its fiduciary duty of loyalty in connection with a challenged transaction may rebut this presumption"); *see also Emerald Partners* 787 A.2d at 91 ("[t]o rebut the presumptive applicability of the business judgment rule, a shareholder plaintiff has the burden of proving that the board of directors, in reaching its challenged decision, violated any one of its triad of fiduciary duties: due care, loyalty or good faith"), *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996) ("[o]nly by demonstrating that the Board breached its fiduciary duties may the presumption of the business judgment rule be rebutted"); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163-64 (Del. 1995) ("a shareholder plaintiff challenging a board decision has the initial burden of rebutting the presumption of the business judgment rule"); *id*. at 1164 ("to rebut the presumption, a shareholder plaintiff assumes the burden of providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty or due care"); *id*. ("the breach of any one of the board's fiduciary duties" overcomes the business judgment rule presumption) (emphasis deleted); *Cede & Co*, 634 A.2d at 361; *Spiegel v. Buntrock*, 571 A.2d 767, 774 (Del. 1990); *Citron v. Fairchild Camera & Instrument Corp*., 569 A.2d 53, 64 (Del. 1989); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *In re Gen. Motors (Hughes) S'holders Litig*., 2005 Del. Ch. LEXIS 65, at *31, 2005 WL 1089021, at *8 (Del. Ch. May 4, 2005), *aff'd*, 897 A.2d 162 (Del. 2006).

15 *See, e.g. Oliver v. Boston University*, 2006 Del. Ch. LEXIS 75, 2006 WL 1064169 (Del. Ch. Apr. 14, 2006), *motion for reargument denied*, 2006 Del. Ch. LEXIS 210, 2006 WL 3742598 (Del. Ch. Dec. 8, 2006)

- *Was an Equitable Remedy Available*? As a court of equity, the Delaware Chancery Court is empowered to formulate such remedies as it may deem appropriate in the event of fiduciary breach. Although the court in *In re Trados* concluded that the plaintiff in effect suffered a $2.1 million loss as a consequence of the adoption and design of the MIP that aligned senior executives' interests with those of the preferred shareholders, it noted that the plaintiff had not pursued a separate claim that the MIP was unfair in reallocating merger proceeds from the common shareholders to management.[16] Given that the court's opinion clearly suggests that such a diversion of merger consideration claim could well have been successful if properly pleaded, one could argue that it would have been appropriate and within the court's equitable powers to nonetheless order restitution of $2.1 million to the common shareholders. Or, analyzing the facts differently, the court could have concluded that the appropriate value of the common stock for purposes of applying the fair price prong should have been computed without giving effect to the economic impact of the defendants' breach (in approving the MIP).
- The opinion in *In re Trados* concludes with an order to the parties to present briefs in connection with the plaintiff's application for the shifting of its fees to the defendants. (A hearing on this issue has been scheduled for October 2013.) The court's discussion of the relevant facts and the bad faith exception to the "American Rule" (which, subject to fairly narrow exceptions, requires each party generally to bear its own legal fees and expenses) led it to conclude that "[t]here is good reason to think that fees might be shifted."[17]

It appears that the plaintiff may receive a consolation prize after all.

16 *Cf. Carsanaro v. Bloodhound Tech., Inc.*, 65 A.3d 618 (Del. Ch. 2013), in which the court upheld the right of a shareholder to bring a direct claim alleging improper diversion of merger consideration to insiders, even if the total merger price is fair. However the court was careful to point out that the funds allegedly diverted to management were a substantial part (18.87%) of the total price paid for the company.

17 *In re Trados*, slip op. at 113