

The Journal

What's Your Preference? How Recent Delaware Decisions May Impact Liquidation Preferences

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A key feature of most venture capital and private equity investments is the liquidation preferences which are provided to the investors. Liquidation preferences (which can come in many shapes and sizes) are intended to govern the waterfall of proceeds in a sale of the portfolio company, and are carefully crafted to provide the investors with their intended return in a variety of exit scenarios. They are often the mostly hotly contested provisions in negotiating an investment.

Typically preferred stock investors want to know that they receive “the first dollars out” from a sale, insuring that they get a return of their invested capital before the common stock holders participate in the proceeds. In an unsuccessful investment, this can often times mean that preferred stockholders receive 100% of the proceeds of a sale transaction, with no proceeds going to the common stockholders. Investors rely upon these provisions in measuring the risk (and necessary return) in an investment transaction based upon the assumption that the negotiated provisions would be honored in any sale.

A recent decision of the Delaware Court of Chancery, however, has undermined, to an extent, the ability of investors to rely upon their liquidation preferences in sales for values which are insufficient to provide any proceeds to the common stockholders. In *In Re Trados Incorporated Shareholder Litigation* (the “Trados Case”) Chancellor Chandler ruled that a board of directors owes fiduciary duties to the common stockholders in a sale transaction and could breach its fiduciary duty by approving a sale of the company which did not yield sufficient proceeds to make ►

a distribution to the common stockholders. The Trados Case has significant potential implications for both structuring preferred stock investments as well as the Board's conduct and consideration of a sale at a value which is insufficient to provide a return to the common stockholders. It will be important for the venture capital and private equity communities to learn the lessons of the Trados Case in order to insure that their liquidation preferences are fully protected.

The Facts of the Trados Case

Trados Incorporated was a venture capital backed company that developed translation software and services. Between 2000 and 2004 it had raised multiple rounds of venture capital, from a variety of investors, with the preferred stock having an aggregate liquidation preference, as of July 2005, of approximately \$57.9 million. As of mid-2004, Trados was experiencing financial difficulties, and the directors took action to (i) turn the company around, including appointing a new chief executive officer and (ii) pursue strategic options, including hiring an investment banker to explore potential exit transactions. At this time, the Trados had a seven member board of directors, including four designees of the preferred stockholders, the CEO and another employee and one outside director.

The investment banker's initial efforts identified a number of potential acquirers, but did not result in any acceptable proposals. In the meantime, the new CEO was quite successful in his turn-around efforts, and Trados had record quarters in the fourth quarter of 2004 and the first quarter of 2005. In addition, Trados was able to access \$4 million of debt to further fund its operations. Notwithstanding the turn-around and the access to capital, the board of directors continued to explore sale possibilities, and in December of 2004 approved a management sale incentive plan which provided management, including the CEO and the other management director, bonuses payable in the event of a sale of the company.

In January of 2005, Trados was approached by SDL, plc ("SDL") regarding a potential acquisition of Trados by SDL. The Trados board signaled to SDL that it would be interested in a transaction, but that the purchase price would have to be in excess of \$60 million. After several months of negotiations, the parties ultimately agreed on a letter of intent providing for a \$60 million price in April 2005, and a merger agreement was approved in June 2005. The sale was pursued notwithstanding that Trados continued to exceed its projections throughout 2005. The common stockholders received no consideration from the merger, with approximately \$8 million going to management pursuant to the bonus plan and the remainder to the preferred stockholders on account of their preferences.

The Allegations and the Court's Decision

A group of common stockholders of Trados brought a class action against the Trados directors alleging, among other things, that the Trados directors had breached their fiduciary duties to the common stockholders in approving the SDL merger. Their fundamental argument was that the directors had failed to consider the interests of the common stockholders in continuing Trados as a going concern, at a time when Trados was well-financed, profitable and beating revenue projections.

In denying a motion to dismiss, the court ruled that a board's fiduciary duties run principally to the common stockholders, and that the liquidation preference and ▶

other preferred stockholder protections were merely contractual protections which the board needed to respect, but did not create separate or conflicting fiduciary duties. Based on this overlay, the court ruled that because the preferred stockholders, as a result of their liquidation preferences, and the CEO and the other management stockholder, all had interests in the SDL transaction which were divergent from the interests of the common stockholders, a majority of the Trados directors had a conflict of interest in considering the SDL Merger, and were not entitled to the protection of the business judgment rule. Fundamentally, the decision requires a board, when conducting a sale process, to not only obtain the best deal (as classically provided under the Revlon case), but also to consider whether, at the time of such sale, it would be more beneficial to the common stockholders to decline to sell at all.

Lessons to Be Learned in Structuring Investments and Conducting a Sale Process

While the Trados Case does call into question the ability of preferred stockholders to realize their liquidation preferences in unsuccessful investments, there are a number of tools that can be used to help protect the liquidation preferences. In structuring the terms of a preferred stock investment, an investor should consider:

- Preferred stockholders rights to force liquidity such as drag-along rights which can be triggered by one or more holders of preferred stock (without the necessity of board consent) or redemption rights. These “contractual” provisions would give the preferred stockholders an enforceable right to force liquidity, notwithstanding the interests of the common stockholders. These rights should further obligate the company to cooperate in marketing and sales efforts, and to otherwise prepare the company for sale. The Chancellor in the Trados Case, in fact, specifically noted that the Trados preferred stockholders lacked any right to force a transaction that would trigger their liquidation preference.
- Using limited liability companies as holding companies to own corporate operating company, and in the LLC Operating Agreement, carefully defining the board’s fiduciary duties in a way which is more limited than the statutory fiduciary duties under corporate law. For example, in an LLC investors can contractually create co-equal or superior fiduciary duties in favor of the holders of preferred interests on the part of some or all of the directors.
- Insuring that boards include a number of “disinterested” directors, who do not have a direct interest in the preferred stock or preferences, and thus are not “conflicted” in considering a sale transaction.

Similarly, in preparing for a sale, a board and the preferred stockholders should take as part of the sale process to insure that any sale is properly protected: ►

- Any decision to pursue a sale, or to create a management sale incentive plan, should carefully consider the status of the company, and a factual record should be established to support the decision that a sale at that time is necessary or appropriate, and not simply being done at the behest of the preferred stockholders. This is particularly important in the context of a company which is struggling or does not have access to needed capital.
- Have sale transactions, and the decision to pursue a sale strategy, considered and approved by an independent committee which does not include representatives of the preferred stockholders or employees entitled to participate in any management bonus plan.
- Consider providing some consideration to the common stockholders, notwithstanding the liquidation preferences, to avoid litigation costs.

With careful structuring and management of investments, preferred stockholders should be able to avoid the pitfalls which lead to the decision in the Trados Case, and regain confidence in obtaining the benefit of their bargain relating to liquidation preference. ■

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Mr. Rosenthal is a member of Sonnenschein's private equity and venture technology groups, where he has been recognized by Chambers USA as one of the nation's leading venture capital lawyers and one of the leading lawyers in Illinois in private equity matters. He regularly works with funds and portfolio companies on venture capital, private equity and M&A transactions, as well as overall corporate counseling.

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