

## SPOTLIGHT ON TERMS AND CONDITIONS

### National Venture Capital Association Modifies Documents in Response to *In Re Trados Case*

The recent case *In re Trados Incorporated Shareholder Litigation* (“*Trados*”) raised heightened concerns for venture capital investors. *Trados* suggests that a board of directors dominated by preferred stock investors may be in breach of its fiduciary duties to common stockholders by electing to sell the company when there is a reasonable probability that waiting until some later time might be in the best interests of the common stockholders. The National Venture Capital Association (“NVCA”) has responded to the risks highlighted in *Trados* by modifying its model form documents to include commentary and drafting options that would afford additional protection to investor directors in these situations. This article summarizes the issues raised by *Trados* and describes the suggestions put forth by the NVCA.

In *Trados*, the company’s seven member board of directors, four of whom were preferred stock designees, approved a sale of the Company for \$60 million. In connection with the sale, most of the preferred stockholders’ liquidation preference was satisfied, a small portion of the proceeds were allocated to satisfy a management carve out plan, and the common stockholders received *nothing*. The plaintiff, a common stockholder, claimed that the defendant directors breached their fiduciary duties to the common stockholders by selling

the company at a time when its performance was improving. In doing so, the directors unfairly favored the interests of the preferred stockholders over the common stockholders, and the common stockholders were stripped of the opportunity to share in the proceeds of a more profitable company sale. The defendant directors sought to dismiss the claim relying on the presumptions of the business judgment rule. In rejecting the dismissal, the court reasoned that because the preferred stockholders stood to receive substantially all of the benefit from the sale, a benefit not shared by the common stockholders, their board designees were self-interested. Therefore the business judgment rule did not apply and the motion to dismiss was denied.

Proposed changes to the NVCA’s model voting agreement shed some light on how to avoid *Trados*-type claims. These modifications would build certain contractual rights into the voting agreement that grant preferred stock investors greater leverage in initiating a sale while at the same time minimizing the need to have the preferred stockholder board designees approve an action that presents a possible or apparent conflict.

The primary change is the insertion of a sales right provision.<sup>1</sup> This sales right provision allows the “Electing Holders” to force the company to initiate a sales process. Via this provision, the company would be required to take a number of affirmative steps towards the sale of the company. Among other actions, the company could be required to engage a banker, negotiate the terms and conditions for the sale of the company, keep

the board abreast of material developments of the sale process, and call a meeting of the board to approve the sale and enter into definitive sale agreements. This sales right provision would put the preferred stockholders in a position to exercise their drag along rights with respect to a specific transaction without ever actually participating in the decision at the board level.

While the sales right provision would position the investors to exercise their drag along rights, in many cases—the approval of a merger or asset sale in particular—board level approval would still be required.<sup>2</sup> The new NVCA provisions contemplate the possibility that the board could reject a transaction that the investors find desirable. To address this scenario, the sales right provision provides that if a transaction is rejected by the board, the Electing Holders would have the right to force the company to redeem all of their outstanding shares in an amount equal to their *pro rata* proceeds of the rejected transaction.<sup>3</sup>

On a related note, the NVCA form changes also suggest that the typical drag along right be drafted such that board approval is not a prerequisite. The court in *Trados* noted that there was no contractual right—such as a drag-along—that entitled the preferred stockholders to make the unilateral decision to sell the company in that case. Since many drag-along provisions are drafted to require board approval along with the vote of the preferred stockholders to trigger a company sale, the NVCA notes that in light of the *Trados* ruling, investors might elect not to include the board as a necessary party to trigger the drag-along.

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<sup>1</sup> This provision is arguably long overdue in the form NVCA documents, and would have had value prior to *Trados*, as without a right to initiate a sale process the drag along right of the investors is of limited use.

<sup>2</sup> In the context of a stock sale transaction there would be no need for board level approval so the transaction could go forward without any action being taken by the investor directors.

<sup>3</sup> While this redemption right would provide investors with a contractual put option, the redemption rights would always be subject to the limitations under the DGCL §160, which would limit its application to situations in which the company has legally available funds.

While it remains to be seen whether the changes proposed by the NVCA will become common practice, *Trados* issues will be a common theme in the drafting and negotiation of venture capital transactions for the foreseeable future.

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## SPOTLIGHT ON THE LAW

### Onex Decision Provides Sales Tax Relief for Start-Up Manufacturing Corporations

The Massachusetts Supreme Judicial Court decided an important sales and use tax case in favor of start-up manufacturing corporations this past July. At issue in the case was whether Onex Communications Corporation, a high-tech venture capital backed company engaged in the development and production of integrated circuits for data and voice transmissions, was eligible for the manufacturing exemption to sales and use tax during its first years of operations.

Under Massachusetts law, purchases of personal property are generally subject to sales or use tax. However, a “manufacturing corporation” does not owe sales or use tax on its purchases of materials, tools, fuel, machinery and replacement parts that are used “directly and exclusively” in manufacturing. The Department of Revenue (DOR) argued that a company is a manufacturing corpora-

tion only if it has produced at least one finished product. Therefore, since Onex Communications had not produced a finished product during the audit period, it owed use tax.

Disagreeing with the DOR, the Supreme Judicial Court ruled that the “finished product” test was inconsistent with Massachusetts case law. Under Massachusetts case law, manufacturing is defined as “change wrought through the application of forces directed by the human mind, which results in the transformation of some pre-existing substance or element into something different, with a new name, nature or use.” To qualify as a manufacturing corporation, a company’s activities must be an “essential and integral” part of the manufacturing process.

The Supreme Judicial Court held that Onex had “perform[ed] some type of transformative process on raw materials”. Specifically, during the tax period at issue, Onex had been primarily working on creating an OMNI chip “blueprint”, a computer-edited design that included technical specifications of hardware and software components and detailed manufacturing instructions. The production of the OMNI chip was dependent on the “blueprint” and its development constituted a “substantial” portion of Onex’s business during the tax period. Thus, Onex was entitled to abatement of the use tax.

Ruling otherwise, the Supreme Judicial Court noted, would be contrary to the exemption’s purpose of encouraging new technology companies, which often require several years of effort before producing a “finished product”, to locate in Massachusetts and encouraging existing companies to develop and expand in the Commonwealth.

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## SPOTLIGHT: TAX ALERT

### Close Deals Prior to Year End for Potentially Significant Tax Benefits

The Small Business Jobs Act of 2010 (the “SBJA”) has created a unique but short window of opportunity for owners and investors to enjoy a significant reduction in tax rates under §1202 of the Internal Revenue Code which provides for reduced capital gains tax rates on qualifying small business stock. The SBJA includes a special incentive for non-corporate shareholders who acquire qualifying small business stock before year end. Under the SBJA, the gain from a later sale of stock of a small business corporation acquired between September 28, 2010 and December 31, 2010, and held for five years, will be eligible for 100% exclusion from federal income tax. In addition, gain from the sale of such stock will not be a preference item for purposes of computing alternative minimum tax. The SBJA incentive will also apply to corporate stock issued to owners in connection with the conversion of an LLC to a corporation.

Persons considering forming, converting an LLC into, or purchasing stock of a small business corporation, should consider the potential SBJA incentives in planning these transactions. Action before year end will be required.

This significant federal tax benefit is available only if certain requirements are met, however. For further information, please contact Robert Finkel at [rfinkel@mbbp.com](mailto:rfinkel@mbbp.com) or Diana Española at [despanola@mbbp.com](mailto:despanola@mbbp.com).

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