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Venture Capital and Preferred Stock

Charles R. Korsmo

Case Western University School of Law, crk64@case.edu

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ARTICLES

Venture Capital and Preferred Stock

Charles R. Korsmo[†]

INTRODUCTION

The time is ripe for reconsidering the jurisprudence of preferred stock.¹ Scholarly attention to the subject has, to this point, been fleeting.² Perhaps this inattention is rooted in a

[†] Assistant Professor, Case Western Reserve University School of Law. J.D., Yale Law School. I am grateful to the participants in the 2012 National Business Law Scholars Conference and the Case Western Reserve University School of Law Summer Scholarship Workshop for their helpful comments, and to Dean Lawrence Mitchell for research support. All errors are my own.

¹ As is discussed more fully *infra* Part I, preferred stock provides investors with certain rights in addition to those possessed by owners of common stock. Among the most common preferred stock rights are special priorities to receive dividends (which may be cumulative if the company fails to pay), and a liquidation preference giving the preferred priority over common stock in the receipt of any proceeds of a liquidation. These rights are frequently accompanied by a panoply of subsidiary contractual protections.

² A 1954 article provided an extensive review of the technique of drafting preferred stock issues. See Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243 (1954). After Buxbaum's effort, a long silence followed. Subsequent treatments include Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1973), and Lawrence Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (1996), along with a student note on unfair treatment of preferred stockholders, Jeffrey S. Stamler, Note, *Arrearage Elimination and the Preferred Stock Contract: A Survey and a Proposal for Reform*, 9 CARDOZO L. REV. 1335 (1988). William W. Bratton and Michael L. Wachter have a forthcoming article on the subject, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock* (U. Penn. L. Sch. Instit. for L. & Econ. Research Paper No. 13-3, 2013), available at <http://ssrn.com/abstract=2214015>. In addition, a number of recent articles have analyzed aspects of the use of preferred stock in venture capital financing. See, e.g., Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309 (2008); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002) [hereinafter Bratton, *Downside*]; Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005). There also exists a somewhat more substantial financial literature on preferred stock.

notion that preferred stock is something of a relic from an earlier era of corporate finance. After all, more than half a century has passed since Benjamin Graham and David Dodd concluded that preferred stock was “fundamentally unsatisfactory,” offering many of the respective downsides of equity and debt, and few of the respective upsides.³ Perhaps the neglect also stems from an impression that the law governing preferred stock is settled and simple, and that the primary legal questions surrounding preferred stock are technical matters of draftsmanship.

Neither of these notions could be further from the truth. First, preferred stock, far from being an outmoded relic, is the investment vehicle of choice for venture capitalists (VCs) investing in today’s high-risk, cutting-edge startup companies.⁴ The nominal dollar value of venture capital financing—while large enough in absolute terms⁵—dramatically understates the importance of venture capital to economic growth and technological innovation.⁶ A recent survey found that U.S. companies that have relied on venture capital financing at some point in their history

³ BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 374 (4th ed. 1962). And, indeed, “preferred [stock] as a mode of finance by mature firms declined markedly in the latter part of the twentieth century.” Bratton, *Downside*, *supra* note 2, at 923. Furthermore, the so-called Collins Amendment to Dodd-Frank will phase out the treatment of trust-preferred securities as equity capital for bank holding companies. See SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 23-24 (2010). According to a working paper, this regulatory change is likely to substantially curtail a form of preferred stock that had recently made up as much as three quarters of preferred issuances by dollar value. See Jarl G. Kallberg et al., Preferred Stock: Some Insights into Capital Structure 8 (Mar. 8, 2008) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108673.

⁴ See, e.g., Bratton, *Downside*, *supra* note 2, at 892 (“Convertible preferred stock is the dominant financial contract in the venture capital market, at least in the United States.” (footnote omitted)); Fried & Ganor, *supra* note 2, at 970 (“VCs investing in U.S. startups almost always receive convertible preferred stock with substantial liquidation preferences.”). Preferred stock is “convertible” if the stockholder has the right to convert shares of preferred stock into common stock on specified terms.

⁵ The total dollar amount of new venture capital investment exploded to \$105 billion in 2000, at the height of the dot-com boom, before cratering to a low of less than \$20 billion in 2003. Following the 2007–2008 financial crisis, the level of new venture capital investment has rebounded to \$25 to \$30 billion per year. See PRICEWATERHOUSECOOPERS NATIONAL VENTURE CAPITAL ASSOCIATION, MONEY TREE REPORT Q1 2012, available at <https://www.pwcmoneytree.com/MTPublic/ns/nav.jsp?page=historical> (last visited Mar. 1, 2013).

⁶ See, e.g., Duke K. Bristow et al., *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, 2004 COLUM. BUS. L. REV. 77, 80 (“[VCs] perform a vital function for the economy and for society.”); Josh Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation*, 87 FED. RES. BANK OF ATLANTA ECON. REV., no. 4, at 25 (“[Venture capital is] an important contributor to technological innovation and economic prosperity . . .”).

generate revenue equal to approximately 21 percent of GDP.⁷ Companies that were backed by venture capital early in their existence include present-day giants and technological trailblazers such as Amazon, Apple, Costco, eBay, Facebook, Google, Medtronic, Staples, and Starbucks.⁸

In addition, a trio of recent opinions out of the Delaware Chancery Court⁹ reveal that the legal issues surrounding preferred stock are not only very much live, but also attended by a great deal of confusion—and even disagreement—as to what the law of preferred stock should aim to achieve. While I will argue that the Delaware Chancery Court arrived at a sensible outcome in each case, the Chancellors were unwilling, or perhaps unable, to flesh out a full and satisfying framework for their decisions. Furthermore, the reasoning announced by the Chancellors threatens to bring destabilizing consequences to the venture capital industry. As such, these three cases provide an excellent opportunity to reassess the law's treatment of preferred stockholders in the venture capital context.

Preferred stock, as discussed below, combines some of the features of debt with some of the features of equity. Debt holders are typically treated as outsiders to the corporation, with their rights and obligations exhausted by contract.¹⁰ Equityholders are traditionally treated as corporate insiders, with any contractual rights and obligations they might bargain for augmented—or even supplanted—by fiduciary rights and obligations.¹¹ As a result of preferred stock's hybrid character, legal treatment of preferred stockholders has long straddled the dividing line between corporate law and contract law.¹²

Any reassessment of this treatment, then, must address two questions at the outset. First, to what extent, if any, should

⁷ NATIONAL VENTURE CAPITAL ASSOCIATION, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY 2 (6th ed. 2011).

⁸ *Id.* at 10.

⁹ *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973 (Del. Ch. 2010); *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010); *In re Trados Inc. S'holder Litig. (In re Trados)*, No. 1512-cc, 2009 WL 2225958 (Del. Ch. July 24, 2009).

¹⁰ *See, e.g., Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1507-08 (S.D.N.Y. 1989); Bratton & Wachter, *supra* note 2, at 3 (“Lenders sit ‘outside’ of [the] corporation, and look to specific, bargained for rights for protection rather than the apparatuses of governance and fiduciary duty.”).

¹¹ Bratton & Wachter, *supra* note 2, at 3 (“The [common stockholders’] interest can be viewed contractually, but the contract that emerges is almost entirely incomplete, with open-ended fiduciary duties substituted for negotiated financial rights.”).

¹² *Id.* at 4 (“Preferred stock sits on a fault line between two great private law paradigms, corporate law and contract law.”).

preferred stockholders be entitled to fiduciary protection from exploitation by common stockholders? Phrased differently, when, if ever, should preferred stockholders be given protections that they have not bargained for and explicitly secured by contract? The second question is the flip-side of the first: to what extent, if any, should common stockholders be entitled to fiduciary protection against exploitation by preferred stockholders? Phrased differently, when, if ever, should a right or power contracted for by the preferred stockholders be subject to and restrained by fiduciary obligations?

This article canvasses the possible responses to these questions.¹³ These responses range from the idea that corporate actions disadvantaging preferred stockholders should always be subject to fiduciary review under a fairness standard of some kind¹⁴ to the notion that fiduciary review has essentially no role to play in preferred stock.¹⁵ Somewhere in the middle lie solutions like imposing fiduciary duties owed to the firm as an entity or, alternatively, defining a “Zone of Preferences” akin to the so-called “Zone of Insolvency” for creditors. Such a framework—discussed more fully below—would give fiduciary protections to preferred stockholders whenever they are likely to be residual claimants on the firm’s earnings, but not otherwise.

The major conclusion of this article is that the best solution lies at one of the extremes: VC holders of preferred stock should never be afforded fiduciary protections, and they should always be required to rely on the protections of their contract.¹⁶

¹³ See *infra* Parts IV and V.

¹⁴ Examples of such arguments can be found, for example, in Brudney, *supra* note 2, at 465-66, Mitchell, *supra* note 2, at 444-45, and Stamler, *supra* note 2, 1342-44. These arguments are discussed more fully below.

¹⁵ A fairly extreme statement of this proposition is found in Baird & Henderson, *supra* note 2. Indeed, it is only subsidiary to their broader proposition that “it may make sense to eliminate the concept of fiduciary duty from corporate law altogether,” in favor of a more limited duty owed by directors to “investors and strangers alike” to “attend to the affairs of the corporation and act in good faith . . .” *Id.* at 1315-16.

¹⁶ In order to operationalize this recommendation, it would, of course, be necessary to define what constitutes preferred stock more precisely than the law has done thus far. Furthermore, it would be necessary to define usable indicia, allowing legislatures and courts (and investors) to determine when preferred stock will be treated as “VC-held,” and thus will not be extended fiduciary protections. Other complications include the treatment of preferred stock if the original holders transfer it to less-sophisticated parties. Such questions of implementation are beyond the scope of this article. The objective here is at once more broad and more modest: to persuade the reader that an economically significant space exists where fiduciary treatment of preferred stockholders is inappropriate. Defining the precise boundaries of that space requires further analysis, and will be done in a future work.

Starting from first principles, I will examine the traditional rationales for imposing fiduciary duties and argue that they are inapposite in the context of preferred stock used for venture capital financing.¹⁷ The sophisticated nature of VCs and their frequent status as repeat players, the heavily bargained nature of venture capital financing, advances in contracting technique, and the lack of any clear majoritarian defaults or norms of fairness all combine to make corporate fiduciary duties an unnecessary—and potentially destructive—supplement to contractual bargaining.

The fact that VC holders of preferred stock should not be entitled to fiduciary protection, however, does not imply that they should not *owe* fiduciary duties to the common stockholders. Indeed, I will conclude that, even in the venture capital context—perhaps *especially* in the venture capital context—fiduciary protections for common stockholders are generally appropriate.¹⁸ A note of caution should be sounded, however: Care must be taken not to allow fiduciary duties to displace voluntary bargains and destabilize contractual relationships. Deciding what is “fair” in a given venture capital scenario is unlikely to be a straightforward proposition, and is likely to be particularly difficult to determine in hindsight. If venture capital is to remain a vital force for innovation and wealth creation, courts must be careful, “lest they upset what they do not understand.”¹⁹

As a result, the fiduciary duties imposed on preferred stockholders in relation to common stockholders should be carefully limited to the so-called “gap filler” fiduciary duties envisioned by contractarian scholars, rather than expanded to encompass broader normative notions of “fairness.”²⁰ Any attempt to use fiduciary duties to impose a contract-trumping,

¹⁷ See *infra* Part IV.

¹⁸ See *infra* Part V.

¹⁹ Baird & Henderson, *supra* note 2, at 1314.

²⁰ See, e.g., FRANK EASTERBROOK & DANIEL FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 92-93 (1996). Kelli Alces describes the contractarian view of corporate law that “fiduciary duties are useful gap fillers in the contracts that make up the corporation and exist because parties to a contract could never provide for every contingency in advance.” Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 241-42 (2009). Alces goes on to note that, under this view, “[f]iduciary duties fill inevitable gaps in contracts and should be interpreted in light of what the parties would have agreed to had they explicitly negotiated terms providing for the situation before the court.” *Id.* at 242; see also Stephen M. Bainbridge, *Presentation of Much Ado about Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 281, 284-85 (2007) (“In the contractarian theory of the firm, fiduciary duties are viewed as gap fillers by which courts resolve disputes falling through the cracks of incomplete contracts.”).

externally imposed “fairness” requirement²¹ is likely to do more harm than good.

This article proceeds in six parts. Part I provides a brief introduction to preferred stock and its use in the venture capital industry. Part II provides a typology of the most common ways in which the interests of preferred stockholders and common stockholders can come into conflict. Part III gives an overview of the case law regarding fiduciary duties and protections for preferred stockholders, including three recent Delaware Chancery Court opinions, and then surveys the potential modifications of this law.

Parts IV and V form the analytical core of the article. Part IV addresses the first question posed above: when should VC holders of preferred stock receive corporate fiduciary-style protection from common stockholders? After surveying the potential justifications for fiduciary duties, this part concludes that VCs should be left to rely on contractual precautions. Part V performs the same analysis for the second question posed above: when should common stockholders be entitled to fiduciary-style protection from VC holders of preferred stock? This part argues that the traditional justifications for fiduciary duties *do* apply in this context, leading to the conclusion that VC preferred stockholders should owe fiduciary duties to common stockholders.

Part VI briefly shows how this analysis brings clarity to the case law, leading to the same results the Delaware courts have thus far achieved, but with greater clarity. The article closes by suggesting some simple measures the Delaware courts (or the Delaware legislature) could implement to create even greater predictability and utility in the law surrounding preferred stock.

²¹ The contractarian conception of fiduciary duty is generally thought of as being in the ascendant in the modern era. *See, e.g.*, Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744 n.50 (2006) (citations omitted) (describing contractarianism as the “dominant legal academic view”). Nonetheless, a number of prominent scholars have argued for a noncontractual conception of fiduciary duties. *See, e.g.*, Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1724-29 (1989-90).

I. PREFERRED STOCK

A. *What Is Venture Capital?*

At the outset, it is essential to have at least a rough idea of what is meant by *venture capital*. For better or for worse, “there is no standard, fixed-in-concrete definition” of the term.²² Some idea of what venture capital is, however, can be gleaned from what VCs do.²³ One of the most influential descriptions of what VCs do was set forth by General Georges Doriot, co-founder of the company American Research & Development, which was a trailblazing venture capital firm in the post-WWII era.

General Doriot described his investment strategy as having the following attributes, which are more or less characteristic of venture capital activity today: (1) an emphasis on new technology, products, and techniques; (2) active, and sometimes even controlling, participation of the venture capitalist in the actual management of the business; (3) investment in outstanding people (the entrepreneurs) at least as much as in outstanding business plans; (4) investment at an early stage of development, but after intellectual property has been secured; (5) a time horizon ranging from a year or two to as long as ten years, followed by “exit” through an initial public offering (IPO) or sale of the entire enterprise; and (6) investments where the VC can add value through technical, financial, and management expertise.²⁴

We might add three other standard attributes to General Doriot’s list. First, venture capital financing tends to be done in “rounds,” with additional capital being injected in stages. The number of financing rounds can vary depending on when in the company’s life venture financing is obtained, but the classical progression moves from an early “seed” round, through several intermediate rounds (usually referred to as “first round,” “second round,” and so on), and finally to a “mezzanine” round meant to finance the company until the VC

²² 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS § 1.1 (2d ed. 1995).

²³ Among the largest and most prominent venture capital firms are Greylock Partners, Sequoia Capital, Menlo Ventures, Oak Investment Partners, Highland Capital Partners, Bain Capital, Kleiner Perkins Caufield & Byers, and Morgenthaler. *The Next Big Thing 2011: The Top 50 Venture-Funded Companies*, WALL ST. J. (Mar. 9, 2011), <http://online.wsj.com/article/SB10001424052748704132204576190644237905576.html>.

²⁴ ARTHUR C. MERRILL, INVESTING IN THE SCIENTIFIC REVOLUTION: A SERIOUS SEARCH FOR GROWTH STOCKS IN ADVANCED TECHNOLOGY 168 (1962).

can exit through an IPO or sale.²⁵ Second, whether by design or by accident, VC investment tends to present an all-or-nothing proposition, where a few home runs generating enormous gains are hoped to outweigh the far more common strikeout where the company is never profitable and the VC loses all or most of the investment.²⁶ Third, the “capital” that funds VCs tends to be highly concentrated. Venture capital firms limit their number of investors to avoid regulation under the Investment Company Act of 1940, which exempts entities with fewer than 100 investors.²⁷ With an average fund size of approximately \$150 million,²⁸ even with the maximum number of investors, the average investment would be \$1.5 million. And although the National Securities Markets Improvement Act of 1996 created a new exemption that theoretically allows up to 500 investors, the exemption is available only with regard to “qualified investors,” defined as individuals with at least \$5 million in liquid investments or institutions with at least \$25 million in liquid investments.²⁹ In either case, the practical threshold for participation is far higher than the most familiar benchmark for investor sophistication, the “accredited investor,” with \$200,000 in annual income or \$1 million in liquid net worth.³⁰

Several of the attributes described above merit emphasis. VCs are active, rather than passive, investors. They are sophisticated about the financial and, often, the technical aspects of the business.³¹ They are concentrated, engaged, and informed. As discussed below, in each of these respects, VCs diverge sharply from the typical conception of the stockholder in a public corporation.

²⁵ 1 BARTLETT, *supra* note 22, at 6-7.

²⁶ *Id.* at 2-3.

²⁷ 15 U.S.C. § 80a-3(c)(1) (2006).

²⁸ As of “2010, the average venture fund size was \$149 million.” See Nat’l Venture Capital Ass’n, *Frequently Asked Questions About Venture Capital*, NVCA, <http://www.nvca.org/index.php?Itemid=147> (last visited Mar. 8, 2013).

²⁹ 15 U.S.C. § 80a-2(51)(A).

³⁰ See Rule 501 of Regulation D of the 1933 Securities Act, 17 C.F.R. § 230.501(a)(5)-(6) (1989).

³¹ 1 BARTLETT, *supra* note 22, at 4 (“The investors are usually experienced professionals with formal academic training in business and finance and on-the-job training as apprentices at a venture fund or financial institution.”).

B. *What Is Preferred Stock?*

Preferred stock has long been regarded as an “anomalous security.”³² Preferred stock is not, in fact, a single thing; there is no Platonic ideal for preferred stock. No single feature or set of features is found in every issuance of preferred stock that could be said to define it. Instead, the rights that accompany ownership of any particular share of preferred stock are simply those that are set forth in the issuing corporation’s charter.³³ As a result, preferred stock comes in a bewildering variety.³⁴

Indeed, the important thing to note at the outset is the highly heterogeneous nature of preferred stock. Preferred stock—particularly as it is used in venture capital financing—is hardly a one-size-fits-all security. Rather, preferred stock is a bespoke security. The needs of the circumstances are carefully measured, and the ultimate terms of a preferred stock issue are typically finely tailored, heavily negotiated, and “sealed with a thick stack of documents.”³⁵ As a result, one must be especially cautious in attempting to generalize about the incentives, motivations, and goals of preferred stock and preferred stockholders.

Nonetheless, some preferences are common to most issues of preferred stock. Most characteristically, preferred stockholders generally have a right to receive specified dividends before the common stockholders may receive any.³⁶ While the board may elect to skip preferred dividends at its discretion, unpaid preferred dividends are typically cumulative—that is, any arrearages will accumulate, and these arrearages must be paid off before any dividends may be paid to the common stockholders. Accompanying this dividend preference is usually a right to priority over common stockholders in receiving the proceeds of a liquidation.³⁷ Thus, upon liquidation, preferred stockholders

³² Buxbaum, *supra* note 2, at 243.

³³ *See, e.g., id.* (“The primary source of a [preferred] share’s legal rights is the share contract. There is no ideal preferred stock but only a collection of attributes the share contract says makes up a share of preferred stock.”); Mitchell, *supra* note 2, at 445 (“Preferred stockholders are preferred precisely to the extent that the corporation’s charter gives them an advantage over common shareholders.”).

³⁴ Technically, any shares that possess rights or privileges that differ from the statutory defaults (i.e., one share, one vote; equal shares of dividends) can be considered “preferred shares,” thus baking increased variability into the very definition of preferred stock.

³⁵ Bratton & Wachter, *supra* note 2, at 47.

³⁶ *Id.* at 45-47; *see also* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 288-92 (5th ed. 1993).

³⁷ KLEIN & COFFEE, *supra* note 36, 288-92.

stand in line ahead of common stockholders, but behind creditors. Preferred stock may also be “participating” or “nonparticipating.” Nonparticipating preferred is entitled to only the specified dividend and liquidation proceeds, and thus has limited upside. Participating preferred additionally shares in the upside by receiving a pro-rata portion of any dividends and liquidation proceeds paid to the common.

These more standard preferences may be accompanied by a host of other preferences, protections, and detriments. Among these are a right to convert preferred into common shares, a right to demand redemption of the preferred stock, a right to force liquidation of the company, and procedural or substantive protections against various transactions that would dilute or otherwise injure the value of the preferred (discussed more fully below).³⁸ Conversely, the firm may retain the right to force conversion of the preferred stock into common stock, or to force redemption of the preferred pursuant to a specified procedure and formula.

Historically, preferred stockholders rarely had the ability to vote in board elections, except when contingent voting rights would kick in upon failure to pay scheduled dividends.³⁹ This stood in contrast to the common shareholders who, by default, elected the board and voted on fundamental corporate decisions. This is no longer the case, however, in the context of modern venture capital financing. As noted above, venture capital is almost always provided in stages.⁴⁰ With each subsequent stage, the VC receives additional preferred stock, which typically carries voting as well as economic rights. As a result, the VC gains increasing voting control of the board with

³⁸ See generally Buxbaum, *supra* note 2; see also Fried & Ganor, *supra* note 2, at 987 (“VCs typically negotiate for a catch-all provision in addition to a list of provisions that explicitly require their consent for most major transactions. Such catch-all provisions allow the preferred shareholders to veto any action that materially modifies their rights under their agreement with the company.”).

³⁹ See Buxbaum, *supra* note 2, at 243 (“[Preferred stock] probably cannot vote in the election of corporate management but may have some contingent voting rights for certain proposed actions and upon default in dividend payments.”). The classic case involved such a share structure, where preferred stockholders gained the ability to vote in board elections if four consecutive dividend payments were missed. See *Zahn v. Transamerica Corp.*, 162 F.2d 36, 39 (3d Cir. 1947).

⁴⁰ See Smith, *supra* note 2, at 323 (“[V]enture capitalists often rely on the practice of staging their investments[.]”); William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473, 506 (1990) (“The most important mechanism for controlling the venture is staging the infusion of capital.”).

each subsequent round of financing.⁴¹ Indeed, a recent survey found that by the final stage of venture capital investment before an IPO, the VC preferred stockholders controlled a majority of the board more often than the common stockholders did.⁴²

C. *Why Do VCs Prefer Preferred Stock?*

As noted above, VCs in the United States who are investing in startup companies almost always hold preferred stock. Given the significant risk that holding preferred stock may create a conflict of interest between VCs and the entrepreneurs and employees at portfolio companies, who typically hold common stock, it is a matter of some debate why preferred stock is so dominant.⁴³ Adding to the mystery, as detailed in the next part, is the potential vulnerability of the preferred to exploitation by the common, which is exacerbated by the almost nonexistent protections courts have provided to preferred stockholders historically.

A number of suggestions have been offered to explain preferred stock's dominance in VC financing.⁴⁴ Of course, the most basic reason for using preferred stock is that it can be specifically tailored to give VCs special preferences and protections. VCs in the United States typically receive convertible preferred stock with a liquidation preference⁴⁵—that is, the preferred stock may at some point be converted into common stock, and the preferred stock is entitled to receive a specified amount of the proceeds from a liquidation before the common stockholders receive anything. This liquidation preference is often remarkably large, greatly exceeding the size of the initial investment.⁴⁶ As a result, the cash-

⁴¹ See Smith, *supra* note 2, at 326-27 (“Because venture capitalists typically gain additional board seats with each round of investment, over time the board composition provisions of venture-backed companies tend to move from ‘entrepreneur control’ or ‘contingent control’ to ‘investor control.’” With these additional board seats, venture capitalists gain increasing voting rights with each round of investment.).

⁴² *Id.* at 327 (finding that in more than three-quarters of the firms where sole control was exercised by either the common or the preferred, control was held by the preferred).

⁴³ See Fried & Ganor, *supra* note 2, at 967-75, 988-89.

⁴⁴ See *id.* at 982-86 for a survey of possible explanations; see also Bratton, *Downside*, *supra* note 2, at 916.

⁴⁵ Fried & Ganor, *supra* note 2, at 970, 981-82 (VCs “invest in startups almost exclusively through” preferred stock); see also Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 313 (2003).

⁴⁶ Fried and Ganor report that:

VCs’ liquidation preferences often far exceed the original purchase price of the stock: The liquidation preference of VC preferred stock sometimes confers

flow rights associated with VC-held preferred stock can look much more like debt than traditional equity.

Another popular explanation for preferred stock's prevalence in VC financing is that the Internal Revenue Service's (IRS) method for taxing employee stock compensation confers certain advantages on preferred stock. In short, when a company grants stock to an employee, the IRS attempts to tax the value of the stock on the grant date as income.⁴⁷ If VCs were to invest in the company via common stock, the IRS would suddenly have a benchmark for valuation—namely, the amount paid by the VCs. Preferred stock, on the other hand does not provide such a benchmark for valuing the common stock because it consists of a different bundle of rights.⁴⁸ As a result, the company (and its employees) can report a lowball value for the common stock, on the ground that the preferred stock's preferences make it much more valuable. Given the difficulty of valuing startup firms, the IRS will not find it easy to challenge such valuations. The upshot is that the use of preferred stock allows startups to reduce the effective tax burden on employees, and thus the pretax cost of compensation for the firm.⁴⁹ This explanation is bolstered by the fact that VC investment through common stock is far more prevalent in other countries, such as Canada, that have different tax rules governing stock compensation.⁵⁰

the right to be paid a multiple of the purchase price before common shareholders may receive any payment. Depending on the circumstances, these multiples can be quite high, as much as six times the original purchase price or higher.

Fried & Ganor, *supra* note 2 at 982; see also Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Startup Company*, 56 ARK. L. REV. 773, 860 (2004). Liquidation prices as high as twelve times the original investment amount are not unheard of. See Vyvyan Tenorio, *VCs Reconsider Tough Terms for Entrepreneurs*, DAILY DEAL (Jan. 28, 2002), <http://www.accessmylibrary.com/article-1G1-82299621/vcs-reconsider-tough-terms.html>. Where cumulative dividends are in arrears, of course, the amount that needs to be paid to the preferred before the common receives anything will be even larger. See Michael Woronoff & Jonathan Rosen, *Effective vs. Nominal Valuations in Venture Capital Investing*, 2 N.Y.U. J.L. & BUS. 199 (2005).

⁴⁷ See 26 U.S.C. § 83(a) (2006).

⁴⁸ See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003). Gilson and Schizer report that startups frequently value common stock for tax purposes at 10 percent of the price paid for the most recent issue of preferred stock. *Id.* at 900-01 n.86.

⁴⁹ See Fried & Ganor, *supra* note 2, at 986.

⁵⁰ See Douglas J. Cumming, *Capital Structure in Venture Finance*, 11 J. CORP. FIN. 550, 553-54 (2005) (finding that preferred stock is far less common in Canadian VC financing, employed in less than 20 percent of venture financing transactions). Cumming has found that even American VC firms are less likely to use

Whatever the reason, the question naturally arises: Why do VCs use preferred stock rather than debt? After all, a convertible bond could largely replicate the cash-flow rights of VC-held preferred,⁵¹ and it would confer the additional advantages of stronger priority in bankruptcy and the potential for tax-deductible interest payments, in contrast to the fully taxed dividend payments.⁵² VCs favor preferred because they tend to take an active role in the control and management of their portfolio companies, and American corporate law does not generally allow bondholders to take such a role.⁵³ Indeed, bondholders who attempt to exercise control risk losing their contractual preferences.⁵⁴

Preferred stock allows the VC to participate in—and even dominate—control of the startup, to negotiate for and receive special preferences and protections, and to receive potentially substantial tax benefits, resulting in lower compensation costs.

II. CONFLICTS BETWEEN COMMON AND PREFERRED STOCKHOLDERS

As described in Part I, preferred stock would seem to offer every advantage for VCs. The dark lining of this silver cloud, however, is that the use of preferred stock creates serious conflicts of interest between the common and the preferred.⁵⁵ While a given capital structure might be

preferred stock when investing in Canadian startups. Douglas J. Cumming, *United States Venture Capital Financial Contracting: Foreign Securities*, 12 ADV. FIN. ECON. 405, 408 (2007).

⁵¹ See Bratton, *Downside*, *supra* note 2, at 914-15 (“[T]he periodic payment properties of noncumulative convertible preferred can be mimicked in part with a convertible income bond.”).

⁵² *Id.* at 915.

⁵³ See *id.*

⁵⁴ The classic cases of creditors being held personally liable after exercising control are *Martin v. Peyton*, 158 N.E. 77, 80 (N.Y. 1927), which involved a loan to a partnership, and *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 288, 292-93 (Minn. 1981), which involved a revolving line of credit to a corporation; see also Bratton, *Downside*, *supra* note 2, at 915 (“A debtholder who exercises control power . . . loses its limited liability status, and could be personally liable to other creditors of the firm or even to [the entrepreneur] in the event its management decisions work out badly.”).

⁵⁵ This conflict between the preferred and the common is, for the most part, what Lawrence Mitchell has described as a “horizontal” conflict—conflict between different classes of shareholders—rather than a “vertical” conflict—conflict between the shareholders and interested directors and managers. See Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1190 (1990); Mitchell, *supra* note 2, at 449-50. With more than one legitimate interest at stake, such

advantageous for all of the players overall, the actual distribution of money at a particular time will always represent a clash of interests. When push comes to shove, any preference granted to the preferred stockholders must necessarily come at the expense of the common stockholders.⁵⁶ Where the common stockholders control the company—which has generally been the case, historically—this conflict creates a substantial risk of exploitation of preferred stockholders.

This exploitation can take a number of forms, but it tends to be directed toward the same end: elimination of dividend arrearages. Where the corporation has, due to straitened circumstances, been unable to pay the required preferred dividends for a substantial period, the large accumulated arrearages can present an obstacle to common shareholders' ability to receive a return when corporate performance eventually improves.⁵⁷ The temptation for management—who are elected by the common stock and often hold substantial quantities of common stock themselves—is to find ways to eliminate preferred arrearages to clear the way for paying dividends to the common or raising new equity capital.⁵⁸

Arrearages can be eliminated in a number of ways, the simplest being an amendment to the certificate of

“horizontal” conflicts tend not to be as amenable to resolution via the traditional fiduciary duties of care and loyalty.

⁵⁶ See Mitchell, *supra* note 2, at 446 (The preferreds' “advantages, of course, come at the expense of the common stockholders, for the distribution of corporate wealth at any given point in time is zero sum. Whatever the size of the pie, and however much it grows, whatever one gets is, by definition, unavailable to the other. Thus, to the extent of their preferences, preferred and common stockholders are in direct conflict with one another.”).

⁵⁷ Such a situation was extremely common after the Great Depression. See Bratton & Wachter, *supra* note 2, at 8 (“As more arrearages cumulate, the issuer's equity capital structure becomes more and more dysfunctional, with the lion's share of the marginal economic interest appended to the preferred even as the votes for the board of directors stay appended to the common. Preferred rights look more and more like barriers on the road to progress for the enterprise as a whole. During the Great Depression the corporate landscape was crowded with such capital structures.”); Stamler, *supra* note 2, at 1336-37 (“Dividend arrearage elimination became widespread after the Great Depression Unpaid dividends on preferred stock would accrue and had to be paid in full before the corporation could declare a dividend on its common stock. Thus, when corporations became profitable following the Depression, management could not declare common stock dividends before it paid the often sizeable preferred stock arrearages which had accrued.”).

⁵⁸ See Brudney, *supra* note 2, at 450 (“[A]t the first sign of a revival of earnings, the common stock—to which management is considerably more responsive than it is to preferred—desires to participate. In order to do so, it must eliminate the barrier to the flow of earnings to itself, the accumulation of arrearages.”).

incorporation, cancelling them.⁵⁹ Similarly, the board could force a “voluntary” exchange of old preferred stock for a new preferred issuance without the arrearages.⁶⁰ One might wonder why the preferred stockholders would ever agree to an amendment that strips arrearages, or to a disadvantageous exchange, when such proposals usually require approval of the preferred by a class vote.⁶¹ Yet, historically, preferred stockholders have agreed to allow arrearages to be eliminated with surprising frequency.⁶² In some cases, this may simply be because the preferred stockholders also own common shares. However, this seeming willingness of the preferred to act against their own interests has traditionally been ascribed to the preferred stockholders’ “bargaining disadvantages in dealing with the common stockholders—disadvantages of economic position and of political posture which enabled the commons to dominate the bargaining and effectively to determine the result.”⁶³

⁵⁹ See, e.g., *W. Foundry Co. v. Wicker*, 85 N.E.2d 722, 729 (Ill. 1949); *O’Brien v. Socony Mobile Oil Co.*, 152 S.E.2d 278, 279 (Va. 1967); *Stamler*, *supra* note 2, at 1337-38.

⁶⁰ See, e.g., *Johnson v. Fuller*, 121 F.2d 618 (3d Cir. 1941); *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff’d*, 146 F.2d 701 (3d Cir. 1944); *Johnson v. Lamprecht*, 15 N.E.2d 127 (Ohio 1938); *Stamler*, *supra* note 2, at 1337; *Bratton & Wachter*, *supra* note 2, at 8.

⁶¹ See 7 SEC. & EXEC. COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES app. B at 473-74 (1938) [hereinafter PROTECTIVE COMMITTEE STUDY]; *Brudney*, *supra* note 2, at 447.

⁶² See *Brudney*, *supra* note 2, at 448 (“Notwithstanding their formal power thus to block the alteration of their rights, experience has shown that with monotonous frequency the preferred stock as a class was induced to cast the necessary votes for what appear to be detrimental, and sometimes disastrous, consequences to itself, consequences for which no necessity was demonstrated.”); E. Merrick Dodd, Jr., *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780, 792 (1942) (“To obtain the cooperation of the preferred shareholders . . . is not as difficult as it would appear to be at first sight.”).

⁶³ *Brudney*, *supra* note 2, at 448. The disadvantageous “economic position” *Brudney* refers to is that, traditionally, “[i]nvestors in preferred stock look for a continuous cash return” akin to the flow of interest payments to a bondholder, and that preferred stockholders have much more to gain from a resumption of dividend payments than from “an increment in the value of their stock from corporate reinvestment of the cash flow.” *Id.* at 460 n.40. This supposed need for continuous flow means that “[d]elay favors the juniors and disfavors the seniors,” thus allowing the common stockholders to credibly threaten to delay any dividend payments in order to extract concessions from the preferred. *Id.*

Among the other “bargaining disadvantages” identified by *Brudney* and other commentators are that preferred shareholders may be widely dispersed; may lack control over and access to the corporation’s proxy machinery; may be rationally ignorant, or at least at an informational disadvantage vis-à-vis the board. See PROTECTIVE COMMITTEE STUDY, *supra* note 61; see also *Brudney*, *supra* note 2, at 448, 459-60; *Dodd*, *supra* note 62; *Stamler*, *supra* note 2, at 338-39. Additionally, where the common control the board—as has traditionally been the case—the common can

The common stockholders can also strip arrearages by performing a “dummy” merger. In a dummy merger, the corporation simply creates a subsidiary to act as a shell company and then merges with it, leaving the former shell company as the surviving corporation. The merger agreement provides for the shares of the original company—including the preferred shares—to be converted into shares of the new company, sans arrearages.⁶⁴ Importantly, this can often be accomplished without a class vote, at least in Delaware.⁶⁵ As a result, if the common stockholders control a majority of the total votes, they will be able to unilaterally strip away arrearages in this fashion.⁶⁶ Indeed, Delaware courts have explicitly blessed this mechanism, and, while hardly routine, it has been done on occasion in recent memory.⁶⁷

The problem of wholesale canceling of arrearages and other preferences via merger, however, is just a subset of a larger category of problems: the allocation of merger proceeds between the common stockholders and the preferred stockholders.⁶⁸ Such an allocation represents a zero-sum game, where the interests of the common and preferred are intractably in conflict. This conflict becomes especially acute

essentially hold the company’s performance hostage as a means for extracting concessions from the preferred. See Dodd, *supra* note 62, at 793.

Of course, one should not neglect the possibility that the preferred could be simply acting in their own best interests in allowing, for example, cancellation of arrearages. Where the existence of large arrearages prevents a needed recapitalization, the preferreds’ choice may be between canceling preferences to salvage some value, or retaining their privileges at the cost of killing the company—thus assuring no return. See Bratton & Wachter, *supra* note 2, at 12.

⁶⁴ See Bratton & Wachter, *supra* note 2, at 12; Stamler, *supra* note 2, at 1352; Buxbaum, *supra* note 2, at 300.

⁶⁵ See *Dalton v. Am. Inv. Co.*, 490 A.2d 574, 578 (Del. Ch. 1985) (rejection of a merger plan by preferred stockholders is insufficient to block the merger because “all shares [are] accorded an equal vote.”); PROTECTIVE COMMITTEE STUDY, *supra* note 61, at app. B at 535 (“[E]ven the right to vote on a proposed merger or consolidation plan may afford but slight protection to small classes of stock, if class voting is not required. Most of the statutes providing for merger or consolidation, however, fail to include such a requirement.”); Stamler, *supra* note 2, at 1352; Bratton & Wachter, *supra* note 2, at 12. Bratton and Wachter, however, cite MBCA § 11.04(f) and note that many states have “merger statutes that carry over a class vote in the merger [context] by reference to the fact that it would obtain given a charter amendment.” Bratton & Wachter, *supra* note 2, at 13 n.40.

⁶⁶ Buxbaum, *supra* note 2, at 293 (“Straight voting of preferred and common stock [is] no protection; numerically the common is usually greater.”).

⁶⁷ See *e.g.*, *Elliot Assocs. L.P. v. Avatex Corp.*, 715 A.2d 843 (Del. 1998); *Fed. United Corp. v. Havender*, 11 A.2d 331 (Del. 1940); *Porges v. Vadsco Sales Corp.*, 32 A.2d 148 (Del. Ch. 1943); *Donohue v. Heuser*, 239 S.W.2d 238 (Ky. 1951); *Bove v. Cmty. Hotel Corp.*, 249 A.2d 89 (R.I. 1969).

⁶⁸ See Bratton & Wachter, *supra* note 2, at 15-16.

where the total merger consideration is greater than the corporation's market capitalization but less than the total amount of the preferred stockholders' liquidation preferences and dividend arrearages.⁶⁹

Another recurring dispute—and the subject of one of the recent Delaware cases discussed below—is the enforcement of mandatory payments to the preferred. While preferred dividends are generally discretionary, situations often arise where the preferred stockholders seek to make dividend payments or redemption of preferred stock mandatory.⁷⁰ When the common stockholders control the board, though, enforcing even a “mandatory” payment can be difficult. This problem is especially salient in the VC context, where mandatory payment rights may be included as downside protection for the VCs as a way to salvage the remains of an unsuccessful investment.

The final important type of conflict represents the flip-side of those introduced thus far. It is entirely possible—and may even be *likely* in VC-financed corporations—that the preferred stockholders will control the board. In general, preferred stockholders—as the owners of senior securities—will have different incentives from the common. When they have control of the board, these incentives will encourage them to choose a course of action that disadvantages the common.⁷¹ In these instances, what protections should the *common* stockholders have against fundamental changes—including mergers, liquidations, and asset sales—initiated by controlling preferred stockholders?⁷²

⁶⁹ Bratton & Wachter give the example of a \$140 million offer to a corporation with a market valuation of \$100 million—\$80 million in preferred shares and \$20 million in common—but where the preferreds' liquidation preferences and arrearages total \$150 million. How should the \$40 million gain from the merger be allocated? All to the preferred? All to the common? Somewhere in between? What is to prevent the common from simply taking the whole \$140 million? *Id.*

⁷⁰ *See id.* at 37.

⁷¹ In particular, there is reason to believe that preferred shareholders, who are generally not the true residual claimant on the upside, will tend to be more risk-averse than the common. *See* Fried & Ganor, *supra* note 2, at 993-94 (“[P]referred-owning VCs in control of the board may, in certain situations, make excessively conservative business decisions, such as choosing immediate ‘liquidity events’ (major corporate transactions that would end the independent life of the company, such as dissolution or a sale of the business) over higher-value strategies involving more risk. The costs of this value-reducing behavior are borne, in the first instance, by the common shareholders.”).

⁷² *See* Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48, at *26-33 (Del. Ch. Apr. 1, 1997).

III. LEGAL TREATMENT OF PREFERRED STOCKHOLDERS

A. *Delaware Law*

In 1973, Victor Brudney lamented that, “in deference to the ideology of free bargaining among groups of corporate security holders and to some felt need for flexibility,” courts had largely abandoned any serious attempt to use fiduciary duties to protect preferred stockholders from disadvantageous treatment at the hands of the common.⁷³ In addition to “ideology,” Brudney also recognized the difficulty of fashioning workable standards of “fairness,” and attempted to develop a standard that would prove usable.⁷⁴ Two decades later, little had changed when Lawrence Mitchell argued that “the position of the preferred stockholder in the corporate firmament, fiduciary rhetoric notwithstanding, is more vulnerable than any other participant.”⁷⁵ Now, nearly twenty years after Mitchell wrote, the law has yet to develop in a way that would ease the anxiety of those who fret over preferred stockholders’ legal lot. If anything, courts have—correctly, as I will argue—become even less willing to provide preferred stockholders any rights or protections they have failed to unambiguously provide themselves by contract.⁷⁶

⁷³ Brudney, *supra* note 2, at 446-47.

⁷⁴ Brudney’s proposed solution was, in essence, to treat preferred stock arrearages “as if” they were matured claims whenever the common moved to cancel or otherwise vitiate them. These matured rights would then be treated, as much as possible, like matured rights in an insolvency proceeding. In particular, Brudney would require whatever new participation the preferred were offered in the recapitalization to be equal in investment value to the amount of the cancelled arrearages. Thus, writes Brudney,

in a case in which preferred arrears totaling \$65 are being amended out of existence and the preferreds are receiving additional, new participations in exchange for giving up the arrearages, the measure of their claim would be \$65, and the fairness of the particular plan would be assessed by comparing the dollar amount of the arrearages with the investment value of the securities given in exchange for cancelling the arrearages.

Id. at 465. As is explored below, this overly rigid conception of fairness would be likely to work significant mischief.

⁷⁵ Mitchell, *supra* note 2, at 443-44; *see also* Bratton & Wachter, *supra* note 2, at 65 (“Any apparent inconsistency [in Delaware law] is dispelled by reference to the results—the preferred always loses.”).

⁷⁶ Bratton complains that “preferred’s legal position deteriorated markedly over the course of the twentieth century . . . [today’s] preferred holders have to rely on the literal terms of their contracts to protect against issuer opportunism.” Bratton, *Downside*, *supra* note 2, at 925. I shall argue, however, that this is actually a positive development.

Courts have consistently described preferred stock as “stock,” naturally enough, conferring on stockholders an ownership interest in the firm.⁷⁷ As a result, courts have traditionally paid at least lip-service to the idea that preferred stockholders are a corporate constituency to whom the corporation’s managers and directors owe fiduciary duties.⁷⁸ Given the frequency of conflict between the interests of the common and the preferred stockholders, however,⁷⁹ the notion of fiduciary duties owed to preferred stockholders threatens to create a perpetual condition of divided duty.

Courts, at least in Delaware,⁸⁰ have attempted to square this circle by treating only those features of preferred stock that are shared with the common as truly “corporate” in nature, while the preferences—the very features of preferred stock that define it as “preferred”—are treated as purely contractual in nature. The classic expression of this doctrinal construction is found in the 1986 case of *Jedwab v. MGM Grand Hotels, Inc.*,⁸¹ where Chancellor Allen stated the following:

[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such a right and the scope of the correlative duty may be measured by equitable as well as legal standards.⁸²

The result is, in theory, that “[p]reference rights are contractual; ordinary stock rights are fiduciary.”⁸³ In practice,

⁷⁷ See DEL. CODE ANN. tit. 8, § 151 (West 2013); *In re Hawkeye Oil Co.*, 19 F.2d 151, 152 (D. Del. 1927) (stating that holders of preferred are to be treated as stockholders, not creditors); see also Mitchell, *supra* note 2, at 445 (“Preferred stock is, of course, stock [T]he most significant consequence of this apparent tautology is that preferred stockholders, like common stockholders, are traditionally regarded as having an ownership interest in the corporation.”).

⁷⁸ See, e.g., *Eisenberg v. Chi. Milwaukee R.R. Corp.*, 537 A.2d 1051, 1062 (Del. Ch. 1987).

⁷⁹ See *supra* Part II.

⁸⁰ As elsewhere in corporate law, Delaware is where the action is. Bratton & Wachter, *supra* note 2, at 5 (“The Delaware courts have emerged in the dominant role as deciders of preferred stock disputes.”). Since 2000, Bratton and Wachter find that “sixty percent of the cases keyed by West as involving preferred stock . . . were decided in Delaware.” *Id.* at 5 n.13. New York is a distant second in terms of numbers of cases. *Id.*

⁸¹ 509 A.2d 584 (Del. Ch. 1986).

⁸² *Id.* at 594.

⁸³ Mitchell, *supra* note 2, at 448; see also Bratton, *Downside*, *supra* note 2, at 929-30 (“Under Delaware law, the preferred share the role of fiduciary beneficiary with the common only with respect to elements of preferred participation constituting an

however, two factors combine to ensure that preferred stockholders virtually always lose litigated disputes.

1. Common-Controlled Boards

In instances where common stockholders control the board, and where preferred stockholders' rights coincide with the rights of the common, no horizontal conflict of interest will exist between the preferred and the common stockholders. While the preferred stockholders could theoretically bring a derivative claim alleging director self-dealing or generic negligent mismanagement, such a claim would necessarily be available to the common stockholders, as well. The preferred would be adequately protected either by the board's desire to serve the interests of the common stockholders, or by the common stockholders' ability to call upon their own fiduciary protections. As a result, any fiduciary protections for the preferred stockholders are largely superfluous where the interests of the common and the preferred stockholders are identical.⁸⁴

It is where a horizontal dispute exists—where the interests of the preferred and the common diverge—that fiduciary duties might at least potentially serve to protect the preferred against opportunism by the common stockholders. And it is here that Delaware withholds the protections of fiduciary duties and requires the preferred stockholders to look to the terms of their contract. Furthermore, as we will see below, the courts tend to interpret the terms of the preferred stockholders' contract narrowly.⁸⁵ The result is that “Delaware

equity participation identical to that of the common. Accordingly, the preferred have a cause of action along with the common where management engages in self-dealing transactions or negligently mismanages the firm. In contrast, where a preferred claim arises from rights and preferences not shared with the common, the Delaware courts characterize the claim as contractual rather than fiduciary.”)

⁸⁴ See Mitchell, *supra* note 2, at 449 (arguing that under *Jedwab*, “preferred stockholders are in no better position than creditors who incidentally have the right to bring derivative litigation, which generally will be of little benefit to them”).

⁸⁵ See Bratton, *Downside*, *supra* note 2, at 930 (citing *Kaiser Aluminum Corp. v. Matheson*, 681 A.2d 392 (Del. 1996), and employing the maxim of *interpretation contra proferentum* against the preferred); *Warner Commc'ns Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962 (Del. Ch. 1989) (rejecting a literal interpretation of the contract that would protect the preferred). Bratton and Wachter seem to suggest that this tendency to interpret preferred stock contractual language strictly against the preferred stems, at least in part, from the Delaware courts' traditional deference to boards of directors, turning—perhaps inappropriately, in their view—a question of contractual interpretation into one of business judgment. See Bratton & Wachter, *supra* note 2, at 4.

law holds out no serious promise of fiduciary protections against issuer opportunism for preferred stockholders.”⁸⁶

Moreover, Delaware courts have suggested that under some circumstances, for a board to give the preferred stockholders more consideration than required by contract would itself constitute a breach of fiduciary duty to the common stockholders.⁸⁷ The courts have occasionally cautioned common-controlled boards on the need to treat all classes “fairly” in zero-sum transactions,⁸⁸ but one searches in vain for a merger or other fundamental transaction that has been blocked for “unfairness” to the preferred, where no explicit contractual protection is traduced. Indeed, as will be developed more fully below, it is difficult to see how a court dedicated to a norm of common-stock value maximization and viewing the preferred stockholders’ rights as contractual could find a basis to deem a transaction “unfair” in the absence of a breach of contract.

2. Preferred-Controlled Boards

Under Delaware law, the situation is somewhat different when the preferred stockholders control the board. The conflict of interest between common and preferred stockholders, of course, remains.⁸⁹ Delaware courts have struggled, however, in attempting to apply fiduciary duties in this situation. On the one hand, requiring a preferred-controlled board to favor the common stockholders would

⁸⁶ See Bratton & Wachter, *supra* note 2, at 4; see also Mitchell, *supra* note 2, at 449 (“[T]o say that preferred stockholders have any meaningful fiduciary rights borders on the fraudulent.”).

⁸⁷ In *Equity-Linked Inv., L.P. v. Adams*, for example, the court noted that “[t]he special protections offered to the preferred are contractual in nature [G]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of 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, where there is a conflict.”

705 A.2d 1040, 1042 (Del. Ch. 1997). Fried and Ganor note that this is “consistent with a long line of Delaware cases holding that boards controlled by common shareholders can take steps that jeopardize preferred shareholders’ economic interests as long as they adhere to the contractual provisions bargained for by the preferred shareholders.” Fried & Ganor, *supra* note 2, at 979.

⁸⁸ See *In re FLS Holdings, Inc. S’holders Litig.*, No. Civ. A. 12623, 1993 WL 104562, at *4 (Del. Ch. Apr. 2, 1993, revised Apr. 21, 1993) (requiring “fair” treatment of preferred shareholders in a merger context).

⁸⁹ See, e.g., Baird & Henderson, *supra* note 2, at 1330-31 (“A board that acts on behalf of a senior investor will tend to play it safe. Directors will resist taking on new projects or even agreeing to keep the firm operational, as they enjoy none of the upside and suffer the consequences if things go badly.”).

largely defeat the purpose of the preferred stockholders using control as a protection in the first place, and would threaten to destabilize bargains involving the possibility of the preferred stockholders taking control of the board. On the other hand, allowing the board to favor the preferred stockholders would leave the common stockholders at risk of exploitation—far more exposed than preferred stockholders are to exploitation by controlling common stockholders, as the common will almost always lack the extensive contractual protections typically possessed by the preferred.

Recognizing this tension, in the case of *Orban v. Field*, the Delaware Chancery Court allowed controlling preferred stockholders to use corporate resources to arrange a merger that, while in the best interests of the corporation as a whole, resulted in the common shareholders being wiped out.⁹⁰ Thus, *Orban* suggests that controlling preferred stockholders may favor themselves over the common, without an obligation to maximize the value of the common stock.⁹¹ *Orban* also suggests, however, that the common shareholders could challenge the merger by showing that it was not in the “best interests of the corporation.”⁹² Unlike controlling common, then, a preferred-controlled board acting to benefit the preferred at the expense of the common may be required to show the fairness of the challenged transaction “to the corporation as a whole.”⁹³

The net result is a control-contingent standard where the form of legal scrutiny depends on whether the common stockholders or the preferred stockholders control the board. Common-controlled boards are unequivocally permitted to

⁹⁰ *Orban v. Field*, No. 12820, 1997 Del. Ch. LEXIS 48, at *29-32 (Del. Ch. Apr. 1, 1997).

⁹¹ *See id.* at *29; Baird & Henderson, *supra* note 2, at 1332 (“*Orban* seems to stand for the proposition that directors can take actions that are in the best interests of the corporation as a whole even when they take actions that are manifestly self-interested or favor non-fiduciaries over fiduciaries.”); Matthew P. Quilter et al., *Duties of Directors: Venture Capital Board Representatives and Conflicts of Interest*, in VENTURE CAPITAL 2002, at 1117-18 (PLI Corp. L. & Practice, Course Handbook Series No. B-1312, 2002). Fried and Ganor suggest that “*Orban* is read by sophisticated lawyers in Silicon Valley” to stand for the proposition that “a preferred-controlled board does not owe a fiduciary duty specifically to the common shareholders and that it has wide discretion to benefit the preferred shareholders instead.” Fried & Ganor, *supra* note 2, at 992 n.82.

⁹² *Orban*, 1997 Del. Ch. LEXIS, at *26 n.23.

⁹³ *Id.*; *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (requiring a showing of entire fairness to the corporation); Baird & Henderson, *supra* note 2, at 1332 (“[T]o take advantage of this rule, the directors may be forced to show the ‘entire fairness’ of the transaction to the corporation as a whole.”).

exercise their discretion to favor the common stockholders over the preferred, subject only to whatever contractual protections the preferred have secured in advance (although even those are interpreted narrowly). At the same time, preferred-controlled boards may only favor the preferred over the common if such actions can be shown to be in the best interests of the corporation as a whole.⁹⁴

B. *Delaware Law Applied: A Trio of Recent Cases*

A trio of recent Delaware cases displays the struggle courts undergo when trying to apply these principles in various circumstances. These cases are introduced here and will be reexamined below to demonstrate how the analysis in Parts IV and V could be applied in actual cases. In the first, *In re Trados Inc. Shareholder Litigation*,⁹⁵ Chancellor Chandler made clear that controlling preferred stockholders owe fiduciary duties to the common, though he suggested that those duties could be circumscribed or even overcome by contract. The second, *LC Capital Master Fund, Ltd. v. James*,⁹⁶ demonstrates the narrowness of the fiduciary protections to which noncontrolling preferred stockholders are entitled, with Chancellor Strine allowing even an ambiguous contractual scheme to displace fiduciary review. Finally, in *SV Investment Partners, LLC v. ThoughtWorks, Inc.*,⁹⁷ Vice Chancellor Laster interpreted the preferred stockholders' seemingly clear contractual protection in a way that left them at the mercy of the common-controlled board's discretion.

1. *In re Trados Inc. Shareholder Litigation*

The first of the three cases featured a stark conflict of interest between the preferred stockholders—who controlled the board—and the common stockholders. The preferred stockholders sought to cut their losses and exit by selling the

⁹⁴ See Fried & Ganor, *supra* note 2, at 992-93 (“The identity of those controlling the board affects the content of the board’s duties. A common-controlled board is free to serve the interests of the common shareholders at the expense of the preferred shareholders and aggregate shareholder value. In contrast, a preferred-controlled board can make business decisions that serve the preferred at the expense of common, as long as those decisions can be defended as in the best interests of the corporation.”).

⁹⁵ No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

⁹⁶ 990 A.2d 435 (Del. Ch. 2010).

⁹⁷ 7 A.3d 973 (2010).

company, even at the cost of wiping out the common stock, while the common stockholders had little to lose—and potentially much to gain—from continuing the effort to turn the company around without a sale. *In re Trados*⁹⁸ involved a “software and services” company, Trados, that had accepted venture capital investment in the hopes of better positioning itself for an IPO.⁹⁹ As it happened, the first round of investment occurred at the tail end of the tech bubble in early 2000.¹⁰⁰ When the bubble burst, the company’s prospects for a successful public offering dimmed, and after four years of failed efforts—and the issuance of five series of preferred stock—the VCs began pursuing exit from their investment through a sale of the company.¹⁰¹

The VCs had gone to great lengths to protect their interests. In addition to a large liquidation preference—which also applied in the event of a transfer of control, and which totaled \$57.9 million by the time the company was ultimately sold—the multiple issues of preferred stock had also given the VCs control of the board.¹⁰² By 2004, the “preferred stockholders had a total of four designees on Trados’ seven member board,” with two of the remaining seats held by Trados officers, and the final seat held by an outside, independent director.¹⁰³

In April 2004, the VCs started to actively seek potential buyers of the company.¹⁰⁴ The board retained an investment bank to identify plausible candidates and contacted seven potential suitors.¹⁰⁵ It received an offer of \$40 million, which it rejected as too low. In an attempt to motivate top executives to improve the company’s performance and place it in a more marketable condition, the board instituted an incentive plan, “which set a graduated compensation scale for the Company’s management based on the price obtained for the Company in an acquisition.”¹⁰⁶ These incentives worked; the company’s performance improved, and the company ultimately attracted a merger offer of \$60 million.¹⁰⁷ Under the terms of the merger agreement, management received approximately \$7.8 million

⁹⁸ No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

⁹⁹ *Id.* at *1.

¹⁰⁰ *Id.*

¹⁰¹ *See id.* at *2; Bratton & Wachter, *supra* note 2, at 51.

¹⁰² Bratton & Wachter, *supra* note 2, at 51.

¹⁰³ *In re Trados*, 2009 WL 2225958, at *1-2.

¹⁰⁴ *Id.* at *2.

¹⁰⁵ *Id.* at *3.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at *3-4.

pursuant to the incentive plan, while “the remainder would go to the preferred stockholders in partial satisfaction of their \$57.9 million liquidation preference.”¹⁰⁸ The common stockholders were left with nothing.

In fact, the management incentive plan had worked perhaps too well. A common stockholder brought a suit for breach of fiduciary duty, arguing that the company’s performance had improved to the point where a merger had become unnecessary.¹⁰⁹ Had the board merely waited, there was at least a chance that the company’s improved performance would eventually create a return for the common stockholders.¹¹⁰ The conflicts of interest here were clear;¹¹¹ continued operations offered the preferred stockholders little upside and a potentially large downside, while it offered the common stockholders little downside and a potentially large upside. The merger enabled the preferred stockholders to recoup around 90 percent of their liquidation preference (approximately \$52 million out of \$57.9 million) and exit their investment.¹¹² The common stockholders received nothing, and they lost any chance of ever receiving anything.¹¹³

The plaintiff argued that the board had violated its fiduciary duties by “never consider[ing] the interest of the common stockholders as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders’ interest in exiting their investment.”¹¹⁴ In short, the plaintiff argued that the board had a fiduciary duty to favor the interests of the common over the interests of the preferred.

Chancellor Chandler denied the defendants’ motion to dismiss. First, he characterized the case as involving a conflict of interest between the preferred and the common. The key passage, citing both *Jedwab* and *Equity-Linked Investors*, stated:

Generally, the rights and preferences of preferred stock are contractual in nature. This Court has held that directors owe

¹⁰⁸ *Id.* at *4.

¹⁰⁹ *Id.* at *3.

¹¹⁰ *Id.* at *6.

¹¹¹ As the court noted, “[p]laintiff’s theory of the case is based on the proposition that, for purposes of the merger, the preferred stockholders’ interests diverged from the interests of the common stockholders.” *Id.* at *7.

¹¹² *Id.*

¹¹³ *Id.* (“It would not stretch reason to say that [the merger] is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.”).

¹¹⁴ *Id.* at *6.

fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred “is not to a preference as against the common stock but rather a right shared equally with the common.” Where this is not the case, however, “generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of 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, where there is a conflict.” Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.¹¹⁵

The conflict between the interests of the preferred and the common was clear in this situation. Chancellor Chandler thus held that the plaintiff could avoid dismissal by pleading facts “that demonstrate that the director defendants were interested or lacked independence with respect to” the decision to enter into the merger.¹¹⁶

Chandler went on to find that lack of independence was sufficiently demonstrated—“under the plaintiff-friendly pleading standard on a motion to dismiss”—by the fact that four of the seven board members were designated by, and had substantial relationships with, the preferred stockholders.¹¹⁷ As a result, the duty of loyalty was implicated, the business judgment rule no longer applied, and—as in *Orban*—the burden shifted to the defendants to establish that the board acted fairly, thus precluding dismissal.¹¹⁸

This result makes clear that a preferred-controlled board owes fiduciary duties to the common.¹¹⁹ Actions by a preferred-controlled board favoring the interests of the preferred over the common are subject to treatment as interested director transactions, implicating the duty of loyalty

¹¹⁵ *Id.* at *7 (footnotes omitted) (citing *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997)).

¹¹⁶ *Id.* at *6.

¹¹⁷ *Id.* at *8.

¹¹⁸ *Id.* at *8-9.

¹¹⁹ The case makes equally clear that a board owes no such noncontractual fiduciary duties to the preferred, where the interests of the preferred diverge from those of the common. Chancellor Chandler goes so far as to suggest that with regards to preferences—such as the liquidation preference implicated in the case—the board owes no more fiduciary duties to preferred stockholders than they do to creditors. *See id.* at *7 n.42 (rejecting the defendants’ argument that a case involving creditors was distinguishable because preferred stockholders, unlike creditors, are owed fiduciary duties).

and removing the protections of the business judgment rule.¹²⁰ It is important, however, not to miss a crucial proviso. The board must “prefer the interests of common stock” only “where discretionary judgment is to be exercised.”¹²¹ Chancellor Chandler was at pains to point out that the board had no contractual obligation to pursue a merger favorable to the preferred, nor did the preferred have a contractual right to force the sale of the company.¹²² Had the preferred bargained to create, contractually, such an obligation in the board, or such a power in themselves, the case would presumably have come out differently.

2. *LC Capital Master Fund, Ltd. v. James*

*LC Capital Master Fund, Ltd. v. James*¹²³ represented the more traditional scenario, where controlling common stockholders were alleged to have taken advantage of the preferred. The preferred stock in *James* had been issued by QuadraMed Corporation at \$25 per share, and was accompanied by a liquidation preference equal to the issue price, together with a substantial dividend preference.¹²⁴ The preferred stock could be converted into common shares at a ratio determined by dividing the liquidation preference by a sliding conversion price, which was equal to \$15.50 per share by the time of the

¹²⁰ See Bratton & Wachter, *supra* note 2, at 52 (“Restating, when preferred holders in control cause the corporation to enter into a transaction that realizes on their contractual preferences on the moderate downside, approval by controlled board members will be treated as a self-dealing transaction at the behest of a complaining common stockholder. The preferred’s rights get no recognition under fiduciary law because they are contractual; the interest of the common, in contrast, does get recognition.”).

¹²¹ *In re Trados*, 2009 WL 2225958, at *8 (internal quotation marks omitted).

¹²² Chancellor Chandler notes that “[d]efendants [did] not argue that the board had an obligation to the preferred stockholders to pursue a transaction that would trigger the large liquidation preference of the preferred stock.” *Id.* at *7 n.38. He goes on to point out that while it is “reasonable to infer that the preferred stockholders would benefit from a transaction that allowed them to exit the investment while also triggering their liquidation preference, [this was] something they did not have a contractual right to force the Company to do.” *Id.* Later in the opinion, Chandler again emphasized that “it does not appear that the preferred stockholders had any contractual right to force a transaction that would trigger their liquidation preference.” *Id.* at *7 n.42.

¹²³ *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010).

¹²⁴ See QuadraMed Corp., Certificate of the Designation, Preferences, and Rights of the Series Cumulative Mandatory Convertible Preferred Shares, Par Value \$.01 per Share, QuadraMed Corp. Form 8-K, filed June 17, 2004, Exhibit 3.1, available at <http://www.sec.gov/Archives/edgar/data/1018833/000119312504104592/dex31.htm> (Certificate).

merger at issue in *James*.¹²⁵ Thus, just before the merger, each share of preferred could be converted into 1.6129 shares of common.¹²⁶ The preferred stockholders had no right to vote in board elections or on any potential merger.¹²⁷

In 2008, QuadraMed's board began serious discussions of a merger with several potential purchasers.¹²⁸ Although the Certificate explicitly provided that the preferred stockholders' liquidation preference was not triggered by a merger, the preferred stockholders demanded that they receive their liquidation preference—\$25 per share—in any merger.¹²⁹ At least one bidder initially expressed a potential willingness to pay the liquidation price or leave the preferred outstanding, but as negotiations dragged on, the amounts on offer fell, for both common and preferred alike. The board created a Special Committee to negotiate any merger. After failing to get any potential merger partners to agree to leave the preferred outstanding, the Special Committee—with the approval of outside counsel—arranged for the preferred to receive an amount equal to what they would receive if they were to convert their preferred into common.¹³⁰ The final merger agreement provided that the common would get \$8.50 per share, and the preferred would get \$13.71 per share (1.6129 times \$8.50).¹³¹

The preferred shareholders sued, arguing that their contractual preferences made the preferred substantially more valuable than the \$13.71 they were receiving in the merger, and that the board's failure to allocate more of the merger proceeds to the preferred stock represented a breach of fiduciary duty owed to the preferred stockholders.¹³² In

¹²⁵ *Id.* at § 7(a).

¹²⁶ *James*, 990 A.2d at 439.

¹²⁷ *Id.* at 440. The Certificate provided a number of trip wires which, if triggered, would provide the preferred stockholders with voting rights, but none of the wires were triggered. *Id.*

¹²⁸ *Id.* at 441.

¹²⁹ *Id.*

¹³⁰ *Id.* at 441-43. Indeed, outside counsel "said that the Board had to be careful about giving the preferred stockholders more unless there were special reasons for doing so." *Id.* at 443. As the defendants argued, "[t]o have added a dollop of crème fraiche on top of the merger consideration to be offered to the preferred would itself, in these circumstances, have amounted to a breach of fiduciary duty" to the common. *Id.* at 446.

¹³¹ *Id.* at 439.

¹³² *Id.* at 438. Notably, the preferred did not bring a *Revlon* claim. "That is, the preferred stockholders [did] not challenge the overall adequacy of the Merger consideration. Rather, the preferred stockholders claim[ed] that they simply did not receive a big enough slice of the pie . . ." *Id.* at 439.

particular, the preferred stockholders looked to Chancellor Allen's admonition in *Jedwab* that "directors owe preferred stockholders a fiduciary duty to 'exercise appropriate care in negotiating [a] proposed merger' in order to ensure that preferred shareholders receive their 'fair allocation of the proceeds of [a] merger.'"¹³³

Vice Chancellor Strine, however, rejected the QuadraMed preferred stockholders' fiduciary duty claim, leaving an appraisal action as their only potential remedy.¹³⁴ Vice Chancellor Strine noted that while the Certificate did not provide the preferred with the right to receive their liquidation preference in the event of a merger, it did provide the preferred with the right to convert their shares into common and subsequently be treated *pari passu* with the common.¹³⁵ Vice Chancellor Strine then distinguished *Jedwab* by pointing out that, "[n]otable in [*Jedwab*] was the absence of any contractual provision such as the one that exists in this case," which provided a contractual basis for allocating merger consideration.¹³⁶ Vice Chancellor Strine summarized the holding as follows:

When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common. When, however, . . . there is no objective contractual basis for treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.¹³⁷

¹³³ *Id.* at 446 (quoting *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986)).

¹³⁴ *Id.* at 439.

¹³⁵ The court summarized the contractual entitlements of the preferred as such:

[I]n a merger the preferred stockholders will receive either: 1) the consideration determined by the Board in a merger agreement; or 2) if the preferred choose, the right to convert their shares using the Conversion Formula into common shares and redeem the same consideration as the common stockholders. The bottom line right of the preferred stockholders in a merger, therefore, is not tied to its healthy liquidation preference or the company's mandatory conversion stock price—it is simply the right to convert the shares into common stock at the Conversion Formula and then be treated *pari passu* with the common.

Id. at 440-41 (internal citation omitted).

¹³⁶ *Id.* at 446.

¹³⁷ *Id.* at 448-49. Vice Chancellor Strine further explained the limited role of fiduciaries in this context, noting that where there is no contractual basis for allocating the merger proceeds,

the only protection for the preferred is if the directors, as the backstop fiduciaries managing the corporation that sold them their shares, figure out a

The Court claimed that to require the board to give the preferred anything more than what the contract required would be to “give [the preferred] leverage that they did not fairly extract in the contractual bargain . . . a judicially imposed substitute for the voting rights and other contractual protections that they could have, but did not obtain in the context of a merger.”¹³⁸

Taken at face value, the result in *James* is a relatively straightforward application of *Jedwab*, perhaps made noteworthy by Vice Chancellor Strine’s use of *Trados* to suggest (in dicta) that giving the preferred anything more than absolutely required by the contract might itself constitute a breach of fiduciary duty owed to the common stockholders.¹³⁹ More broadly, though, *James* is also notable in allowing even an arguably incomplete and ambiguous contractual provision to preclude any kind of fiduciary review.

Bratton and Wachter, for example, take issue with the court’s contention that the Certificate truly provides an objective measure of what the preferred stockholders should receive in the event of a merger, describing the court’s reading of “standard conversion provisions” as potentially “subversive.”¹⁴⁰ As is discussed more fully below, however, even if it is true that the preferred stockholders in *James* did not expect the conversion provisions to govern their rights in a merger—expecting instead that their treatment in a merger would be dictated by fiduciary obligations of fair dealing—the fact remains that the conversion provision, as drafted, *does* provide a benchmark for allocating merger consideration between the preferred and the common stockholders that is not facially absurd. Furthermore, if the preferred stockholders

fair way to fill the gap left by incomplete contracting. Otherwise, the preferred would be subject to entirely arbitrary treatment in the context of a merger.

Id. at 447.

¹³⁸ *Id.* at 451; *see also id.* (The court posed the question: “Having had the chance to extract more and having only obtained the right to demand treatment under the Conversion Formula that operates to allocate any consideration in a merger between the preferred and the common on a basis the preferred assented to in the Certificate, why should the preferred have the right to ask the Board to give them more?”).

¹³⁹ *Id.* at 447; *see also* Bratton & Wachter, *supra* note 2, at 29 (characterizing *James* as suggesting that “fiduciary law, far from requiring the board to make a fair allocation, *disables* the board from doing so: the Court cautions that the duty to maximize for the common could lead to liability for a director who intervenes to protect the preferred.”).

¹⁴⁰ Bratton & Wachter, *supra* note 2, at 31.

wanted to assure themselves of some other kind of treatment in a merger—even fiduciary treatment—they easily could have done so explicitly. Nonetheless, *James* vividly illustrates the high drafting burden on the preferred. If the door remains open to fiduciary protection where an incomplete contract utterly fails to address a topic, it is a narrow opening indeed.

3. *SV Investment Partners, LLC v. ThoughtWorks, Inc.*

*ThoughtWorks*¹⁴¹ provides a somewhat different example of the fine line preferred stockholders must walk in Delaware. Whereas the *James* court found that a rather ambiguous contractual provision precluded fiduciary scrutiny, the *ThoughtWorks* court refused to find that a seemingly clear contractual provision provided any meaningful protection. *ThoughtWorks* was another venture capital case involving dashed hopes from the dot-com bubble of the 1990s. The difficulties that arose in *ThoughtWorks* originated in part from ThoughtWorks’s business model. ThoughtWorks was founded in 1993 as an “information technology professional services firm that develops and delivers custom business software applications.”¹⁴² ThoughtWorks attempted to hire and retain superstar computer programmers,¹⁴³ who would be hired by large businesses to create custom software within a relatively short timeframe.¹⁴⁴

The crucial aspect of ThoughtWorks’s business model was that it required very little in the way of physical or financial capital. ThoughtWorks, as a result, possessed few assets, and did not even have long-term contracts with customers to provide steady cash-flow that might be easily capitalized.¹⁴⁵ Most of ThoughtWorks’s “assets” were simply the

¹⁴¹ *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973 (2010).

¹⁴² *Id.* at 977.

¹⁴³ *Id.* ThoughtWorks’ founder “fostered a ‘secret sauce culture’ that would appeal to the very best software developers” and “place[d] tremendous emphasis on recruiting elite professional and providing them with challenging and intellectually stimulating work.” *Id.*

¹⁴⁴ *Id.* (“ThoughtWorks’ engagements are typically short-term. Although some clients have engaged ThoughtWorks on multiple occasions over the years, each engagement typically lasts three to six months, does not automatically renew, and is subject to cancellation on as little as fifteen-days’ notice. ThoughtWorkers arrive at the scene, solve the problem, and move on.”).

¹⁴⁵ *Id.*

large amounts of human capital represented by its employees.¹⁴⁶ This human capital, however, was at best only loosely tied to ThoughtWorks. Indeed, the programming skills possessed by ThoughtWorks's employees were highly transferable. As such, ThoughtWorks resembled other low-physical capital-high-human capital businesses—such as a pure investment bank—in that it could potentially have significant value as a going concern while having little or no liquidation value.¹⁴⁷

In 1999, however, with the dot-com bubble accelerating to its climax, concerns about downside protection and liquidation value were not at the forefront of investors' minds during the rush to cash in on a potentially lucrative IPO.¹⁴⁸ Looking to position itself for an IPO, ThoughtWorks sought, and quickly found, VC financing from a firm called SVIP. ThoughtWorks ultimately issued \$26.6 million worth of preferred stock to SVIP at a price of \$8.95 per share, with both parties expecting to perform an IPO within a year or two.¹⁴⁹ Not entirely neglecting the downside, SVIP received a mandatory redemption right—if SVIP was unable to exit its investment within five years, through an IPO or otherwise, SVIP could insist that ThoughtWorks buy back the preferred stock at a price equal to the purchase price plus any accrued dividends.¹⁵⁰ This seemingly powerful right for SVIP illustrates both the impressive bargaining power of a VC firm and—due to the fact that it did not actually work, as the later discussion will show—the unavoidable vulnerability of an investor in an early-stage company.

The mandatory redemption provision contained standard language allowing the redemption to be made “out of funds legally available therefor.”¹⁵¹ This phrase has typically

¹⁴⁶ *Id.* (“The Company’s employees, known as ‘ThoughtWorkers,’ are its most valuable asset.”).

¹⁴⁷ In the event of a liquidation (or even a merger), ThoughtWorks’ employees could potentially flee en masse, taking their valuable human capital with them. *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995) (“For firm 1’s acquisition of firm 2 to make economic sense, there must be some source of firm 2 value over and above the workers’ human capital, i.e. some ‘glue’ holding firm 2’s workers in place.”).

¹⁴⁸ *ThoughtWorks*, 7 A.3d at 978 (“As SVIP noted in its investment recommendation, ThoughtWorks ‘[c]ould be an early IPO in a market which has recently seen some extraordinary valuations.”).

¹⁴⁹ *Id.* at 978.

¹⁵⁰ *Id.*

¹⁵¹ *Id.* In his influential article on preferred stock contractual technique, Buxbaum notes that “[t]he common corporate provision for dividends is that they may be paid ‘out of funds legally available therefor.’ This phrase equates the source of dividends to the applicable statutory provisions and leaves problems of definition to the

been regarded as creating the maximum possible requirement for redemption—if funds are legally allowed to be used for redemption, the corporation must so use them.¹⁵² Here, SVIP's desire to create the strongest possible redemption obligation is evidenced by other clauses providing (1) that in determining the funds legally available for redemption, the company should use the “highest amount permissible under applicable law,” and (2) that, after a potential one-year grace period, the obligation to make redemptions would be “continuous,” such that any cash that became available would be required to be diverted toward redemptions.¹⁵³

Soon after SVIP secured these contractual rights, the dot-com bubble burst, the window for an IPO slammed shut, and the clock began to tick on the redemption provision. After initial squabbling over the grace period, SVIP demanded full redemption of its stock in August 2006, by which time the total redemption price totaled \$45 million.¹⁵⁴ Each quarter for the next four years, the ThoughtWorks board met and determined the amount of “funds legally available” for redemption payments.¹⁵⁵ Although the company's financial advisors consistently found that the company had substantial “net asset value,” and even nontrivial “cash availability,” the board consistently found that little or no funds were available for redemption. By the time of the Chancery Court's opinion in 2010, only \$4.1 million in preferred stock had been redeemed.¹⁵⁶

In 2009, the board began seeking to finance the redemption through borrowing, and cast a wide net for potential lenders.¹⁵⁷ Given the intangible nature of ThoughtWorks's assets, however, borrowing against assets was not a realistic option. ThoughtWorks did manage to get a commitment from a lender focused on the company's cash flow to provide \$25 million for redemption, but the

latter . . .” Buxbaum, *supra* note 2, at 250. Buxbaum speaks of dividends, but such provisions are equally applicable to redemption privileges.

¹⁵² Buxbaum, *supra* note 2, at 250 (“Usually the limit of the statute is the desired corporate limit; hence the popularity of ‘out of funds legally available.’”).

¹⁵³ *ThoughtWorks*, 7 A.3d at 988.

¹⁵⁴ *Id.* at 980.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 981.

¹⁵⁷ *Id.* (“[A]n information memorandum . . . was sent to seventy financing sources. The seventeen who expressed interest and signed confidentiality agreements received additional information. Three sources provided nonbinding commitment letters. After due diligence, two lenders provided definitive term sheets.”).

deal was conditioned on SVIP agreeing to tender all its stock for this amount—something SVIP refused to do.¹⁵⁸

Desperately attempting to salvage its investment—and understandably frustrated by its inability to secure payment from what remained, after all, a nontrivial going concern—SVIP sued to enforce the mandatory redemption privilege, which had by then ballooned to nearly \$67 million. SVIP claimed that ThoughtWorks had more than adequate surplus under the legal capital rules¹⁵⁹ to cover the redemption—SVIP’s expert estimated ThoughtWorks’s balance sheet surplus at \$68 to \$137 million.¹⁶⁰ As a result, SVIP argued that ThoughtWorks had “funds legally available” for a full redemption, and that SVIP was entitled to a judgment for the full \$67 million.

Vice Chancellor Laster rejected this argument, for the very basic reason that “funds legally available” is simply not equivalent to “balance sheet surplus,”¹⁶¹ and the existence of surplus does not necessarily imply the existence of “funds legally available” for redemption. While the lack of balance sheet surplus may be the most common reason for a lack of legally available funds,¹⁶² lack of surplus is not the *only* reason funds might not be available. Most obviously, even where surplus exists, a corporation may not divert funds to dividends or redemptions where doing so could render them insolvent or otherwise impair the rights of creditors.¹⁶³ Moreover, a company may be insolvent on a cash-flow basis even where it has a

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 976. Under § 160(a)(1) of the Delaware Code, “a corporation may use only its surplus for the purchase of shares of its own capital stock,” including the redemption of preferred stock. *In re Int’l Radiator Co.*, 92 A. 255, 256 (Del. Ch. 1914). “Surplus” is defined by § 154 of the Delaware Code to be “the excess of net assets over the par value of the corporation’s issued stock,” while “[n]et assets means the amount by which total assets exceed total liabilities.” *ThoughtWorks*, 7 A.3d at 982 (quoting DEL. CODE ANN. tit. 8, § 154, and *Klang v. Smith’s Food & Drug Ctrs., Inc.*, 702 A.2d 150, 153 (Del. 1997)).

¹⁶⁰ *ThoughtWorks*, 7 A.3d at 976, 982-83.

¹⁶¹ *Id.* at 983 (“Equating ‘funds legally available’ with ‘surplus’ performs all of the work in SVIP’s argument. With that move, SVIP converts a provision contemplating payment ‘for cash’ into a formula based on an incorporeal legalism. This is a fallacy.”).

¹⁶² *See id.* (“Because the existence of surplus under Section 160 most commonly constrains a corporation’s ability to pay dividends or redeem stock, ‘funds legally available’ is colloquially treated as if synonymous with ‘surplus.’ The two concepts, however, are not equivalent.”).

¹⁶³ *See id.* at 985-86 (“Most significantly for the current case, the common law has long restricted a corporation from redeeming its shares when the corporation is insolvent or would be rendered insolvent by the redemption.”).

substantial balance sheet surplus.¹⁶⁴ As the Court noted, SVIP's valuation expert had not considered whether redeeming the preferred stock in a lump sum would impair ThoughtWorks's obligations to creditors.¹⁶⁵

While the decision could have rested on this ground alone, Vice Chancellor Laster took the opportunity to make a more fundamental point about the "funds legally available" language—that funds may be *legally* available without being *actually* available. In other words, funds—cash—must be actually available and at hand before one can even ask whether it would be legal to use those funds—that cash—to finance a redemption.¹⁶⁶ It may be commonplace for a corporation to have cash on hand that cannot legally be used for redemptions. It may, however, also sometimes be the case that a corporation could have a sizeable accounting surplus out of which dividends could legally be paid, in theory, yet lack access to ready cash as a practical matter.¹⁶⁷ In some cases the corporation will be able to liquidate assets, or even distribute assets to shareholders directly as payment—for example, Vice Chancellor Laster referenced the famous example of "whiskey dividends"¹⁶⁸—but such an approach has obvious drawbacks when the assets in question are computer programmers.

Vice Chancellor Laster seemed determined to emphasize the futility of trying to invoke the "funds legally available" language as a magic wand, transforming a balance

¹⁶⁴ *Id.* at 987 ("A corporation may be insolvent under Delaware law either when its liabilities exceed its assets, or when it is unable to pay its debts as they come due.").

¹⁶⁵ *Id.* at 989.

¹⁶⁶ *Id.* at 988 (The term "[f]unds legally available . . . contemplates 'funds' (in the sense of cash) that are 'available' (in the sense of on hand or readily accessible through sales or borrowing) and can be deployed 'legally' for redemptions without violating Section 160 or other statutory or common law restrictions, including the requirement that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution.").

¹⁶⁷ *Id.* at 984 ("A corporation easily could have 'funds' and yet find that they were not 'legally available.' A corporation also could lack 'funds,' yet have the legal capacity to pay dividends or make redemptions because it had large surplus." (citations omitted)).

¹⁶⁸ *Id.* During World War II, at least one distillery company paid dividends in warehouse receipts for whiskey. See *Donahue v. Comm'r*, 11 T.C.M. (CCH) 530 (1952). More recently, it has become popular for incorporated vineyards to pay "wine dividends," with shareholders having the option to receive bottles of wine in lieu of cash. See Vanessa O'Connell, *Wine Investors Are Courted with Concerts, Winery Tours*, WALL ST. J. (Aug. 24, 1998), <http://online.wsj.com/article/SB903908058517515500.html>.

sheet entry into cold hard cash.¹⁶⁹ Ultimately, ThoughtWorks was unable to transform its large balance sheet surplus into cash, either through selling assets or by borrowing. Furthermore, the nature of the business made it difficult or impossible to reduce costs and stockpile the cash necessary to finance a redemption. The major cost of ThoughtWorks's business was compensation to the ThoughtWorkers. Cut this compensation, though, and the ThoughtWorkers skedaddle for greener pastures, taking the value of the business with them. The result is a Catch-22—so long as ThoughtWorks does not attempt to redeem the preferred, a large surplus exists, which is seemingly available and sufficient to redeem the preferred; but if ThoughtWorks attempts to redeem the preferred, the surplus no longer exists, even for the purposes of redeeming the shares.¹⁷⁰

The result of this standard contractual language is thus not a cut-and-dried analysis but rather an inquiry requiring business judgment by the board. Given Delaware law's strong tradition of deferring to boards in matters of business judgment, it is unsurprising that the standard Vice Chancellor Laster enunciated for challenging the board's decision is rather tough:

[T]he plaintiff must prove that in determining the amount of funds legally available, the board acted in bad faith, relied on methods and data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud.¹⁷¹

SVIP did not come close to meeting this standard.¹⁷² The net result is that the Chancery Court's narrow contractual interpretation has rendered a venerable protective provision far less protective than had previously been thought. What was undoubtedly intended and expected to be a powerful and unequivocal contractual protection was transformed by the court into a question of business judgment for the board, shielded by the business judgment rule and thus, as a practical matter, beyond the reach of judicial scrutiny.

¹⁶⁹ *ThoughtWorks*, 7 A.3d at 983 (“Rather than examining ThoughtWorks’ assets to determine whether it has ‘funds’ that are ‘available’ and can be used ‘legally’ for redemptions, SVIP seeks a judgment based on an accounting convention.”).

¹⁷⁰ Vice Chancellor Laster chided SVIP’s valuation expert for “never consider[ing] how making an eight-figure redemption payment would affect ThoughtWorks’ ability to operate and achieve the projections on which her analyses relied. She had no thoughts on how ThoughtWorks might raise the funds for such a redemption payment.” *Id.* at 989.

¹⁷¹ *Id.* at 988.

¹⁷² The court found the procedure followed by the ThoughtWorks board to be “impeccable”—a “thorough investigation” assisted by “well-qualified experts.” *Id.*

C. *Criticisms and Potential Alternatives to Delaware Law*

The general paucity of theoretical analysis of preferred stock in the legal literature has not meant that Delaware law has escaped criticism in this area. The overall thrust of the commentary has been that Delaware law is insufficiently protective of the rights of preferred stockholders; regardless of the reasoning courts follow, the one constant is that the preferred stockholders always lose. Earlier articles, in particular, decried the courts' unwillingness to extend fiduciary protections to preferred stockholders.¹⁷³ More recently, however, a broader spectrum of recommendations has emerged, ranging from a call to abandon the concept of fiduciary duties altogether and let preferred stockholders live or die entirely by their contracts,¹⁷⁴ to a call for a nuanced analysis that treats preferred stockholders as straddling the line between corporate stakeholders and contractual counterparties.¹⁷⁵

One alternative to Delaware's treatment of preferred stockholders would be to always impose fiduciary duties on boards with respect to the preferred. Of course, taken to its extreme—that is, requiring boards to favor the interests of preferred stockholders—this approach would leave the common stockholders in the same exposed position the preferred find themselves under today's Delaware law, but without the contractual protections usually available to the preferred stockholders. Some standard is necessary for mediating the unavoidable conflicts of interest between the common and the preferred stockholders. One possible approach would be to abandon the modern notion of fiduciary duties owed to shareholders and return to an older conception, whereby officers and directors were said to owe fiduciary duties to the corporate entity itself.¹⁷⁶ Under this conception, so long as

¹⁷³ See Brudney, *supra* note 2, at 448-49; Mitchell, *supra* note 2, at 444-45; Stamler, *supra* note 2, at 1341-42.

¹⁷⁴ See Baird & Henderson, *supra* note 2, at 1313, 1315-16, 1328-29, 1333.

¹⁷⁵ See Bratton & Wachter, *supra* note 2, at 3-4.

¹⁷⁶ In fact, the corporate law of the early twentieth century moved along these lines. As Lawrence Mitchell explains, prior to WWII, "[t]he corporation was . . . seen as an entity, with the duties of directors and officers running to the entity and not to the stockholders themselves." Mitchell, *supra* note 2, at 447. As stockholders, owners of preferred were entitled to enforce these duties via litigation. This deals with the problem at hand "by saying that stockholders *qua* stockholders had no fiduciary rights at all. Rather, the rights ran to the 'community of interests' which was the corporate entity." *Id.* (citing *Peeper v. Litton*, 308 U.S. 295, 307 (1939), where the Supreme Court acknowledged fiduciary rights of creditors).

directors act in the best interests of the corporation as a whole—maximizing enterprise value—courts will not interfere. Thus, the modern norm of maximizing the value of the common stock would be replaced by a norm of maximizing the value of the enterprise as a whole.

This “duty to the entity” approach is fine as far as it goes, and would block actions that harm both the preferred and the corporation itself, but it is inadequate to deal with zero-sum situations like the allocation of merger proceeds. In *James*, for example, the preferred stockholders did not contest that the board had satisfied its *Revlon* duties and secured the best deal it could for the corporation as a whole.¹⁷⁷ The dispute simply centered around the allocation of merger consideration as between the common and the preferred stockholders.¹⁷⁸ In a zero-sum scenario, it becomes necessary to have some standard of fairness to judge the board’s actions against.

As long ago as 1972, Victor Brudney identified the difficulty of developing a workable standard of fairness as one of the reasons courts were reluctant to provide preferred stockholders with meaningful fiduciary protections.¹⁷⁹ Brudney went on to develop a standard of his own, looking for benchmarks in the priority rules in federal bankruptcy law, while acknowledging the difficulty of valuing the rights held by preferred stockholders.¹⁸⁰ Brudney suggested that courts could be assisted by administrative agencies such as the SEC in evaluating whether the preferred had been accorded fair treatment, but he admitted the questionable feasibility of such a procedure.¹⁸¹

Lawrence Mitchell also suggests that preferred stockholders should be entitled to fiduciary protections—but protections of a somewhat special sort. Rather than searching for a standard of fairness by attempting to determine the value of the preferred stockholders’ contractual rights, Mitchell focuses on the motivations of the board. He would allow preferred shareholders to bring fiduciary duty claims wherever they can show “differential treatment of the preferred and the common.”¹⁸² Where such differential treatment is demonstrated, the board would bear the burden of showing that the

¹⁷⁷ LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 439 (Del. Ch. 2010).

¹⁷⁸ *Id.*

¹⁷⁹ Brudney, *supra* note 2, at 446-49.

¹⁸⁰ *Id.* at 486-87.

¹⁸¹ *Id.* at 487.

¹⁸² Mitchell, *supra* note 2, at 475.

challenged transaction was undertaken primarily for business reasons—to increase enterprise value—rather than simply to transfer wealth from the preferred to the common.¹⁸³ Mitchell does not address the situation where the preferred control the board, but one can imagine the same standard applied in favor of common stockholders subjected to unfavorable treatment by a preferred-controlled board.

One possibility for side-stepping the problem of defining standards of fairness would be to expand the availability of appraisal as a remedy for preferred stockholders.¹⁸⁴ Instead of having fiduciary duty litigation as the sole recourse for aggrieved preferred stockholders, an appraisal action could be made more widely available where, for example, arrearages are canceled or preferred stock is cashed out in a merger. Such a remedy would seemingly avoid the difficulty of formulating an uncontroversial standard of fairness and reduce the judicial problem to simply valuing the preferred stock. Furthermore, such a determination would apparently not require a determination of the board's motives, nor a review of its business decisions. Unfortunately, these seeming advantages are largely illusory. The value of preferred stock is intimately dependent upon the rights that stock confers. As a result, determining the fair value of preferred stock first requires determining what rights preferred stockholders possess that

¹⁸³ *Id.* (“[I]f the primary or exclusive purpose of a transaction is to transfer wealth from the preferred to the common, it is inherently unfair. If, on the other hand, it is motivated primarily by business reasons—wealth creation—any incidental harm to the preferred is not unfair.”). Mitchell’s requirement that a transaction be motivated by “business reasons” looks similar to the “legitimate business purpose” test for freeze-outs in the close corporation context embraced by the Massachusetts courts in *Donahue v. Rodd Electrotype* and *Wilkes v. Springside Nursing Home*, but pointedly rejected by the Delaware courts in *Weinberger*. See *Donahue v. Rodd Electrotype Co.*, 328 N.E. 2d 505, 515 (Mass. 1975); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E. 2d 657, 663 (Mass. 1976); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983). The same objections that have been made as to the “legitimate business purpose” test are applicable to Dean Mitchell’s “business reasons” test—namely, that given the ease of formulating *some* purpose, such a test can provide no meaningful protection not offered by a fairness test. See, e.g., *Weinberger*, 457 A.2d at 715 (“[W]e do not believe that any additional meaningful protection is afforded . . . by the business purpose requirement . . .”).

¹⁸⁴ See *Stamler*, *supra* note 2, at 1336. Under Delaware Code § 162, minority shareholders dissenting from a merger may elect to institute an appraisal action and receive the judicially determined fair value of their stock as an alternative to the consideration provided in the merger agreement. DEL. CODE ANN. tit. 8, § 162 (West 2013). While the availability of appraisal is somewhat limited in Delaware, there is no reason why, in theory, it could not be made more widely available in the event of a wide array of fundamental transactions potentially affecting the value of stock. Indeed, appraisal is more widely available under the MBCA than under the Delaware Code. See generally Mary Siegel, *An Appraisal of the Model Business Corporation Act’s Appraisal Rights Provisions*, 74 LAW & CONTEMP. PROBS. 231 (2011).

cannot properly be taken away—the very question appraisal was meant to avoid.

Another possibility—one that would generally avoid the difficulty of mediating between the conflicting interests of the common and the preferred—would be to treat preferred stockholders more like creditors for purposes of fiduciary duty claims. Normally, of course, creditors are not owed fiduciary duties.¹⁸⁵ The common shareholders are typically the residual claimants on the value of the corporation. A regime of fiduciary duties requiring the board to seek to maximize the wealth of common shareholders will therefore be welfare maximizing in most cases—in short, the shareholders as residual claimants have the proper incentives to maximize societal gain from the operation of the corporation.¹⁸⁶ Creditors' incentives typically are not wealth-maximizing, because creditors do not share fully in the corporation's upside and thus will tend to be risk-averse.¹⁸⁷ Accordingly, to the extent that creditors are to be protected from opportunism, it must be through the contracts they negotiate rather than fiduciary duties requiring the board to seek to maximize creditor wealth.

Where the corporation is on the verge of bankruptcy, however, the situation changes. The common stockholders, facing little or no downside, have an incentive to engage in risk-seeking behavior, taking large risks if they provide even a

¹⁸⁵ See, e.g., Mitchell, *supra* note 2, at 448-49; Baird & Henderson, *supra* note 2, at 1315-16.

¹⁸⁶ See, e.g., Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1431 (1993); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-04 (1983) ("As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions."); Fried & Ganor, *supra* note 2, at 980 ("As residual claimants, common shareholders tend to be affected most, on the margin, by changes in firm value. Accordingly, their interests are generally aligned with the goal of maximizing corporate value. Thus, giving common shareholders control of the board and permitting them to use this control to advance their own interests should increase corporate value."); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23-24 (1991); Smith, *supra* note 2, at 322 ("[T]he entrepreneur is the right decisionmaker when her private benefits are consistent with total returns, and the venture capitalist is the right decisionmaker when his monetary returns are consistent with total returns." (citing Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 476 (1992))).

¹⁸⁷ See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 91 (1985) ("Creditors are generally more risk averse than stockholders; why else do creditors arrange for the equity claimants to bear the most risk? Creditors accept a lower rate of return on investment precisely because the stockholders are wiped out first."); Macey, *supra* note 186, at 28-29.

small chance of a positive result. The creditors, on the other hand, who have payment priority in the event of a bankruptcy or other liquidation, begin to look much more like the residual claimants because all or most of any additional dollar of value will go to creditors when the company goes under. Thus, it is the creditors who have the proper incentives in this instance, and it is the maximization of creditor wealth that will tend to maximize societal well-being.¹⁸⁸ In fact, the Delaware courts have recognized that, in the so-called “zone of insolvency,” boards of directors will owe fiduciary duties to creditors as well as—or instead of—common stockholders.¹⁸⁹

A similar situation may arise with preferred stockholders, and thus a similar solution is tempting. When large arrearages have built up, making the possibility of return to the common shareholders remote or nonexistent, it is the preferred stockholders rather than the common who are the true residual claimants. *Trados* represents a case in point. With nearly \$60 million in arrearages standing between the common stockholders and any return, the common shares were worth virtually nothing. With the preferred stockholders bearing virtually all of the downside, the common had every reason to take even a negative-expected-value gamble on turning the company around, rather than selling or liquidating it in a fashion that would leave them empty-handed.¹⁹⁰ In such a situation, it is the preferred who possess the efficiency-

¹⁸⁸ As Chancellor Strine explained, “[i]n insolvency, creditors, as residual claimants to a definitionally-inadequate pool of assets become exposed to substantial risk as the entity goes forward The elimination of the stockholders’ interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company’s creditors on the directors.” *Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004).

¹⁸⁹ See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No. CIV.A.12150, 1991 WL 277613, at *1155-56 (Del. Ch. Dec. 30, 1991) (“[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders . . . would make if given the opportunity to act.”).

¹⁹⁰ See Baird & Henderson, *supra* note 2, at 1331. Consider a simplified example where the preferred stockholders had accumulated arrearages and liquidation preferences of \$50 million, such that in a liquidation the common would receive nothing from the first \$50 million, but everything above \$50 million. If the company’s assets were under \$50 million—a board controlled by and beholden to the common stockholders—would have no incentive not to roll the dice on a turnaround rather than pursue a liquidation. If, for example, the company had \$10 million in assets, the common would have every incentive to risk the entire \$10 million on even a 1% chance (or 0.1% or 0.01% chance) of generating a return of \$100 million. The fruits of success would redound to the benefit of the common, while the wages of failure would be paid entirely by the preferred.

maximizing incentives. Thus, it may be appealing to recognize a “zone of arrearages” doctrine paralleling the “zone of insolvency” doctrine enunciated by the Delaware courts. Like the “zone of insolvency” doctrine, recognizing fiduciary duties to the preferred in the “zone of arrearages” would avoid the need to either evaluate the competing claims of the common and the preferred stockholders or to sweep embarrassingly difficult questions under the rug by invoking the business judgment rule.¹⁹¹

Yet another possibility is to abandon the notion of fiduciary protections for preferred shareholders altogether and fully embrace the contractual nature of preferred stock. In a recent article, Baird and Henderson make a broader argument that modern financial engineering has rendered dubious any attempt to generalize about the identity of the residual claimant, or the efficiency-maximizing incentives faced by various corporate constituencies. As a result, they argue, the notion of fiduciary duties in corporate law should be abandoned altogether, because such duties are more likely to interfere with voluntary contractual arrangements than to provide any overall benefit.¹⁹²

In doing so, they reject the alternative of recognizing fiduciary duties to the corporate entity itself, requiring the board—whoever is in control—to seek to maximize firm value. They point out that, just as courts would enforce loan covenants that are “value reducing ex post,” courts should also enforce preferred stockholder control rights enabling the preferred to favor their own interests over the corporation’s.¹⁹³ Baird and Henderson point in particular to VC deals, where it may often be desirable for preferred stockholders to secure contingent control rights that serve as “trip wires,” providing

¹⁹¹ See Baird & Henderson, *supra* note 2, at 1312-15, 1326 (“By asserting that fiduciary duties turn on the identity of the residual claimant . . . a court avoids having to use the business judgment rule in circumstances when a decision, however sensible, is transparently contrary to the interests of the shareholders.”). It bears mentioning, however, that some influential commentators have suggested that the “zone of insolvency” doctrine is something of a mirage, and that the results in the cases can be more parsimoniously explained by application of the business judgment rule in a manner highly deferential to the board. See Kelli A. Alces & Larry E. Ribstein, *Directors’ Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529, 538-39 (2007).

¹⁹² Baird & Henderson, *supra* note 2, at 1314 (“Corporate finance and corporate governance are not one-size-fits-all, and firm capital structures are heterogeneous, complex, negotiated, and, most importantly, priced by the market. From this perspective, courts should tread lightly, even when faced with self-serving behavior, lest the upset what they do not understand.”).

¹⁹³ *Id.* at 1332-33.

incentives for the common stockholders to manage the company well and allowing VCs to seize control and favor themselves at the expense of the enterprise, should things go poorly.¹⁹⁴ Using fiduciary duties to require preferred-controlled boards to show that their actions are maximizing the value of the entity would, they argue, simply interfere with the parties' contractual arrangements, destroying the desired incentive structure and adding legal uncertainty, thus making it more difficult to price contractual terms in the first place.¹⁹⁵

Finally, Bratton and Wachter have rejected the possibility of treating preferred stock as either wholly "corporate" in nature or wholly "contractual" in nature.¹⁹⁶ Instead, they call for a kind of practical ad hocery—attempting to give force to contractual terms, but holding out the possibility that the contracts themselves are not complete and should be supported by a fiduciary backstop.¹⁹⁷ Beyond a firm rejection of fully "corporate" or fully "contractual" treatment of preferred stock, Bratton and Wachter are perhaps not as clear as they might be in the particulars of their prescriptions. Despite the nod toward primacy of contract, the process of contractual interpretation they propose takes place under a judicial scrutiny that is, if anything, more searching than that of the Delaware courts. Their framework is "built on three principles":

First, the meaning and scope of preferred contract rights should be determined by the court rather than the issuer board of directors. Second, conflicts between preferred and common should not be

¹⁹⁴ *Id.* ("Giving senior investors control rights at certain times may be efficient, even if they use these rights to serve their selfish ends at the expense of firm value. The granting of this real option . . . may create just the right incentives for shareholder managers to operate the firm efficiently in the first place.")

¹⁹⁵ *Id.* at 1333 ("The ability to put in place directors who would engage in a sale that suited the interests of the preferred stockholders is not different from a secured creditor who bargains for the right to repossess collateral in the event of default and who can exercise that right without having to show that it is value maximizing ex post . . . Imposing fiduciary duties in this environment, even one that imposed a duty to the corporation as a whole and that came with a generous business judgment rule, is a potential source of mischief.")

¹⁹⁶ Bratton & Wachter, *supra* note 2, at 68 ("In the end, however, we do not think that paradigmatic consistency is a viable alternative given a subject matter on which two paradigms come to bear.")

¹⁹⁷ *Id.* ("Left to our own devices, we would opt for nuanced mediation across the paradigmatic divide. Consistency here lies in taking a considered look in both directions when difficult conflicts arise. Contract should be the major theme, but only on the understanding that completeness should not be assumed."); *see also id.* at 4 (the corporate and contractual "paradigms come to bear and decision makers need to look both ways and synchronize the two paradigms' simultaneous application").

decided by reference to a norm of common stock value maximization. Enterprise value should be the reference, more particularly, maximization of the value of the equity as a whole. Third, independent director determinations of conflicts between classes of preferred and common should not be accorded ordinary business judgment review. Instead, a door should be left open for good faith review tailored to the context—a showing of bad faith treatment *of the preferred* where the integrity of the deal has been undermined.¹⁹⁸

Two aspects of this framework bear emphasis. First, Bratton and Wachter's emphasis on a norm of entity value maximization may not actually be in conflict with Baird and Henderson's observation that it may often be efficient to allow stockholders to contract, *ex ante*, for the right to take actions that may harm the entity *ex post*. After all, Bratton and Wachter still advocate giving content to contractual rights where they are clear; the requirement to maximize entity value is merely a fiduciary backstop in situations where the contractual arrangement is less than clear. If there is a disagreement at all, it is that Bratton and Wachter might impose a somewhat higher drafting burden in establishing a "waiver" of fiduciary duties and the right of a class of stockholders to favor itself over the entity.¹⁹⁹ Second, Bratton and Wachter do not distinguish between situations where the common are in control and those where the preferred are in control; they apply the same framework in either situation. The analysis in the next two parts suggests that this is overly simplistic.

IV. FIDUCIARY DUTIES TO PREFERRED STOCKHOLDERS

In light of the seemingly comprehensive scope of the doctrinal alternatives proposed by commentators over the years, it is perhaps surprising that no one has seen fit to conduct an analysis, from the ground up, of whether and when fiduciary duties might be appropriate in the context of VC preferred stock. This part provides such an analysis for fiduciary duties running to preferred stockholders when the common control the board, concluding that mandatory fiduciary duties owed to preferred stockholders are not justified. The next part analyzes the desirability of fiduciary duties running to common stockholders when the preferred control the board.

¹⁹⁸ *Id.* at 4 (emphasis in original).

¹⁹⁹ *Id.* at 63 (such a provision "arguably should be enshrined in block capitals and initialed in the margin").

The fiduciary duty with bite in the preferred stock context is the duty of loyalty. That is, if a board is found to have improperly favored the common over the preferred—for example, by diverting value from the preferred to the common in a dummy merger—the impropriety, if any, must consist of a breach of a duty of loyalty owed to the preferred. The duty of loyalty is the archetypical “mandatory” rule in corporate law, in that it is not permitted to be altered by contractual agreement—even in Delaware, where freedom of contract is generally respected.²⁰⁰ If this were not so, and fiduciary duties were, like most corporate law rules, simply default rules,²⁰¹ nothing particularly important would turn on the question of whether to apply fiduciary duties in the VC context. If the parties did not want fiduciary duties, they would simply contract around them.²⁰² It is the mandatory nature of fiduciary duties that is crucial. The question thus becomes: is a mandatory duty of loyalty owed to preferred stockholders justified?

In a classic article, Jeffrey Gordon set out five hypotheses that might explain the existence of mandatory rules in corporate law: “the investor protection hypothesis, the uncertainty hypothesis, the public good hypothesis, the innovation hypothesis and the opportunistic amendment hypothesis.”²⁰³ Of these, the uncertainty and innovation hypotheses do not apply directly to fiduciary duties, in particular, as a form of mandatory rule. Gordon ultimately found some of the remaining hypotheses

²⁰⁰ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1417 (1989) (noting that one of the few mandatory rules of corporate law is one that “require[s] managers to live up to a duty of loyalty to investors”); Fried & Ganor, *supra* note 2, at 1417-18 (“corporate fiduciary law is considered mandatory and not contractually alterable.”). Note that while Fried and Ganor speak of “fiduciary law” in general as being mandatory, it is really the duty of loyalty that is most properly considered mandatory. Under Delaware law, at least, the duty of care can be largely vitiated in the corporate charter. See DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011).

²⁰¹ See, e.g., Easterbrook & Fischel, *supra* note 200, at 1417 (“The corporate code in almost every state is an ‘enabling’ statute.”); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMP. L. STUD. 279, 280 (2009) (“Much of corporate law consists of nonmandatory ‘enabling’ statutes.”).

²⁰² Listokin finds that corporate charters are significantly more likely to contain “default rules” that require the parties to explicitly opt out than they are to contain “menu” laws that require the parties to explicitly opt in. Listokin, *supra* note 201, at 279. In that respect, even if fiduciary duties were not mandatory, it might matter whether the parties were required to opt in to them, or to opt out of them. Still, one might expect the effects found by Listokin to be less pronounced in the VC context—featuring sophisticated investors and heavily negotiated charter terms—than in the ordinary public company situation involving common stock.

²⁰³ Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1555 (1989).

more convincing than others, but it is worth examining each of them in sequence in the context of mandatory fiduciary duties to preferred stockholders.

As we will see, the hypotheses that were implausible in the common-stock context become still more implausible here, and even those hypotheses that seemed compelling become less so in the context of preferred stockholders. In one way or another, these hypotheses all depend on a vision of stockholders as widely dispersed, apathetic (rationally or otherwise), and operating at a substantial informational and bargaining disadvantage in relation to management and the board. These hypotheses for the application of mandatory rules fall short when applied to VCs, not in small part due to the extraordinary financial (and often managerial) control that VCs exercise, the concentrated and sophisticated nature of VCs as investors, and the minutely bargained contracts they bring to the table.

A. *Traditional Rationales for Fiduciary Duties: The Investor Protection Hypothesis*

The investor protection hypothesis can take a number of forms. At its most crude, the investor protection hypothesis assumes that issuers have an informational advantage over investors, and yet investors are still willing to invest.²⁰⁴ As a result of this informational advantage, the hypothesis goes, investors will not fully understand—or even know—the terms of the stock issuance. Issuers are thus able to include terms in the preferred stock contract that are disadvantageous to investors, without these terms being fully reflected in the price.²⁰⁵

This vision of issuers exploiting naïve investors seems to loom large for critics of Delaware's preferred stock jurisprudence. In Brudney's call for fiduciary protection, for

²⁰⁴ In the absence of an informational imbalance, any terms that are disadvantageous to investors will result in investors lowering the amount they would be willing to pay for the stock. As a result, the issuers would be forced to internalize the costs of any undesirable features of the share contract, giving them an incentive to avoid such features. See Easterbrook & Fischel, *supra* note 200, at 1430 ("Unless entrepreneurs can fool the investors, a choice of terms that reduces investors' expected returns will produce a corresponding reduction in price. So the people designing the terms under which the corporation will be run have the right incentives.").

²⁰⁵ See Gordon, *supra* note 203, at 1556 ("An investor protection argument flows directly from rejection of the contractarian information assumption. Many investors do not read the prospectus or do not understand or fully register the entailments of charter provisions. Promoters may therefore include charter terms that negatively affect shareholders without bearing the cost . . .").

example, he describes preferred stockholders as typically having “relatively small stakes”—implying rational ignorance or apathy—and suggests that preferred stockholders are unlikely to be aware of the fact that arrearages may be cancelled by class vote or dummy merger.²⁰⁶ In his note, Jeffrey Stamler also argues that preferred stockholders simply must not have fully appreciated the ways in which arrearages could be eliminated or liquidation preferences evaded,²⁰⁷ concluding that these uninformed investors require judicial protection.²⁰⁸

Jeffrey Gordon dismisses the investor protection hypothesis in the context of publicly traded securities, pointing to the structural protections provided by securities markets in which sophisticated traders are active,²⁰⁹ together with the protections provided by underwriters and the involvement of large institutional investors in the IPO market.²¹⁰ While VCs invest prior to an IPO and the creation of a public secondary market,

²⁰⁶ See Brudney, *supra* note 2, at 459 (“If the preferreds’ investment contract ever expressly provides for the possibility of modification or cancellation of arrearages by a class vote, that feature of the contract is rarely pressed on the investor’s attention in selling him the stock; nor is there any reason to believe that the possibility of eliminating arrearages by contrived merger is called to the investor’s attention.”). Brudney goes on to argue that

[t]he bargaining posture of the preferred stock investor when he first invests, and the intrinsic limitations on his ability to make an intelligent assessment at that time, of the risk of effectively unilateral arrearage cancellation in the indefinite future, taint the validity of the inference that the initial purchase constitutes consent to unconstrained rebargaining by the majority of the class when the occasion to modify arrearages materializes.

Id. at 460 n.39.

²⁰⁷ Stamler, *supra* note 2, at 1341 (“[S]ome courts permitted arrearages to be eliminated by . . . amendment or merger on the theory that preferred holders purchased their stock knowing that their rights were statutorily defeasible by amendment or merger. But few preferreds could actually have known that their rights were not vested.” (footnote omitted)).

²⁰⁸ Stamler explicitly rejects the possibility “that preferred stock prices [necessarily] already reflect the arrearage elimination risk inherent in owning preferred stock” on the grounds that “this argument assumes that prospective investors are fully informed of these risks, an assumption which is not necessarily accurate.” *Id.* at 1354. He acknowledges that the “smart money” may purchase in full knowledge, but argues that “uninformed investors” will not, and that “[t]hese are the stockholders who require protection.” *Id.*

²⁰⁹ Gordon, *supra* note 203, at 1557 (“Well-functioning securities markets aggregate information from all active market participants, embody that information in a single fact—price—and make that fact available for free . . . [U]nformed investors will pay too high a price only if the market is not efficient, that is, only if there are too few sophisticated market participants who choose to become specifically informed.”).

²¹⁰ *Id.* at 1559 (“Because shares of the same class must have identical terms, the firm cannot offer better terms to sophisticated investors than it does to unsophisticated investors. Thus unsophisticated investors capture the benefits of underwriters’ efforts on behalf of sophisticated investors.”).

the investor protection hypothesis is, if anything, even less compelling in the VC context. It is highly implausible to suggest that VCs are at an informational disadvantage in drafting share contracts, vis-à-vis the founding entrepreneur of the startup company. VCs are almost always highly sophisticated, experienced investors, and they are repeat players when it comes to designing investment terms. It strains credulity to suggest that they are unaware of, or unable to comprehend and price, the provisions of the preferred stock contract.

In his influential work on fiduciary duties, Lawrence Mitchell has set forth a more sophisticated version of the investor protection hypothesis. According to Mitchell, rather than being rooted in contractual concerns about information asymmetry, fiduciary duties are best seen as being rooted in a power disparity.²¹¹ In short, he argues that fiduciary duties are properly

imposed in situations of significant power disparity, where one party is given responsibility and power over something that matters to another party and that vulnerable party is at the mercy of the power-holding party. Once the relationship has been established, the dominated party effectively loses any control over the subject of the relationship, while the power-holder remains autonomous.²¹²

Mitchell goes on to characterize the situation of the preferred stockholder in a common-dominated corporation in these terms.

Whatever force this description carries in the case of publicly traded preferred, it rings hollow as a description of the relationship between VC preferred stockholders and a startup corporation, even where the board is controlled by the common. The very structure of the relationship makes it impossible for the VC to “lose[] any control over the subject of the relationship” while the founder “remains autonomous.” VC financing is virtually always staged, such that the funds necessary to operate the startup are doled out incrementally.²¹³ These increments can be quite short, on the order of a few months.²¹⁴ This staging provides the VC with enormous practical power and

²¹¹ Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1684-86 (1990).

²¹² Mitchell, *supra* note 2, at 457-58.

²¹³ See Smith, *supra* note 2, at 323; D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949, 952 (1999) (“[S]tagged financing [is] the practice of investing only enough money to allow the Entrepreneur to progress to the next milestone in its business plan.”).

²¹⁴ See Smith, *supra* note 2, at 324 (“Staged investments typically occur over a relatively short time period, almost always less than one year apart and frequently at much shorter intervals.”).

control, even where formal control is lacking. In effect, the VC always holds a Sword of Damocles over the “fortunate” entrepreneur’s head, threatening to withhold the next round of financing and wipe out at a stroke the entrepreneur’s investment of time, energy, and often money.²¹⁵

Thus, it is a tremendous stretch to describe VCs as being “at the mercy” of the common stockholders, even where the VCs do not formally control the board. If fiduciary protections are to be deemed necessary, it will need to be for some other reason.

B. Traditional Rationales for Fiduciary Duties: The Public Good Hypothesis

The public good hypothesis holds that in the absence of mandatory rules, a large variety of contractual terms would proliferate. The existence of a large variety of potential terms would generate increased uncertainty and result in increased costs, including the need for potential investors to investigate the particulars of each stock issue.²¹⁶ The first-order costs of novel contractual terms may be borne by the issuers themselves, as investors will insist on paying less for untested contractual clauses. Ultimately, however, a profusion of customized terms may erode even the certainty surrounding standard terms, which will tend to be tested less frequently by litigation as they decline in relative frequency. As a result, the value of Delaware’s case law itself as a source of legal certainty could eventually be eroded.²¹⁷

²¹⁵ See, e.g., *id.* at 323-24 (“This threat of abandonment . . . mitigates the entrepreneur’s holdup incentive and provides substantial incentives for the entrepreneur to maximize the potential of the company quickly.”); William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473, 506 (1990) (“The most important mechanism for controlling the venture is staging the infusion of capital.”).

²¹⁶ See Gordon, *supra* note 203, at 1564 (“In a regime of contractual freedom . . . the corporate form might vary radically among firms One clear cost imposed under such a regime, as compared to a mandatory regime, is the uncertainty associated with different terms.”). The uncertainty hypothesis is similar, in its general outline, to *numerus clausus* explanations for the limited number of forms of property rights found in property law. See, e.g., Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000).

²¹⁷ See Gordon, *supra* note 203, at 1567 (“Viewed globally, a regime of complete contractual freedom in corporate law imposes externalities. As charters diverge from the standard form, the uncertainty surrounding even standard form terms begins to grow. Those terms are tested less frequently, either through operation in particular circumstances or through successive judicial interpretation.”).

Whatever purchase this hypothesis has for unusual terms in publicly traded common-stock issues, it can have little application in determining whether fiduciary duties should be extended to VCs holding preferred stock. Preferred stock terms are far from standardized; they are almost always heavily negotiated and specifically tailored to the unique circumstances and needs of the particular startup and the particular VCs. Once issued, ownership of the preferred stock almost always remains with the original VC who participated in crafting the terms and is virtually never transferred or sold to an unsophisticated party. If anything, it is the imposition of mandatory fiduciary duties that would increase uncertainty, throwing into doubt whether and when the literal terms of the share contract will be enforced literally. At the end of the day, the “unfairness” of a contractual term only matters to the extent that it is not fully and accurately priced. Adding a layer of legal uncertainty only makes the task of pricing contractual terms more difficult.

A related version of the public good hypothesis argues that corporate law—including the imposition of fiduciary duties—reduces transaction costs by providing a set of “off-the-rack” rules for parties to choose from, rather than requiring parties to negotiate each arrangement from scratch.²¹⁸ Viewed in this light, fiduciary duties have an especially important role to play. As Bratton points out repeatedly, share contracts are inevitably incomplete since circumstances beyond the contemplation of the drafters will inevitably arise. Fiduciary duties can be explained as an attempt to plug these gaps.²¹⁹ As Easterbrook and Fischel point out, “Corporate law—and in particular the fiduciary principle enforced by courts—fills in

²¹⁸ See, e.g., STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 30-31 (2008); Easterbrook & Fischel, *supra* note 200, at 1444.

²¹⁹ See Bratton, *Downside*, *supra* note 2, at 894 (“The terms of venture capital contracts improve in significant respects on those of traditional preferred stock contracts. But they are not perfect, and they offer incomplete protection from issuer opportunism.”); *id.* at 934 (“The complete contingent claims contract that the law thus demands as a vehicle for protecting preferred in the absence of boardroom control arguably is an economic impossibility. Preferred stock contracts traverse a considerable expanse of noncontractible territory.”); Bratton & Wachter, *supra* note 2, at 2 (the common stock contract “is almost entirely incomplete, with open-ended fiduciary duties substituted for negotiated financial rights”); *id.* at 22 (“Corporate fiduciary law can be defended from a contractarian perspective on the ground that common stockholders invest pursuant to a contract that is inevitably incomplete.”); *id.* at 33 (“The pattern of incomplete contracting [is deeply] embedded and leaves an open a door [sic] for conscience-shocking opportunism.”); *id.* (The dummy merger example reminds us that “[preferred stock] contracts can be incomplete in fact and make no business sense whatsoever if their performance is remitted to a common maximizing board without backstop judicial scrutiny.”).

the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.”²²⁰ In a world of costly contracting—and, as a consequence, incomplete contracts—fiduciary duties have some advantages. Rather than having to contract ahead of time for every conceivable situation, parties can rely on the *ex post* common-law-style protections of fiduciary duties.²²¹

While this argument convincingly explains why fiduciary duties will often be desirable, it is less persuasive in explaining why fiduciary duties should be mandatory. Easterbrook and Fischel suggest that standardization results in a more detailed and reliable case law.²²² Gordon, too, echoes this thinking, arguing that a single, mandatory fiduciary standard “represents a valuable public good.”²²³

However true this may have been in the past, it is perhaps time to recognize that it may be less true today. Over the past century, a tremendous body of fiduciary duty case law has been generated, and now stands ready to benefit any who desire to avail themselves of it. The canon is written, it exists in the world, and the bookshelf bows under its weight. Most importantly, it may be referred to and invoked by contracting parties, if they so choose. Contracting parties need not invent their own detailed fiduciary standards; they can simply incorporate the existing standard by reference. Indeed, Lawrence Mitchell, in arguing the need for fiduciary protection, concluded by suggesting that preferred stockholders could—

²²⁰ Easterbrook & Fischel, *supra* note 200, at 1444-45.

²²¹ *See id.* at 1445 (“Court systems have a comparative advantage in supplying answers to questions that do not occur in time to be resolved *ex ante*. Common law systems need not answer questions unless they occur.”); *see also* Gordon, *supra* note 203, at 1593 (“Fiduciary duties provide a set of standards to restrain insiders in exercising their discretionary power over the corporation and its shareholders in contingencies not specifically foreseeable and thus over which the parties could not contract.”). In many ways, this argument resembles Benjamin Cardozo’s classic defense of vague “reasonable person” standards in accident law—it allows courts to resolve, *ex post*, matters that would be expensive or impossible for courts, legislatures, or private parties to provide for *ex ante* by detailed rules and regulations. *See Pokora v. Wabash Ry. Co.*, 292 U.S. 98 (1934).

²²² Easterbrook & Fischel, *supra* note 200, at 1445 (“The accumulation of cases dealing with unusual problems . . . supplies a level of detail that is costly to duplicate through private bargaining.”).

²²³ Gordon, *supra* note 203, at 1593 (“[A] stable conception of fiduciary duty develops only through applying a single standard across a great range of cases. Such a baseline represents a valuable public good, since the verbal formulas and the standards would vary considerably in the absence of a mandatory rule.”).

and occasionally do—provide for fiduciary-type protections contractually.²²⁴

Herein lies the folly of worrying overmuch about the necessary incompleteness of preferred stock contracts or the “noncontractible” nature of the stockholder relationship. It is patently true that it is impossible to write a contract that explicitly prescribes, in detail, how to deal with every possible contingency (though the length and level of detail of VC preferred-stock contracts suggest that the parties make a valiant attempt). Even so, contracts can complete themselves by providing mechanisms and rules of decision for deciding disputes that arise later. These mechanisms could conceivably range from full, traditional fiduciary protection through the courts, to arbitration pursuant to a specified standard of decision, to a spirited round of rock-paper-scissors. The ability of the parties to provide a mechanism for dispute resolution by contract can complete an otherwise incomplete contract, traversing any otherwise noncontractible terrain.

Several objections are possible. First, the canon—the body of decisional law that describes fiduciary duty—will change over time, as new circumstances arise and are addressed in litigated cases. Should parties who invoke fiduciary duties be subject to the law as it existed at the time of the contract, or as it has subsequently evolved? Second, if fiduciary duties are not applied uniformly, the body of case law will gradually become less uniform itself, and the value of fiduciary law as a public good will ultimately be eroded. Third, it is difficult to imagine circumstances where stockholders would not want the benefit of at least a duty of loyalty. What is the harm, then, in providing it? Finally, if it is not mandatory, the dispute resolution mechanism established by contract may itself be subject to opportunistic amendment over time.

The first objection can be dealt with by the parties themselves. Parties desiring a completely stable fiduciary regime can specify that the relationship be governed by the fiduciary duty law in place at the time the contract is entered into. Parties desiring to benefit from the evolution of the law

²²⁴ Mitchell, *supra* note 2, at 476 (“Perhaps the best interim solution would be a covenant precluding the corporation from behaving in a manner that defeats the preferred’s legitimate expectations. Such provisions already are used in the specific context of preferred conversion rights. In effect, such a covenant incorporates the fiduciary concept [advocated by Mitchell] into the preferred stock provisions of the certificate . . .”).

can either say so in their contract, or amend their contract to adopt new law. While amendment would likely not be feasible where the shareholders are dispersed and rationally inattentive, the concentrated and sophisticated nature of VC investment makes dynamic amendment a realistic possibility. Indeed, the staged nature of VC financing provides a natural opportunity for periodic amendment, if desired. I describe in the Conclusion below steps the Delaware legislature could take to clarify the ability and process by which parties may select a fiduciary regime by contract.

The second objection is at least potentially more serious. After all, if fiduciary duty case law is to remain a vital source of detailed decisional law, it needs to be continually tested in contemporary circumstances. If issuers and stockholders are permitted to pick and choose elements of fiduciary duty, the precedential benefits of a uniform standard may be lost. This concern, however, is overblown. First, the enormous body of existing case law already provides a valuable reservoir of experience. Second, the fact that some—perhaps most—VC cases will no longer be governed by standard fiduciary duties does not mean that fiduciary duties will not be litigated in the vast majority of other contexts. In particular, typical fiduciary duty cases will continue to arise with respect to common stock, providing a vital source of contemporary decisional law. Finally, a body of case law has developed, and will continue to develop, around the standard contractual provisions VCs include in their preferred stock investments. Debt contracts have not been rendered unmanageable by the absence of fiduciary protections, and there is little reason to fear that preferred stock contracts would be, either.

The third and fourth objections are more easily discussed in the context of the opportunistic amendment hypothesis and are thus addressed below.

C. *Traditional Rationales for Fiduciary Duties: The Opportunistic Amendment Hypothesis*

More promising as an argument for fiduciary duties is the opportunistic amendment hypothesis, which argues that mandatory law can function as “a hands-tying mechanism that provides assurance against opportunistic charter amendment.”²²⁵

²²⁵ Gordon, *supra* note 203, at 1573.

As we have seen, common-controlled boards have historically had significant bargaining advantages, enabling them to extract seemingly self-destructive concessions from the preferred stockholders, or to bypass them altogether in pushing through amendments or mergers that expropriate value from the preferred.²²⁶ Some amendment mechanism will be necessary because “the corporate contract is inevitably incomplete.”²²⁷ Once the share contract is subject to amendment, however, even the right to a class vote will be inadequate to protect the preferred from opportunistic amendment.

At its simplest, the opportunistic amendment hypothesis suggests that whoever controls the board will control—or at least unduly influence—the amendment process. This can take the form of inside directors taking advantage of the shareholders as a whole or of the common stockholders using control of the board to take advantage of the preferred. In either case, the dominant party will be “continually tempted to relax fiduciary standards that govern their behavior and expose them to liability.”²²⁸ Even where the preferred formally have the ability to block amendment by class vote, “shareholder voting as a means of evaluating and consenting to a proposed charter amendment is fraught with severe problems, in particular, collective action problems in acquiring and disseminating information among shareholders, and strategic behavior by insiders that amounts to economic coercion.”²²⁹ Thus, the argument goes, even if the preferred stockholders provide for fiduciary-type protections by contract, these protections risk being whittled away by subsequent opportunistic amendment if they are not mandatory.²³⁰

This argument is perfectly coherent—perhaps even compelling—in the typical public shareholder scenario. It is, however, simply inapplicable in the VC setting. VC holders of preferred stock are not diffuse or dispersed; they are concentrated. They are not ignorant or apathetic; they are highly involved and strongly motivated. Furthermore, staged financing provides them with great practical economic

²²⁶ See *supra* Part II.

²²⁷ Gordon, *supra* note 203, at 1550.

²²⁸ *Id.* at 1593.

²²⁹ *Id.* at 1574-75.

²³⁰ *Id.* at 1574 (“Proposed charter amendments will be sponsored by a relatively cohesive proponent, the insiders, who will argue that the proposed change . . . is wealth increasing. A diffuse group of public shareholders must evaluate this claim . . .”).

leverage, even in situations where they lack formal contractual rights. The idea that common stockholders will systematically take advantage of VCs borders on the fanciful.

Even so, it might be considered worthwhile to impose fiduciary duties anyway. After all, it has long been argued that rational parties would always choose to impose a duty of loyalty, as the only practical way of dealing with the agency problems inherent in the long-term relationship between shareholders and management.²³¹ And if rational parties would always choose fiduciary duties, the argument goes, what is the harm in making such duties mandatory? Indeed, viewed in this light, fiduciary duties are simply one species of a larger genus of legal rules, whereby courts monitor performance under long-term contracts. John Coffee, for example, has argued that fiduciary duties “are analogous to similar legal rules that restrict opportunism in other areas of complex, long-term contracting.”²³² This appears to be precisely the thinking behind Bratton and Wachter’s call for stronger review of opportunistic common stockholder behavior under the rubric of “good faith.”²³³

The problems with this argument, however, are twofold. The most straightforward problem is that VC preferred stock is not the same kind of open-ended, long-term contract typically used for common stock, or even for older public issues of preferred stock. As Bratton and Wachter emphasize, “Perpetual preferred is no longer the rule Today’s preferred, whether publicly issued or privately placed, often has a due date and a promise to redeem.”²³⁴ This is particularly true for VC preferred, where “exit via mandatory redemption is

²³¹ See *id.* at 1594 (“It is my argument that parties taking into account the insiders’ power and positional advantage would pick a standard of fairness or good faith as measured ex post and that this radically undermines the case for opting out of fiduciary duties.”); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989) (“In short, because such long-term relational contracting is necessarily incomplete, the court’s role becomes that of preventing one party from exercising powers delegated to it for mutual benefit of all shareholders for purely self-interested ends.”). Roberta Romano, along with others, occasionally suggests that a duty of loyalty is so likely to be voluntarily adopted that making it mandatory is of little consequence. See ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 178 (2d ed. 2010) (“How much do you think investors would pay to invest in a new firm whose charter contains a provision eliminating the duty of loyalty?”); Bernard Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989).

²³² Coffee, *supra* note 231, at 1620.

²³³ Bratton & Wachter, *supra* note 2, at 37.

²³⁴ *Id.*

hard-wired into the business model.”²³⁵ VC preferred stock typically remains outstanding for a few years at most, and opportunities for renegotiation are presented with each stage of financing, which may be only months apart. The relatively short-term nature of VC preferred stock dramatically reduces the universe of unforeseeable circumstances that must be provided for by the imposition of broadly drawn fiduciary duties. Furthermore, as discussed more fully above, the parties themselves can bridge any “noncontractible” terrain by voluntarily providing for fiduciary-type review.

More fundamentally, the horizontal nature of the conflict between preferred and common stockholders simply does not lend itself to a “one-size-fits-all” solution that we can be confident all rational parties would voluntarily adopt. The familiar vertical conflict of interest between management and common shareholders is relatively simple. It may be said—with only slight risk of over-simplification—that management is and should be required to manage the corporation for the benefit of the shareholders. A simple duty of loyalty follows: management must favor the shareholders’ interests over their own.

With a horizontal conflict of interest, these easy certainties melt away. Depending on the circumstances, the parties in a VC deal may desire one of many possible rules: that controlling common stockholders be required to manage the firm for the benefit of the preferred, maximize common stockholder value, or maximize enterprise value; that they be permitted to favor themselves over the preferred stockholders, while the preferred are protected by devices like redemption or conversion rights; that they be permitted to favor themselves under some circumstances, and not under others; or any number of permutations and combinations. To ask a judge to determine what the parties “would have wanted” is simply to tempt error. To ask a judge to do so even where it requires overriding the contractually expressed wishes of the parties is simply perverse, and risks destabilizing voluntary arrangements that the court simply does not understand.

In sum, mandatory fiduciary duties in this context seek to solve a problem—a large noncontractible domain—that does not need solving, and in the process they threaten to create genuine difficulties for contracting parties. Therefore, fiduciary duties should not be imposed to protect VC preferred

²³⁵ *Id.*

stockholders from common stockholder opportunism. In the Conclusion below, I suggest several measures the Delaware courts or legislature could take to increase preferred stockholders' ability to protect themselves, even in the absence of fiduciary protection.

V. FIDUCIARY DUTIES TO COMMON STOCKHOLDERS

In this part, I consider the reverse scenario, where it is the preferred stockholders who control the board of directors, and ask whether it is desirable to extend fiduciary protections to the common stockholders. As before, this part proceeds by examining the traditional rationales for imposing mandatory fiduciary duties as they apply in the context of a VC startup. This time, however, the analysis suggests that fiduciary duties *do* have a positive role to play. Common stockholders in VC startup companies are far more likely than the VCs to require protection from exploitative charter provisions and opportunistic amendment by controlling preferred. Furthermore, so long as courts allow controlling preferred to exercise their explicit contractual rights, there is far less danger that fiduciary duties will destabilize beneficial bargains. As a result, except insofar as the preferred stockholders have an explicit contractual right to take a particular action, a preferred-controlled board should be required to act with a goal of maximizing the wealth of the common stockholders.

Recall that the most straightforward justification for mandatory fiduciary duties is that they serve to protect naïve investors from exploitation. That is, information disparities can lead to a situation where exploitative provisions are included in the charter or other share contract but are not fully appreciated and priced by the stockholders. As was discussed in Part IV, this story rings false where the VC is cast in the role of the bumpkin. The story gains plausibility, however, when the VC plays the role of the shark, and it is the entrepreneur playing the mark.

Like the VCs, entrepreneurs must evaluate charter provisions without the protections provided by public secondary markets, or even by the institutional participants in the IPO market. Unlike VCs, however, entrepreneurs are rarely repeat players and are not expert at performing such evaluations. Startup entrepreneurs, of course, tend to be highly educated and driven, and they are no doubt intelligent and sophisticated in their specialty. This does not imply, however, that they possess the financial and legal sophistication required to

accurately price charter provisions. Despite the popular image of the serial entrepreneur, in reality the vast bulk of VC-financed startups involve first-time entrepreneurs.²³⁶ Even the rare entrepreneur who has participated in at least one prior VC-financed startup will usually be sitting across the table from a VC who has participated in hundreds of startups.

The situation is even more difficult for the employees who come later and receive a significant portion of their compensation in the form of stock grants and options. While in most industries, equity compensation is generally limited to high-level executives—who may be thought to possess substantial financial sophistication or who may benefit from the counsel of those who do—it is quite common in VC-financed startups for all but the most menial of employees to receive substantial compensation in the form of equity.²³⁷ Again, while the computer programmers and biologists who populate Silicon Valley are undoubtedly of higher-than-average intelligence, there is little reason to believe that they possess the financial sophistication necessary to evaluate and price what could be potentially exploitative charter terms. The result is a very real possibility that VCs could exploit their informational advantage to undercompensate entrepreneurs and other startup employees by paying them with common stock that is worth less than it may appear.

Even when one's conception of fiduciary duties is rooted in power disparities, as in Lawrence Mitchell's formulation, the case for applying them here is equally strong. As discussed above, even where VCs lack formal control of the board, they wield substantial practical power over the common through the structure of staged investment. If VCs are unhappy with the way the company is being run, they can simply threaten to withhold the next round of financing and bring the enterprise crashing down. Where the VCs also control the board, the

²³⁶ Even in the late 1990s, when serial entrepreneurs were at their zenith, the percentage of VC startups involving serial entrepreneurs—entrepreneurs who had at least one prior VC-financed startup—never exceeded fourteen percent. See Paul Gompers et al., *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs* 12 (NBER Working Paper Series, No. 12592, 2006). A recent survey of startup founders on LinkedIn found that “only 2% are serial entrepreneurs.” Monica Rogati, *Sequencing the Startup DNA on LinkedIn*, LINKEDIN BLOG (Sept. 1, 2011), <http://blog.linkedin.com/2011/09/01/entrepreneur-data/>.

²³⁷ See Richard A. Booth, *Give Me Equity or Give Me Death—The Role of Competition and Compensation in Building Silicon Valley* 6 (U. Maryland Leg. Stud. Res. Paper No. 2006-44, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=940022.

power disparity is even more glaring. In this instance, the common stockholders are most certainly at the mercy of the preferred stockholders.

The case for mandatory fiduciary duties is further bolstered by the possibility of opportunistic amendment. Recall that one of the traditional functions of mandatory fiduciary duties is to serve as a hands-tying mechanism, preventing the party who controls the board from exploiting his control of the amendment process to amend the charter to the detriment of others. In a VC-financed startup where the common control the board, this argument is not compelling. The VC holders of preferred stock are concentrated, with no conflicts of interest or other collective action problem, and through staged financing they maintain strong bargaining leverage, even apart from their contractual rights.

The situation is entirely different for the common stockholders where the VC-held preferred control the board. First, as I have emphasized, the holders of common stock are unlikely to possess the same high level of financial and legal sophistication as the VCs. Second, depending on the number of employees who have received stock grants, there could be dozens—or even hundreds—of holders of common stock. Even in the absence of divergent interests, significant collective action problems could arise.²³⁸ Third, there are likely to be significantly divergent interests among the holders of the common stock. Entrepreneurs with an eye toward future startups may kowtow to the VCs, desiring to maintain a good working relationship for future deals. Employees with substantial cash compensation may have very different interests from those who do not. And, at the end of the day, the ability of the VCs to pull the plug on future stages of financing provides them with tremendous leverage in extracting concessions from the common stockholders.

In sum, both a straightforward rationale of investor protection and the potential for opportunistic amendment strongly suggest the propriety of mandatory fiduciary protections for common stockholders against controlling preferred stockholders. But what of the difficulty, discussed above in Part IV, of formulating a meaningful duty of loyalty where the conflict of interest is horizontal (between classes of

²³⁸ See Gordon, *supra* note 203, at 1575-76 (concluding that “collective action problems in acquiring and disseminating information among shareholders” will lead to “[r]ational apathy”).

stockholders) rather than vertical (between, say, management and stockholders)? Indeed, this remains a difficulty, though there is reason to think it presents less of a difficulty here than where the common control the board.

It presents less of a difficulty for three closely related reasons. First, the situations where controlling preferred stockholders would legitimately want the right to put their own interests ahead of the interests of the common stockholders are relatively few in number and can be easily defined. The key issue will almost always resemble the situation in *Trados* and *Orban*—an exit from an investment where the parties' fondest hopes have not been realized, but where some value remains on the table. In particular, the VCs will want the ability to liquidate or sell the company and receive as much as possible of their liquidation preference, even where the common stockholders would prefer to continue as an independent going concern. If the VCs indeed desire the right to liquidate or sell the company, even to the detriment of the common stockholders, they can explicitly provide for such a power in the share contract.

Of course, including explicit contractual provisions will only be effective if courts enforce these provisions. Implicit in my argument is the conclusion that the fiduciary duties extended to the common stockholders should truly serve as gap-fillers, and that they must be silent where the contract explicitly speaks. This conclusion follows directly from the fact that, in this context, no standard of fairness exists that we can be confident rational parties would always choose. Allowing contractual provisions to, in a sense, elbow fiduciary duties out of the way creates an obvious danger that unsophisticated common stockholders will not fully appreciate—and price in—the power of the preferred to force sale or liquidation. This danger is much reduced, however, where the power is spelled out explicitly, rather than simply being a silent, implicit consequence of preferred stockholder control of the board—as it might very well be in the absence of any fiduciary protections at all.

The other two reasons why fiduciary protection for common stockholders would not be as destructive as fiduciary protection for preferred stockholders both relate to the relative ease of drafting explicit provisions allowing the preferred stockholders to prefer their own interests. Again, the actions that the preferred might take at the expense of the common would tend to be the affirmative exercise of an explicit power, for example forcing a liquidation, merger, or redemption. It is far easier to draft contractual provisions explicitly allowing all

or some such actions—spelling out certain “enumerated powers,” so to speak—than to draft contractual provisions explicitly forbidding every destructive action imaginable.²³⁹

Finally, the burden of drafting provisions providing the preferred with the powers they need would naturally fall upon the preferred themselves—in this case the VCs. The VCs, being highly sophisticated repeat players, are well situated to perform this drafting.²⁴⁰ If the situation were reversed, and fiduciary duties were imposed on common-controlled boards, the relatively unsophisticated common stockholders would find it much more difficult to meet this drafting burden by explicitly enumerating all of the situations where controlling common stockholders might favor themselves over the preferred.

In sum, mandatory fiduciary protections for common stockholders in the VC context can serve a real purpose, without themselves creating insurmountable problems. It is plausible—indeed, probable—that common stockholders in VC-financed startups require protection from exploitative but unpriced charter provisions, and from opportunistic amendment. Fiduciary duties can provide this protection. And so long as these duties are viewed narrowly—as serving a gap-filling function—there is little reason to fear that their imposition will destabilize mutually beneficial voluntary bargains.

VI. APPLICATION TO RECENT CASES

In Parts IV and V, I argued that in the VC context, preferred stockholders should be owed no fiduciary duties, while controlling preferred should owe fiduciary duties to common stockholders. The three recent Delaware cases introduced in Part III serve as excellent examples of how this regime would work in practice and how the respective situations would be resolved. As we shall see, the overall outcome of each of the cases remains largely the same, but these outcomes are achieved in a more straightforward fashion, with a reduced risk of deal-destabilizing uncertainty.

The result—and even the reasoning—of *In re Trados* remains largely undisturbed. Recall that Chancellor Chandler held that the preferred-controlled board of Trados could

²³⁹ See generally Letter from James Madison to Thomas Jefferson (Oct. 17, 1788), in 1 THE PAPERS OF JAMES MADISON 477 (Univ. of Chi. Press 1962).

²⁴⁰ In the Conclusion, I will suggest some measures the Delaware courts and legislature could take to reduce this drafting burden.

potentially breach its fiduciary duties by favoring the interests of the preferred over the common.²⁴¹ In the key passage, Chancellor Chandler cited an earlier case in holding that

generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of 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, where there is a conflict.²⁴²

This is entirely in keeping with Part V's conclusion that preferred-controlled boards should owe fiduciary duties to the common, requiring them to maximize common stockholder wealth.

While the basic result stands, two aspects of the *Trados* opinion create more uncertainty than is necessary. The first difficulty with Chancellor Chandler's opinion is that he did not make it as clear as he might—and perhaps did not intend to make it clear—that where the charter explicitly gives the preferred the power to force a merger or liquidation, fiduciary obligations will not stand in the way. Chancellor Chandler repeatedly pointed out that that the board had no contractual obligation to pursue a merger favorable to the preferred, nor did the preferred have a contractual right to force the sale of the company.²⁴³ He left it unstated, however, that had the board in fact had such an obligation, or had the preferred in fact possessed such a right, fiduciary duties would not stand in the way, even where, *ex post*, the result may seem “unfair” to the common stockholders. *Trados* thus leaves a residue of uncertainty as to the enforceability of such provisions. This uncertainty would be removed by applying the framework developed here.

The second uncertainty created by *Trados* is a result of the lack of clarity as to what standard of fairness should be

²⁴¹ See *supra* Part III.B.1 (discussing the *Trados* case).

²⁴² *In re Trados*, No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009) (quoting *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (internal quotation marks omitted)).

²⁴³ Chandler notes that “Defendants [did] not argue that the board had an obligation to the preferred stockholders to pursue a transaction that would trigger the large liquidation preference of the preferred stock.” *Id.* at *7 n.38. He goes on to point out that while it is “reasonable to infer that the preferred stockholders would benefit from a transaction that allowed them to exit the investment while also triggering their liquidation preference, [this was] something they did not have a contractual right to force the Company to do.” *Id.* Later in the opinion, Chandler again emphasized that “it does not appear that the preferred stockholders had any contractual right to force a transaction that would trigger their liquidation preference.” *Id.* at *7 n.42.

employed in determining whether the board had treated the common shareholders “fairly.” As in a typical shareholder action,²⁴⁴ once the duty of loyalty is implicated, the business judgment rule no longer applies, and the burden shifts to the defendants—here, the preferred-dominated board—to establish that the board acted fairly toward the common stockholders.²⁴⁵ Typically, of course, fairness would be evaluated according to a norm of common-stockholder wealth maximization. And, indeed, the framework developed above dictates that a preferred-dominated board attempt to maximize common stock value, except where the preferred have an explicit contractual right to do something that is harmful to the common stockholders. Given the calls from many scholars to require a norm of maximizing entity value only, however, it would be best for the Delaware courts to clarify that no shift in norms is intended in this context—that is, that the “fairness” of the transaction will be evaluated under the ordinary norm of common stockholder wealth maximization.

The result in *James* also remains undisturbed under the framework developed here, though the bulk of the rather extensive dicta runs counter to the analysis. Recall that Vice Chancellor Strine held that where the share contract contained a plausible benchmark for how the preferred would be treated in a merger—here, a conversion provision that allowed the preferred to convert their stock to common at a certain ratio and then receive the same consideration provided to the common—the common-controlled board had no duty to go further and provide any “fiduciary beneficence on the preferred at the expense of the common.”²⁴⁶ This reasoning is perfectly in keeping with the analysis above.

Vice Chancellor Strine, however, went on to suggest that where the contract provided no objective basis for treatment of the preferred, *Orban* required the board to “act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.”²⁴⁷ This dicta can only lead to mischief. As argued above, there is no reason to think that a share contract’s silence on the treatment of the preferred in a merger suggests that the parties necessarily want the board to be required to “reconcile the competing

²⁴⁴ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

²⁴⁵ *In re Trados*, 2009 WL 2225958, at *8-9.

²⁴⁶ *LC Capital Master Fund v. James*, 990 A.2d 435, 448-49 (Del. Ch. 2010).

²⁴⁷ *Id.*

interests of the common and preferred” stockholders in a merger situation.²⁴⁸ Moreover, there is no straightforward standard by which the board could reconcile what are essentially irreconcilable differences—division of merger proceeds between common and preferred is the quintessential zero-sum game.

Contractual silence should leave the board’s judgment unconstrained, not bind it to an unknown and unknowable obligation of fairness. If the parties—and particularly the preferred—desire a certain guaranteed treatment in a merger, they can provide for it in the contract. If they desire “fair treatment” according to one standard or another, they can also provide for that in the contract. If, for reasons that may or may not be clear after the fact, they desire to protect themselves entirely through contingent control mechanisms or staged financing—or to simply price in the lack of protection—the courts should not step in to overrule that choice. To the extent that *Orban* and *James* would require a court to do so, the Delaware courts should revisit and revise them.

ThoughtWorks is a case that, at first blush, seems to fly in the face of the recommendations of Parts IV and V. After all, the preferred stockholders explicitly contracted for a mandatory redemption right and apparently did everything in their power to make this contractual right as broad and strong as possible. And yet Vice Chancellor Laster appears to have been unwilling to enforce the clear intentions of the parties, instead remitting the redemption decision to the judgment of the board. This impression, however, is superficial. As Vice Chancellor Laster mentions, numerous contractual options were available that would have given the preferred the right to force payment, even at the risk of insolvency.²⁴⁹ Most simply, the preferred could have negotiated a contractual right to force liquidation of the firm, with the preferred having priority on the proceeds. The “funds legally available” language chosen by SVIP simply did not achieve this effect.

In reality, of course, SVIP would be unable to recover its investment in a lump sum no matter what contractual rights it negotiated, and no matter how Vice Chancellor Laster interpreted the language of the contract. The economic reality was that, as an inescapable result of its business model,

²⁴⁸ *Id.* at 449.

²⁴⁹ *See* *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 991-92 (Del. Ch. 2010).

ThoughtWorks was valuable as a going concern but had little or no liquidation value.²⁵⁰ SVIP knowingly invested on a gamble that ThoughtWorks would quickly go public at a high valuation, and its gamble did not pay off. Better draftsmanship—or a judge more willing to stretch the meaning of the contractual language—would have availed SVIP little.

In fact, although the parties may not have intended it, *ThoughtWorks* provides an excellent example of contractual language that incorporates by reference fiduciary-type obligations where they would not otherwise exist. The language “funds legally available” explicitly requires the board (and, ultimately, a reviewing court) to determine what funds are “legally available.” Much like fiduciary duties, the legal limitations on the availability of funds for redemption are themselves a product of statutory law and case precedents. The “funds legally available” language then, rather than creating an absolute right to payments under enumerated circumstances, instead sets forth a standard—embedded in a body of law—for the board to use in determining when a payment to the preferred is required. The role of the reviewing court is, as Vice Chancellor Laster says, to ensure the board has interpreted this standard in “good faith,”²⁵¹ just as would be required in any other contractual dispute.

Viewed in this light, *ThoughtWorks* gets it just right. The Court refuses to extend any fiduciary protections to the preferred and forces them to rely on the protections of their contract. And while Vice Chancellor Laster’s interpretation of the “funds legally available” language is debatable in terms of furthering the parties’ intentions, it preserves maximum flexibility for future parties to tailor their contractual relationship. If preferred stockholders want the right to force immediate repayment, they can negotiate a provision allowing them to force liquidation. If preferred stockholders want a lesser right to redemption, subject to the existing body of law on when funds are “legally available,” they can use that language. Had the Court interpreted this language to mean what SVIP argued it meant, it would have eliminated this latter option as a practical matter, while availing SVIP little.

²⁵⁰ See *supra* Part III.B.3 (discussing the *ThoughtWorks* case).

²⁵¹ *ThoughtWorks*, 7 A.3d at 989.

CONCLUSION

This article's major conclusion is that preferred stockholders should never be afforded fiduciary protections against common-dominated boards of directors. Rather, they should be required to rely on the protections of their contract. The traditional rationales for the imposition of fiduciary duties do not apply in the context of preferred stock used for venture capital financing. The financial and legal sophistication of VCs, their frequent status as repeat players, the heavily bargained nature of venture capital financing, the strong bargaining power of VCs, the lack of collective action problems, advances in contracting technique, and the lack of any clear majoritarian defaults or norms of fairness all combine to make corporate fiduciary duties unnecessary at best, and at worst affirmatively destructive of voluntary contractual bargains.

The supplemental conclusion is that even though preferred stockholders should not be entitled to fiduciary protection, preferred-dominated boards *should* owe fiduciary duties to the common stockholders. When VC preferred control the board, standard corporate fiduciary protections for common stockholders will generally be appropriate. This conclusion should not be taken to suggest, however, that courts should be cavalier in ignoring contractual provisions in the name of equity. Great care must be taken not to allow fiduciary duties to displace voluntary bargains and destabilize contractual relationships. Where the preferred have secured an explicit contractual right, they should not be prevented from exercising it, even where it appears to harm the common stockholders—and even where it appears to harm the enterprise as a whole. “Fairness” in a given venture capital scenario is unlikely to be a straightforward proposition, particularly in hindsight. If venture capital is to remain a vital force for innovation and wealth creation, courts must be careful “lest they upset what they do not understand.”²⁵²

As a result, the fiduciary duties imposed on preferred stockholders in relation to common stockholders should be limited to the “gap filler” fiduciary duties envisioned by contractarian scholars. Any attempt to use fiduciary duties to impose a contract-trumping requirement of “fairness” is likely to do more harm than good.

²⁵² Baird & Henderson, *supra* note 2, at 1314.

The refusal to provide fiduciary protections to preferred stockholders in VC-financed startups places a high drafting burden on the VCs. Whatever protections they will receive must be provided through the contract. This burden is far from insurmountable, and concerns that the preferred shareholder relationship is inherently noncontractible are fundamentally misplaced. Nonetheless, there are undoubtedly measures that Delaware could take to reduce what is unquestionably a heavy drafting burden. I will close by suggesting two.

First, the Delaware legislature could make clear the ability of parties to “opt into” fiduciary duties where they otherwise would not exist. As discussed in Part IV, the mere fact that a contractual relationship traverses some “noncontractible terrain” does not, by itself, justify the imposition of mandatory fiduciary duties. After all, the parties can voluntarily choose to impose fiduciary duties contractually. This argument loses force, however, if there is substantial uncertainty as to whether and how the courts will interpret and enforce “fiduciary provisions” in the charter. The legislature could eliminate any uncertainty by providing in the Delaware Code that a charter may include a provision providing fiduciary duties to preferred stockholders, and that the inclusion of such a provision will allow the preferred to invoke the entire body of Delaware fiduciary duty decisional law.

The Delaware courts could also take steps to reduce error. When a dispute leads to litigation, the preferred stockholders will typically be arguing that the share contract grants them a particular power or, conversely, that the share contract provides them with a particular kind of protection. Where the court ultimately finds that the contract does *not* provide the power or protection sought, it would behoove the judge to provide a clear and simple provision that *would* have.²⁵³ This could be as simple as providing that contracting parties in the future can explicitly refer to the case name in question, as an unambiguous signal of the intention of the parties.²⁵⁴ The Delaware courts are already fairly diligent about suggesting

²⁵³ Ian Ayres has recently suggested something similar, as a general judicial policy. See generally Ian Ayres, *Regulating Opt Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2055 (2012).

²⁵⁴ As an example, parties desiring the preferred to have the power to enter into a merger at any time, even where it wipes out the common stock, could make explicit reference to *In re Trados*. See *id.* at 2082-83 (suggesting that contracting parties be allowed to alter default rules “by adding an explicit citation” to court decisions discussing such alterations).

the ways in which the losing party—usually the preferred—could have drafted the contract in such a way as to prevail. In Vice Chancellor Laster’s *ThoughtWorks* opinion, for example, he rattled off several mechanisms that would have entitled the preferred to force redemption payments.²⁵⁵ Doing this more consistently, and as clearly as possible, would, over time, help to develop a body of unambiguous, judicially approved contractual provisions from which the parties to VC transactions could pick and choose as needed.

Together, these two measures would go at least some way toward diminishing the heavy drafting burden that the framework developed in this article would place on VCs.

²⁵⁵ See *ThoughtWorks*, 7 A.3d at 990-92. Of course, given the economics of the company, even if SVIP had an enforceable legal right to force payments, they would have been unlikely to recover much actual cash.