



Virginia Business Lawyers

Who's Looking out for the Little Guy?

By: Thomas L. Bowden, Sr. *This was posted Friday, October 29th, 2010*

Delaware Chancery Court – that's who!

In [venture capital deals](#), there is a highly standardized [corporate structure](#). A venture backed company has [common stock](#), owned by founders and employees, and [preferred stock](#), owned by the investor VCs. There may be several series or classes of preferred stock, depending on the number of rounds of investment. Each series or class will have specific rights of priority, rate of return etc. Within the standard model, the actual deal terms can vary widely, but market conditions tend to restrict them to a fairly narrow range at any given time.

One of the key features of preferred stock is the "[liquidation preference](#)." Liquidation preference is the amount of money per share of preferred stock. That must be paid before the common stockholders can receive any payment for their stock. This typically matters only if the company is sold, merged or liquidated.

Historically, when a venture-backed company experiences difficulty or misses certain agreed performance targets, the preferred stockholders essentially take control. At that point, they may be less interested in getting a return on their investment as they are in just getting as much of their investment back as they can. If the company ends up in a "fire sale" transaction, the preferred stockholders may assume that the common stockholders will be left with nothing after the preferred liquidation preference is paid.

A recent case in the [Delaware Chancery Court](#) (the most influential court on corporate issues) may have changed the ground rules in such situations. In that case, [In Re Trados Incorporated Shareholder Litigation](#), the directors of the company were found to have breached their fiduciary duty to the common stockholders by declining to initiate a "sale process" i.e. an auction, for the company. A majority of the directors had been elected by the preferred stock investors (venture capital funds). The company had experienced major setbacks and generally failed to meet the expectations of the preferred investors, but appeared to be on the rebound, and was not in danger of failure. Nonetheless, the Board approved a merger of the company in a transaction with the result that the preferred investors recovered most of their investment, some officers received bonuses, but the common holders received nothing. Common stockholders brought a class action against the board members who approved the transaction, and the court ruled in their favor.

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As in any case, there were numerous factors in the court's decision, and there is no general "rule of thumb" that can be derived, but the implications for a director's duties are significant.

The National Venture Capital Association ("NVCA") maintains a set of legal forms regarded among VCs and their counsel as the industry standard templates for VC transactions. In the wake of *Trados* the Association has modified the documents to provide greater protection for directors in situations where the interests of the preferred investors and the common owners may be at odds. Anyone considering purchase of convertible preferred stock¹ in a private company, and any board member of such a company should be aware of the heightened duties to other shareholders in light of *Trados*, and should also make certain that their counsel is aware of their concerns and the changes to the NVCA documents. Conversely, company founders seeking investors, and other common stock holders, or holders of options on common stock (e.g. key employees), would also be well advised to understand this case and its implications for corporate structure.

[1] At the "angel round" stage, many companies are formed as limited liability companies under the law of the state where the company was formed. Although these investments often have a structure similar to that used in VC transactions, the LLC statutes and applicable case law are not identical to the Delaware laws that applied to *Trados*. Even so, the principles of *Trados* may guide courts in other states when interpreting the LLC statutes as applied to operating agreements and other investment documents of angel round companies.

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