

# Recent Court Decision *In re Trados* Has Implications for Venture Capital or Private Equity-Funded Companies Contemplating Sale

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Boards of Directors of companies funded by venture capital or private equity funds who are contemplating a sale of the company should take note of a recent court decision from Delaware faulting the Board for failing in its fiduciary duty to common stockholders.

When private equity funds back a company, it is standard practice for the fund to receive preferred stock with special rights such as receiving certain dividends, which may accumulate if not paid out each year, and to receive priority in liquidation. Sale of the company is typically defined as a liquidation event. It is also standard practice for the venture capital firm to receive the right to appoint a director to represent its interest. The Delaware Court of Chancery has held that these special rights of preferred stock are contractual rights, and the fiduciary duty of the Board members remains to the common stockholders. The director appointed by the fund needs to have an awareness that his or her fiduciary duties are to the common stockholders despite being appointed to protect the interest of a particular preferred stockholder.

In an opinion published on August 16, 2013 in *In re: Trados*, the Delaware Court of Chancery applied the entire fairness standard, the strictest of the possible standards of review, to determine a shareholder derivative suit. The Court applied this standard because the Court found that six of seven of the Directors of the company had conflicts of interest - three because they were appointed by venture capital firms who had invested in the company, two because they were management directors receiving special incentives for the sale of the company, and one due to other loyalties to a venture capital firm.

The Court faulted the Board for failing to consider the best interests of common stockholders when pursuing an exit strategy. The Court further found that the process used by the Board was procedurally unfair to the common stockholders. The preferred stock had a liquidation priority over common stock, causing a diversion between the interests of the two types of stockholders when pursuing a sale exit strategy: the private equity fund may have an interest in pursuing an exit strategy under far less profitable conditions than would benefit common stockholders.

The Board added to the problem by implementing a Management Incentive Plan (MIP) to reward management for sale of the company. This MIP was to pay out before common stockholders received value for their shares. Had there not been a MIP, common stockholders would have received some value for their shares at the time of the sale. The Court held that the Board did not consider the best interests of the common stockholders by pursuing this exit strategy.

Despite finding that the Board members had personal interests in the outcome of the sale, despite applying an entire fairness standard, and despite finding the sale procedurally unfair, the Court still held that the sale price was fair. The value of the common stock prior to the Board implementing the exit strategy was zero (due to the liquidation rights of the preferred stock) and thus, when the common stockholders received nothing in the sale, this was still fair market value.

Companies with Boards comprised of such interested directors may need to consider alternative strategies to ensure that the Board is meeting its duty to the common stockholders. This may include appointing a special committee tasked with protecting common stockholders. At a minimum, Board meeting minutes should reflect the consideration the Board has taken to consider and act in the best interests of the common stockholders.

### **Additional Information**

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