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THE SAY-SO ON A SALE

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Venture capitalists generally make their investments through preferred stock with liquidation preferences. They also take seats on the boards of their portfolio companies. Two recent Delaware Court of Chancery decisions call into question the ability of venture capitalists to effect a sale of a portfolio company in a distress situation, even when they represent a majority of the board.

In In re Trados Inc. Shareholder Litigation, the board of directors approved a merger in which the preferred stockholders received a portion of their contractual liquidation preference and no consideration remained for the common stockholders. The common stockholder plaintiff alleged that the company was a viable business and that the common stockholders could have received consideration in a future transaction had the company been permitted to continue operations until a later time.

The Trados court declined to dismiss the complaint because the plaintiff had alleged that a majority of the directors were designated by, and had economic ties with, the preferred stockholders and were unable to exercise independent and disinterested business judgment in deciding whether to approve the sale transaction.

The significance of the Trados decision to preferred stockholders is that their designees to the board may not be considered independent and disinterested in making a determination to sell the company, where the preferred stockholders will receive all of the transaction consideration and it is possible that common stockholders would receive some consideration if the company were permitted to continue and pursue an alternate liquidity event at a future date. This is of particular concern to preferred stockholders whose designees compose a majority of the board, as is often the case in venture-backed companies.

The Trados problem is exacerbated by LC Capital Master Fund Ltd. v. James. In LC Capital, the company's charter was drafted in an unusual manner so that the preferred stockholders' liquidation preferences did not apply in a merger. Pointing to economic rights of the preferred stockholders under the charter outside the merger context, the preferred stockholder plaintiffs argued that the board had a fiduciary duty, rather than a contractual obligation under the charter, to allocate more of the merger consideration to the preferred stockholders.

At first look, LC Capital may not seem troubling in the usual situation where the charter provides that the preferred stockholders will receive their liquidation preferences in a merger. However, the LC Capital court suggested that once the contractual rights of the preferred are honored, the board's fiduciary duties to preferred stockholders are fully satisfied and any fiduciary duties are owed solely to common stockholders. The significance of this is that directors not elected by the preferred may view LC Capital as a basis simply to vote against a transaction where the contractual rights of the preferred stockholders do not dictate a sale and the common stockholders will receive nothing.

We and other commentators have considered a number of approaches that venture capital investors may employ to avoid a situation in which the board's vote would be subject to common stockholder claims based on Trados and LC Capital. These potential approaches include adding independent directors to the board, making the preferred stock redeemable if certain milestones are not achieved and using contractual drag-along provisions that force the common stockholders to vote in favor of the sale transaction. We believe the most viable approach may be to provide in the company's corporate charter (called the certificate of incorporation under Delaware law) that the company will be sold at the election of the preferred stockholders in the event that specific economic or other milestones are not achieved. With these charter provisions in place, the board members would potentially be seen by a court as merely fulfilling their contractual duties under the charter, as opposed to exercising a discretionary decision to which their fiduciary duties would apply.

Finally, although the measures the board employs in the sale process may not solve the issues raised by these two cases, a thorough sale process may improve a court's overall view of the board's decision to sell the company. Best or better practices would include ascertaining whether alternate sources of funding are available, forming a committee of independent directors to supervise the sale process, obtaining a fairness opinion and possibly conditioning the sale on the approval of the disinterested common stockholders.

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