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Venture Capitalists Fall Prey To Fiduciary Suits

By **Evan Weinberger**

Law360, New York (March 22, 2010) -- Venture capital firms usually enter a company with an exit plan and a contract to protect themselves from common shareholder lawsuits, but falling valuations in the economic downturn have made venture capitalists targets for breach of fiduciary claims, as two recent cases highlight.

The two cases, filed by shareholders against the directors of Trados Inc. and KOR Electronics Inc., show not only that litigation has resulted from the departure of venture capital investment in companies during the recession, but just what venture capital firms must do to defend their decision to sell or recapitalize a company, even if that decision leaves common shareholders with nothing.

"I think that Trados and KOR are examples of situations that small companies which have received venture capital financing can find themselves in when the preferred exit strategy of an IPO is not available for whatever reason," said Frank Burke, the head of Steptoe & Johnson LLP's securities practice group.

"The directors in these small companies have to be careful to remember to whom they owe their fiduciary duties," Burke said, referring in particular to those directors appointed by venture capital firms.

Typically, when venture capital firms pump money into a startup company they receive preferred stock and seats on the board of directors in return.

The preferred stock means venture investors get paid before common shareholders when the company goes public through an initial public offering, the preferred exit option; is sold to a corporate buyer or private equity firm; or is recapitalized.

Common shareholders in these types of small companies tend to be either employees or executives or close associates who get in before a company goes public.

"Ordinarily, when the venture capital fund comes in and makes an investment, there are some pretty strict terms and conditions, usually in preferred stock, that all voters have to approve at the time of incorporation," said Chuck Hertlein, a partner at Dinsmore & Shohl LLP.

The decade or so since the 2000 tech bubble has not been kind to the IPO world, and the corporate governance rules set out by the Sarbanes-Oxley Act have made the IPO process tougher, attorneys say.

Many startups turned to private equity as an outlet, but that lowered company valuations, said Thomas Wardell, a partner at McKenna Long & Aldridge LLP.

Lowered valuations, in turn, led to an increase in tensions between preferred and common shareholders, where “people reach for whatever club they can find,” Wardell said.

The typical venture capital structure includes strict contracts that shut off most federal securities claims, but common shareholders still have recourse to breach of fiduciary duty claims under state law, said Bill Gutermuth, the head of Bracewell & Giuliani LLP's corporate and securities practice group.

In the Trados case, which is being fought in the Delaware Chancery Court — common shareholders claimed that directors of the translation software company pushed for an unnecessary merger solely for their own benefit.

SDL PLC's acquisition of Trados totaled \$60 million, of which \$52 million went to Trados' preferred shareholders — four venture capital firms that controlled 51 percent of the company. The remaining \$8 million went to company executives, which left nothing for common shareholders, according to court documents.

Chancellor William B. Chandler III found in July that Trados' common shareholders made a compelling case that the company's financial position was on the upswing and that the decision to merge with SDL was not covered by the business judgment rule.

Because the board of directors did not have an independent, nonaligned party evaluate the transaction, Chandler said, the Trados defendants were not persuasive in their bid to dismiss the case.

The ruling means that the venture capital firms and executives who made the decision to merge with SDL are going to have to defend their position in court — not that they necessarily made the wrong decision, Gutermuth noted.

“The Trados case should not be read that what the board did was not fair,” he said.

The defendants in the more recent KOR case, however, fared better in court.

The venture capital firms, as well as the company's directors and management, pushed for a recapitalization of KOR that left common shareholders empty-handed.

The defendants won their bid to the Superior Court of California in Orange County to toss the case in February, and the reason for their success, according to attorneys, was that they had four independent directors evaluate the deal.

Fourteen current and former employees of KOR — a privately held small defense contractor — had sued after the venture capital firm New Enterprise Associates forced the recapitalization, according to court documents.

KOR purchased all the shares of preferred stock held by NEA units for \$40.3 million in cash and \$9 million in promissory notes. NEA also set up new investment vehicles that purchased \$40.3 million in new KOR preferred stock.

Prior to entering into the recapitalization agreement, four independent directors pursued an IPO, looked into mergers and investigated other options. They rejected NEA's original offer and generally worked for a solution to the problem that benefited all parties, Judge Gary L. Taylor of the Superior Court of California ruled.

And that was enough to have the common shareholders' breach of fiduciary duties claims dismissed, according to Robert Brownlie, the international co-chair of DLA Piper's securities litigation group, KOR's lead attorney.

“They get the business judgment rule, and that results in a defense verdict in this case,” Brownlie said.

Having nonconflicted directors making decisions on behalf of the company allowed the company to argue that noninterested parties made the best decision out of a bad group of options, Gutermuth added.

“It brings you back inside the protection of the business judgment rule,” he said.

Counsel for the common shareholders in this case could not be reached for comment.

The lesson to be drawn from the two cases is that when venture capital investors seek to get out of their investment, companies should bring on independent directors, Gutermuth said.

Venture capital firms should also heed the lesson, Burke said.

“I think KOR provides them a pretty good road map on the pathway that they should take when they are forced into these alternative exit strategies,” he said.

The cases are: *In re Trados Inc. Shareholder Litigation*, case number 1512, in the Court of Chancery of the State of Delaware; and *Alexandros et al. v. KOR Electronics*, in the Superior Court of California for Orange County. Case number not immediately available.