

Directors' Duties to Common versus Preferred Shareholders—The Aftermath of the Delaware Chancery Court's Decision in the *In re Trados Inc. Shareholder Litigation*

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By way of its path-breaking 2009 decision in In re Trados Incorporated Shareholder Litigation,¹ the Delaware Chancery Court held that where the interests of the common stockholders diverge from those of the preferred stockholders, a board of directors member may be held liable for breach of fiduciary duty if he favors the interests of the preferred over the interests of the common.² According to Trados, in the context of merger or other corporate liquidation event, a director must, therefore, favor common stockholders as a general rule and confine considerations to preferred stockholders only to those preferences specifically conferred by contract.

INTRODUCTION

It is (and has been) well-settled Delaware law that the rights and preferences of preferred stockholders (sometimes “preferred”) are generally contractual in nature.³ “[R]ights of preferred shareholders are contractual in nature and the construction of preferred stock provisions are a matter of contract interpretation for the courts.”⁴

Therefore, while the courts have repeatedly held that directors owe fiduciary duties to preferred stockholders as well as to common stockholders (sometimes “common”), those otherwise parallel duties are limited to situations where the right claimed by the preferred is not a preference as against the common stock—but rather a right shared equally through contract with the common.⁵

Hence, by default, it “will be the duty of the board, where *discretionary judgment* is to be exercised, to prefer the interests of the 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.”⁶ [Quotation omitted, emphasis added]

Trados makes it clear that, where a board has a choice, specifically where the preferred cannot assert a particular contractual right to the contrary, the board must favor the common shareholders over the preferred shareholders.

This edict has been blurred, however, by prior seemingly contradictory Delaware Chancery Court decisions. Such decisions appeared to establish the existence of a baseline (that is, noncontractual) fiduciary duty owed by directors to preferred shareholders to “exercise appropriate care in negotiating [a] proposed merger,” in order to ensure that preferred shareholders receive their “fair” allocation of the proceeds of [a] merger.⁷

This broadly stated duty from *Jedwab* could be read to place directors on the horns of a dilemma. In the absence of clear contractual rights conferred on the preferred shareholders, what standards apply to directors who must use discretion to allocate merger consideration between the common and preferred?

And what if clear contractual rights afforded the preferred essentially zero out the value of the common in the event of merger? How should directors

make discretionary decisions when the interests of the preferred differ from those of the common?

POST-*TRADOS*, BOARDS AND DIRECTORS DO NOT OWE PREFERRED SHAREHOLDERS EXTRA-CONTRACTUAL DUTIES

Drawing from *Trados*, and other decisions such as *Jedwab*,⁸ the Delaware Chancery Court recently concluded that when, by contract, through the corporate charter or certificate of designation creating the preferred stock, “the rights of the preferred in a particular transactional context are articulated,” it is “[only] those rights that the board must honor.”⁹

So long as specific rights are articulated by the contract creating the preferred, the board “need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common.”¹⁰

In other words, after *Trados*, the question of whether a board or a director may owe preferred shareholders any extra-contractual duty seems to have been answered. Put simply, after *Trados* and its progeny, no such extra-contractual duties are owed.

Even still, though, when “there is no objective contractual basis for [special] treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.”¹¹

Although this statement presents some obvious ambiguity (particularly in situations where the contractual rights of the preferred are not perfectly clear), that ambiguity may be reconciled by reference to the well-established rights of the common. And, at bottom, *Trados* serves a reminder of just what those established rights are.

THE DELAWARE CHANCERY COURT’S DECISION IN *TRADOS* TO OVERRULE THE DIRECTOR DEFENDANTS’ MOTION TO DISMISS

In *Trados*, the plaintiff (a common stockholder) pled sufficient facts to demonstrate (for purposes of surviving the defendants’ motion to dismiss) that four board designees of preferred stockholders breached their duty to common stockholders. This was because they were financially interested in a

decision to merge their corporation and were not sufficiently independent.¹²

The common stockholder-plaintiff in *Trados* alleged that the interests of the preferred stockholders diverged from those of the common stockholders. This was because the company’s merger triggered a multi-million dollar liquidation preference in favor of the preferred stockholders—after which the common shareholders received nothing.¹³

Liquidation preferences often contractually occur in the event of a merger. Such preferences offer the preferred stockholders a preferred payout and downside protection if their investment in a company does not go well.

Because the common stockholders in *Trados* alleged the directors each had an ownership interest or employment relationship with an entity that owned the corporation’s preferred stock, the Delaware Chancery Court held that it was reasonable to infer the directors were interested in the merger transaction. Therefore, the directors were incapable of exercising their independent business judgment for matters related to it.¹⁴

As a result, the *Trados* court had to decide whether the business judgment rule should apply to protect the defendant directors.

APPLICATION OF THE BUSINESS JUDGMENT RULE IN THE CONTEXT OF CONFLICTS BETWEEN PREFERRED AND COMMON SHAREHOLDERS

The *Trados* court had to decide whether to apply the business judgment rule to bar the plaintiff’s claims for breach of fiduciary duty. Directors of Delaware corporations are protected in their decision-making by the business judgment rule. This rule establishes “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹⁵

This rule gives a board of directors wide berth to manage the business and affairs of a corporation, while mitigating directors’ theoretical legal exposure to disgruntled shareholders.¹⁶

A party challenging the decision of a board of directors “bears the burden of rebutting the presumption [created by the business judgment rule].”¹⁷ If that party cannot rebut the presumption, then a court “will not second-guess the



business decisions of the board.”¹⁸ However, if the party challenging the board action successfully rebuts the presumption, “then the burden of proving *entire fairness* shifts to the director defendants.”¹⁹ [emphasis added]

To survive a motion to dismiss, the party challenging the board action must plead facts from which “a reasonable inference can be drawn that a majority of the board was interested or lacked independence with respect to the relevant decision.”²⁰

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 the corporate decision “will have a materially detrimental impact on a director, but not on the corporation and the stockholders.”²¹

Moreover, the personal benefit inuring to the director must be of a “sufficiently material importance, in the context of the director’s economic circumstances, [so] as to have made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest.”²²

“Independence,” as it relates to the business judgment rule, simply means that a “director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”²³

A lack of independence can be shown by pleading facts that support a reasonable inference that “a

director is beholden to a controlling person, or ‘so under their influence that [her] decision would be sterilized.’”²⁴

THE BUSINESS JUDGMENT RULE AS APPLIED BY THE DELAWARE CHANCERY COURT IN *TRADOS*

In *Trados*, the plaintiff’s theory of the case was that, for purposes of the merger, “the preferred stockholders’ interests diverged from the interests of the common stockholders.”²⁵

The plaintiffs further contended that the merger “took place at the behest of certain preferred shareholders, who wanted to exit their investment.”²⁶

The defendants countered and contended that the plaintiff was ignoring an “obvious alignment” of interests between common shareholders and preferred shareholders in “obtaining the highest price possible for the company.”²⁷

The defendants further contended that, because the preferred shareholders would not receive one hundred percent of their liquidation preference as a result of the merger (per their contracts with the company), all shareholders would benefit if a higher price was obtained for the company.²⁸

The *Trados* court flatly rejected the defendants’ “alignment of interest” arguments. Generally, the *Trados* court determined that the interests of the preferred and the common were not aligned “with respect to the decision of whether to pursue a sale of the company or continue to operate the Company without pursuing a transaction at the time.”²⁹

This conclusion by the Chancery Court, it seems, was something of an understatement. The *Trados* merger in fact triggered a \$57.9 million liquidation preference in favor of the preferred shareholders—and the preferreds actually realized approximately \$52 million in liquidation proceeds from the merger.³⁰ By contrast, the common shareholders received nothing from the merger, and “lost the ability to ever receive anything of value in the future for their ownership interest in *Trados*.”³¹

As the Chancery Court put it, “it would not stretch reason to say that this [wa]s the worst

possible outcome for the common shareholders;” and accordingly, the common shareholders “would certainly be no worse off had the merger not occurred.”³²

Hence, the *Trados* court concluded, it was reasonable to infer from the alleged facts that “the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger a liquidation preference of the preferred and result in no consideration for the common shareholders.”³³

This conclusion by the Chancery Court led to the question of whether the *Trados* board had violated its fiduciary duty to the common shareholders by exercising discretionary power in favor of the preferred shareholders—in the form of the liquidation preferences. The *Trados* court held that such alleged facts, if proven, could give rise to the determination that “the director defendants were interested or lacked independence with respect to th[e] decision [to approve the merger].”³⁴

This ruling underscored the basic premise of the distinction between the duties owed by directors to the preferred versus those owed to the common. That is, the fiduciary duties owed by the board to the preferred are delimited by contract, whereas the fiduciary duties owed by the board to the common are those more broadly conferred under the general law concerning fiduciaries (duty of loyalty, duty of disclosure, duty of entire fairness, etc.).

THE PRACTICAL IMPLICATIONS OF THE *TRADOS* DECISION

As stated earlier, once a common shareholder successfully rebuts the protective presumption afforded a board and its directors by the business judgment rule, then the “burden of proving entire fairness shifts to the director defendants.”³⁵ The practical implications of this situation are several.

First, as the Delaware Chancery Court declared in *LC Capital*, “a board of directors that allocates consideration in a manner fully consistent with the bottom-line contractual rights of the preferred need not, as an ordinary matter, do more.”³⁶

As the *LC Capital* court put it, once a board satisfies any special contractual rights of the preferred, directors can, consistent with *Trados*, exercise their entitlement to “favor the interests of the common stockholders.”³⁷

Second, the burden of the entire fairness rule subjects the affected directors to significant and microscopic scrutiny. This scrutiny logically dictates that wise directors will encourage their boards to undertake prophylactic measures to diminish potential legal exposure. For instance, where there are plainly disinterested directors on the board, those directors might function as an “independent directors committee,” as alluded to in *LC Capital*.³⁸

Having an independent committee decide conflicting issues between preferred and common would demonstrate the intent of the board to avoid conflicted decisions. And, it may in fact avoid the existence of any conflict at all. These actions alone might bring the board within the protective scope of the business judgment rule, and thereby avoid application of the entire fairness test altogether.

Certainly, where the interests of the preferred are debatable, and may arguably encroach upon those of the common, the utilization of disinterested directors in any form to engage and decide such debate seems advisable.³⁹

Another potential protective route would be for the board to undertake the most deliberative process possible, such as hiring outside counsel to evaluate and opine upon any putative board decision, if the board concludes it “must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.”⁴⁰

These methods, and others rationally suited to the circumstances, are the types of actions courts would assess for purposes of determining entire fairness by applying the business judgment rule.



THE LESSONS OF *TRADOS* IN A NUTSHELL

In summary, there are two central tenets expressed in *Trados* that ought to garner any director's attention where conflicts exist between preferred and common shareholders. First, a board of director's duty runs to the common shareholders. "[I]t will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock . . . [over] the interests of the [preferred stock]."41

Second, the rights of the preferred shareholders extend no further than the terms of their express contractual rights.⁴²

Directors swim in perilous waters when they protect or serve the interests of the preferred beyond their express contract rights. Hence, it would behoove preferred stock investors to make sure that whatever protections they desire are plainly and directly reflected in the underlying corporate charter or certificate of designation (the contractual documents setting forth the preferred's entitlements).

Following these two basic rules (1) should help ensure application of the protection offered by the business judgment rule, specifically in the context of conflicts in merger situations, as between preferred and common shareholders, and (2) should diminish overall liability exposure resulting from a corporate merger or liquidation.

Notes:

1. *In re Trados Incorporation Shareholder Litigation*, No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).
2. See *Trados* at *7 (citing *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986) and *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997).
3. See, e.g., *Trados* at *7.
4. See *In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 899-900 (Del. Ch. 2009).
5. *Trados* at *7.
6. *Id.*
7. *Jedwab*, 509 A.2d at 594.
8. *Jedwab*, 509 A.2d at 593 and *FLS Holdings, Inc. Shareholders Litigation*, 1993 WL 104562 at *5 (Del. Ch. Apr. 2, 1993).
9. *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 448-49 (Del. Ch. 2010).
10. *Id.* at 449.

11. *Id.*
12. *Trados* at *1-2, 9.
13. *Id.* at *1.
14. *Id.*
15. *Id.* at *6 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).
22. *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999).
23. *Aronson*, 473 A.2d at 816.
24. *Trados* at *6 (quoting *Rales*, 634 A.2d at 936).
26. *Id.*
27. *Id.* at *7.
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *LC Capital*, 990 A.2d at 438.
37. *Id.* (citing *Trados* generally).
38. See *Id.* at 446 (discussing suggestions to form a committee of disinterested directors that would specially consider the interests of the preferred, etc.).
39. See, e.g., *Trados* at *8 (discussing the problem created by the fact that four directors on the *Trados* board were designated "by a holder of a significant number of preferred shares").
40. *LC Capital*, 990 A.2d at 449.
41. *Trados* at *7.
42. *Id.*

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