

August 20, 2013

Delaware Court of Chancery Finds Zero Merger Consideration to Be Entirely Fair to Common Stockholders

In *In re Trados Inc. S'holder Litig.*, the Delaware Court of Chancery held that while management and the preferred stockholders received all of the merger consideration in the sale of a corporation, the merger was still entirely fair to the common stockholders because the common stock had no economic value before the merger.

Although “the defendant directors did not adopt any protective provisions, failed to consider the common stockholders, and sought to exit [the corporation] without recognizing the conflicts of interest presented by the Merger,” the defendants prevailed because the common stock had no economic value before the merger.

Trados Inc., a venture capital backed corporation, increased its revenue for years, but was never profitable. In 2004, the venture capital related directors began searching for an exit and adopted a management incentive plan which compensated management in a sale of the corporation even if the common stockholders received nothing. When the corporation was sold for \$60 million in 2005, management received \$7.8 million of the merger consideration, pursuant to the management incentive plan, and the venture capital investors received \$52.2 million of a \$57.9 million liquidation preference. The common stockholders received zero merger consideration.

The plaintiff common stockholders alleged that the board had a fiduciary duty to continue to operate the corporation on a stand-alone basis, rather than sell the corporation, because that course of action would maximize value for the common stockholders. Further, the plaintiffs argued that the board's actions should be subject to entire fairness because the majority of the directors that approved the merger were not disinterested and independent. Of the seven directors on the board, two of the directors received post-transaction employment and material payments under the management incentive plan, and three of the directors were “fiduciaries for [the venture capital investors] that received disparate consideration in the Merger in the form of a liquidation preference.”

The court agreed that the defendants had to prove that the transaction was entirely fair. As a result, the defendants were obliged to demonstrate that the sale was the product of both fair dealing and fair price.

Applying the entire fairness standard of review, the court found that the evidence relating to fair dealing weighed in favor of the plaintiff because no contemporaneous evidence suggested “that the defendants set out to deal with the common stockholders in a procedurally fair manner.” In fact, the evidence suggested that the defendants sought only to advance the preferred stockholders' interests. For instance, the venture capital directors hired a new CEO who understood his “mission” was to sell to the corporation. Further, the management incentive plan (i) eliminated the common stockholders' ability to receive merger consideration in certain circumstances in which the sale price was greater than the preferred stockholders' liquidation preference and (ii) changed management's incentives from being aligned with the common stockholders. Moreover, the fact that the merger was not conditioned on a vote of a majority of the disinterested common

stockholders, while not evidencing unfairness, "deprive[d] the defendants of otherwise helpful affirmative evidence of fairness."

With regard to fair price, however, the court held that the evidence did not weigh in favor of either side. While the new CEO had made headway in improving business performance, the corporation had been facing cash flow problems. On the other hand, the court found that the defendants' expert witness provided persuasive testimony that the corporation was worth less than the merger consideration. As such, even under the high standard of entire fairness review, the defendants proved that the corporation "did not have a reasonable prospect of generating value for the common stock." The court noted if common stock has no value pre-merger, then the common stockholders received the "substantial equivalent in value of what they had before" and the transaction was entirely fair.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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ArtSpace
Cash Flow 2010 - 2017

	Historical & Current Cash Flow					Forecasted Cash Flow					
	FY 2010	FY 2011	FY 2012	FY 2013	Jul-14	Cumulative	Sep - Dec 14	FY 2015	FY 2016	FY 2017	Cumulative
Receipts & Funding											
Capital	1,225,000	1,950,845	1,905,000	7,048,399	0	12,129,244	0	0	0	0	0
Revenue	0	757,738	2,276,574	2,354,257	1,253,751	6,642,320	897,076	3,067,804	4,886,246	8,914,381	17,765,507
Loans	0	0	0	0	736,664	736,664	0	0	0	0	0
	1,225,000	2,708,583	4,181,574	9,402,656	1,990,415	19,508,228	897,076	3,067,804	4,886,246	8,914,381	17,765,507
Payments											
Operational											
COGS	0	(612,311)	(1,768,007)	(1,874,781)	(993,207)	(5,246,506)	(704,882)	(2,311,067)	(3,479,205)	(6,271,974)	(12,767,128)
Salaries	0	(693,314)	(1,341,826)	(2,536,383)	(1,610,411)	(6,181,934)	(662,302)	(2,215,817)	(2,290,124)	(2,381,729)	(7,549,972)
Marketing	0	(283,432)	(823,360)	(823,360)	(249,641)	(1,986,483)	(110,000)	(270,000)	(278,100)	(286,643)	(944,543)
Technology	0	(354,691)	(412,762)	(416,944)	(523,186)	(1,507,583)	(64,208)	(196,682)	(213,544)	(216,573)	(691,017)
Professional Fees	0	(109,069)	(191,941)	(381,635)	(765,695)	(1,386,339)	(65,000)	(60,000)	(50,000)	(60,000)	(245,000)
T&E	0	(76,550)	(119,639)	(222,299)	(81,686)	(500,174)	(20,000)	(50,000)	(50,000)	(50,000)	(170,000)
Merchandising/Product/Edit	0	(281,296)	(69,800)	(145,153)	(116,459)	(612,708)	0	0	0	0	0
Other Expenses	(109,982)	(117,016)	(213,838)	(187,489)	23,761	(604,565)	(22,000)	(46,000)	(46,000)	(46,000)	(160,000)
VIP Art Fair Purchase	0	0	0	(100,000)	0	(100,000)	0	0	0	0	0
Other Salaries/Wage Related	0	0	0	(46,649)	0	(46,649)	0	0	0	0	0
Security Deposits	0	(24,764)	0	0	0	(24,764)	0	0	0	0	0
Fixed Assets	0	(37,837)	(41,766)	0	0	(79,603)	0	(100,000)	(160,000)	(100,000)	(300,000)
Taxes & Interest	0	0	0	(11,202)	(14,379)	(25,581)	0	(100,000)	(100,000)	(100,000)	(300,000)
Accrued Commissions	0	0	0	0	0	0	(400,000)	0	0	0	(400,000)
Bonuses (Stay)	0	0	0	0	0	0	(250,000)	0	0	0	(250,000)
Integration Costs	0	0	0	0	0	0	(50,000)	0	0	0	(50,000)
	(109,982)	(2,390,810)	(4,767,198)	(6,695,895)	(4,328,903)	(18,292,857)	(2,348,392)	(5,349,576)	(6,616,973)	(9,512,719)	(23,827,660)
Working Capital Movement	(52,898)	114,780	(740,019)	(581,720)	(155,669)	(1,415,526)	0	0	0	0	0
Total Payments	(162,880)	(2,276,100)	(5,507,217)	(7,277,615)	(4,484,572)	(19,708,383)	(2,348,392)	(5,349,576)	(6,616,973)	(9,512,719)	(23,827,660)
Cash Flow Summary											
Total Cash Inflows	1,225,000	2,708,583	4,181,574	9,402,656	1,990,415	19,508,228	897,076	3,067,804	4,886,246	8,914,381	17,765,507
Total Cash Outflows	(162,880)	(2,276,100)	(5,507,217)	(7,277,615)	(4,484,572)	(19,708,383)	(2,348,392)	(5,349,576)	(6,616,973)	(9,512,719)	(23,827,660)
Net Cash Inflow	1,062,120	432,483	(1,325,643)	2,125,041	(2,494,157)	(200,156)	(1,451,316)	(2,281,772)	(1,730,727)	(598,338)	(6,062,153)

* Original Cash Flow Forecast for 2014 - 2017 assumed minimal movement in Working Capital Merchandising/Product/Edit 2014 - 2017 covered by Salaries & Phaidon internal resources

