Increased Liability of Preferred Directors and Techniques to Reduce Potential Exposure

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G&R Review

The preferred stockholders' liquidation preference described above in this Chapter could potentially lead to breach of a preferred director's duty of loyalty given the inherent conflict of interest between the director's conflicting preferred and common stockholder constituencies. A recent Delaware Chancery Court decision, *In Re Trados Securities Litigation***[1]**, alarmingly illustrates this dilemma. In that case, the directors, a majority of whom the preferred stockholders designated, approved a change of control transaction where all of the merger consideration was shared between the preferred stockholders on account of their liquidation preference and the management team under a management compensation program. Given this valuation, the common stockholders therefore received nothing.

The common stockholders then sued the Preferred Directors alleging that the directors breached their fiduciary duties and alleging that if the Board had not approved a sale of the company and continued to carry out the company's business plan, the company would have appreciated in value in the future and the common shares would have ultimately become "in the money." This decision, the plaintiffs contended, resulted from the preferred directors conflicting loyalties between the preferred and common stockholders.

The court denied the preferred director defendants' motion to dismiss the suit and held that the presumption in favor of the business judgment of the preferred directors had been successfully rebutted given this conflict. Whether the defendants are in fact liable is a matter for trial. However, this decision, unless it is overturned on appeal, imposes considerable risk on preferred directors.

A few careful steps could have enabled the preferred directors to avoid this liability. First, the acquisition documents failed to contain any drag-along provisions which would have obviated any board action. Second, the business was a Delaware corporation where the state corporate statute and case law impose various fiduciary duties on directors. If the target had been a limited liability company, its operating agreement could have disclaimed or limited these types of duties and insulated the directors from this exposure (although this form could have possibly different and inefficient tax results depending on the nature and form of ultimate exit).

Further, directors should evaluate the breadth and scope of applicable contractual indemnity agreements with the company and corollary charter provisions. Director and officer insurance policies are also an obvious means to reduce if not eliminate the economic exposure of liability if not the mere existence of litigation.

Finally, the directors in this case did not develop a careful record of the degree of deliberation and sensitivity which they may have given to the needs of the common stockholders. The court inferred that a better record might have reached the legal conclusion that the directors discharged the appropriate quantum of care. It is possible that the trier of fact will ultimately reach this conclusion, many years and countless dollars later.

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Fred Tannenbaum is recognized by the Illinois Venture Capital Association as a leading expert on private equity and venture capital, by a national bar association organization as a leading authority on mergers and acquisitions, and by the leading business publication, Crain's Chicago Business, as a top expert on family-owned businesses. Mr. Tannenbaum has been recognized as an Illinois Super Lawyer for many years, an honor conferred on only 5 percent of Illinois lawyers, and a Leading Lawyer in Business Law for 2010 by the Leading Lawyers Network. He also serves on the firm's Management Committee. Mr. Tannenbaum can be reached at or at ftannenbaum@gouldratner.com.

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[1] Civil Action No. 1512-CC, Decided July 24, 2009.