DELAWARE
CORPORATE AND COMMERCIAL LITIGATION
BLOG

SUMMARIES AND ANALYSIS OF KEY DELAWARE CORPORATE AND COMMERCIAL LAW CASES, PRIMARILY FROM THE DELAWARE CHANCERY COURT AND DELAWARE SUPREME COURT.

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Delaware Corporate and Commercial Litigation Blog

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Post Merger Class Action Claims Survive Motion to Dismiss Where Common Stockholders Received Nothing and Preferred Stockholders Received $52 Million

In the case of *In Re: Trados Incorporated Shareholder Litigation*, No. 1512-CC (July 24, 2009), read opinion here, the Court of Chancery denied defendants' motion to dismiss breach of fiduciary duty claims arising out of the approval by the Board of Directors of Trados Incorporated ("Trados") of a transaction whereby Trados became a wholly-owned subsidiary of SDL, plc ("SDL") and granted defendants' motion as to claims of breach of fiduciary duty and aiding and abetting based on alleged revenue manipulation.

Kevin Brady, a highly regarded Delaware litigator, provides us with this synopsis.

Background

Trados started out as a German company in 1984, but in the mid 1990's Trados was interested in going public so it moved to the United States and incorporated in Delaware. It started accepting investments from entities who became preferred stockholders in the company. Eventually, the preferred stockholders had a total of four designees on Trados' seven member board. In April 2004, the Trados' board began to discuss a potential sale of the Company. In June 2004, Trados engaged JMP Securities, LLC, an investment bank, to assist in identifying potential alternatives for a merger or sale of the Company. At the July 7, 2004 meeting of the board of directors, the board determined that the fair market value of Trados' common stock was $0.10 per share.

By July 2004, JMP Securities had identified potential buyers including SDL. By August 2004, JMP Securities had conducted discussions with SDL which made an acquisition proposal in the $40 million range. Trados informed SDL that it was not interested in a deal at that price. At the same time, there was a concern that the executive officers of Trados might not be sufficiently incentivized to remain with the Company or pursue a potential acquisition of the Company, based upon "the high liquidation preference of the Company's preferred stock." In December 2004, the board approved a management incentive plan (the "MIP"), which set a graduated compensation scale for management based on the price obtained for the Company in an acquisition.

Even though Trados' financial condition improved toward the end of 2004, the board continued to work toward a sale of the Company. In January 2005, SDL again expressed interest in a merger, and in response the Trados board said that "it was not interested in any transaction involving less than a "60-plus" million dollar purchase price." On June 19, 2005, Trados and SDL entered into an

Agreement and Plan of Merger for $60 million, approximately $7.8 million of which was scheduled to go to management pursuant to the MIP, and the remainder to go to the preferred stockholders in partial satisfaction of their $57.9 million liquidation preference. The common shareholders received nothing in the merger which was completed on July 7, 2005.

Appraisal Action Filed – Three Years Later Class Action Filed

Soon after the merger was completed, plaintiff filed a petition for appraisal. Three years later, plaintiff filed an individual and class action against the director defendants claiming: (i) the transaction was driven by certain preferred stockholders who wanted a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados because it was performing poorly; (ii) the Trados board favored the interests of the preferred stockholders "either at the expense of the common stockholders or without properly considering the effect of the merger on the common stockholders"; (iii) the four directors designated by preferred stockholders had other relationships with preferred stockholders and thus were incapable of exercising disinterested and independent business judgment; (iv) two Trados directors who were also employees of the Company received material personal benefits as a result of the merger and were therefore also incapable of exercising disinterested and independent business judgment; and (v) SDL and certain of its executive officers conspired with certain Trados directors to defer revenue until after the merger.

Court Rejects Defendants' Defense of Laches

Defendants argued that the plaintiff's claims for breach of fiduciary duty were barred by laches and should therefore be dismissed. Defendants argued that plaintiff's three-year delay in bringing the fiduciary duty claims has caused them prejudice because "[t]he parties have been embroiled in the Appraisal Action for three years and have engaged in discovery battles, depositions and other motions." The Court noted that "equity follows the law and will apply a statute of limitations by analogy in appropriate circumstances" but that the Court "is not bound by the analogous statute, and, "as the equities require, may apply a period either shorter or longer than that fixed by statute."

The statute of limitations for breach of fiduciary duty is three years and the defendants conceded that plaintiff had filed the fiduciary duty claims within three years of the close of the merger. However, the defendants argued that the Court has the discretion to apply a shorter period if "in terms of equity, the plaintiff should have acted with greater alacrity, and when the plaintiff's failure to seek equitable relief with alacrity threatens prejudice to the other party." The Court however, did not find that there was any prejudice to the defendants, let alone the type of prejudice that would allow the Court to shorten the period of time since plaintiff sought monetary damages instead of injunctive relief or specific performance. As a result, the Court denied the defendants' motion to dismiss based on laches.

Fiduciary Duty Claims

The plaintiff claimed that the director defendants breached their fiduciary duty of loyalty to Trados' common stockholders by selling the company when they did because "the Company was well-financed, profitable, and beating revenue projections." In addition, the plaintiff complained that the director defendants, in approving the Merger, never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over preferred stockholders' interest in exiting their investments."

Plaintiff contends that the merger took place at the behest of certain preferred stockholders, who wanted to exit their investment. Defendants counter by arguing that plaintiff ignored the "obvious alignment" of the interest of the preferred and common stockholders in obtaining the highest price available for the company. Defendants assert that because the preferred stockholders would not receive their entire liquidation preference in the merger, they would benefit if a higher price were obtained for the Company.

The Court rejected the defendants "obvious alignment" argument saying that the interests of the preferred and common stockholders were not aligned because the merger triggered a $52 million preference payout to the preferred stockholders while the common stockholders would get nothing. The Court went on to note that "it is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred." The Court noted that this "inference" was supported by, among other things, the recent improvement in the Company's performance.

Rights of Preferred v. Common Stockholders

The Court noted that while the rights of preferred stock are contractual in nature, directors still owe fiduciary duties to preferred stockholders (as well as common stockholders) where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common." The Court went on to note that "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of 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, where there is a conflict."

Thus, the Court concluded that in circumstances such as here where the interests of the common stockholders diverge from those of the preferred stockholders, it is possible that a director could breach his or her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.

Were the Directors Interested or Lacking Independence?

Plaintiff also alleged that four directors were "interested" in the decision to pursue the merger with SDL which had the effect of triggering the large liquidation preference of the preferred stockholders because they were designated to the Trados board by a holder of a significant number of preferred shares and that each of the directors "had an ownership or employment relationship with an entity that owned Trados preferred stock." In addressing the issue of whether a director is interested or independent, the Court stated:

> A director is interested in a transaction if "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" or if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." The receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be "of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest . . . ." Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." At this stage, a lack of independence can be shown by pleading facts that support a reasonable inference that the director is beholden to a controlling person or "so under their influence that their discretion would be sterilized."

While the Court noted that simply designating a director to a board is not enough to rebut the presumption of the business judgment rule, when that allegation is combined with the allegation relating to ownership or employment relations, that was sufficient on a motion to dismiss to

rebut the presumption of the business judgment rule. As a result, the Court denied the motion to dismiss the fiduciary duty claims based upon the Board's decision to approve the merger.

Court Dismisses Revenue Shifting and Aiding and Abetting Claims

Plaintiff alleged that two director defendants, Campbell and Hummel, breached their fiduciary duty of loyalty to the common stockholders by wrongfully agreeing to "shift revenue" by deferring certain revenue until after the close of the merger, which thereby caused the price of SDL stock to increase after the merger. Plaintiff alleges that this agreement was wrongful because of the possibility that a higher SDL stock price would provide a material benefit to Campbell and Hummel that would wrongfully give them an incentive to approve the merger. The Court disagreed with plaintiff finding that not only did plaintiff fail to specify what accounting rule or other requirement was violated by these actions, plaintiff also failed to show how these actions would directly cause harm to Trados. In addition, the Court found that the plaintiff had not alleged facts that "reasonably suggest than any benefit to Campbell and Hummel … would be material to them." As a result, the Court dismissed that claim as well as the plaintiff's allegations that the remaining defendants "aided and abetted" such a breach of fiduciary duty.

UPDATE: Professor Bainbridge provides scholarly commentary about this post by Kevin Brady, and the *Trados* case here.

Trackbacks (1)

ProfessorBainbridge.com - *August 26, 2009 4:29 PM*
A post by Kevin Brady on Francis Pileggi's Delaware corporate law blog alerts us to Chancellor Chandler's decision in In Re: Trados Incorporated Shareholder Litigation, No. 1512-CC (July 24, 2009), read opinion here. The facts are fairly complicated. S...

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