The Judges' Book

Volume 5 Article 9

2021

Corporate Law: Does Trados Matter?

Abraham J.B. Cable

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Does Trados *Matter?*

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Introduction

In 2013, the Delaware Chancery Court issued an opinion that reverberated loudly in Silicon Valley. In the case of *In re Trados Inc. Shareholder Litigation*,[2] the court scrutinized the action of a board of directors controlled by venture capital investors. Specifically, the court considered the board's decision to sell Trados Incorporated for an amount that, in accordance with customary Silicon Valley stock terms, resulted in payouts to venture-capital (VC) funds holding preferred stock but no payouts to common shareholders. After a lengthy trial, the court ultimately found that the transaction was fair to the common shareholders because of the company's limited prospects.[3] Yet the case was notable for the court's sharp critique of the board for failing to more vigilantly serve common shareholders.[4]

The case inspired a wave of law-firm memos and client alerts speculating about effects on VC financing terms.[5] Leading law firms, acting through the National Venture Capital Association, developed elaborate forms of contracts to circumvent the case's effects.[6] Legal scholars also took note of the case.[7] In particular,

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[1] Excerpted and adapted from Abraham J.B. Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020).
[2] 73 A.3d 17 (Del. Ch. 2013).
[3] *Id.* at 78.
[4] *Id.* at 45.
[5] *E.g.*, *Venture Capital Investing: Can the Liquidation Preference of Preferred Stock Over the Common Stock Be Protected Where the Common Stock Receives Little or Nothing in an Exit?*, LATHAM & WATKINS: CLIENT ALERT (Oct. 21, 2010).
[6] *See* NAT'L VENTURE CAPITAL ASS'N, NVCA MODEL VOTING AGREEMENT n.53 (2018).
[7] *E.g.*, Robert P. Bartlett III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255, 290–95 (2015) (criticizing the court's reasoning for failing to recognize the board as a venue for bargaining over the company's future); Elizabeth Pollman, *Startup*

they scrutinized language in the opinion adopting a rule of "common maximization." Under this controversial approach to conflicts between common and preferred shareholders, a board has a paramount duty to pursue value for the common holders even when preferred holders have negotiated for control of the board.[8]

But how much does *Trados* matter in influencing how boards and their advisors think and act? I examined the question through original interviews with 20 lawyers who guide startups and investors through financing and exit transactions. Because these transactional lawyers are a primary conduit of corporate law, *Trados*, in a practical sense, means what these lawyers think it means. Based on the interviews, I offer five primary observations.

Venture Capital Deal Terms

Trados has not meaningfully affected the terms of venture-capital investments. Technically, contractual mechanisms can evade *Trados*. One mechanism is a "drag-along right" that allows one set of shareholders to cause other shareholders to agree to a merger or stock sale. Ordinarily, drag-along rights require board approval of the triggering transaction. But one could avoid entanglement with *Trados* by drafting a drag-along right that is triggered solely by the preferred shareholders, without any board

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Governance, 168 U. PA. L. REV. 155, 216–20 (2019) (discussing *Trados*).

[8] *Trados*, 73 A.3d at 40–41 ("[G]enerally 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."). The primary conceptual alternative to common maximization is enterprise maximization. *See* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1885–86 (2013) (advocating for a rule that directors should maximize aggregate enterprise value regardless of distributional consequences to different classes of stockholders). Another alternative is the "control-contingent" approach. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 993 (2006) (advocating for a rule that would in some circumstances allow a director to favor a class of stock that has negotiated for board control).

involvement, in order to force a stock sale by common shareholders.

My interviewees reported, however, that drag-along provisions are not usually modified in response to *Trados* because such provisions are impractical to enforce. One interviewee stated that most lawyers are "nervous about enforcement" of drag-along rights in general because shareholders can make procedural objections. Another suggested that any discussion of using drag-along provisions in response to *Trados* was just "optics" and has not had any lasting effect. Yet another observed that it is "virtually impossible" to buy a company without the support of the founders.[9]

Board Process

Trados has modestly improved board process at the time a company is sold. Responding to one of the court's chief criticisms of the Trados board,[10] directors now more carefully document whether common stock has any probable value given the company's chances of a turnaround. One interviewee reported that *Trados* gave rise to "a notion" that the board has to "take into account what benefits the common shareholders." Another stated that *Trados* results in "focus on process" and "build[ing] a record" that the company "is running out of money" and "went out for deals." This documentation focuses on qualitative indications of company distress rather than formal valuations by advisors.[11]

Allocations to Common

At the margins, *Trados* may motivate allocations to common shareholders beyond their baseline entitlements. When a board determines that common shares arguably have value, preferred holders may insure against litigation by shifting some proceeds to common shareholders.[12]

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[9] Cable, *supra* note 1, at 327–29.

[10] *Trados*, 73 A.3d at 62 (stating that the board members "did not understand . . . their job" when they failed to specifically consider the effects of the sale on common holders).

[11] Cable, *supra* note 1, at 330–34.

[12] *Id.* at 334–35.

Corporate Law Ambiguities

Many aspects of *Trados* remain ambiguous to the "startup lawyers" who are primarily responsible for counseling startups through financings and exits. For example, there is no clear consensus regarding the boundaries of *Trados*—i.e., what precisely in the *Trados* fact pattern triggered enhanced scrutiny. Interviewees also did not agree on the extent to which *Trados* endorsed a theory of common maximization, or whether such an approach to common-preferred conflicts is in fact correct as a matter of Delaware fiduciary principles. For example, several interviewees stated that a board owes duties to "all shareholders," but this formulation does not precisely align with common maximization or any of its usual alternatives.[13]

Some of this ambiguity may stem from the novelty and complexity of issues addressed by *Trados.* Corporate scholars have debated common maximization and its alternatives for years. It is also possible that startup lawyers have limited knowledge of *Trados* and other nuances of Delaware corporate law. While interviewees reported being familiar with the case, they also revealed that they do not consider themselves to be specialists in Delaware corporate law. They instead envision themselves as "general" corporate lawyers who call on specialists, such as M&A lawyers or Delaware counsel, as needed.[14]

Muted Responsiveness

Due to resource constraints and a relatively mild litigation environment, startup boards may not be as responsive to judicial caselaw as their public-company counterparts. While public-company boards may regularly use fairness opinions and independent committees to insulate transactions from judicial scrutiny, startup boards consider these trappings of public-company governance to be disproportionately expensive or impractical. One interviewee, for example, described a "disconnect" between the amount of process required for a Delaware corporation and the amount available to most startups, and another stated that many sale transactions are not large enough

[13] *Id.* at 336–38.
[14] *Id.* at 340–41.

to justify "fund[ing]" a special committee.[15] As the Delaware judiciary continues it dialogue with Silicon Valley startups, it should be aware that judicial influence can be muted in this environment. Such an awareness might ultimately affect doctrine, such as sharpening the boundaries of *Trados* and employing standards grounded in the practicalities of customary practice rather than comparisons to public-company governance.

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Judges can benefit from knowing how responsive the business community is to judicial pronouncements. In the case of *Trados,* the court's message got through loudly but not entirely clearly.

[15] *Id.* at 339.

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