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A Theory of Preferred Stock

Law Working Paper N° 201/2013
Revised December 2013

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thanks to John Armour, Henry Hu, Travis Laster, Adam Levitin, Andrew Lund, Roberta Romano, Gordon Smith, Gil Sparks, Leo Strine, Eric Wilensky, and participants at the Oxford Law & Finance Seminar, the Tilburg University Anton Philips Fund Conference on Institutional Investors, and the Penn Law Institute for Law & Economics Roundtable for their com?

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Abstract

Should preferred stock be treated under corporate law as an equity interest in the issuing corporation or under contract law as a senior security? Should a preferred certificate of designation be subsumed in the corporate charter and treated as an incomplete contract filled out by fiduciary duty, or should it be treated as a complete contract with the drafting burden on the party asserting the right, as would occur with a bond contract? Is preferred stock equity or debt? This Article shows that preferred stock is both corporate and contractual - neither all one nor all the other. It sits on a fault line between two great private law paradigms, corporate and contract law, and draws on both. The overlap brings two competing grundnorms to bear when interests of preferred and common stockholders come into conflict: on the one hand, managing to the common stock as residual interest holder maximizes value; on the other hand, holding parties to contractual risk allocations maximizes value. When questions arise concerning the relative rights of preferred and common stock, the norms hold out conflicting answers. Delaware courts have taken the lead in confronting these questions by seeking to synchronize the law of preferred stock with the rest of corporate law - a project that has led to both innovation and stress.

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ARTICLE

A THEORY OF PREFERRED STOCK

WILLIAM W. BRATTON[†] & MICHAEL L. WACHTER[††]

Should preferred stock be treated under corporate law as an equity interest in the issuing corporation or under contract law as a senior security? Should a preferred certificate of designation be subsumed in the corporate charter and treated as an incomplete contract filled out by fiduciary duty, or should it be treated as a complete contract with the drafting burden on the party asserting the right, as would occur with a bond contract? Is preferred stock equity or debt? This Article shows that preferred stock is both corporate and contractual—neither all one nor all the other. It sits on a fault line between two great private law paradigms, corporate and contract law, and draws on both. The overlap brings two competing grundnorms *to bear when interests of preferred and common stockholders come into conflict: on the one hand, managing to the common stock as residual interest holder maximizes value; on the other hand, holding parties to contractual risk allocations maximizes value. When questions arise concerning the relative rights of preferred and common stock, the norms hold out conflicting answers. Delaware courts have taken the lead in confronting these questions by seeking to synchronize the law of preferred stock with the rest of corporate law—a project that has led to both innovation and stress.*

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†† William B. and Mary Barb Johnson Professor of Law and Economics; Co-Director, Institute for Law and Economics, University of Pennsylvania Law School. Our thanks to John Armour, Henry Hu, Travis Laster, Adam Levitin, Andrew Lund, Roberta Romano, Gordon Smith, Gil Sparks, Leo Strine, Eric Wilensky, and participants at the Oxford Law & Finance Seminar, the Tilburg University Anton Philips Fund Conference on Institutional Investors, and the Penn Law Institute for Law & Economics Roundtable for their comments and questions.

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This Article examines recent cases about preferred stock to show two facets of Delaware law coming to bear as the synchronization process proceeds: first, reliance on independent directors for dispute resolution, and second, the common stock–value maximization norm. These trends cause the law to tilt toward corporate norms, thereby disrupting allocated risks in heavily negotiated transactions, particularly in the venture capital sector. The Article makes three recommendations that would promote the goal of restoring balance between the corporate and contract paradigms. First, the meaning and scope of preferred contract rights should be determined by courts, rather than by issuer boards of directors. Second, conflicts between preferred and common should not be decided by reference to a norm of common stock–value maximization. Instead, the goal should be the maximization of the value of the equity as a whole. Third, independent-director determinations of conflicts between 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. This review would require a showing of bad faith treatment of the preferred where the integrity of a deal has been undermined, with the burden of proof on the board.

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INTRODUCTION

Preferred stock is undertheorized. The most recent comprehensive study appeared almost six decades ago.[1] Commentary on the subject since then has been sporadic.[2] Yet preferred stock's economic salience has increased notably

[1] *See generally* Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 243 (1954) (attempting to analyze the rights of preferred stockholders "to see the extent to which the share contract creates and protects them and the extent to which the law details them when the share contract is defective"). One of us frequently consulted Professor Buxbaum's article when practicing law during the 1970s. We have it on good authority that corporate lawyers continue to refer to it.

[2] There are two leading subsequent articles on preferred stock. *See* Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445, 448-49 (1973) (examining judicial standards of fairness in weighing the rights of preferred shareholders);

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in recent decades. The volume of new preferred offerings outstrips both that of initial public offerings (IPOs) of common stock and of new public common offerings by seasoned issuers.[3] Preferred also is the favored mode of investment in the venture capital sector.[4] Finally, it is much utilized in the financial sector.[5] For example, the U.S. Treasury purchased more than $200 billion of preferred under the Troubled Asset Relief Program.[6]

It is time for a new look at preferred. There are three reasons why such a review is warranted—the first theoretical, the second institutional, and the third normative.

Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 445 (1996) (analyzing "the question of when fairness standards are to be applied in assessing the effects of corporate transactions upon preferred stockholders"). There has also been legal scholarship on venture capital preferred. *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1313 (2008) (finding that "fiduciary duties are becoming more harmful than helpful," and that courts should require directors to follow "the course that, in their judgment, maximizes the value of the firm as a whole" instead of strict reliance on "the idea that fiduciary duties are owed shareholders"); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 891 (2002) ("examining the law and economics of downside arrangements in venture capital contracts"); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 971-72 (2006) (analyzing the "unique" corporate governance structure that startups with venture capital funding typically employ, in part due to preferred rights and interests); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 318 (2005) (looking at how venture capitalists and entrepreneurs "ensure optimal allocation of decisionmaking authority while preserving the venture capitalists' exit options").

[3] From 1999 to 2005, U.S. firms issued over $868 billion in preferred stock while raising only $374 billion through common equity IPOs and only $590 billion through seasoned equity offerings. Jarl G. Kallberg et al., *Preferred Stock: Some Insights into Capital Structure*, 21 J. CORP. FIN. 77, 78 (2013). Three-quarters of the preferred equity took the form of trust preferred securities, thus implying that $217 billion was traditional preferred, which is the form discussed in this Article. *See* Jarl G. Kallberg et al., Preferred Stock: Some Insights into Capital Structure 8 (Feb. 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/id=1108673.

[4] *See* Bratton, *supra* note 2, at 914-16 (discussing reasons venture capital contracts typically involve preferred stock versus debt or common stock).

[5] *See* Jennifer Salutric & Joseph Willcox, *Emerging Issues Regarding Trust Preferred Securities*, SRC INSIGHTS (Fed. Reserve Bank of Phila., Philadelphia, Pa.), First Quarter 2009, at 8, 8 (describing trust-preferred securities as "a very popular vehicle for raising capital throughout the past decade").

[6] CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM 4 (2011), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/12-16-TARP_report.pdf; *see* BAIRD WEBEL, CONG. RESEARCH SERV., R41427, TROUBLED ASSET RELIEF PROGRAM (TARP): IMPLEMENTATION AND STATUS 2-8 (2012), *available at* http://www.fas.org/sgp/crs/misc/R41427.pdf (detailing the costs of various TARP programs).

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A. *Corporate Legal Theory*

The theoretical interest concerns the problem of defining the corporation's boundaries, asking the "who's in and who's out" question regarding the line dividing fiduciary beneficiaries from contract counterparties. The problem has been traversed extensively in corporate legal theory[7] without anyone noticing the special case of preferred. Preferred stockholders are the only corporate constituents who straddle the line—their participation being both corporate and contractual. It therefore follows that resolving problems relating to preferred stock offers special information about the corporation's borderland.

The classic common stockholder surrenders capital to the company with no right to pull it back out: the stockholder takes the residual financial risk on both the downside and upside and gives up direct input into business decisions in exchange for a vote at an annual election of the board of directors. The interest can be viewed contractually, but the contract that emerges is almost entirely incomplete, with open-ended fiduciary duties substituted for negotiated financial rights. Whether viewed through the lens of corporate or contract law, common stockholders are seen as "insiders." Lenders also contribute capital to corporations, often for long periods, but they do so under contracts that create enforceable financial priorities. The contracts approach completeness, and courts balk when asked to imply additional rights in cases where lenders find themselves in vulnerable positions.[8] Lenders sit "outside" of the corporation, and look to specific, bargained-for rights to protect their interests rather than the apparatuses of governance and fiduciary duty.

Stockholders are corporate, lenders are contractual, and a well-understood wall separates their legal treatments. Preferred stock straddles the wall. The holder receives a share of stock issued pursuant to the same corporate code and charter as a share of common stock. The stock, viewed

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[7] *Compare* Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, J. APPLIED CORP. FIN., Winter 2010, at 32, 33 (arguing that enlightened stakeholder–value maximization, in which "maximization of the long-run value of the firm" is the goal used to determine which tradeoffs among stakeholders are permissible, is the most appropriate corporate objective), *with* Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1268 (1999) (stressing that "shareholders' [position as] the exclusive beneficiaries of fiduciary duties is the *default* rule").

[8] *See, e.g.*, Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) ("Accordingly, this Court holds that the 'fruits' of these indentures do not include an implied restrictive covenant that would prevent the incurrence of new debt to facilitate the recent LBO."). Employees are treated similarly by the courts. *See, e.g.*, Merola v. Exergen, Corp., 668 N.E. 2d 351, 355 (Mass. 1996) (refusing, as a matter of course, to find a breach of fiduciary duty following a corporation's firing of an employee-stockholder).

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in isolation, carries the same vulnerabilities as a share of common stock and exists in the same regime of rights and duties. The issuer then adds contract rights to the stock—either financial preferences or a debt-like right to be paid certain sums on set dates—thus rendering it preferred stock.[9]

So is preferred stock equity or debt? Is it stock subject to the rules of corporate law or a senior security governed by contract law? Is it an incomplete contract filled out by fiduciary duty or a complete contract with the drafting burden on the party asserting the right? These are the central questions of the law of preferred stock. This Article provides answers and thus fills the void of corporate legal theory.

Preferred stock sits on a fault line between two great private law paradigms, corporate law and contract law. It is neither one nor the other; rather, it draws on both.[10] The overlap involves two *grundnorms* and brings them into conflict. On the one hand, the corporate paradigm instructs that managing to the common stock, since stockholders are residual interest holders, maximizes value; on the other hand, the contract paradigm instructs that holding parties to contractual risk allocations maximizes value. When questions arise concerning the relative rights of preferred and common, the paradigms can hold out conflicting answers. Decisionmakers choose between the two, sometimes applying corporate law principles, while at other times opting instead for the framework of contract law. As a result, the law vacillates.

This observation does not mean that the law never draws lines. Sometimes, clear categorical placements must be made, and preferred is effectively pigeonholed on one side or another of the debt–equity line. For example, bank capital rules treat preferred as equity (sometimes, on par with common).[11] Generally Accepted Accounting Principles (GAAP) require some preferred

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9 *See* DEL. CODE ANN. tit. 8, § 151(a) (2011) (setting the parameters of stock issuance under Delaware law and permitting preferred stock).

10 Thus, there is a clear contrast between preferred stockholders on one hand, and convertible bondholders and warrantholders, who are treated contractually, on the other. *See, e.g.*, Aspen Advisors LLC v. United Artists Theatre Co., 861 A.2d 1251, 1262-64 (Del. 2004) (refusing appraisal rights to a warrantholder and holding that such rights are "narrow statutory right[s] that [are] available only to stockholders"); Harff v. Kerkorian, 347 A.2d 133, 134 (Del. 1975) (denying convertible bondholders the right to bring a derivative action "because they are not 'stockholders'" (internal citation omitted)).

11 *See, e.g.*, SULLIVAN & CROMWELL LLP, BANK CAPITAL RULES: FEDERAL RESERVE APPROVES NPRS ADDRESSING BASEL III IMPLEMENTATION AND SUBSTANTIAL REVISIONS TO BASEL I-BASED RULES FOR ALL BANKS AND FINALIZES AMENDMENTS TO MARKET RISK RULES 2-5 (June 8, 2012), *available at* http://www.sullcrom.com/files/upload/SC-Publication-Bank-Capital-Rules-June-10-2012.pdf (describing the Federal Reserve proposal to treat noncumulative preferred issued by REIT subsidiaries of banks as Tier 1 capital but phase-out trust preferred and cumulative preferred from Tier 1 status).

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to be booked as debt, even though formally it is stock, while other preferred is booked as equity.[12]

Things get harder and neat results prove elusive when courts address cases in which the economic interests of preferred and common stockholders come into conflict. The Delaware courts have attempted to effect a clean paradigmatic split by referencing corporate law when the matter concerns "a right shared equally with the common" and referencing contract law when the matter concerns special rights and preferences.[13] But this line of demarcation proves too vague and the area of paradigmatic overlap proves too extensive to permit easy compartmentalization. Decisions are not remitted to the law of debtor–creditor on the "rights and preferences" side of the split; rights shared with the common are not defined by exclusive reference to corporate law. Preferred sits on the line; it is both. Therefore, coherence in treatment cannot follow from black-and-white references to contract or corporate law. Both paradigms come to bear and decisionmakers need to synchronize their simultaneous application.

This is not easy to do. This Article clarifies the field with a close examination of four recurring points of dispute—equity recapitalizations, allocations of merger proceeds, enforcement of payment mandates, and fundamental changes effected by preferred in control. We show that dispute resolution in all four categories requires negotiation between the two paradigms rather than unwavering reliance on one or the other.

B. *Institutional Posture and Normative Concerns*

The Delaware courts have emerged as the dominant arbiters of preferred stock disputes.[14] What was once a disparate, multistate case law on the

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12 *See generally* FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE: ACCOUNTING FOR REDEEMABLE EQUITY INSTRUMENTS (Aug. 2009), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175819483183&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs (requiring mandatory redemption preferred to be booked as debt on the balance sheet); Fin. Accounting Standards Bd., *Summary of Statement No. 150: Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, FASB: PRE-CODIFICATION STANDARDS (May 2003), http://www.fasb.org/summary/stsum150.shtml.

13 Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593-95 (Del. Ch. 1986).

14 Since 1980, 60% of the cases keyed by West as involving preferred stock were decided in Delaware. New York came in a distant second with 20%. From 1940 to 1950, Delaware cases comprised only 12.7% of the set. Preferred Stock Key Numbers, WESTLAWNEXT, www.next.westlaw.com (ensure that search is for all federal and state cases; click "Tools" link; click "West Key Number System"; click "101: Corporations and Business Organizations"; under "V. Capital and Stock, k1280-k1499," click "(A) Nature and Amount Of Capital and Shares, k1280-k1309"; under "1288 Division of Capital into Shares" click "1292: Preferred Stock"; verify total number of cases in above time periods; add up number of Delaware and New York cases in this key number

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subject is now articulated by the Delaware judiciary in a closed, self-referential context—a context highly sensitive not only to each case's facts but also to its implications for the overall framework of Delaware corporate law. That framework has undergone notable developments over the past several decades. As ever, the Delaware courts accord respect to boards of directors' business judgments, but they now push boards to remit dispute resolution to independent directors and temper their board centrism by recognizing a norm of shareholder-wealth maximization.

Recent Delaware cases strive to integrate the law of preferred within this framework. The integration project both inspires innovation and causes stresses and strains. Unfortunately, the latter effects have been in ascendance recently as the courts have reset the balance between corporate and contractual treatment. Although framed in contractual terms, the rebalancing has the effect of pushing preferred deeper into corporate territory. Board decision-making primacy has that effect: because courts review processes leading to outcomes rather than the outcomes themselves, questions about substantive rights that a half century ago were seen as matters for judicial determination now devolve to corporate boards.[15] In addition, challenges to board judgments now can be viewed through the lens of common stock–value maximization.[16] The two frames, taken together, tend to assure that preferred stockholders lose their cases. Taken alone, this outcome would not be problematic, but destabilizing implications follow for the financial markets, particularly the venture capital sector. Arm's length deals are being undercut due to overemphasis of preferred's corporate character and under-emphasis of transactional context.

We propose a contrasting framework built on three principles. First, courts, rather than issuer boards of directors, should determine the meaning and scope of preferred contract rights. Second, conflicts between preferred and common should not be decided by reference to a norm of common stock–value maximization. Instead, the goal should be the maximization of

over given time periods; repeat for "1475: Preferred or Other Special Stock"; add totals from both key numbers and calculate percentages). Buxbaum cites a total of 381 cases in his article. New York leads that set with 20.7% (79); Delaware came second with 9.5% (36). *See generally* Buxbaum, *supra* note 1.

15 *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 681-83 (2006) (describing the transition from substantive fairness review to process review of cashout mergers).

16 *See* Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (requiring directors to maximize short-term value once they have decided to sell a company for cash). Of course, *Revlon* deals with a narrow fact pattern. This Article shows that its spirit now motivates judicial responses in preferred stock cases. For an example of such a response, see HB Korenvaes Investments, L.P. v. Marriott Corp., Civ. A. No. 12922, 1993 WL 205040, at *746 (Del. Ch. June 9, 1993); *infra* note 124 and accompanying text.

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the value of the equity as a whole, with the enterprise rather than the common stock as the value yardstick. 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 rule leading to judicial intervention when there has been a showing of bad faith treatment *of the preferred* that undermined the integrity of a deal.

C. *Structure of This Article*

Part I describes the corporate–contract balance set during the first half of the twentieth century. The courts confronted downside situations in which preferred stockholder claims interfered with corporate equity recapitalizations that would have enhanced enterprise value. Preferred holders played the contract card, analogizing to the claims of bondholders. The companies insisted that the preferred, as stock, be made to sacrifice for the good of the enterprise. The companies won; preferred henceforth would irretrievably be *stock*, and the corporate law paradigm would limit claims to contractual priority.

Part II addresses problems arising from acquisitions of preferred stock issuers. Although a corporate charter can fix an allocation of merger proceeds for a preferred class in advance, such a term often is omitted. It follows that a merger creates an allocational issue for decision by the issuer board of directors, a body elected by common stockholders. The preferred holders frequently complain about the conflicted result. We show that a plausible case can be made for either corporate or contract treatment—the former meaning fiduciary scrutiny along majority-to-minority lines and the latter limiting the preferred to rights explicitly reserved by contract and the statutory appraisal remedy. We go on to show that both approaches have influenced Delaware decisions, thereby creating a classic case of mixed signals in mutual tension due to paradigmatic overlap. The tensions recently came to a head in a Delaware Chancery Court decision, *LC Capital Master Fund, Ltd. v. James*, in which the court forcefully resolved them by treating the charter as a complete contract, effectively expanding the board's zone of allocational discretion.[17] But we read the contract in question differently than did the Chancery Court. In particular, we show more generally that preferred stock contracts cannot presumptively be modeled as complete and that the common stock–maximization norm has no productive role to play in merger allocation disputes. At the same time, we share the Chancery Court's aversion to full-dress fiduciary review and agree that statutory

[17] 990 A.2d 435, 447-48 (Del. Ch. 2010) (citing *HB Korenvaes*, 1993 WL 205040, at *744-45).

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appraisal usually affords an adequate remedy.[18] We think that some minor boardroom process adjustments and minimal judicial scrutiny under the good faith rubric can both finesse the problem of paradigmatic ambiguity and accommodate the interests at stake.

Part III considers the paradigmatic overlap occasioned by preferred with mandatory dividend and redemption rights—debt-like promises to pay preferred holders. The promises take second-order status because their performance is conditioned on the presence of "legally available funds" as defined by corporate legal capital rules, fraudulent conveyance law, and an open-ended and conflicting body of old cases. The Delaware Chancery Court has taken a new look here as well. In *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, it resolved ambiguities in favor of corporate treatment by leaving the decision whether to pay to the business judgment of issuer boards of directors.[19] We agree that ambiguities need resolution but suggest that the modern legal framework better accommodates resolution in the opposite, contractual direction.

Part IV addresses the venture capital context, where preferred stockholders often control the board of directors but also operate under pressure to monetize their equity investments. The Chancery Court, at the behest of complaining minority common, recently reviewed a sale engineered by exiting venture capitalists.[20] The *In re Trados* court opened a wide door to intrinsic fairness review on the common's behalf[21]—in our view, too wide. Part IV looks critically at *Trados* and projects that the case will negatively impact the venture capital business model. We trace the problem to the court's application of the common stock–maximization norm and recommend, first, that enterprise value maximization be substituted as the fiduciary yardstick and, second, that a door be opened to waiver by common of fiduciary protection in venture deal documentation.

Part V reviews the Article's sequence of analyses and asks whether a more consistent regime of across-the-board corporate or contract treatment would improve matters. We find that a paradigmatic harmonization initiative would disturb both transactional risk allocations and corporate governance. Rather, preferred is dual and works only when both paradigms are consulted.

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18 *See James*, 990 A.2d at 438-39 (favoring relief for preferred stockholders through appraisal).

19 *See* 7 A.3d 973, 988-89 (Del. Ch. 2010), *aff'd*, 37 A.3d 205 (Del. 2011).

20 *See generally In re* Trados Inc. S'holder Litig., Civ. A. No. 1512-CC, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009).

21 *Id.* at *5 ("If the presumption of the rule is rebutted, then the burden of proving entire fairness shifts to the director defendants.").

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I. THE PARADIGMATIC BACKDROP: CORPORATE TREATMENT IN DEPRESSION-ERA EQUITY RECAPITALIZATIONS

Courts confronted the choice between the corporate and contract paradigms in stark terms during the first half of the twentieth century. In those days, American industrial firms routinely financed with priority, cumulative preferred.[22] "Priority" means that a set preferred dividend must be paid before a dividend may be paid to the common, but that the preferred dividend may be skipped at the discretion of the board of directors.[23] "Cumulative" means that past skipped preferred dividends must be made up before the common can receive dividends.[24] Although there is no promise to make a payment, the cumulative priority can constrain the issuer board's freedom of action.

The priority arrangement works well in prosperous times. The enterprise creates free cash flows and the preferred gets its dividend at a rate of return higher than that on the same issuer's bonds. However, even moderate distress alters the situation in the following manner: The enterprise pays its bondholders and even turns a small profit, but the board needs to reinvest every cent to keep the business functioning; therefore, it withholds preferred dividends. Under the cumulative feature, dividend arrearages gradually build up. The arrearages in turn prevent the company from making periodic payments on its common, thus inhibiting the sale of additional common to raise new equity capital. As more arrearages accumulate, the issuer's equity capital structure becomes increasingly 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 with the common.[25] Under this scenario, preferred rights look increasingly like barriers to progress for the enterprise as a whole.

During the Great Depression, such capital structures crowded the corporate landscape.[26] The project of clearing the wreckage triggered disputes

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22 *See* 1 ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 133-36 (4th ed. 1941) (providing an overview of the characteristics of industrial preferred of the early twentieth century); BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 378 (4th ed. 1962) (describing early twentieth century–corporate financing patterns).

23 *See* WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 609-10 (7th ed. 2012).

24 *Id.* at 610.

25 *Cf.* Eliasen v. Itel Corp., 82 F.3d 731, 735-36 (7th Cir. 1996) (arguing that separation of the marginal economic gain and loss from the interests of the principals who elect the board is inefficient).

26 *See* Robert M. Blair-Smith & Leonard Helfenstein, *A Death Sentence or a New Lease on Life? A Survey of Corporate Adjustments Under the Public Utility Holding Company Act*, 94 U. PA. L. REV. 148, 149-52 (1946) (describing dysfunctional utility capital structures, in which utilities, as

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that posed fundamental choices between contract and corporate treatment. Contract law privileged preferred fixed claims and reinforced barriers, while corporate law facilitated the barriers' removal. The early twentieth-century courts emphatically endorsed corporate treatment, and the choice has stuck. The result is a curious hybrid legal status for the preferred: contract rights, no matter how thickly applied, are potentially subject to diminution for the good of the enterprise.

This Part recounts the Depression-era choice set. Section I.A describes the problem confronting the issuer of preferred in arrears more fully than the brief overview above. Section I.B sets out the solution of a cramdown recapitalization and the resulting legal questions and finishes by looking at the courts' move to corporate treatment in resolving these issues. Section I.C considers the paradigmatic implications of this Part's points.

A. *The Recapitalization Problem*

Consider hypothetical ABC Corporation, which has a total market equity capitalization of $100 million. There are one million preferred shares outstanding and two million common shares, with the preferred trading for $80 per share and the common for $10 per share. The preferred carries a cumulative dividend preference plus a liquidation preference under which its holders will be paid $100 per share along with all accrued dividends before the common receives any liquidation proceeds. The liquidation preference plus dividend accruals total $150 per share.

An infusion of new capital into ABC will facilitate a turnaround. Money is tight and no loans are available; therefore, a new equity offering makes sense. The preferred arrearages, however, block this option, since a new common issue holding out no prospect of cash returns will not sell for much in the market. Alternatively, if the preferred can be transformed into common through a recapitalization, the arrearages will disappear. A successful recapitalization to an all-common structure will increase the company's equity to $120 million.

An allocation question arises: Recapitalization increases the pie's size to $120 million and then slices it and hands the pieces to the preferred and the common by any of a range of possible splits. At one end, the entire gain could be allocated to the preferred, which would follow if the preferred received eight common shares for each preferred share (eight million to the preferred, valued at $100 million; two million to the common, valued at $20

part of elaborate holding company structures, lost much of their earnings through "expenses, fixed charges, and preferred stock dividend requirements").

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million). At the other end, the entire gain could be allocated to the common, which would follow from a four-to-one allocation to the preferred (four million to the preferred, valued at $80 million; two million to the common valued at $40 million). Directly in the middle, an exchange ratio of six-to-one evenly splits the $20 million gain (six million to the preferred valued at $90 million; two million to the common valued $30 million).

Assume that the board decides to split the gain equally and recapitalize on a six-to-one basis. How does it successfully structure the recapitalization? The board could set up a *voluntary* exchange offer, asking the preferred to tender back their shares and, in turn, receive six common for each preferred tendered. Unfortunately, the offer creates a hold-out problem. The preferred can refuse to tender and insist on a more favorable ratio. Even if a majority of the preferred cooperate, a minority will likely stand pat. If 80% of the preferred holders accept, the 20% holding out retain their stock with liquidation preference and arrearages intact at $150. If their ploy works, the holdouts eventually get their arrearages paid down, coming out significantly ahead of the others. This holdout possibility destabilizes the transaction.

B. *Cramdown*

The ABC board needs to cram down a recapitalization. Under the contract paradigm, strictly applied, cramdown is impossible. To see why, compare an issue of *bonds* that stands in the way of progress. To scale back the bondholders' claims, the issuer must either procure their unanimous consent to a direct amendment of the bond contract[27] or get a supermajority to consent to an exchange offer.[28] Either way, the issuer must confront the aforementioned holdout problem.[29] The debt claimant can face an *involuntary* haircut only in a bankruptcy reorganization proceeding,[30] and then only if every junior claimant is wiped out.[31]

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27 *See* Trust Indenture Act of 1939, § 316, 15 U.S.C. § 77ppp(b) (2006) (requiring unanimous consent to amendment of payment terms).

28 *See* BRATTON, *supra* note 23, at 462-63 (providing an overview of exchange offers).

29 *See, e.g.*, William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 56-60 (2004) (describing the holdout problem of the division of surplus between creditors); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 241-42 & n.29 (1987) (discussing a case in which a single bondholder held out and destroyed a deal to which 80% of bondholders had agreed).

30 *See* BRATTON, *supra* note 23, at 529-31 (observing that some reorganization plans "are judicially ordered to be crammed down on nonconsenting classes").

31 *See* 11 U.S.C. § 1129(b) (2006) (making absolute priority treatment of a reorganization plan available on a contingent basis); BRATTON, *supra* note 23, at 530-31 (describing the role the absolute priority rule continues to play in bankruptcy).

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Preferred stock worked the same way during the Victorian era. The Victorians took contract law seriously; amendments to corporate charters could not proceed without unanimous consent.[32] But the unanimity rule was relaxed during the early twentieth century when corporate codes were revised to permit charter amendment by majority vote.[33] This relaxation opened a route to an *involuntary* out-of-bankruptcy cramdown against preferred. Although the preferred's obstructive priorities are contract terms, they are embedded in the issuer's charter rather than in a freestanding contract (as occurs with debt securities). Once corporate codes allowed charter amendment by majority vote, it logically followed that the boards and common stockholders could join together to impose *mandatory* exchanges on preferred issues.

To see how, we return to ABC Corporation and note that the preferred holds only one-third of the votes. So, preferred shareholders accordingly cannot block an amendment approved by the board and submitted for shareholder ratification. At the same time, the common can be expected to vote in favor of an amendment only if it holds out a clear-cut gain. The board, concerned about this threat, takes a hard look at the six-to-one exchange ratio, and decides that the allocation favors the preferred enough that it could trigger possible resistance among the common. To avoid that undesirable outcome, it adjusts the ratio to five-to-one (71.5% or $85.7 million to the preferred and 28.5% or $34.3 million to the common) and submits the amendment to a vote.

The corporate–contract issue is joined at this point. Assume no preferred issuer has ever attempted such an amendment. The revised corporate code, read literally, not only permits it, but, indeed, contains a reservation clause that permits legislative amendments to alter existing rights.[34] Still, it is likely that a wall of conceptual resistance to the proposed amendment will exist. Preferred rights are widely assumed to be contractual and vested,[35]

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32 John F. Meck, Jr., *Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine*, 55 HARV. L. REV. 71, 79 (1941) (describing the doctrine of unanimous consent as a "carry-over from partnership law"). The unanimity rule originated in early- to mid-nineteenth-century judicial opinions that filled gaps in corporate charters and state codes. *See* Edward O. Curran, *Minority Stockholders and the Amendment of Corporate Charters*, 32 MICH. L. REV. 743, 744-45 & nn.10-12 (1934).

33 *See* E. Merrick Dodd, Jr., *Statutory Developments in Business Corporation Law, 1886–1936*, 50 HARV. L. REV. 27, 43-50 (1936) (describing the 1933 Illinois statute, which moved in the direction of the current state of the law by requiring approval by two-thirds of shareholders for most changes, and comparing it to the Massachusetts and Delaware statutes in effect at the same time).

34 *See, e.g.*, MODEL BUS. CORP. ACT § 1.02 (2011) (granting the state legislature the "power to amend or repeal all or part of the Act at any time").

35 Note that the vested-rights approach runs parallel to absolute priority in bankruptcy. *See* Bankruptcy Code of 1978, 11 U.S.C. § 1129(a)(8), (b)(2) (allowing for bankruptcy plans that classes

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just like the rights of bondholders. However, when one views the preferred contractually, the amendment makes no structural sense: What stops the company from transferring value from the preferred to the common by cramming down a recapitalization on a one-to-one basis or a one-fourth-to-one basis? What is the value of a promise that can be unilaterally amended away by the promisor? Arguably, such rights are illusory and without value. Allowing the amendment, then, undercuts the financial transaction that created the preferred in the first place, particularly given a class of preferred issued and sold before the amendment of the corporate code.

The reviewing court faces a stark choice. Contract treatment ensures the consent of the preferred, but also leads to holdup and a dysfunctional capital structure. On the other hand, corporate treatment undercuts the deal but also applies the corporate code as written and facilitates a fresh start in the best interests of the corporate community.

Depression-era courts split on the question. Some, including the Delaware Supreme Court, held that the amended code's majority vote provision could only be applied prospectively—that is, to preferred created after the enactment of majority amendment.[36] Courts in most states, including New York, both in the Depression era and the decades following it, held that no such vested rights existed.[37]

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have accepted or that do not impair those classes, and ensuring that holders of junior claims do not recover before holders of senior ones). Both follow from the notion that a contract right cannot be impaired without its holder's consent. Unfortunately for the preferred, an absolute priority objection is structurally ill-suited to the context of an out-of-court equity recapitalization. These recapitalizations require a shareholder vote, and a common stock majority has no incentive to vote in favor of a recapitalization that eliminates or reduces the value of its participation. The bottom line is simple: no preferred haircut, no recapitalization. Ruling the transaction unfair for traversing absolute priority would, in effect, reinstate the vested-rights barrier. *Adjudicated* recapitalizations present a different case, and the SEC effected a series of them under the Public Utility Holding Company Act of 1935 (PUHCA) § 11, 49 Stat. 803, 820 (repealed 2005). *See* Otis & Co. v. SEC, 323 U.S. 624, 633-35 (1945) (sanctioning an absolute priority violation in an SEC recapitalization proceeding under PUHCA).

36 *See* Keller v. Wilson & Co., 190 A. 115, 116-17, 125-26 (Del. 1936) (invalidating recapitalization pursuant to charter amendment made following Delaware code procedures promulgated after creation of the preferred because the amendment could only be applied prospectively); *see also* Consol. Film Indus. v. Johnson, 197 A. 489, 493 (Del. 1937) ("There is nothing in the language to suggest that the section, as amended, was intended to have a retrospective operation."); NORMAN D. LATTIN, THE LAW OF CORPORATIONS 578 (2d ed. 1971) (discussing "judicial battles" in Delaware courts "over the status of accrued but undeclared dividends on preferred shares where the legislature has authorized their alteration or elimination").

37 *See* Davison v. Parke, Austin & Lipscomb, Inc., 35 N.E.2d 618, 622-23 (N.Y. 1941) (rejecting the vested-rights doctrine); *see also, e.g.*, Bove v. Cmty. Hotel Corp. of Newport, R.I., 249 A.2d 89, 94-98 (R.I. 1969) (discussing and rejecting vested-rights analysis and confirming that reserved power gives the legislature authority to affect rights of the preferred).

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The vested-rights era did not last long, even in Delaware. A few years after recognizing vested rights, the Delaware Supreme Court encountered a case in which an issuer used a different technique to the same end: *Federal United Corp. v. Havender*.[38] This time, instead of directly amending its charter, the issuer effected a "dummy" merger in which it created a wholly owned shell subsidiary and then entered into a merger agreement with the subsidiary pursuant to which the subsidiary was the surviving corporation.[39] Typically in these mergers, the merger agreement provides that the existing shares of the issuer, both preferred and common, will be "converted" into common shares of the surviving corporation.[40] The conversion strips the arrearages. Significantly, different sections of Delaware's corporate code governed mergers and charter amendments at the time; this practice continues even today.[41]

In *Havender*, the Delaware Supreme Court found the statutory difference to be determinative.[42] The code's merger section permitted the transaction in question and had always done so.[43] The preferred argued that the section's employment in the present case amounted to a formal ruse, in that it accomplished what the court had forbidden by direct charter amendment.[44] The court rejected this argument, along with a "vested contract rights" claim to unpaid dividends[45]: transactional limitations found in one section of the code do not constrain a party's use of another section of the code to reach the same substantive result that the first section prohibits.[46] The point survives as Delaware's "bedrock" doctrine of independent legal significance.[47]

Henceforth, recapitalizations would be easily effected with or without the voting support of the preferred—so easily, in fact, to have prompted the

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38 11 A.2d 331 (Del. 1940).

39 *Id.* at 333-35.

40 *See id.* at 334 (noting that, in a variation on the traditional dummy merger, the old preferred stock was converted into both new preferred stock and Class A common stock).

41 *Id.* at 338-39.

42 *See id.* at 338 (finding *Keller* to have "no application beyond its philosophy" since it did not deal with a merger).

43 *Id.* at 338.

44 *See id.* (noting that the preferred shareholders saw this case as essentially identical to *Keller*).

45 *See id.* at 339 (contrasting preferred shareholders from those who do hold vested rights, such as creditors or lienholders).

46 *Id.* at 338.

47 *See, e.g.*, Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 853 (Del. 1998) ("[A]ll parties agree that [statutory] pure amendment protection available to the First Series Preferred stockholders . . . does not—absent the very phrase at issue here—apply to this merger."); Warner Commc'ns, Inc. v. Chris-Craft Indus., Inc., 583 A.2d 962, 970 (Del. Ch. 1989) ("Our bedrock doctrine of independent legal significance compels the conclusion that satisfaction of the requirements of Section 251 is all that is required legally to effectuate a merger." (citation omitted)).

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legislature to make a concession to the preferred. Now, in Delaware and elsewhere,[48] a charter amendment that alters or changes "the powers, preferences, or special rights" of a given class must be approved by a majority vote of that class.[49] The class vote mandate holds out a veto of a one-sided amendment while substantially diminishing the holdout problem. But Part II demonstrates that the dummy-merger route to cramdown remains open.[50]

C. *Summary*

To create an absolute contractual claim against a corporation in exchange for an infusion of $1 million of capital, an authorized officer simply needs to write, "The corporation promises to pay you $1,000,000" on a piece of paper and sign it. Absent the holder's consent, the claim can be impaired only in the context of a bankruptcy proceeding. Resistance to unconsented impairment persists even there, manifested in the absolute priority rule.[51]

Preferred stock is *stock* issued under a corporate charter and is therefore more vulnerable than debt. The Depression-era courts removed the contract paradigm's protection to make way for enterprise value enhancement under the corporate paradigm. A question arises: Is there any way to invoke contract and draft the preferred into the same absolute contractual status enjoyed by debt? Parts II and III will show that such status is not possible. With preferred, corporate and contract inevitably overlap.

II. PREFERRED STOCK AS FIDUCIARY BENEFICIARY: MERGERS

When a corporate bond issuer merges into another corporation, the bonds, by operation of law, carry over to the surviving corporation's capital structure with their rights untouched.[52] It is different with preferred stock.

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48 *See, e.g.*, MODEL BUS. CORP. ACT § 10.04(a)(3) (2011) (giving the holders of a separate class of stock the right to vote, as a group, on amendments that would "change the rights, preferences, or limitations of all or part of the shares of the class"). Delaware followed other states in making this concession. *See* Dodd, *supra* note 33, at 44-49 (describing a class vote provision modifying majoritarian amendment in the Illinois statute of 1935).

49 DEL. CODE ANN. tit. 8, § 242(b)(2) (2011).

50 However, many states have merger statutes that require a class vote in the merger when one would be necessary if the corporation had instead chosen to amend its charter. *See, e.g.*, MODEL BUS. CORP. ACT § 11.04(f)(1)(ii).

51 11 U.S.C. § 1129(b)(2) (2006).

52 *See* DEL. CODE ANN. tit. 8, § 259(a) ("[A]ll property rights, privileges, powers and franchises and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation as they were of the several and respective constituent corporations."). Trust indentures customarily require the surviving corporation to formally assume the

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When a preferred issuer merges into another company, the preferred lies on the corporate side of the line, and corporate law makes it possible for merging companies to effect top-to-bottom rewrites of their equity capital structures. What comes into the merger as a fixed interest security can come out the other end as cash, common stock, preferred with different rights and preferences, or debt, and, in any case, in an amount with a value determined by the issuer's board of directors. A merger also can be structured to leave a target company's preferred's rights unaffected, as would occur with a bond. But nothing requires such treatment. Mergers thus hold special risks for minority preferred. It would seem to follow that the preferred, as a minority voting class, should benefit from the same fiduciary protection extended to common stock minorities cashed out in parent–subsidiary mergers.[53]

It is not so simple, however. Preferred stock, as *stock*, does enjoy the protection of the duties of care and loyalty. Given, for example, injurious management self-dealing, a holder of preferred has the same standing as a holder of common to enforce the duty of loyalty in a derivative action.[54] But once we get past cases in which the preferred and the common share an interest in good, clean management, tensions between the contract and corporate paradigms undermine the preferred stockholder's case for fiduciary beneficiary status.

There are three countervailing considerations, the first two of which are corporate. First, the preferred's financial interest is defined by contract rights that conflict intrinsically with the interests of the common, and corporate law generally resists attempts to bring adverse contract counterparties inside the fiduciary tent.[55] Second, it is thought that a single-minded focus on the common interest keeps management better focused on value

bonds. *See, e.g.*, Ad Hoc Comm. for Revision of the 1983 Model Simplified Indenture et al., Am. Bar Ass'n, Revised Model Simplified Indenture, 55 Bus. Law. 1115, 1134-35 (2000); *see also* Dawson v. Pittco Capital Partners, L.P., C.A. No. 3148-VCN, 2012 WL 1564805, at *17-19 (Del. Ch. Apr. 30, 2012) (addressing the question of whether a debt claim should be attached to a preferred stock interest or considered separately).

53 For the first in a line of important majority–minority cash-out merger cases in Delaware, see Weinberger v. UOP, Inc., 457 A.2d 701, 711-12 (Del. 1983) (noting that the "transaction [did not satisfy] any reasonable concept of fair dealing," due to a lack of disclosure of key factors to the minority stockholders).

54 *See, e.g.*, MCG Capital Corp. v. Maginn, No. 4521-CC, 2010 WL 1782271, at *6 (Del. Ch. May 5, 2010) ("Nothing in the statutes, rules of procedure, or case law of this state expressly prevents preferred shareholders, as opposed to common shareholders, from pursuing a derivative action.").

55 *See, e.g.*, Simons v. Cogan, 542 A.2d 785, 791 (Del. Ch. 1987) (refusing to extend fiduciary protection to convertible bondholders); Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (refusing fiduciary protection to bondholders subject to an exchange offer, and noting, more broadly, that it is "[t]he terms of the contractual relationship agreed to and not broad concepts such as fairness [that] define the corporation's obligation to its bondholders").

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maximization.[56] The third consideration is contractual: protective contract terms are available to preferred while publicly traded common tends to draw its rights from corporate law's background default regime.

However, the Delaware courts do entertain preferred claims of unfair treatment in the context of divisions of merger proceeds. This line of cases dates back to the early twentieth century but consists of cases that, at best, tentatively recognize these preferred rights.[57] These cases take such a tentative approach that the Delaware Chancery Court recently expressed second thoughts about the whole enterprise in *LC Capital Master Fund, Ltd. v. James*.[58]

This Part conducts a de novo review of preferred stockholders' rights in the merger context. Section II.A lays out the policy alternatives: (1) fiduciary scrutiny for preferred (which poses a difficult follow-up question about the proper standard of review) versus (2) the complete rejection of fiduciary scrutiny for preferred on the grounds that their rights are contractual and that the statutory appraisal remedy always provides adequate protection against oppressive treatment. Section II.B reviews Delaware precedent and shows that its reliance on both of the foregoing alternatives imbued it with internal contradictions. Section II.C considers the *James* opinion, which pushes in the direction of the contractual alternative in looking negatively at the fiduciary precedent without explicitly overruling it. We conclude that fiduciary review remains a necessary part of the law surrounding preferred rights in mergers, held in reserve for extreme cases. More particularly, given a merger allocation effected by a preferred issuer's independent directors, good faith suffices as the standard of review, but the issuer's board of directors should bear the burden of proof on the good faith question. Our treatment follows from a critical legal conclusion: preferred shareholders have no corporate law right to share in merger gain.

A. *The Problem and the Alternative Solutions*

Mergers of preferred issuers tend to create allocational problems on the moderate downside. To see why, compare the downside and upside extremes. On the extreme downside, the issuer's debt load is unsustainable and any

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[56] *See, e.g.*, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (noting that board imposition of risk upon preferred combined with "board action . . . taken for the benefit largely of the common stock . . . do[es] not constitute a breach of duty").

[57] *See infra* text accompanying notes 91-93.

[58] *See* 990 A.2d 435, 438 (Del. Ch. 2010) (asserting that a board's duty regarding allocating consideration between common and preferred in a merger is "gap-filling" and is only present where "there is no objective basis to allocate consideration," and further, that a board need only "allocate[] consideration in a manner fully consistent with the bottom-line contractual rights of the preferred").

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acquisition is likely to be through a Chapter 11 reorganization where the preferred's contract rights will be transformed into a matured claim with priority over the common.[59] On the upside, there is plenty for everybody so there is not much about which to fight. The preferred's dividends are paid up. If the preferred shareholders are fortunate enough to have a conversion privilege, they can protect themselves by converting. If they have no conversion privilege, the preferred's share of the issuer's value likely is capped at the stated liquidation amount, and there will be no serious argument that the preferred is worth less.[60] If the acquiring corporation wants the preferred out of the surviving corporation's capital structure, it can redeem the issue at the principal amount stated in the charter. If the acquiring corporation deems the preferred's financial terms favorable, it can leave the preferred in place.

Things are less clear-cut when a merger occurs on the moderate downside. To set up the problem, let us return to ABC Corporation and its $100 million market capitalization comprised of 1 million preferred shares trading for $80 and 2 million common shares trading for $10, with the preferred's liquidation preference and dividend arrearages totaling $150 per share. Assume that ABC's board of directors has entered into a merger agreement with XYZ Corporation for a consideration of $140 million. Further, assume that the board has fulfilled its duty to obtain a beneficial merger price[61] and that the acquirer wishes to cash out the preferred along with the common. A question arises regarding the preferred's share of the merger proceeds of $140 million—a share to be assigned by the issuer's board of directors.

We pose three possible results: Allocation 1 splits the $40 million merger gain evenly (if not pro rata)[62] with $100 million to the preferred and $40 million to the common; Allocation 2 splits the proceeds with $80 million to the preferred and $60 million to the common, thereby leaving the preferred in its premerger market position and allocating the entire gain to the common; and Allocation 3 gives $70 million to the preferred and $70 million

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[59] *See* BRATTON, *supra* note 23, at 544-45 ("The maturing of the claim results either from the express terms of the investment contract, which typically accelerate maturity on the default, or from the formal 'sale' of the debtor's property and liquidation of the debtor . . . .").

[60] Cases in this area address the other, related question of whether the preferred is worth more than the liquidation value, a matter of charter interpretation. *See, e.g.*, *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 977 (Del. Ch. 1997) (interpreting Delaware law to allow charters to establish the value of preferred stock outside of the appraisal process).

[61] *See* Paramount Commc'ns v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994) (describing a duty to search for "the best value reasonably available" given a sale of control).

[62] A pro rata split of the merger gain by number of shares would be $93.33 to the common and $46.67 million to the preferred. A pro rata split by reference to premerger market value would be $112 million preferred to $28 million common.

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to the common, thus transferring $10 million of the preferred's ex ante market value to the common.

The corporate and contract paradigms suggest contrasting responses when the preferred come to court and argue that a board's allocation is unfair. Under the corporate paradigm, the court entertains the fiduciary claim—a decision that requires articulating a standard of review. Under the contract paradigm, the court withholds fiduciary scrutiny on the ground that the preferred could have contracted for protection; preferred shareholders, having failed to do so, have left only the statutory appraisal remedy. We will show that both approaches are plausible but also problematic.

1. Fiduciary Treatment and Standards of Review

A decision to subject a preferred–common allocation of merger proceeds to fiduciary review follows from a rough analogy to duties for majority–minority common shareholders. Although the preferred stock contract might have specified a merger payout in advance (for example, liquidation value or liquidation value plus arrearages), it does not. This omission leaves the preferred in a vulnerable position—members of a board of directors who owe their positions to the votes of common stockholders fix the value of its participation. The common thus in some sense "control" the board. If the board, instead of proceeding in an even-handed way, skews the allocation of merger gain to the common, the situation arguably is one of a majority-dominated board using its control power to exclude the "minority" preferred to its detriment.[63]

The claim is stronger under Allocation 3, with its negative-sum wealth transfer, than under Allocations 1 and 2. No action can be grounded on the fact that an allocation falls short of the preferred's $150 liquidation preference. The Depression-era courts rejected such an absolute priority theory of fairness[64] and the Delaware courts have maintained that view in the cash-out merger context.[65] The law thus does not provide an objective calculus of fair allocation. Indeed, contemporary courts avoid such pie-slicing inquiries and instead review the boardroom process that resulted in the merger.

With process as the focus, courts must choose a standard of review. Corporate law offers a choice between the strict intrinsic fairness test and the

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63 The classic Delaware case is *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720, 723 (Del. 1971), in which the court found that slow liquidation through dividend payments did not constitute self-dealing, and thus was subject only to the more deferential business judgment standard.

64 *See supra* notes 36-37.

65 *See* Rothschild Int'l Corp. v. Liggett Grp. Inc., 474 A.2d 133, 137 (Del. 1984) ("Moreover, the measure of 'fair value' is not 'liquidation value.'").

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less strict good faith standard, with variations within the two categories. Formulating and then sticking with a given standard will prove difficult because the analogy to majority–minority fiduciary duties may be stronger or weaker depending on the issuer's shareholding configuration. Accordingly, we analyze the standard of review question through two shareholding lenses—first, from the perspective of a blockholder-dominated board, and second, from the perspective of an independent-director board elected by dispersed shareholders.

a. *Blockholder Domination*

We begin with a board dominated by a blockholder, in which the blockholder owns a majority of the common shares and its agents comprise a majority of the company's board of directors. The merger allocation thus deeply implicates the blockholder's financial interests. Indeed, the situation strongly resembles the well-worn fact pattern of a parent–subsidiary merger where the parent company merges the subsidiary into itself using its control power to effect a lowball payment to the subsidiary's minority shareholders.[66] The best the preferred can expect is Allocation 2, yet they should be prepared for Allocation 3.

Analogizing this blockholder-dominated board situation to parent–subsidiary mergers should result in intrinsic fairness as the standard of review, with the burden of proof on the controlled board.[67] Under the parent–subsidiary merger cases, the fairness burden of proof can be shifted to the challenger if the subsidiary board appoints a special committee of independent directors to negotiate the merger price on the minority shareholders' behalf and accords the committee veto power.[68] It would seem to follow that the preferred here should have a veto-wielding special committee of disinterested directors appointed to negotiate its merger allocation.

However, the analogy is imperfect. In the parent–subsidiary context, intrinsic fairness review and the resulting special committee force a negotiation

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66 *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969, 979-80 (Del. 1977) (finding that a merger executed "solely to *eliminate* the minority" is a violation of the corporation's fiduciary duty), *overruled by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); *see also Weinberger* 457 A.2d at 715 (eliminating the extra protection provided shareholders by the business purpose requirement of the *Singer* line of cases and its progeny, and instead noting that "the expanded appraisal remedy," coupled with the Chancellor's broad discretion, is adequate protection for shareholders).

67 *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) (explaining the entire fairness standard and its burden of proof).

68 *See, e.g.*, *id.* at 1117 & 1121 n.10 (noting the burden shift but emphasizing that the standard remains "entire fairness").

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over a single point—the value of the subsidiary. Once the value is set, the relative proportions of stock ownership determine its allocation. The preferred's place in a merger is more complicated. The issuer, its majority stockholder, and its board negotiate the company's value with a third-party acquirer. A committee of independent directors may take the lead in that process on the issuer's behalf.[69] A second special committee representing the preferred would address an ancillary allocational matter—a matter unlikely to admit of a clear answer. The appearance of such an additional committee in the merger process would be cumbersome at a minimum. It also could be disruptive where the primary negotiation with the third-party acquirer (or group of potential acquirers) is ongoing. For instance, assume that a tentative price is on the table, but that questions remain open about the mode of payment (cash or stock) and acquirer financing (whether it will borrow money or issue new preferred). A second negotiation between the target issuer and its own preferred could raise valuation questions with spillover effects on valuation at the primary negotiation.

If the company deemed salient the potential negative consequences associated with a second preferred committee, it would refuse to form the committee, thereby remitting the preferred allocation to the special committee charged with approving the terms of the merger. The refusal would be significant, for independent-director negotiation is sufficient to shift the burden of proving unfairness, whether as to process or to price, to the complaining preferred.[70]

b. *Dispersed-Common Standard of Review*

Contrast the above with a case where both the common and preferred are widely held and a majority of the board is independent, and the independent directors own some common, either awarded as incentive compensation or purchased as a bonding exercise. Assume the merger leads to

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69 The independent committee rule originated in the cashout merger context. *See Weinberger*, 457 A.2d at 709 n.7 (suggesting an independent committee as a best practice and noting that "fairness . . . can be equated to conduct by a theoretical, wholly independent board of directors"). Today, companies most often form special committees when the interests of the sell-side corporation's managers are tainted by conflict. *See, e.g.*, Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 504 (Del. Ch. 2010) (noting creation of a special committee of "non-management directors" where "the cross-holdings" and shared interests of some members of the board of the two firms may have presented conflicts of interest). Though common, such special committees are not ubiquitous. *See, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 237-39 (Del. 2009) (detailing acquisition negotiations between two CEOs).

70 *See Kahn*, 638 A.2d at 1117 ("[A]n approval of the transaction by an independent committee of directors . . . shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.").

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Allocation 2. One can still draw an inference of self-interest—the preferred get no share of the merger gain—but one also can give the independent board members the benefit of the doubt. Dispersion of the set of voting principals arguably relieves the board of pressure to skew the distribution in the common's favor. If the directors' holdings of common do not comprise significant portions of their personal wealth, we can imagine them as credible independent decisionmakers constrained by reputational interests. From this perspective, these directors are no less able to dispose of their financial conflict than to handle a conflict posed by a self-dealing transaction between a top manager and the company, a job they are routinely called on to perform. Leaving the decision to the business judgment of independent directors therefore seems more reasonable than in the blockholder case, discussed above in subsection II.A.1.a.

Thus, for the standard of review in this situation, we abandon the analogy to parent–subsidiary mergers that applied in the blockholder context and instead adopt an analogy to independent-director review of a management self-dealing transaction. In recent years the courts have relaxed the standard of review for these determinations. Under the former standard, the test was intrinsic fairness with the burden of proof on the plaintiff as long as disinterested directors had approved of the transaction.[71] More particularly, a board defending its approval of a self-dealing transaction would have the burden of proving its own disinterestedness and inquiry into the terms of the transaction.[72] If the board satisfied this burden, the plaintiff still would have a chance to prove that the value allocation was substantively unfair.[73] Such a showing would seem easy to make under Allocation 3, arguable under Allocation 2, and quite difficult under Allocation 1. Under the current, relaxed standard, however, the business judgment standard of review applies once a majority of the board's informed, disinterested directors approve the transaction.[74] At this point the plaintiff loses his direct

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71 *See, e.g.*, Cooke v. Oolie, Civ.A. No. 11134, 1997 WL 367034, at *9 (Del. Ch. June 23, 1997) ("It is now clear that even if a board's action falls within the safe harbor of section 144, the board is not entitled to receive the protection of the business judgment rule. Compliance with section 144 merely shifts the burden to the plaintiffs to demonstrate that the transaction was unfair.").

72 *See* DEL. CODE ANN. tit. 8, § 144(a)(1) (2011) (eliminating a presumption of invalidity for interested transactions provided that the director's or officer's interests are disclosed to the board and it "in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors").

73 *Id.* § 144(a)(3); *see also In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 757 (Del. Ch. 2005) ("If plaintiffs succeed in rebutting the presumption of the business judgment rule, the burden then shifts to the defendants to prove . . . that the challenged transactions were entirely fair to the corporation."); *supra* note 71 and accompanying text.

74 Benihana of Tokyo, Inc. v. Benihana Inc., 906 A.2d 114, 120 (Del. 2006).

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shot at showing substantive unfairness and instead must show that the board acted in bad faith.[75]

2. Contract Treatment

This subsection examines the possibility of full-dress contract treatment. Under this approach, courts will refuse entirely to conduct fiduciary review, leaving complaining preferred holders with only the statutory appraisal remedy.

a. *The Preferred Contract as Complete*

A contractarian could defend corporate fiduciary law on the ground that common stockholders invest pursuant to an incomplete contract.[76] The common takes the residual interest along with the right to elect the board, but beyond that relies on the board's capabilities and fidelity along with the backstop terms of corporate law. Protecting that reliance with fiduciary principles is thought to be more efficient than forcing common stock investors to specify their rights ex ante.[77] Indeed, the set of possible contingencies for the common is so large as to make ex ante contractual specification unfeasible.[78] Since stockholder interests are so broad as to be noncontractible, incomplete transactions are inevitable, and therefore make fiduciary protection necessary.

Preferred stock arguably differs because its preferences are contracted for and presumably can be protected with explicit provisions. Indeed, there are well-known means of dealing with skewed merger allocations. The

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75 *See id.* ("[T]he business judgment rule is a presumption that in making a business decision, the directors of a corporation acted . . . in good faith." (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))).

76 Marco Becht et al., *Corporate Governance and Control* 9-10 (European Corporate Governance Inst., Finance Working Paper No. 02/2002, 2005); *cf.* Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1205-06, 1210-11 (1984), *available at* http://papers.ssrn.com/id=343461 (describing shareholders as those who own "numerous and ill-defined [assets, which] cannot be protected in a well-focused, transaction-specific way").

77 For an example of the contemporary view of fiduciary duty as a default "gap-filler," see Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 CARDOZO L. REV. 491, 503-04 (2012). This basic proposition notably appeared in Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1432-34 (1989). Recent experience with other forms of business organization provides a basis for questioning this assumption. *See, e.g.*, Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 233-36 (2009) (discussing Delaware's contractual treatment of LLCs and LPs and contending that the default standard of conduct should be contract good faith rather than fiduciary duty).

78 *See* Williamson, *supra* note 76, at 1210-11 (discussing various protections necessary to safeguard the rights and interests of shareholders).

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charter can dictate a merger price or otherwise provide that a merger constitutes a liquidation event and condition the transaction's effectiveness on payment of the liquidation preference.[79] Alternatively, the charter can require a class vote of the preferred to approve any merger, according the preferred a veto-group veto.[80] As a further alternative, the charter can require that the preferred be left unimpaired in the issuer or merger survivor's capital structure.[81]

Given the availability of contractual protection, fiduciary review can be withheld on a penalty default theory.[82] Under this theory, a skewed outcome in individual cases is acceptable on the assumption that withholding scrutiny in the long run causes the preferred to insist that merger contingencies be dealt with in the charter. Incorporating a penalty default here thus leads contractibility to trump fiduciary treatment.

This approach arguably fits in well with the corporate law paradigm that dominates our "shareholder value" era. As between the preferred and the common, today's regime of value enhancement signals the common as the appropriate fiduciary beneficiary because it holds the residual interest. Managing to the common is thought to encourage risk-taking, thereby creating value. The preferred, with its fixed income features, is a more financially conservative interest; therefore, it is best to keep preferred

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79 *See* Matthews v. Groove Networks, Inc., Civ.A. No. 1213-N, 2005 WL 3498423, at *2 (Del. Ch. Dec. 8, 2005) ("Article IV [of the charter] clearly expresses that the Liquidation Preference will apply in the event of a merger."); *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 974 (Del. Ch. 1997) ("[P]roperly expressed terms . . . may establish the consideration to which holders of the [preferred] stock will be entitled in the event of a merger . . . .").

80 *See* DEL. CODE ANN. tit. 8, § 151(a) (2011) ("Every corporation may issue 1 or more classes of stock[,] . . . which classes or series may have such voting powers . . . as shall be stated or expressed in the certificate of incorporation . . . .").

81 Such a provision might allow a survivor other than the original issuer to issue a substantively equivalent class of stock. In the preferred stock contracts collected and reviewed for this Article, the alternative of leaving the preferred in the issuer capital structure showed up as a condition excusing application of a class vote provision; that is, if the preferred is left untouched, the preferred holders get no class vote. For information on the contracts we examined, see *infra* notes 85-87.

82 *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97-99 (1989) ("Penalty defaults, by definition, give at least one party to the contract an incentive to contract around the default."). Cases applying business judgment review to board allocations between holders of common and tracking stock (the returns of which are tied to the performance of a subdivision of a larger corporate group) provide support for a penalty default approach. *See, e.g.*, *In re* Gen. Motors Class H S'holders Litig., 734 A.2d 611, 619 (Del. Ch. 1999) ("This case is thus substantively indistinguishable from those in which . . . a board's alleged evasion or breach of a charter provision for the benefit of a particular class of stockholders could be asserted only as a contract claim, not as a claim for breach of fiduciary duty."); Solomon v. Armstrong, 747 A.2d 1098, 1118 (Del. Ch. 1999) (denying plaintiffs' claims that the board violated its duty of loyalty by "load[ing] the process against the Class E shareholders").

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holders' interests out of the boardroom and instead force them to make their rights explicit on paper. In short, if the legal regime should stress maximizing value *for the common*, then any judicial intervention against a merger allocation that favors the common traverses a *grundnorm,* and is, by definition, inefficient.

A penalty default thus makes theoretical sense. It does not necessarily follow, however, that it makes cost sense in the real world, even to a common stockholder. Penalty defaults, as mooted in law and economics, do not force contracting for its own sake. Rather, by fixing the default at a result neither party is likely to want,[83] the rule compels parties to adjust by negotiation, thereby causing them to achieve an efficiency goal, such as the disclosure of more information or the invention of superior contract terms.[84] The additional information and new terms facilitate a more efficient allocation of risk in the contract. However, in the merger context, it is not clear that any efficiencies could be gained through the use of a penalty default. Nor is it clear that judicial intervention respecting merger allocations somehow constrains boardroom discretion to take risks. The intervention questions only an end-period decision, and does not envision preferred stock–value maximization as a going-concern fiduciary proposition.

More importantly, penalty default treatment of the preferred could disserve the common stock interest. For an illustration of this disservice, consider the following question: Why do preferred stock charter provisions often fail to provide for a merger class vote? We located new issues of preferred registered for public offering since 2009 on the SEC's EDGAR database and surveyed their certificates of designation.[85] Fifty percent of the certificates provided for merger class votes (or otherwise included effective protection in the event of a merger), while the other 50% left the preferred unprotected.[86] We also examined the certificates of preferred stock privately placed during the second quarter of 2011 and filed in EDGAR as disclosure exhibits. Only 29% of these certificates provided for merger class votes (or

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83 *See* Ayres & Gertner, *supra* note 82, at 97 ("The U.C.C.'s zero-quantity default is . . . a 'penalty default' . . . that neither party would want . . . .").

84 *Id.* at 97-99.

85 *Historical SEC EDGAR Archives: Company Search*, SEC, http://www.sec.gov/cgi-bin/srch-edgar (last visited May 6, 2013). Using EDGAR's advanced search function, we queried "certificate of designation," sorted results to isolate reports of newly filed preferred stock financings, and omitted filings of poison pill preferred certificates of designation.

86 The dataset contains twenty-two certificates of designation. *But cf.* Jeffrey S. Stamler, Note, *Arrearage Elimination and the Preferred Stock Contract: A Survey and a Proposal for Reform*, 9 CARDOZO L. REV. 1335, 1352 (1988) (observing in a survey of New York Stock Exchange–listed preferred that only 14% of the issues had the benefit of a class vote in a merger).

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otherwise included effective protection in the event of a merger).[87] Issuers have a legitimate reason to resist the inclusion of merger class vote provisions in their charters. Class votes give preferred the ability to hold up a merger in moderate distress situations. Return to our ABC Corporation hypothetical, where a class vote would hand the preferred a bargaining chip for a premium price above $80. The preferred would only vote in favor of the merger when the allocation so favored the preferred as to cause the merger to lose the common's voting support. If the preferred stock lies in institutional hands, an aggressive negotiation is likely. Omitting the class vote makes it easier to sell the company and avoids a possible allocational skew that favors the preferred.

The same analysis applies to clauses that treat mergers as liquidations. The issuer has every reason to resist this concession. For example, with ABC Corporation, the preferred's liquidation preference soaks up the entire merger proceeds.[88] Under that scenario, ABC would have to negotiate with the preferred to get them to agree to the company paying less, using its privilege to walk away from the deal as a lever. Liquidation preference payment provisions thus make merger negotiations much more time-consuming and potentially less remunerative. From the issuer's point of view, then, a legal regime that pushes investors toward insisting on liquidation treatment makes little sense.

Alternatively, the preferred could contract for the right to remain in the capital structure of the entity surviving the merger, but such an approach also ties the issuer's hands. A potential acquirer of ABC Corporation is unlikely to favor retention of a preferred class with $50 in arrears. If it acquires ABC anyway, the price it pays to the common will have to be adjusted downward due to the cost of the preferred's accumulated contractual baggage.[89]

The contractual back-and-forth bolsters the case for fiduciary review. The best explanation for a preferred stock contract that omits to specify a merger price or provide for a class vote is the issuer's interest in avoiding a commitment to pay the preferred a premium over premerger value on a

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87 The dataset contains sixty-eight certificates of designation.

88 See *supra* Section II.A for an overview of the potential merger terms for ABC Corporation.

89 We also note that the preferred could contract for across-the-board appraisal rights. *See* DEL. CODE ANN. tit. 8, § 262(c) (2011) ("Any corporation may provide in its certificate of incorporation that appraisal rights under this section shall be available for the shares of any class or series of its stock as a result of an amendment to its certificate of incorporation, any merger or consolidation in which the corporation is a constituent corporation or the sale of all or substantially all of the assets of the corporation."). Such a move would blunt, but not reverse, the negative effects on preferred investors of a penalty default regime. Still, if fiduciary scrutiny is to be withheld, across-the-board appraisal rights would be better effected as a legislative adjustment.

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moderate distress fact pattern. The omission expands the issuer's zone of freedom of action and so facilitates enterprise value enhancement. While the omission is thus clearly rational for the issuer, it is only rational for the preferred if fiduciary duties cover merger allocations made by the issuer board of directors.

b. *Appraisal Rights*

The availability of statutory appraisal strengthens the case for contract treatment.[90] Under this remedy, dissatisfied shareholders can dissent from unfavorable mergers and demand a judicial appraisal of the value of their shares.[91] Let us imagine that the ABC Corporation merger payout goes to appraisal. The inquiry concerns the "fair value of the shares exclusive of any . . . value arising from . . . the merger"[92] and so is not about reaping a share of merger gain. Assuming that the $80 premerger market price reflected the value of the preferred, appraisal looks attractive only given Allocation 3. If, under Allocation 2, the preferred holders see the $80 market price as inaccurately low, they must marshal experts who can plausibly project increasing future ABC cash flows to show that the preferred is cumulatively worth more than $80 million. A successful challenge to Allocation 1 is highly unlikely, for the preferred's $150 million liquidation preference is relevant only to the extent it contributed to its premerger fair value.

Appraisal as the exclusive recourse available to holders of preferred presents several problems. First, virtually no recent case law exists on judicial valuation of preferred,[93] so the substantive parameters of such proceedings

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[90] In a parent–subsidiary merger case, the plaintiff secures fiduciary review only on a showing of process unfairness. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983) ("The appraisal remedy we approve may not be adequate in certain cases, particularly [those of] fraud, misrepresentation, [or] self-dealing . . . ."). If the complaint goes only to price, it generally must be made in an appraisal. *See id.* at 714-15.

[91] *See* DEL. CODE ANN. tit. 8, § 262 (appraisal rights).

[92] *Id.* § 262(h).

[93] But, for a recent appraisal proceeding of preferred, see generally *In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893 (Del. Ch.), *aff'd*, 985 A.2d 389 (Del. 2009). That case, however, was not relevant to our question since the court decided it by reference to conversion value, rather than to the expert reports. *See id.* at 901-02. *See also* Gearreald v. Just Care, Inc., C.A. No. 5233-VCP, 2012 WL 1569818, at *8-9 (Del. Ch. Apr. 30, 2012) (holding that the preferred stock should be treated as converted in appraisal for a venture capital investee pursuant to a charter provision allowing the company to convert preferred shares to common if a merger occurs). Historically, however, valuation of preferred was litigated under PUHCA. *See, e.g.*, E. Gas & Fuel Assocs., PUHCA of 1935 Release No. 9633, 30 SEC Docket 834, 850 (Feb. 3, 1950) (analyzing "the rights attaching to the securities with respect to earnings, dividends, and assets" in determining if allocations are fair); Note, *A Standard of Fairness for Compensating Preferred Shareholders in Corporate*

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are a matter of speculation. Preferred holds out daunting problems for appraisers. Not only must they project a company's future cash flows under uncertainty, but the appraisers also must assess the probability that the issuer board will exercise its discretion to direct the projected flows to a future preferred dividend or redemption payment. Second, the process context in appraisal is not plaintiff-friendly. Appraisals may not be framed as class actions.[94] Appraisal plaintiffs accordingly must be large stockholders acting for their own accounts. This problem is less important today than it was formerly, due to the proliferation of hedge funds as strategic investors in publicly traded equity[95] and preferred's position as the vehicle of choice in venture capital finance.[96] Preferred stockholders thus increasingly tend to be large institutions with the wherewithal to undertake expensive appraisal litigation.[97] Third, the Delaware statute makes appraisal available only for a subset of mergers. Appraisal rights obtain if the preferred is privately held, as is the case with venture capital financing or a rule 144A offering[98] resulting in fewer than 2000 holders of record.[99] Appraisal also is available if the preferred stock is publicly traded and the merger consideration is cash or debt securities.[100] But there are no appraisal rights if the preferred is publicly traded and the merger consideration is publicly traded stock.[101]

To show how the three problems can combine to undermine the proposition that appraisal is an "adequate remedy," let us return to the dummy merger. Recall that dummy mergers provide a means to cram down an equity

Recapitalizations, 33 U. CHI. L. REV. 97, 102-03 (1965) (discussing the valuation method used in PUHCA cases).

94 *See* DEL. CODE ANN. tit. 8, § 262(d)(1) (requiring appraisal claimants to file individually). The Delaware courts apply this individual filing requirement literally. *See, e.g,* Nelson v. Frank E. Best Inc., 768 A.2d 473, 479 (Del. Ch. 2000) (observing "Delaware Supreme Court case law requiring a strict construction of 8 *Del. C.* § 262").

95 *See Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?*, M&A DEAL COMMENTARY (Latham & Watkins LLP, New York, N.Y.), May 2007, at 1-2, *available at* http://www.lw.com/upload/pubcontent/_pdf/pub1883_1.pdf (suggesting that hedge fund plaintiffs could make appraisal rights a more salient legal procedure for investors dissatisfied with merger proceeds).

96 *See* Bratton, *supra* note 2, at 914-16.

97 *See, e.g.*, MARK J. ANSON ET AL., THE HANDBOOK OF TRADITIONAL AND ALTERNATIVE INVESTMENT VEHICLES 328-29 (2010) (discussing hedge fund strategies involving preferred).

98 *See generally* BRATTON, *supra* note 23, at 297 (summarizing rule 144A offerings).

99 DEL. CODE ANN. tit. 8, § 262(b)(1).

100 *See id.* § 262(b)(1)–(2) (blocking appraisal rights where stock is publicly traded except in cases where holders are required to accept "[s]hares of stock of the corporation surviving or resulting from such merger or consolidation . . . [or s]hares of stock of any other corporation . . . which . . . will be either listed on a national securities exchange or held of record by more than 2,000 holders").

101 *Id.*

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recapitalization against preferred, and that the Delaware courts sanctioned the technique in *Havender*.[102]

Let us turn back the clock at ABC Corporation to the time of the preferred's original public issue for $100 per share, for a total consideration of $100 million. Assume that times were good and that the 2 million shares of common trade for $100 per share. Two months later, an investment banker approaches ABC with a recapitalization plan under which the board engineers a dummy merger on a one-for-two basis. This merger would divide ABC's market capitalization, allocating one-fifth to the preferred ($60 million) and four-fifths to the common ($240 million). ABC submits the merger to its stockholders, and the common uses its majority to cram down the deal. ABC's preferred will not have the right to seek appraisal—the premerger preferred is publicly traded and the stockholders receive publicly traded stock as consideration in the merger, so the appraisal statute's exceptions apply.[103]

The ABC preferred's goose is cooked unless it can persuade a court to enjoin the transaction on fiduciary grounds. Although the hypothetical is unrealistic, it makes an important structural point regarding the vulnerability of the preferred: the level of exposure is more severe than often recognized, potentially permitting even this quasi-conversion of newly raised capital. Indeed, even if appraisal were available in this dummy merger, it would be unreasonable to leave it as the exclusive remedy for the preferred. The transaction is in manifest bad faith, and an ex ante injunction is the cleanest, most appropriate mode of intervention. Interestingly, an old line of Delaware cases waives appraisal exclusivity and permits injunctions against dummy mergers following from "acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error of judgment."[104] It bears noting that dummy mergers still occur,[105] if not in the particularly

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102 *See supra* text accompanying notes 38-47.

103 *See supra* note 101 and accompanying text.

104 Porges v. Vadsco Sales Corp., 32 A.2d 148, 150-51 (Del. Ch. 1943); *see also* Hottenstein v. York Ice Mach. Corp., 45 F. Supp. 436, 438 (D. Del. 1942) ("In actions to enjoin the operation of a plan of merger . . . the Court may afford relief only if it finds that the plan is so unfair as to shock the conscience of the court and to amount to fraud." (citation omitted)); Cole v. Nat'l Cash Credit Ass'n, 156 A. 183, 187 (Del. Ch. 1931) ("Furthermore, if consent to the merger be induced by fraud practiced upon a consenting company, a stockholder is under no duty to elect whether he will abide by a merger so induced or take his money."). For a seminal discussion of the exclusivity of appraisal as the preferred shareholder's remedy in a merger context, see James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1208-10 (1964).

105 *See, e.g.*, Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 844 (Del. 1998) (describing a wholly owned subsidiary into which the parent corporation announced its plan to merge one day after creating it).

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crude mode hypothesized here. We can likely attribute corporate restraint to the prospect of judicial scrutiny.

3. Summary

A plausible case can be made for both corporate and contract treatment for preferred in the merger context. At the same time, each paradigm leads to excess when applied full dress. Intrinsic fairness review under the corporate paradigm could unravel negotiations and in any event would occasionally hold up lawsuits by institutional preferred holders. Complete contract treatment coupled with appraisal exclusivity is untenable in extreme cases. A door needs to be left open for judicial scrutiny of the motivation for and effect of mergers. This qualified conclusion confirms our point about the intrinsic legal instability of preferred stock—because it straddles the corporate–contract divide, every problem admits a range of solutions. The next section turns to Delaware law and illustrates, through analysis of decided cases, this conceptual instability in action.

We note a point of contrast between the equity recapitalizations discussed in Part I and the mergers under discussion in this Part. Both involve transactions that create gain and trigger the carving of corporate pies. In both cases the pie can be sliced either (1) to split the gain between the preferred and the common; (2) to leave the preferred at its pretransaction value and allocate all the gain to the common; or (3) to transfer pretransaction value from the preferred to the common along with all of the gain. Assuming corporate treatment and fiduciary scrutiny, two questions arise: First, does the preferred have a right to gain-splitting in a recapitalization, a merger, both, or neither? Second, does a transfer of pretransaction value from the preferred to the common breach a right owed to the preferred in a recapitalization, a merger, both, or neither? We think that with regard to the gain-splitting question, the two transactional modes can be distinguished.

A recapitalization strips rights from the preferred to enhance enterprise value. The transaction makes everybody better off only so long as the gain is shared; a class vote imports a circumstantial guarantee that such sharing occurs. Given no gain sharing and absent class consent, the preferred surrenders rights without any return. Leaving the preferred holders stuck with their shares' pretransaction value differs from an affirmative transfer of value from the preferred to the common only as a matter of degree—either way, pure exploitation occurs.

Third-party mergers are different. The gain comes from an outside purchaser rather than from a sacrifice by the preferred. Moreover, there are fact patterns on which it is quite clear that the preferred has no right to share

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the gain. In an upside scenario where the company has grown and the preferred stock's premerger value is higher than its face value (whether due to an attractive dividend payout or a conversion privilege in the money), the merger parties will likely exercise their option to take out the preferred at its redemption price before any question about gain sharing arises. In other words, the preferred are treated as senior claims with a capped upside. In downside patterns, where the preferred's market value is below its liquidation value, the holders have a right to liquidation value in a merger only if the charter explicitly so provides.[106] A preferred stockholder's right to share merger gain in the downside fact pattern—an amount higher than the stock's premerger value but lower than its liquidation value—could be implied by analogy to the rights of minority common stockholders. But it is not at all clear that such an analogy should be drawn here. Nothing compels it, and reference to the contract paradigm undercuts it: if the preferred holders want a premium, all they have to do is negotiate a class vote.

B. *Delaware Law*

In this section, we put the hypothetical ABC Corporation preferred through a modern cashout merger, applying Delaware cases decided prior to the recent decision, *LC Capital Master Fund, Ltd. v. James*.[107] Section II.C reconsiders matters in light of *James*.

We will start the ABC Corporation cashout merger with one changed fact from our previous discussion of the company—the preferred's liquidation price plus arrearages now adds up to only $110 per share. XYZ Corporation proposes a $140 million cash merger to the ABC board, offering $110 per share for the preferred and $15 per share for the common. As has happened in litigated cases, XYZ makes its bid under the impression that the preferred must be paid its liquidation preference in order to be cashed out in a merger.[108] ABC's investment banker points out the error to XYZ at the same time that ABC's CEO suggests that the bid should allocate more to the common. XYZ reformulates the bid accordingly. The new bid is for the same total consideration, but now the offer is $80 per share for the preferred

106 *See* Rothschild Int'l Corp. v. Liggett Grp., Inc., 474 A.2d 133, 137 (Del. 1984) (holding that "the stockholder is entitled to be paid for . . . his proportionate interest in a going concern," not liquidation value (quoting Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950))).

107 990 A.2d 435 (Del. Ch. 2010).

108 *See, e.g.*, *id.* at 441 (noting the preferred's "mistaken view that they had a right to their liquidation preference" and the bidders' initial offers in light of that view); Dalton v. Am. Inv. Co., 490 A.2d 574, 576 (Del. Ch. 1985) (observing that the bidder offered a "$25 redemption and liquidation value . . . [for preferred shares] trading for about $9").

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and $30 per share for the common. ABC's top executives collectively hold 15% of the common and no preferred. A majority of ABC's directors are independent, and all of these directors hold trivial amounts of the common and no preferred. After the reformulation of the bid, ABC organizes a committee of independent directors. The committee negotiates the merger and secures $10 million additional consideration. The added consideration is distributed between the common and the preferred in proportion with the existing allocation, making the final price $85.70 per share for the preferred and $32.15 per share for the common. The special committee determines the preferred–common allocation to be fair—a conclusion in line with that of its investment banker. At no point, however, does the committee consider the origins of the allocation or inquire further into the value of the preferred's claim. Nor does the committee request a valuation report addressing the allocational question from the investment banker. The preferred will not have a class vote because the charter does not provide for one, but in this case it will have appraisal rights.[109]

Claiming a breach of fiduciary duty by the ABC board, the preferred bring an action in the Delaware Chancery Court to enjoin the merger. The Delaware cases do not entirely reject this line of argument, but it is unlikely to succeed.

We already have seen that old dummy merger cases express a preference for the appraisal remedy but hold out the possibility of an injunction against a bad faith cramdown.[110] The modern precedent begins with the standard Chancellor Allen announced in 1986 in *Jedwab v. MGM Grand Hotels, Inc.*:

> [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 right and the scope of the correlative duty may be measured by equitable as well as legal standards.[111]

At a minimum, this standard means that the preferred will not be able to base a fiduciary claim on the merger's failure to yield its $110 liquidation

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109 *See* DEL. CODE ANN. tit. 8, § 262(b)(2) (2011) (granting appraisal rights where the shareholders are cashed out).

110 *See supra* text accompanying notes 102-04.

111 509 A.2d 584, 594 (Del. Ch. 1986).

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preference plus arrears.[112] But it also stands for the proposition that a merger allocation between preferred and common is subject to fiduciary scrutiny.

A question nonetheless arises regarding the standard's division of the field into a *contractual* zone and a *fiduciary* zone. This approach could operate as a filter, dividing merger fact patterns into two groups, one subject to judicial scrutiny and the other immune from it. A specific question would be, if the preferred receive at least what the common receive, have they been treated equally under *Jedwab*? In ABC's case, such a scenario would mean taking the $150 million consideration and distributing it pro rata to the common and preferred at $50 per share. If such a division is "equal," the reason is that any consideration paid to the preferred beyond $50 by definition compensates it for its "contractual" rights and thus lies outside of fiduciary territory. If dissatisfied, the preferred can seek appraisal.

The *Jedwab* court did not directly address the above question,[113] but Chancellor Allen himself impliedly rejected the above narrow reading in a later opinion, *In re FLS Holdings Shareholders Litigation*.[114] In that case, the preferred received slightly more than the common.[115] The board of directors, dominated by representatives of the common, had steadily carved out a larger share for the common in the course of an extended negotiation.[116] Chancellor Allen asserted that the directors still had a duty to both classes and were "obligated to treat the preferred fairly," even though the standard of review was "somewhat opaque."[117]

Both the *Jedwab* and *FLS Holdings* courts discuss boardroom process. *Jedwab* suggests that a special negotiating committee for the preferred, composed of independent directors, is an important factor in a fairness determination,[118] while *FLS Holdings* implies that the presence of "a truly independent agency on the behalf of the preferred" plays an important role in figuring out if a transaction was fair.[119] In *FLS Holdings*, Chancellor Allen added that a valuation study prepared ex post by the board's investment

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112 *See* Rothschild Int'l Corp. v. Liggett Grp. Inc., 474 A.2d 133, 137 (Del. 1984) (rejecting a fairness claim based on the preferred's expectation that they would receive their liquidation preference in a cashout merger).

113 In *Jedwab*, the preferred received *less* than the common, because the preferred's preferences limited its upside potential. 509 A.2d at 597-98.

114 Civ. A. No. 12623, 1993 Del. Ch. LEXIS 57, at *13-15 (Del. Ch. Apr. 21, 1993).

115 *See id.* at *10 (noting that the preferred received $18.124 per share and that the common received $17.998 per share).

116 *Id.* at *2-3.

117 *Id.* at *14.

118 509 A.2d at 599. The opinion also suggests that the existence of a class vote for the transaction is a factor in the fairness analysis. *Id.*

119 1993 Del. Ch. LEXIS 57, at *14.

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banker amounted to a "relatively weak" protection.[120] Yet, ultimately the cases rejected a rule-based approach to process protections, concluding that while "such factors typically constitute indicia of fairness; their absence . . . does not itself establish any breach of duty."[121]

Jedwab and *FLS Holdings* therefore stand for the proposition that the preferred can get more per share than the common and still get a hearing, but the cases do little else to add details to our understanding of preferred rights. Chancellor Allen later characterized the cases as providing a sort of backstop protection for preferred—they get the hearing when in an "exposed and vulnerable position *vis-a-vis* the board of directors."[122] Just what makes for exposure and vulnerability is unclear, although it bears noting that *Jedwab* and *FLS Holdings* involved issuers and boards under the immediate control of majority blockholders.[123] ABC Corporation, by contrast, has dispersed shareholders and a majority independent board.

Jedwab and *FLS Holdings* are not the only modern cases about the scope of fiduciary duties for preferred stock in the Delaware canon. In *HB Korenvaes*, Chancellor Allen later voiced a contractual view of preferred:

> [T]o a very large extent, to ask what are the rights of the preferred stock is to ask what are the rights and obligations created contractually by the certificate of designation. . . . In most instances, given the nature of the acts alleged and the terms of the certificate, this contractual level of analysis will

120 *Id.*

121 *Jedwab*, 509 A.2d at 599-600.

122 HB Korenvaes Invs., L.P. v. Marriott Corp., Civ. A. No. 12922, 1993 WL 205040, at *745 (Del. Ch. June 9, 1993).

123 *Jedwab*, 509 A.2d at 587; *FLS Holdings*, 1993 Del. Ch. LEXIS 57, at *5 (noting that senior management of the company owned 33.78% of the voting stock and Goldman Sachs held 45.56%). A case closer on the facts to ABC's situation is *Dalton v. American Investment Co.*, 490 A.2d 574 (Del. Ch. 1985). In *Dalton*, an initial offeror proposed an eventually aborted merger that would have paid a class of perpetual preferred its liquidation value of $25 and $12 for the common. *Id.* at 576. The issuer's CEO then shopped the company and hinted that $13.50 would be an appropriate price for the common. *Id.* at 577. The eventual acquirer paid $13 for the common and suggested the preferred, which had a low dividend payout rate, be left untouched in the issuer's capital structure as "cheap debt." *Id.* at 577, 581. The court found that the acquirer's interests were the determining factor in the fiduciary analysis. *Id.* at 582-83. Since the acquirer had "its own [legitimate] economic justification" for the way it structured the merger, it followed that there was no breach of duty. *Id.* at 585. The court's emphasis on causation and culpability implies that it was not using the intrinsic fairness standard but rather a standard of review closer to the good faith standard invoked in dummy merger cases and applied by the court in *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 150-51 (Del. Ch. 1943), with its emphasis on "bad faith" and "reckless indifference to the rights of others."

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> exhaust the judicial review of corporate action challenged as a wrong to preferred stock.[124]

Finally, in the last case in the series, *Equity-Linked Investors, L.P. v. Adams*, Chancellor Allen gestured to common stock–value maximization:

> [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.[125]

The applicable Delaware law appears to include the following five principles: (1) fiduciary intervention is possible where the preferred are in an "exposed and vulnerable position;"[126] (2) fiduciary duties are owed regarding rights shared equally with the common but not regarding preferences; (3) boards should prefer the common when exercising discretion; (4) the preferred should generally look to appraisal for a remedy; and (5) the preferred should protect themselves contractually.

This summary reveals that the relevant Delaware law is more than open-ended. It incorporates elements of both of the hard-edged alternatives laid out in Section II.A—fiduciary scrutiny and the view of preferred as a complete contract with appraisal as its exclusive remedy. The various components of the doctrine seem to stand in mutual tension; they do not "synthesize." If the board's duty is to favor the common when making discretionary decisions, it is hard to see how a boardroom process could breach a duty to the preferred, even on Allocation 3. Yet, if the default rule is explicit contractual protection with appraisal as the exclusive remedy for preferred, it is hard to see how vulnerability of the preferred and exploitation of its rights can ever be actionable. The tension follows from preferred's dual corporate and contractual character. Given the long list of choices, the judge in effect must make a menu choice, deciding which paradigm to stress given the facts of the case.

Let us now state a case for why the ABC preferred should receive fiduciary protection. This argument builds on four points about the process surrounding the merger. First, the allocational shift from the preferred to the common came at the insistence of ABC's CEO, who owned a significant chunk of common. Second, the subsequent deal management by ABC's

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124 1993 WL 205040, at *745 (citations omitted); *see also In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 899-900 (Del. Ch. 2009) ("A preferred shareholder's rights are defined in either the corporation's certificate of incorporation or in the certificate of designation . . . .").

125 705 A.2d 1040, 1042 (Del. Ch. 1997) (citation omitted).

126 *HB Korenvaes*, 1993 WL 205040, at *745.

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independent directors failed to correct the allocational mishap because they did not inquire into the causal chain, the acquirer's business interests, or the relative values at stake. Third, all of the independent directors owned common, thus raising a question regarding their actual independence. Finally, the process did not include an independent agent to negotiate for the preferred. The question is whether the four points, taken together, show that the preferred's position was "exposed and vulnerable."

ABC will argue in response that *Jedwab* and *FLS Holdings* do not mandate a special committee[127] and that the availability of appraisal weighs against a request that a merger be enjoined.[128] To the extent the preferred seeks to show that its share of the merger price falls below the stock's intrinsic value, it should seek an appraisal. More importantly, a class of preferred walking away with a premium over market price has no cause to complain; if anyone has a complaint, it is the common whose merger gain has been diverted.

C. James *Analysis*

In *LC Capital Master Fund, Ltd. v. James*, then–Vice Chancellor Strine tilted emphatically toward the contract paradigm. The preferred in question had been issued in a rule 144A offering for $25 per share, an amount equal to its liquidation preference.[129] The charter provided for a $1.375 discretionary but cumulative dividend.[130] The stock was convertible into common at a conversion price of $15.50.[131] The initial $3.10 conversion price was set at the high end of the trading range of the issuer's common stock for the second quarter of 2004.[132] The common's price promptly declined; during the life of the preferred issue, there were only two quarters in which the stock price briefly, and slightly, exceeded the conversion price.[133] In the merger, the

127 *See supra* text accompanying notes 118-19.

128 *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 454 (Del. Ch. 2010) (denying an injunction and citing appraisal rights as an "important factor" in making that decision).

129 *Id.* at 440; QuadraMed Corp., Current Report (Form 8-K), at 3 & exhibit 99.1 (June 17, 2004).

130 *James*, 990 A.2d at 440.

131 QuadraMed Corp., Current Report (Form 8-K), at 4 (June 5, 2008). The price was revised pursuant to the charter in the wake of a reverse stock split by the issuer. The original conversion price was $3.10. *Id.*

132 *See* QuadraMed Corp., Pre-Effective Amendment No. 2 to Form S-1 Registration Statement, at 18 (June 14, 2004) (noting that the stock price ranged from $2.70 to $3.55 during the second quarter of the year through the date of the report).

133 This conclusion follows from an inspection of the quarterly stock price charts in the issuer's 10-K reports filed in 2006 and 2009. The two quarters discussed above are the second quarter of 2004, when the price peaked at $3.55, and the first quarter of 2007, when the price peaked at the equivalent of $3.29, taking into account the one-to-five conversion. QuadraMed Corp., Annual

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common were cashed out at $8.50 and the preferred at $13.71.[134] The $13.71 was derived by applying the conversion ratio (1.6129) to the common's merger consideration[135]—as if the charter provided (though it did not) that a merger triggered a mandatory conversion.[136]

The deal process had been tense. There were discussions with several suitors; one negotiation started out at a $25 per share figure for the preferred.[137] A committee of independent directors then took charge.[138] All members of the committee owned common, four out of five in trivial amounts, but with one holding an 8% block worth over $5.6 million.[139] The committee found itself between a rock and a hard place. The preferred would likely sue if its price was not raised above $13.71. But if the committee was to raise the preferred payout, it would run the risk that the deal would lose the voting support of the common,[140] 83.4% of which was owned by five hedge funds.[141] The committee also may have been wary of an additional potential lawsuit: counsel advised the committee that it needed to be "careful" about allocating more to the preferred, absent "special reasons," due to fears of a suit by common holders.[142] As it navigated these shoals, the committee dragged anchor on cashing out the preferred and tried to cut a deal with a second merger partner that would leave the preferred in the issuer's capital structure untouched, a result that apparently would have satisfied both the common and the preferred. Unfortunately, the second potential merger partner wanted to replace the preferred with debt that torpedoed the deal.[143] In the end, the committee approved the original merger, which cashed out the preferred at $13.71, without the support of a fairness opinion from its investment banker.[144]

The preferred, whose discretionary dividends appear to have been paid up to date,[145] took the position that its financial rights entitled it to a good

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Report (Form 10-K), at 20 (Mar. 10, 2009); QuadraMed Corp., Annual Report (Form 10-K), at 29 (Mar. 16, 2006).

134 *James*, 990 A.2d at 439.

135 *See id.* at 439, 444 & n.36 (explaining the committee's reasoning in approving price terms).

136 *Id.* at 440.

137 *Id.* at 441.

138 *Id.* at 442.

139 *Id.* at 442 & n.26.

140 *Id.* at 444.

141 *See* QuadraMed Corp., Definitive Proxy Statement (Schedule 14A), at 85 (Feb. 8, 2010) (listing major beneficial owners of common stock).

142 *James*, 990 A.2d at 443.

143 *Id.*

144 *Id.* at 443-44.

145 The corporation made open market common stock repurchases, which would have been forbidden by the charter provisions protecting the preferred. *See* QuadraMed Corp., Annual

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bit more than $13.71. It saw $13.71 as the functional equivalent of Allocation 3. Then–Vice Chancellor Strine, however, refused to enjoin the merger and remitted the preferred to appraisal.[146]

The Strine opinion stoutly resisted invoking *Jedwab* and *FLS Holdings*.[147] The court in *James* could have rejected the preferred's claim to a second special committee on the facts of the case—the deal was fragile and a second special committee might have disrupted the negotiations[148]—but it went further by invoking both the complete contract and the common stock–value norm. The court asserted that the preferred, having passed up the opportunity to address merger pricing contingencies in the charter and negotiate a class vote or liquidation treatment, could not later call on the Chancery Court's solicitude.[149] Summarizing his attitude towards fiduciary protection of preferred holders, Chancellor Strine stated, "Our law has not, to date, embraced the notion that Chancery should create economic value for preferred stockholders that they failed to secure at the negotiating table."[150] Indeed, fiduciary law, far from *requiring* the board to make a fair allocation, *prevents* the board from doing so: the duty to favor the common could lead to liability for a director who intervenes to protect the preferred.[151]

Thus, the *James* court undertook to abrogate *Jebwab* and *FLS Holdings*. But it did so in dicta, and therefore should be read more narrowly. Taking a cue from the board committee, the court deemed the conversion price to be a contractually designated merger payout.[152] Where the charter fixes a merger payout, there is no basis for a claim of breach of fiduciary duty, since the board has no allocational decision to make. Indeed, given a fixed merger payout, any board that had allocated more than the fixed payout for the preferred would indeed be left open to a lawsuit by the common.

Report (Form 10-K), at 23 (Mar. 10, 2009) (describing these stock repurchases in 2008); QuadraMed Corp., Certificate of the Designation, Powers, Preferences and Rights of the Series Cumulative Mandatory Convertible Preferred Shares (Form 8-K), exhibit 3.1, § 3(d) (June 17, 2004) [hereinafter QuadraMed Certificate] (preventing repurchase of certain types of shares).

146 *James*, 990 A.2d at 454.

147 *See id.* at 447 ("The broad language in *FLS Holdings* and *Jedwab* must, I think, be read against [their] factual backdrop. . . . Without this factual context, those opinions are otherwise in sharp tension with the great weight of our law's precedent in this area.")

148 *See id.* at 444 (describing how the committee unanimously approved the merger in part due to fears about how altering the deal would upset holders of common).

149 *See id.* at 449. The court even questioned the discretionary dividend preference. Despite the facts that the dividend was cumulative and in fact was paid, and that the issue was deemed financially burdensome by potential acquirers, the court suggested that given only a discretionary dividend there was no value to allocate. *Id.* at 450 n.56.

150 *Id.* at 451 n.56.

151 *See id.* at 447.

152 *Id.* at 451.

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The court, however, did not indicate where and how the charter effects this result. Our review of the charter finds no express merger price designation. The charter's conversion provisions mention mergers, but only to set conversion rights going forward in a case where the preferred remains in the capital structure of the corporation surviving the merger.[153]

Since the charter does not expressly designate a merger price for preferred, the contractual allocation on which the court relies must be implied. It is hard to fathom an economic basis for such an implication. A conversion privilege is an option that gives a fixed interest holder an opportunity for upside gain. It does not have the converse effect of dragging the fixed interest holder down with the issuer—on the downside, the convertible holder relies on its fixed payment stream to preserve the value of its interest.[154] This heads-I-win-tails-you-lose result is not a free lunch; the conversion privilege's value is incorporated in the interest rate on the security.[155] Given this tradeoff, it makes no sense to have the convertible's value in a merger decline in lockstep with the issuer's common stock.[156] Indeed, it undercuts the deal. Nothing in the charter in *James* signals anything other than such a conventional arrangement. Any implications in the charter go in the opposite direction: it *did* provide for mandatory conversion, but only in the event the common stock sustained a price of $25.50,[157] an event that had never occurred. Otherwise, this conversion

153 QuadraMed Certificate, *supra* note 145, at exhibit 3.1, § 7(f).

154 *See* BRATTON, *supra* note 23, at 684-87 (describing the upside and downside market behavior of convertible bonds).

155 *Id.* at 684.

156 Since we read the *James* conversion privilege in this conventional way, we are unpersuaded by Chancellor Strine's argument that *James* is consistent with *Jedwab* and *FLS Holdings*. *See James*, A.2d at 447-49 ("When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor . . . . 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."). In reconciling *James* with the earlier cases, the Chancellor relied on *HB Korenvaes Investments, L.P. v. Marriott Corp.*, Civ. A. No. 12922, 1993 WL 205040 (Del. Ch. June 9, 1993). *HB Korenvaes* points out that the existence of a fiduciary duty to preferred is situational and finds, on the facts, that the charter had allocated the risk in question. *Id.* at *745-46. We find the contract in *James* every bit as incomplete as those in *Jedwab* and *FLS Holdings*. Moreover, *HB Korenvaes* is distinguishable from *James* since it did not involve a merger. It was a straightforward application of an anti-dilution clause. *See id.* at *741-42 ("Thus, among other things, plaintiffs complain that the planned transaction constitutes a breach of the terms of the certificate of designation that defines the relative rights of the Series A Preferred Stock.").

157 QuadraMed Corp. Certificate, *supra* note 145, at exhibit 3.1 § 8(a). The $5.10 figure therein provided has been adjusted in the text for the company's later one-to-five reverse stock split. *See supra* note 131.

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privilege was drafted as an option paid for by the holder to be held in reserve for the holder's benefit.

We do not read *James* to require this subversive reading of standard conversion provisions. The court would have had no reason to mention the appraisal option if the charter had in fact specified a merger payout, for such an appraisal would have yielded $13.71 and not a penny more.[158] We read the court's insistence on an ex ante contractual settlement the same way we read its rejection of *Jedwab* and *FLS Holdings*. In our opinion, the court, having determined on the facts to go the contractual route, emphasized contractual items in the doctrinal toolbox at the expense of fiduciary ones. *Jedwab* and *FLS Holdings* are still in the toolbox, even as the court's refusal to bring them to bear in *James* makes their future use less likely.

We have no quarrel with the result in the case, if only due to several specific facts in it. First, there was a large risk that an injunction might have caused the acquirer to walk away from the deal. Second, appraisal was available.[159] Additionally, as we read the facts, the preferred was not necessarily claiming a share of merger gain, but only the economic value of its participation. Roughly speaking, the preferred in *James* allege that they were forced into the most unfavorable division of value, Allocation 3. In this posture, given the risk of deal disruption, appraisal sufficiently vindicates the claim. Finally, as the court notes, the struggling board acted in good faith.[160]

D. *Summary*

The overlapping contract and corporate paradigms come to bear on *James* with more than their usual dysfunction. This is because the law, in its present posture, poses a stark dichotomy, asking the court whether the preferred's vulnerability and the board's exploitation of that situation combine to trigger intrinsic fairness scrutiny. If the preferred was vulnerable and exploited, heavy, potentially disruptive process obligations fall upon the board. If the preferred failed to satisfy those criteria, however, contract and appraisal determine the result. We believe courts can avoid this doctrinal *sturm und drang* by using the good faith standard of review employed in the old dummy merger cases.[161] Under this standard, the court asks whether the

158 *See, e.g.*, *In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 907-08 (Del. Ch. 2009) (fixing appraisal recovery at the price set in the charter).

159 The merger consideration for the preferred was cash. *See* DEL. CODE ANN. tit. 8, § 262(b)(1)–(2) (2011) (providing for appraisal rights in cases of cash consideration).

160 *James*, 990 A.2d at 451-54.

161 *See supra* note 104 and accompanying text.

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board acted in bad faith with reckless indifference to the rights of the preferred, as opposed to making an honest business judgment.[162]

The good faith standard opens a big tent that accommodates the results of all of the cases along with the overlapping paradigms. While *James*'s contractual aspirations are understandable, a totally contractual posture is unsustainable. A pattern of incomplete contracting remains embedded in preferred stock drafting, leaving a door open for conscience-shocking opportunism by boards. Moreover, boards are more likely to exercise great care in making these allocational decisions if counsel advises them of the possibility of judicial second-guessing. Indeed, to assure scrupulous adherence to the standard of independent-director determination on a well-informed basis, we would specify that the burden of proof on the issue of good faith fall on the board of directors.

For the board to meet that burden without much trouble, we offer the following suggestion: the independent committee should include at least one director charged with representing the interests of the preferred. Such an approach is potentially disruptive because a dissenting vote by a committee member would virtually ensure future litigation. But we believe that the possibility of litigation would be minimized if courts clarified the law on the basic distributional point. We know of no principle according the preferred a right to Allocation 1 that would provide it with a share of the gain in a third-party merger. The corporate–contract paradigms would overlap more peacefully if courts explicitly announced the following proposition: the preferred's rights are capped at premerger value.

To the extent an issue of preferred wants a shot at gain in a merger, it should negotiate a class vote. Given this clarification, the preferred's representative would have the limited task of avoiding Allocation 3, one that looms large only in the absence of a market price establishing premerger value. Absent such a price, the representative should force the committee to confront evidence of premerger value in the form of a neutral investment banker report—something that does not appear to have occurred in *James*.

Good faith review thus would serve to direct the board to Allocation 2 and away from the temptation of Allocation 3. Absent bad faith, objecting preferred should have only appraisal as a remedy. Delaware corporate law should also be amended to make appraisal universally available to preferred forced to accept anything other than their existing stock.

We would make one additional change in the law. Courts need to remove common stock–value maximization from the doctrinal toolbox used to

162 Porges v. Vadsco Sales Corp., 32 A.2d 148, 150-51 (Del. Ch. 1943). We suspect that the court in *James* asked precisely this question sub silentio when choosing among the competing paradigms.

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evaluate preferred's claims in mergers. The concept is analytically unsuitable. To see why, let us return to ABC Corporation and ask how a common stock–maximizing board should make the allocation. The answer is easy: it should employ *Jedwab*'s core equity-versus-contract-rights distinction[163] and allocate the same $50 per share to everybody, transferring $20 million of premerger value from the preferred to the common. Carrying the point to its logical conclusion, the ABC board never should have allowed preferred arrearages to accumulate in the first place. Rather, it should have effected a one-to-one dummy merger against the preferred immediately upon issuance. The board in *James* should have done the same thing. With the preferred convertible into common at $15.50, an immediate dummy merger after sale of the preferred for $25 would have created $9.50 of shareholder value!

These contracts can be incomplete and make no business sense if a common-maximizing board has sole responsibility over their performance in the absence of backstop judicial scrutiny. Meanwhile, the law can satisfy the intuition that motivates the common-maximization principle by clearly blocking any preferred claim to a share of merger gain.

Finally, we note that the overlap of the two paradigms raises an alternate route to fairness review: the contractual duty of good faith. The analysis starts with *Jedwab*'s division between contractual preferences and rights in common.[164] As the value impaired in the merger stems from the preference, the contract treatment arguably is appropriate. A party can trigger a contractual good faith constraint by exercising a contract right in such a way as to deprive a counterparty of core expectations,[165] which arguably is the case with the ABC proposal to allocate $50 per share to everyone in the merger. One could frame the case objectively and analyze the degree of deprivation, or subjectively and look at the culpability of the actors who effected the injury.[166] In the subjective framing, the contract case roughly tracks the corporate good faith case.

But some sticking points impede application of the contract variant. A special formulation of contractual good faith applies to financial contracts

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163 *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593-94 (Del. Ch. 1986) (stating that the corporation's duty "with respect to matters . . . that distinguish preferred stock from common . . . [is] contractual," whereas when "the right asserted is . . . shared equally . . . the scope of the correlative duty may be measured by equitable as well as legal standards").

164 *Id.*

165 *See, e.g.*, Kirke La Shelle Co. v. Paul Armstrong Co., 188 N.E. 163, 167 (N.Y. 1933) ("[I]n every contract there exists an implied covenant of good faith and fair dealing.").

166 *Cf.* Quadrangle Offshore (Cayman) LLC v. Kenetech Corp., No. 16362NC, 1999 WL 893575, at *9-10 (Del Ch. Oct. 13, 1999) (entertaining the suggestion that the board of a distressed issuer may have taken a series of actions with an intent to frustrate the preferred's right to a liquidation preference), *aff'd*, 751 A.2d 878 (Del. 2000).

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governing senior securities, under which good faith comes to bear only when the issuer traverses rights explicitly created in the contract.[167] In cases concerning bonds, this formulation tends to cut off good faith review.[168] The preferred can contend that this barrier does not apply because the merger has the effect of stripping its contract rights, but this theory is untested. Delaware precedent raises an additional barrier: good faith claims require a counterfactual finding as to whether the parties would have drafted for the right asserted by the preferred had they considered it.[169] If the right asserted is defined as a class vote, then a counterfactual finding cannot be made. If the right is defined more broadly as a right to have the preferred's going concern value considered in the merger allocation, then the contractual good faith case should lie.

Thus sketched, a contractual good faith case differs little from the corporate alternative, but for the two sticking points. An issue arises as to whether the corporate or contract good faith route is more "appropriate." In our view, the corporate path makes more sense. The courts opted for corporate treatment of mergers and charter amendments long ago, so a shift to contract only confuses matters further.

III. THE PAYMENT STREAM

Financial preferences, the basic rights making up the core of preferred stock's value, can be structured as priorities or as promises to pay. Either way, they exist in an ambiguous, unstable legal environment. We have seen that priority dividends in arrears can be stripped in a dummy merger. This Part turns to mandatory preferred to examine the strange, second-order status of an issuer's promise to pay a preferred dividend or redeem a preferred issue at stated value. Second-order status follows from preferred's dual nature. The promise to pay is, of course, contractual. But, because it is attached to a corporate equity interest, the law refuses to enforce preferred payment rights if doing so would impair the interests of contract creditors. The parameters of the enforceability of preferred's financial preferences remain unclear and admit of a narrow approach that enhances the promise's contractual power and a broad approach that emphasizes corporate status and makes enforcement difficult. One reason the doctrine is murky is that most of the cases in this area are old.

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167 *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 957 (5th Cir. Apr. 1981) (en banc) ("[T]his implied covenant of good faith and fair dealing cannot give the holders of Debentures any rights inconsistent with those explicitly set out in the Indenture.").

168 *Id.* at 958.

169 Katz v. Oak Indus., Inc., 508 A.2d 873, 880-81 (Del. Ch. 1986).

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More recently, in *SV Investment Partners, LLC v. ThoughtWorks, Inc.*,[170] the Delaware Chancery Court radically expanded the zone of enforcement constraint, stripping away a promise's contractual vitality by remitting the decision to perform the promise to pay to the discretion of the issuer's board, thereby subordinating the preferred's payment rights not only to the interests of the issuer's creditors, but to those of its common stockholders.[171] This Part sees *ThoughtWorks* as an updating exercise. The old cases are not only unclear but institutionally dated, relying on judicial business judgments about issuers' ability to pay.[172] The *ThoughtWorks* court, by submitting the matter to board discretion, aligns the legal treatment with the modern corporate law approach. The case also imports clarity by minimizing the old cases' dualistic use of the corporate and contract paradigms, pushing the treatment deep into corporate territory.

This judicial updating, however, swings the pendulum so far in one direction that it virtually knocks the promise out of the contract. Therefore, in this Part, we experiment with the converse approach, asking whether it is feasible to push the treatment of financial preferences deep into contract territory by minimizing the enforcement constraint. We show that this approach holds out no danger to corporate going concerns and protects transactional integrity.

Section III.A describes the doctrinal inheritance. Section III.B analyzes the *ThoughtWorks* opinion and the changes it made to the doctrine in the area of financial preferences. Section III.C accounts for the approach taken in the case and outlines an alternative. Section III.D provides a conclusion.

A. *The Promise to Pay on Preferred*

We have seen that dividend and liquidation priorities remit considerable payment discretion to issuer boards of directors. Making a preferred issue redeemable only at the board's option is another way to expand board discretion. One-way redemption permits the board to pay down the preferred at its stated value when an alternative means of financing becomes more desirable or the preferred issue otherwise becomes burdensome.[173] The stated amount, even though it bears a more-than-passing resemblance to the

170 7 A.3d 973 (Del. Ch. 2010), *aff'd*, 37 A.3d 205 (Del. 2011).

171 *See infra* Section III.B.

172 *See generally, e.g.*, Mueller v. Kraeuter & Co., 25 A.2d 874 (N.J. Ch. 1942).

173 Buxbaum, *supra* note 1, at 265 ("The option to redeem preferred shares . . . enable[s] the corporation to retire an obligation or a claim on the earnings . . . when it becomes advisable for purposes of corporate financing." (quoting HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 509 (rev. ed. 1946))).

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principal amount of a bond, does not otherwise "come due" pursuant to a preset repayment schedule. The issuer can leave the preferred in its capital structure indefinitely.[174] The matter of payment being largely vested in the board's business judgment, the financial rights of priority-preferred holders, while created contractually, very much lie within the corporate paradigm.[175]

Preferred also can be drafted to look like debt, with a promise to pay a fixed dividend (paralleling the payment of interest) and a promise to redeem the issue on a fixed date or series of dates (paralleling the repayment of principal). This discretion-constraining alternative has long been available, but companies have only sporadically used it.[176] When companies have taken this route, historically there has been a residuum of legal hostility. Some states have imposed statutory barriers to fixed redemptions,[177] and courts have resolved interpretive doubts respecting constraints on boards' payment discretion in issuers' favor.[178]

There also was (and remains) a doctrinal barrier to enforcement of preferred payment mandates. Promises to pay dividends on stock or redeem stock for cash cannot be made absolute in the same sense as promises to pay interest and to repay principal on a bond. Because preferred is *stock*, the promise takes a second-order status. It is enforceable with respect to the common,[179] but carries a claim junior to claims of the corporation's creditors. The law embeds this junior status when it makes payments to preferred stockholders subject to state law legal capital rules and fraudulent conveyance law, both of which protect creditors of distressed corporations from opportunistic payouts to

174 *See* Buxbaum, *supra* note 1, at 265 ("Rarely does a corporation fail to express in its articles that redemption shall be in the board of directors' discretion.").

175 *See* W.Q. O'Neall Co. v. O'Neall, 25 N.E.2d 656, 657, 659 (Ind. Ct. App. 1940) (in banc) (ordering a dividend for preferred stock on grounds of oppression of the heirs of one of two shareholders of a family corporation); *cf.* Channon v. H. Channon Co., 218 Ill. App. 397, 401 (1920) (ordering a dividend on common in a family corporation on grounds of an arbitrary refusal to pay).

176 Buxbaum, *supra* note 1, at 265 (describing compulsory redemption clauses as "seldom used" and "somewhat anomalous to the nature of preferred stock"). *But see* DEWING, *supra* note 22, at 155-56 (noting that mandatory redemption preferred fell out of favor after mandatory terms resulted in some of the issuers' financial distress in the 1920s).

177 *See* CAL. CORP. CODE § 500 (West 2013) (restricting redemption to sinking fund out of earnings).

178 *See, e.g.*, Crocker v. Waltham Watch Co., 53 N.E.2d 230, 233 (Mass. 1944) (noting "reluctance on the part of the courts to construe provisions relative to the declaration of dividends in such a way as to hold that it is mandatory . . . to declare dividends").

179 *See* Ammon v. Cushman Motor Works, 258 N.W. 649, 651 (Neb. 1935) (describing an undertaking between the issuer and the holder, noting that "such [an] agreement is valid and enforceable where it appears that the redemption and retirement of the stock will not impair the rights of the corporate creditors").

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stockholders.[180] The former prohibit dividend or redemption payments that render the corporation's balance sheet insolvent or reduce a stated capital figure booked on the balance sheet as shareholder equity.[181] The latter protects corporate creditors on a going-concern basis by blocking payments on stock that leave the corporation with an asset base that is too small to sustain its business or that would disable it from paying its debts as they come due.[182]

The law of preferred could simply refer to these well-articulated doctrines, block payments to preferred that violate them, and stop there. Some courts do simply state that the payment may not render the issuer insolvent.[183] Other courts, however, articulate a variety of unclear, open-ended limitations.[184] These cases prohibit redemptions that impair,[185] "prejudice,"[186] or "injure"[187] interests of creditors, thus suggesting a barrier that is higher than the legal capital rules and fraudulent conveyance otherwise create. Whatever

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180 Thus, a preferred acceleration provision triggered by skipped dividends is ineffective against creditors. *See* Allied Magnet Wire Corp. v. Tuttle, 154 N.E. 480, 483 (Ind. 1926) (construing an acceleration provision conditioned on a shipped dividend to apply only when the amount of the dividend actually had been earned to preserve the provision's legality).

181 DEL. CODE ANN. tit. 8, §§ 154, 170 (2011); *see* BRATTON, *supra* note 23, at 498-500 (discussing different legal standards available to a corporation to establish distribution constraints).

182 UNIF. FRAUDULENT TRANSFER ACT § 4(a) (1984); *cf.* BRATTON, *supra* note 23, at 518-21 (discussing the risk of fraudulent conveyance claims in the leveraged buyout context).

183 *See, e.g.*, *In re* Greenebaum Bros. & Co., 62 F. Supp. 769, 771 (E.D. Pa. 1945) ("[T]he obligation to redeem cannot be enforced after the corporation becomes insolvent."); Hurley v. Bos. R.R. Holding Co., 54 N.E.2d 183, 198 (Mass. 1944) ("It is an implied limitation upon the contract for the redemption of 'preferred stock,' created by the issuance of such 'preferred stock,' that such contract for redemption 'cannot be enforced if the effect is to render the corporation insolvent.'" (citation omitted)); McIntyre v. E. Bement's Sons, 109 N.W. 45, 46 (Mich. 1906) ("[T]here is no theory permitting a recovery by the plaintiff which does not require him . . . to establish affirmatively the solvency of the corporation . . . ."); Booth v. Union Fibre Co., 171 N.W. 307, 309 (Minn. 1919) (noting that if "the rights of creditors [are] not affected" then "the agreement to redeem was valid").

184 *Compare* Westerfield-Bonte Co. v. Burnett, 195 S.W. 477, 481 (Ky. 1917) ("[I]f [the stockholders] contract in such a way as to be legally bound to appropriate a portion of the capital to redeem the share of the preferred stockholder, the contract may be enforced, if the enforcement does not affect the collection of the claims of the creditors of the corporation."), *with* Rider v. John G. Delker & Sons Co., 140 S.W. 1011, 1013-14 (Ky. 1911) (refusing a receivership that a preferred stockholder who alleged that the company was insolvent had requested in an attempt to collect his dividends, "absent of some charge that its officers were guilty of some illegal, fraudulent, or other wrongdoing in the conduct of the business").

185 *See* Koeppler v. Crocker Chair Co., 228 N.W. 130, 132 (Wis. 1929) ("The general rule is that a corporation cannot give holders of preferred stock any preference, either in respect of payment of principal or dividends which will be superior to the rights of creditors . . . .").

186 *See* Cring v. Sheller Wood Rim Mfg. Co., 183 N.E. 674, 677-78 (Ind. App. 1932) ("[R]edemption may be made only in case the rights of creditors are not thereby prejudiced and the stock is held valid . . . if creditors' rights are not prejudiced by the payment.").

187 *See Burnett*, 195 S.W. at 479 ("[A] court is authorized to declare [a contract] to be void . . . [where] the agreement has a tendency to injure the public . . . .").

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the phrasing, the burden of proof is on the preferred seeking to enforce its promise.[188] It is accordingly the drafting custom to condition preferred payment mandates on the presence of "funds legally available therefor."[189]

The payment constraint's meaning is clear only at the extremes. On one side stands an issuer in severe financial distress. Here, the promise to pay on preferred is clearly unenforceable. On the other side stands an issuer in excellent financial health. Assume that a large mandatory redemption is coming due and the company has the cash or sources of financing to fund it. If the company nonetheless misses the payment, its easily verifiable ability to pay puts the preferred in a position to meet their burden of showing "legally available" funds and thus to bring a successful enforcement action. Even in this extreme situation, although the payment constraint's meaning is clear, the mandate itself is problematic. If the preferred sue on the unperformed promise, get a judgment, then levy execution on the judgment, they technically bootstrap themselves to the status of secured creditors, jumping over preexisting unsecured creditors.[190] However, given a healthy issuer, presumably no creditors will raise an objection.

Between the two extremes, where the issuer is not in distress but does operate under financial constraints, the validity of preferred redemption claims is not clear at all. Board discretion starts to matter, despite the existence of an enforceable promise. To see why, consider two scenarios. Assume first that the board actually *wants* to make a promised payment to the preferred and that there would not be a fraudulent conveyance, but the company's balance sheet presents an obstacle under the legal capital rules. The willing board can surmount that obstacle because the legal capital rules provide it with discretion to alter the balance sheet numbers by revaluing assets, subject only to good faith review of its decision.[191] A heavy burden then falls on objecting creditors to show bad faith.

Now turn to the more likely case in which a class of preferred comes due for redemption, and the board, which does not have the cash in a sock under

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188 *See, e.g.*, *Hurley*, 54 N.E.2d at 198.

189 *See* C. Stephen Bigler & Jennifer Veet Barrett, *Drafting a Mandatory Put Provision for Preferred Stock After* ThoughtWorks, BUS. L. TODAY, Jan. 23, 2012, http://apps.americanbar.org/buslaw/blt/content/2012/01/delaware-insider.shtml (quoting SV Inv. Partners, LLC v. ThoughtWorks, 7 A.3d 973, 978 (Del. Ch. 2010), *aff'd*, 37 A.3d 205 (Del. 2011)).

190 *See, e.g.*, N.Y. C.P.L.R. § 5202 (McKinney 2013) (granting priority the moment the judgment is delivered to the sheriff). *But see* David Gray Carlson, *Critique of Money Judgment (Part Two: Liens on New York Personal Property)*, 83 ST. JOHN'S L. REV. 43, 51-74 (2009) (describing two New York exceptions to the validity of execution liens: pre- and post-levy transfers).

191 *See* Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 154 (Del. 1997) ("[W]e . . . allow . . . corporations to revalue properly its [sic] assets and liabilities to show a surplus and thus conform to the statute.").

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the bed, resists the payment. As we have seen, the promise to honor the financial preferences held by the preferred is conditional: payment comes due only if funds are "legally available." The board, however, can defend by claiming that payment would "impair, prejudice, or injure"[192] creditor interests. The standard thus leaves impairment in the eye of the beholder, and it can be applied tightly and contractually or loosely and corporately.

On a contractual reading, the enforcing court would aggressively push the recalcitrant issuer to the limit of fraudulent conveyance law by forcing it to liquidate assets to raise the cash. Alternatively, concern for creditor interests can lead to an expansive, corporate approach, in which the court would open up a discretionary envelope for the issuer's board of directors and thereby relieve the common stock interest of the payment burden. What began as *creditor* protection turns into *common* protection.

Until recently, the leading promise-to-pay case was *Mueller v. Kraeuter & Co.*, decided by the New Jersey Chancery Court in 1942.[193] The court there took the contractual route and pushed the limits in favor of a payment to the preferred against a board that had been stalling while reinvesting earnings to expand the business.[194] But the preferred did not get a judgment for the entire amount the company owed them, because the issuer did not have the cash on hand; therefore, an immediate payment might have injured creditors.[195] The court instead drew on its equitable powers and ordered counsel to prepare a schedule of installment payments.[196]

Other cases, however, have taken more of a corporate route. At the extreme is an 1879 Pennsylvania case, in which the court held that the preferred have no right to enforce the promise if it would cripple the issuer's business and impair the interests not only of creditors but also of common stockholders.[197]

Unsurprisingly, financial practice has changed significantly since these cases were decided. Preferred dividends remain discretionary in many contexts, particularly in venture capital deals.[198] But mandatory dividend

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192 *See supra* text accompanying notes 185-87.

193 25 A.2d 874 (N.J. Ch. 1942).

194 *Id.* at 876.

195 *Id.*

196 *Id.* at 876-77.

197 Culver v. Reno Estate Co., 91 Pa. 367, 375 (1879); *see also* Warren v. Queen & Co., 87 A. 595, 597 (Pa. 1913) (conditioning redemption on an affirmative showing that no injustice would be done to the existing rights of other stockholders or creditors).

198 BRATTON, *supra* note 23, at 741.

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provisions are not uncommon.[199] Redemption provisions also depend on the deal. Perpetual preferred still is issued, but mandatory redemption terms are also not uncommon.[200] Indeed, with venture capital, exit via mandatory redemption is hardwired into the business model.[201]

B. *The* ThoughtWorks *Solution*

Thus sat the law and the practice until 2010, when a hard-fought litigation between a venture capitalist seeking to enforce a redemption right against a recalcitrant, but not insolvent, investee reached the Delaware courts.[202] That case, *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, resulted in a new and leading pronouncement on the enforceability of promises to pay preferred.[203] The Chancery Court's decision forcefully pushes the law in the corporate direction, implying that the preferred will not be able to get a judgment unless the issuer has cash on hand (or the equivalent).[204]

The issuer in question sold $26.6 million of preferred to a venture capital firm in 2000, at the peak of the dot-com bubble.[205] The goal was to put the company in a position to go public at an early date, but the bubble's burst dashed those upside hopes.[206] Meanwhile, the charter provision creating the preferred contained a heavily negotiated five-year redemption provision, which contained the standard "out of any funds legally available" clause,[207] but otherwise took steps to put the screws on the issuer. The issuer got a year of grace in the event its working capital proved insufficient to redeem the preferred.[208] Once the one-year period expired the charter specified that redemption would be "continuous," that is, that the issuer would divert cash to preferred redemption on a going-concern basis.[209] The charter also provided

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199 In our EDGAR-based survey of recent preferred issues, 23% of the registered issues had mandatory dividend provisions and 70% of the unregistered issues had mandatory dividend provisions. *See supra* text accompanying notes 86-87.

200 In our EDGAR-based survey of recent preferred issues, 14% of the registered issues had mandatory redemption provisions and 36% of the unregistered issues had mandatory redemption provisions. *See supra* notes 85-87 and accompanying text.

201 *See* BRATTON, *supra* note 23, at 742 (describing how venture capitalists typically exit investments).

202 SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 976 (Del. Ch. 2010), *aff'd*, 37 A.3d 205 (Del. 2011).

203 *See generally id.*

204 The Delaware Supreme Court affirmed the Chancery's ruling, confirming the standard of review applied, but otherwise adding no new law, in *ThoughtWorks*, 37 A.3d at 212.

205 *ThoughtWorks*, 7 A.3d at 978.

206 *Id.* at 978-79.

207 *Id.* at 978.

208 *See id.* (describing the "one-year working capital carve-out").

209 *Id.* at 978-79.

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that the company would value its assets at "the highest amount permissible under applicable law" when determining funds "legally available."[210]

The issuer, a services company with a volatile earnings stream, took advantage of the grace year and thereafter consistently took the position that there were minimal or no significant funds available.[211] Duly prepped by counsel, ThoughtWorks' board of directors discussed the matter of redemption payment on a quarterly basis. It took into account a list of factors, and developed a plan "for the Board to follow:"

> [T]he Board must (a) not declare an amount that exceeds the corporation's surplus . . . , (b) reassess its initial determination of surplus if . . . a redemption based on that determination . . . would impair the Company's ability to continue as a going concern, thereby eroding the value of any assets . . . that have materially lower values in liquidation than as part of a going concern, such that the value assumptions underlying the initial computation of surplus are no longer sustainable and the long term health of the Company is jeopardized, [and] (c) exercise its affirmative duty to avoid decisions that trigger insolvency . . . .[212]

In all, the company redeemed $4.1 million through 2010, while the total principal amount owing on the issue, including cumulated, unpaid dividends, rose to $45 million by 2006.[213] The board also looked for takeout financing but only found it in the amount of $30 million, conditioned on repurchase of all of the preferred for no more than $25 million.[214] The preferred rejected the haircut and went to court.[215]

The preferred argued that the court should order redemption so long as it implicated no invasion of surplus within the meaning of the legal capital rules,[216] and introduced valuation evidence showing that ThoughtWorks had more than enough balance sheet equity to sustain the payment.[217] Vice

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210 *Id.* at 979.

211 *Id.* at 980-81. The board's actions included going to court and proposing a charter interpretation that would have made the working capital carve-out permanent. The Delaware Chancery Court rejected this argument in *ThoughtWorks, Inc. v. SV Investment Partners, LLC*, 902 A.2d 745, 754 (Del. Ch. 2006).

212 *ThoughtWorks*, 7 A.3d at 980.

213 *Id.* at 980-81.

214 *Id.* at 981.

215 *Id.*

216 The argument reflected the general view among practitioners that "legally available" derived its exclusive meaning from reference to the legal capital rules. *See* Bigler & Barrett, *supra* note 189. We wonder how this interpretation ever found its way into corporate practice. We suspect it entered circulation because it reduces uncertainty. Unfortunately, it is utterly lacking in support from the cases.

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

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Chancellor Laster rejected this argument; he reckoned that a balance sheet showing did not suffice to satisfy the creditor impairment limitation, which at least required an additional showing addressing going-concern insolvency.[218] The Vice Chancellor reckoned correctly. A ruling favoring the plaintiff's position implies that the issuer has the burden to show negative going concern effects of a judgment for plaintiffs. That has never been the law. The opinion, however, goes on to make broad pronouncements beyond what was necessary to resolve the case.

The Vice Chancellor took the occasion to flesh out the legal standard for redemption with a two-part inquiry. The first half is substantive—a definition of "funds legally available."[219] The court stressed dictionary definitions of "funds" and "available"[220] so that "funds legally available" emerges as ready cash—"accessible, obtainable, and present or ready for immediate use," which are not otherwise subject to any legal prohibition on their use.[221] The "not otherwise illegal" leg of the test subsumes the longstanding creditor injury condition, which in turn is jacked up to a liquidation standard—the preferred has no entitlement to "any part of the corporate assets until the corporate debts are fully paid."[222] The result is significant: ready cash must be on the table first; once it is, the board asks whether its payment to a stockholder would impair the creditor interest. Impairment seems possible even when there is only a small, outstanding piece of open-account debt.

The second leg of *ThoughtWorks* sets out a standard of review keyed to boardroom process: "the 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

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218 *Id.* at 983-86.

219 In Delaware, "funds legally available" derives partly from a statutory constraint keyed to the legal capital rules, *see* DEL. CODE ANN. tit. 8, § 160 (2011), and partly from common law. *See In re* Int'l Radiator Co., 92 A. 255, 255 (Del. Ch. 1914) ("[W]hen at the time the bargain is made the rights of creditors of the company are, or would be, affected by it, then clearly such an agreement is unenforceable . . . ."); Farland v. Willis, No. 4888, 1975 WL 1960, at *475 (Del. Ch. Nov. 12, 1975) (prohibiting stock repurchases that defraud or injure creditors). Taken together, the statute and the cases amount to a mandate; preferred stock provisions that do not contain a limitation that is not otherwise illegal do not reflect a contractual, negotiated choice. *See* Buxbaum, *supra* note 1, at 263-64 ("[A] contract to purchase shares . . . is subject to avoidance if at the time of payment or performance the company is insolvent, the payment would harm creditors or capital would be impaired." (footnotes omitted)). Contractual constraints are not unheard of; however, half a century ago, it was not uncommon to see negotiated financial tests that blocked dividend payments. *See id.* at 255.

220 *ThoughtWorks*, 7 A.3d at 983-84.

221 *Id.* at 984.

222 *Id.* at 986 (citation omitted).

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the mark as to constitute actual or constructive fraud."[223] The court drew this good faith standard from Delaware's legal capital cases.[224] As noted above, those cases concern shareholder payouts that the board *wants to make*,[225] and they accord wide discretion to board asset valuations.[226] It is ironic, to say the least, to see a standard intended to facilitate payments to stockholders redeployed to protect a board wishing to duck a contractually undertaken stockholder payment. In any event, the court found the ThoughtWorks board's process to have been "impeccable," since the board undertook a "thorough investigation" and relied on detailed analyses developed by "well-qualified experts."[227]

Add up the test's two parts and you get a change in the law that takes a giant step away from contract into corporate territory. We started out with a contract enforcement case that called on the court to determine whether a board breached a promise. The precedent presupposes direct appraisal of the issuer's ability to pay; it does not remit the decision regarding payment to the business judgment of the issuer's board of directors.

Here, in contrast, we get a substantive test emphasizing the availability of ready cash that then uses a good faith standard of review and focuses on the board's informational base. The reference to board process displaces the contract paradigm and restates the issue in corporate terms: the question is no longer, "Can the issuer pay?" but, "Did the issuer's board do an adequate job of justifying its decision not to pay?" Thus, *ThoughtWorks* undercuts the redemption promise: a promise to pay is not meaningful if its performance is left to the promisor's discretion.

C. *An Explanation and an Alternative*

The court's approach can be explained as an effort to integrate the law of preferred stock with the wider framework of corporate law, a framework

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223 *Id.* at 988.

224 The court cited *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150 (Del. 1997), which we previously discussed in the context of boards' abilities to alter their balance sheets. *See ThoughtWorks*, 7 A.3d at 988; *supra* text accompanying note 191. Additionally, the court cited *Morris v. Standard Gas & Electric Co.*, 63 A.2d 577, 584-85 (Del. Ch. 1949), which also approves of board discretion in valuation.

225 *Klang*, 702 A.2d at 152; *Morris*, 63 A.2d at 578.

226 Historically, courts have set the zone of discretion liberally. Notably, as the zone of board discretion widens, the creditor-protective properties of the rules diminish. *See* BAYLESS MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 61-64, 71-72, 84-90 (2d ed. 1981). Note also that directors who make payouts in violation of the rules face personal liability. *See* DEL. CODE ANN. tit. 8, § 174(a) (2011) ("In case of any wilful or negligent violation of § 160 . . . the directors under whose administration the same may happen shall be jointly and severally liable . . . .").

227 *ThoughtWorks*, 7 A.3d at 989.

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that changed during the seventy years that followed the decision of *Mueller v. Kraeuter*.[228] Judicial review now goes to the quality of the processes directors employ when making decisions rather than to the substance of the decisions themselves.

The old cases invite messy litigation. Suppose that the plaintiff in *ThoughtWorks*, instead of going for a judgment for the whole hog of $45 million,[229] had played it differently, seeking a decree that holds the obligor's feet to the fire without threatening the going concern. In this scenario, as in *Mueller*,[230] the court decides that the issuer has the ability to pay more than it has demonstrated and sends the parties back to negotiate a payment schedule, in effect, reallocating bargaining chips to the preferred in an ongoing negotiation. Such an approach holds out a cognizable threat of continuing judicial involvement with the defendant's business operations, which is just the sort of involvement that Delaware's process-based standards seek to obviate. The preferred's second-order promise cannot be enforced without somebody, presumably the court, making a business judgment concerning the issuer's ability to pay, and the Delaware courts are allergic to such decisionmaking environments.[231]

Further, the *ThoughtWorks* standard could prove less liberal in application than its bare statement suggests. The issuer, as depicted by the court, was asset- and cash-poor;[232] it tried to refinance but could raise only $20 million.[233]

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228 25 A.2d 874 (N.J. Ch. 1942).

229 A $45 million judgment might indeed have injured creditors (although the opinion makes no reference to any evidence on the issuer's debt load). Judgment leads to levy and secured creditor status for the preferred, with execution on the lien threatening the issuer's producing capacity. The creditor injury limitation, *see supra* note 222 and accompanying text, bars that result, as does the Bankruptcy Code with its automatic stay. *See* 11 U.S.C. § 362 (2006) (providing an automatic stay in various actions against the debtor after a petition for bankruptcy has been filed).

230 *See* 25 A.2d at 876 (noting that the profit received during a previous five-year period was "enough of itself to pay two-thirds of the amount required to retire the preferred stock"); *id.* at 877 (instructing counsel to "employ their ingenuity in devising proper means to accomplish the redemption of the preferred stock").

231 The courts' reluctance to engage in such decisionmaking is a result of the tradition of respect for board business judgments, which the Delaware courts traverse only on a showing of breach of fiduciary duty. Exceptions are limited. Courts, for example, exercise their own business judgment in reviewing litigation settlements. *See* Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1285 (Del. 1989) (describing courts' broad discretion in evaluating the fairness of a settlement). There is also an exception in the case of enhanced scrutiny under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986), in which the court describes the higher standards used to assess board action in a hostile takeover. Even under *Revlon*, however, a court may not "second-guess reasonable, but debatable, tactical choices that directors have made in good faith." *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1000 (Del. Ch. 2005).

232 *See ThoughtWorks*, 7 A.3d at 976 ("ThoughtWorks does not have and cannot obtain the cash to redeem the Preferred Stock in full.").

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Let us hypothesize a harder case: the preferred issuer has a large cash balance; debt finance is available to pay down the preferred. The board determines, on an extensive record, that redemption would interfere with its business plan; it reasons that the cash balance fortifies the company against its competitors and that credit lines need to be husbanded in the interest of the enterprise. Accordingly, it redeems 20% of the preferred, leaving the rest outstanding and awaiting a later exercise of board discretion. Payment is feasible, but inconvenient. Would this redemption amount to bad faith under *ThoughtWorks*? One hopes so. Delaware courts are, above all, fact sensitive and adept at avoiding disruptive applications of their standards, but the matter is far from clear.

ThoughtWorks imports coherence by pushing the treatment of the promise to pay out of the awkward territory of paradigmatic overlap and over to the corporate side. We wonder whether the opposite adjustment might be feasible—a push to the contract side. The old cases also predate modern bankruptcy reorganization[234] and bespeak a fear of crippling levy and execution at the behest of the preferred. That fear is no longer justified.

If the ThoughtWorks preferred got a $45 million judgment, the execution of which would dismember the going concern, either the issuer or one of its creditors would solve the problem with a bankruptcy filing. Bankruptcy's automatic stay provision[235] prevents destructive levy and execution. Negotiations respecting the issuer's ability to pay claims against it would be remitted to the bankruptcy proceeding, where the preferred, as a junior claimant, would have to take its chances.[236] Admittedly, this counterfactual treatment cuts against the precedent every bit as much as the *ThoughtWorks* opinion. It treats the redemption as a first-order promise and, rather than attempting to thread the needle with a decree in the case, remits the issuer to the machinery in place that obviates value-destructive effects of enforcement of first-order promises.

Interestingly, Vice Chancellor Laster's *ThoughtWorks* opinion makes a gesture in the direction of our alternative scenario, suggesting that the

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233 *See id.* at 979 ("ThoughtWorks had hoped to secure at least $30 million in debt financing, but the largest proposal was for $20 million.").

234 The first statutory corporate reorganization procedure dates from 1934 with the enactment of section 77B of the Bankruptcy Act of 1934, ch. 424, 48 Stat. 911, 912-22, which was replaced by Chapter X of the Chandler Act, ch. 575, 52 Stat. 883 (1938).

235 *See* 11 U.S.C. § 362 (2006).

236 In bankruptcy, the preferred is junior to debt claimants. *See id.* § 1129(b)(2)(B), (c). It bears noting that bankruptcy does not necessarily follow from the fact that the preferred hold an enforceable promise and the issuer lacks the cash to pay on demand. The parties could simply work it out at the negotiating table with the preferred holding enforcement of the judgment and bankruptcy as a potential trump card.

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whole problem would go away if the preferred's contract specified an upstream conversion—that is, on the redemption date, the stock would be automatically convertible into a note due in one year.[237] The note, assuming that its issue survived fraudulent conveyance scrutiny,[238] would provide the preferred the enforcement cudgel it presently lacks, triggering a liquidity crisis and a bankruptcy filing. A question arises: Is this formal ruse really necessary? It certainly has no creditor protective properties, for it promotes the preferred to *equal* status with preexisting creditors. Nor does it import added certainty regarding the parties' intent that the preferred be paid. The charter provisions in *ThoughtWorks* already were quite clear about that.[239]

The upstream conversion ploy clearly accomplishes one thing—it takes the lawsuit out of the messy corporate law framework into the more clearly outlined contractual context of debt versus equity; indeed, it might even take the lawsuit out of the Delaware Chancery Court and into a bankruptcy court. Whether it would work as advertised in practice is a more difficult question. Upstream conversion from equity to debt is permitted by corporate codes.[240] But the issue of the debt is constrained by fraudulent conveyance law just as is the payment of redemption cash.[241] Presumably, the earlier the cash comes due on the debt, the greater the risk of invalidation as a transfer-triggering insolvency; if the principal amount of the note were greater than shareholders' equity listed on the issuer's balance sheet, the conversion would trigger balance sheet insolvency and would be invalid as of occurrence.

If the parties themselves can lift the burden with an upstream stock-to-debt conversion, then a proactive court can save them the trouble. All it has

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237 *See* 7 A.3d at 991 (noting that investors can request penalty provisions to take effect where a "[c]ompany's available cash flow does not permit . . . redemption—e.g., the redemption amount shall be paid in the form of a one-year note to each unredeemed holder" of the preferred stock (quoting NVCA, Model Term Sheet For Series A Preferred Stock Financing 6 n.14 (Apr. 2009) *available at* http://businesslaw.ncbar.org/media/6018628/nvca_term_sheet.doc)); *id.* at 992 (noting that the existence of the one-year note penalty, among other solutions, shows that the investor "easily could have protected its investment and avoided its [losses] through any number of means").

238 *See infra* note 241 and accompanying text.

239 *See supra* notes 207-10 and accompanying text.

240 *See, e.g.*, N.Y. BUS. CORP. LAW § 519(a) (McKinney 2003) ("[A] corporation may issue shares or bonds convertible into . . . indebtedness or other securities of the same or another corporation."); MODEL BUS. CORP. ACT § 6.01(c)(2) (2007) (recommending that articles of incorporation authorize shares that are "convertible . . . for . . . indebtedness, securities or other property"). In Delaware, the result follows from an interpretation of the sections allowing redemption at the option of the stockholder and payment for redeemed stock in debt as well as cash. *See* DEL. CODE. ANN. tit. 8, § 151(b), (e) (2011) (redemption provision). The logic is that the power to redeem in exchange for debt implies authorization of stock convertible upstream into debt. *See* Alexander J. Triantis & George G. Triantis, *Conversion Rights and the Design of Financial Contracts*, 72 WASH. U. L.Q. 1231, 1242-43 (1994).

241 *See* Triantis & Triantis, *supra* note 240, at 1240-44.

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to do is resolve the ambiguities created by the old cases on the contract side. The promise is presumptively enforceable and creditor protection thus becomes an affirmative defense. The preferred get a judgment absent a legal capital violation or a fraudulent conveyance; the issuer bears the burden of proof of "legally available funds" with "legal availability" defined in terms of actual creditor interests rather than the interests of the going concern.[242] No roof would cave in as a result of any subsequent insolvency, for chapter 11 is there to reinforce the underlying corporate structure in such an event. Meanwhile, uncertainty (that the court aggravates when it remits the preferred to the stock-to-debt drafting ploy) is avoided. This is a late date on which to impose such a formality as an enforcement requirement. Additionally, doing so substantially diminishes the value of the existing generation of mandatory redemption preferred stock and creates enforcement uncertainty for the next generation.

D. *Summary and Analysis*

ThoughtWorks takes a promise historically treated as second order and downgrades it to third order. The historical treatment attempts to walk the corporate–contract divide with a foot in each paradigm. The results are awkward; further, when *ThoughtWorks* rejoins the issue, it is not clear exactly what enforcement of a second-order promise means. Clarity follows only if one plants both feet on one side or the other. *ThoughtWorks* opts for the corporate side: it permits the corporate board to tie up the preferred in the black box of business judgment.[243] The contractual enforcement alternative does not map onto the old cases any better than does corporate treatment. But it is every bit as feasible. It would not, as a practical matter, turn the holder of preferred into a judgment creditor who tears the producing enterprise apart in the course of levy and execution, compromising the interests of preexisting creditors along the way. Instead, the practical result is a negotiation at which the board of directors no longer controls the marginal dollar, and the preferred's interest in repayment assumes a primary place in business planning. Either choice is reasonable. Left to our own devices, we would err on the side of enforcement, making it harder for the issuer to avoid its own promise to pay.

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242 To the extent the regime described causes discomfort on the part of creditors of a preferred issuer, the issuer easily could draft back into the old regime by including traditional "no creditor impairment" language.

243 *See supra* notes 219-27 and accompanying text.

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We note two factors that are not implicated by the foregoing choice. First, contract treatment does not traverse a meaningful norm of common shareholder value maximization. Making a costly corporate obligation unenforceable always enhances shareholder value, at least in the short term. But there is no normative case to support a value bump from nonenforcement, for the contract paradigm comes to bear with full, trumping force. It is true that to the extent enforcement gets the preferred a seat at the table to share or take control, its incentives may not be consistent with enterprise value maximization. Alternatively, the preferred, once seated, could have every incentive to maximize. It would depend on the case.

Second, the enforcement question raised in *ThoughtWorks* cannot meaningfully be resolved by allocating a drafting burden or conducting default-rule analysis. Vice Chancellor Laster suggests the contrary when he faults the preferred for failing to protect itself with a built-in promissory note exchange.[244] We construe the reasoning in the opinion to follow a four-step sequence: (1) both the corporate and the contract paradigms put the burden on the claimant to procure a contract right expressly—"no right" is the default rule; (2) an express right could have been procured here but was not; (3) therefore the claimant has no right; and (4) the claimant is forced to procure the right explicitly next time, prompting information revelation or otherwise making the transaction more certain.[245] The logic is sensible in many situations, but it is unhelpful here. The preferred holder here did negotiate for an express right—the right to be paid out of funds legally available, and for ought that appears to be the highest payment right known to be appropriate for preferred stock. The Vice Chancellor, in imposing a contract burden to procure an even higher right—the right to be paid unconditionally—simply restates the holding in chief, which is the refusal to enforce the right actually bargained for. The ascription of fault on a "could have/should have procured" basis has no bite, for the tables can be turned. If more specificity would have been useful at the drafting table, particularly given this negotiation's emphasis on the construction of a promise with teeth, the burden to include such specificity can be placed just as easily on the issuer's shoulders. That is, if the issuer's board intended ex ante to make

244 *See supra* note 237 and accompanying text.

245 *Cf.* SV Inv. Partners, LCC v. ThoughtWorks, Inc., 7 A.3d 973, 992 (Del. Ch. 2010) ("SVIP easily could have protected its investment and avoided its current fate through any number of means. SVIP decided not to, and that choice was rational at the time. . . . Now, with hindsight, SVIP understandably wishes it had additional rights, but 'it is not the proper role of a court to rewrite or supply omitted provisions to a written agreement.'" (quoting Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998))), *aff'd*, 37 A.3d 205 (Del. 2011).

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payment a matter of business convenience, should not an express condition to that effect have been placed in the contract?

Finally, it bears noting that *ThoughtWorks* is a venture capital case. Venture capital is a high-risk, high-return corner of the world of finance with special characteristics.[246] The financial economists who explain its contractual outlines and productivity contribution teach that venture capitalists contribute substantive discrimination and monitoring capability lacking in other financiers. Such contributions are not made for free. The deal makes sense only if the venture capitalist gets contingent control power.[247] Redemption rights are a prominent means of exercising that power. Therefore, a court that inhibits their enforcement not only diminishes the utility of preferred, but also disables a productive mode of financing.

IV. PREFERRED IN CONTROL: VENTURE CAPITAL UNDER CORPORATE FIDUCIARY LAW

There is something hapless about the preferred plaintiffs we have seen so far. They take minority stock positions in reliance on special contract rights only to find that they cannot enforce the rights because the contract is embedded in a stock issue. When for the same reason the rights prove vulnerable to elimination by common stock majorities, the preferred stockholders get little backup protection from the majority–minority stockholder branch of corporate fiduciary law.

A preferred stockholder in control doesn't have these problems. Historically, such an actor was the exception—preferred was about finance, not

246 *See* Andrew Winton & Vijay Yerramilli, *Entrepreneurial Finance: Banks Versus Venture Capital*, 88 J. FIN. ECON. 51, 52 (2008) ("[F]irms with venture capital finance tend to have very risky and positively skewed return distributions, with a high probability of weak or even negative returns and a small probability of extremely high returns." (citation omitted)).

247 *See generally* Masako Ueda, *Banks Versus Venture Capital: Project Evaluation, Screening, and Expropriation*, 59 J. FIN. 601, 601-02 (2004) (positing that venture capitalists are specialists and do a better job than do banks of screening good and bad projects, but use their position to extract rents from projects that have less collateral but higher risk, growth, and profitability); Winton & Yerramilli, *supra* note 246, at 51-53 (positing that venture capitalists work with high risk projects and demand significant control). Venture capitalists wield this control to effect results within the company, often in the form of control changes when performance metrics are not met. *See* Michael T. Hannan et al., *Inertia and Change in the Early Years: Employment Relations in Young, High Technology Firms*, 5 INDUS. & CORP. CHANGE 503, 526 fig.1 (1996) (displaying in Figure 1 that 40% of founder CEOs are replaced within the first 40 months and 80% within 80 months); Steven N. Kaplan et al., *Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies*, 64 J. FIN. 75, 78, 91, 98 tbl.VI (2009) (finding that a majority of firms that go public, including venture-backed firms, tend to maintain the same line of business while frequently replacing managers, and concluding that venture capitalists back ideas rather than individuals).

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governance, and preferred rarely controlled the board or held a majority of the votes.[248] Modern venture capital financing changed the pattern. Venture capital is about both finance and governance and preferred stock is the investment vehicle of choice.[249] Venture capitalists holding preferred sometimes take voting control and can dominate the boards of directors even when holding a minority of the votes.[250]

The controlling venture capitalist poses a new question for the law of preferred stock: Does fiduciary law come to bear to protect a common stock minority when a preferred stockholder in control exercises its contract rights to impair the common's interest?

This question, like others regarding preferred, tends to arise on the moderate downside, where the issuer is viable but has not generated enough value to go around. Things are markedly easier on the extreme downside: where there is no value, there are no allocational issues worth pressing. Similarly, there is not much to fight over on the upside either, assuming a minimum of ex ante planning. In this case, the venture impresses the market and proceeds to an initial public offering (IPO).[251] The venture capitalist converts its preferred into common, sells into the offering, and makes a killing.[252] The venture capitalist's counterparty, the "entrepreneur," shares the jackpot and resumes control of the company in the wake of the venture capitalist's sale.[253]

Contrast the preceding two extreme cases with the moderate downside, wherein the interests of the venture capitalist and the entrepreneur can sharply conflict. There is value in the enterprise but not enough to facilitate the venture capitalist's exit by IPO. The venture capitalist in control, under

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248 A few charters allocated a majority of board seats to preferred given a set number of missed dividends. *See* GRAHAM, ET AL., *supra* note 22, at 472-73. For the exceptional case on this fact pattern, see Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 655 (Del. Ch. 1975) ("[A]t any time six or more quarterly dividends . . . on the Preferred Stock shall be in default . . . the holders of the Preferred Stock, voting as a class, shall have the right . . . by plurality vote to elect a majority of the Directors of the Corporation." (quoting Allied's amended certificate of incorporation)).

249 *See* BRATTON, *supra* note 23, at 741 (noting that venture capital transactions typically use convertible preferred stock and that the Stock Purchase Agreement "sets out governance rights for the venture capitalist, including rights to information and the right to inspect the issuer's premises").

250 *See infra* notes 288-92.

251 *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 260 (1998) ("[A]n IPO is available to the portfolio company only when the company is successful.").

252 *See id.* at 261 ("Typically, the terms of the convertible securities held by the venture capital fund require conversion into common stock at the time of the IPO . . . ." (citation omitted)).

253 *See id.* ("[T]he venture capital fund's special control rights end at the time of an IPO . . . . Control becomes vested in the entrepreneur, who often retains a controlling stock interest and, even if not, retains the usual broad discretion enjoyed by chief executives of companies without a controlling shareholder." (citation omitted)).

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pressure to create cash returns for its investors, brings the conflict to a head by either exercising its redemption rights or using its board seats and voting shares to cram down a sale of the venture to a third party who has no room for the entrepreneur.[254] Having discarded the entrepreneur to the scrap-heap, the venture capitalist claims a priority share of the merger proceeds.[255]

How should corporate law treat this transaction? Under the contract paradigm, there is no basis for intervention. The entrepreneur makes its bed at the get-go by selling control to the venture capitalist in exchange for needed capital and a shot at an IPO jackpot. Sale at the venture capitalist's insistence is an eminently foreseeable consequence. The corporate paradigm, by contrast, invites fiduciary review—the fact pattern invites application of the duty imposed on a majority shareholder who uses its control power to extract value from a minority shareholder.

The Delaware Chancery Court recently opted emphatically for corporate treatment and fiduciary review in the common stockholders' favor in a venture capital case, *In re Trados Inc. Shareholder Litigation*.[256] *Trados* contrasts starkly with *James*, where, on the converse fact pattern, the court questioned the very availability of majority–minority scrutiny to protect minority preferred.[257] *Trados* not only proceeds to scrutinize, but breaks the precedential mold in so doing. Under the traditional doctrinal framework, a majority shareholder that uses its control power to self-deal at a minority's expense violates a fiduciary duty in its capacity as a shareholder.[258] *Trados* switches to a corporate-level framework, looking not at the venture capitalist and its voting control, but at its director designees, and treating their boardroom action in the venture capitalist's favor as a self-dealing transaction, thereby expanding

254 *See* Bratton, *supra* note 2, at 940.

255 *See id.* at 939-40.

256 *See* Civ. A. No. 1512-CC, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009) (deciding in favor of common stockholders by denying a motion to dismiss "breach of fiduciary duty claims arising out of the board's approval of [a] merger").

257 *Compare id.* at *7 ("[T]he factual allegations in the Complaint support a reasonable inference that the interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger. Given this reasonable inference, plaintiff can avoid dismissal if the Complaint contains well-pleaded facts that demonstrate that the director defendants were interested or lacked independence with respect to this decision."), *with* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 448-49 (Del. Ch. 2010) ("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.").

258 *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (holding that "[a] parent . . . owe[s] a fiduciary duty to its subsidiary when there are parent–subsidiary dealings," and that in the case of self-dealing, the intrinsic fairness standard applies); *id.* at 719-720 ("Under [the intrinsic fairness] standard the burden is on [the parent] to prove, subject to careful judicial scrutiny, that its transactions with [the subsidiary] were objectively fair.").

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the intensity of fiduciary constraint.[259] Taken together with other Delaware precedent,[260] *Trados* raises questions about the treatment of venture capitalists in the Delaware courts.

This Part examines *Trados* critically, asserting that fiduciary scrutiny under the intrinsic fairness standard and the common stock–maximization norm are unsuited to this context. The coupling allows the entrepreneur to recapture what it has already bargained away; worse, it can inhibit value maximization. At the same time, we do not think that preferred stockholders in control should be immunized from fiduciary scrutiny per se, even though their control may be vested by an elaborate, exhaustively negotiated contract structure. The moderate downside fact pattern holds out incentives for preferred in control to sell the company for less than enterprise value, and it is not clear that venture capital contracting structures contemplate that result. We turn once again to good faith as the standard of review best suited to the zone of corporate–contract overlap.

Section A describes venture capital contracting, focusing particularly on control relationships. Section B turns to *Trados*, where controlling venture capitalists effected an exit in apparent good faith, doing their best to get a good price and settling for less than their liquidation preference, only to be waylaid afterward by underwater common shareholders using fiduciary law to extract holdup value. Section C addresses the case's potential perverse effects. Read literally, *Trados* requires venture capitalists to deploy their control to yield value for the common shareholders even where the deployment impairs the value of the corporation. The case's unmitigated rule of common stock maximization accordingly chills value-maximizing deals. We pose a narrower rule under which fiduciary review for the common succeeds only where the venture capitalist deploys control to sacrifice enterprise value: a formulation that can easily be read together with mainstream fiduciary law. Section D confronts a follow-up question: Should the contract paradigm be substituted in the venture capital context to block fiduciary review where enterprise value is sacrificed? There is a strong case in favor of doing so: an entrepreneur who transfers control in exchange for venture capital financing arguably waives the common stockholder's objection to a sale below enterprise value. Such a

259 *See generally Trados*, 2009 WL 2225958.

260 *See, e.g.*, Benchmark Capital Partners IV, L.P. v. Vague, 2002 WL 1732423, at *16 (Del. Ch. July 15, 2002) (rejecting a venture capitalist's motion for a preliminary injunction, noting that the venture capitalist's "claims to a right to vote [on a merger] implicate significant issues of corporate governance"); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1058-59 (Del. Ch. 1997) (concluding that it was in the board's discretion to act in pursuit of the "highest achievable *present* value").

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waiver should be effective, but should be express, not implied. Finally, Section E considers the alternative of relaxed scrutiny under the good faith standard of review. Although relaxed scrutiny imposes some process costs on the venture capitalist, they are not nearly as onerous as those that follow from intrinsic fairness scrutiny. Given the exhaustive background of contractual risk allocation in venture capitalist cases, relaxed scrutiny is the best fit.

A. *Venture Capital Financing*

Venture capital deals often are sealed with a thick stack of documents.[261] Such "contracts' primary job is to align the incentives of both the entrepreneur and the venture capitalist toward success and, in the event of success, to provide for gain sharing and liquidity for the venture capitalist" while simultaneously assuring the entrepreneur of control going forward.[262] The contracts also provide for the event of failure by allocating such value as has been created to the venture capitalist.[263] As noted above,[264] this is a singular mode of financing. Venture capital contemplates intense involvement in the business by the senior security holder, along with actual or contingent control rights holding out potential destruction of the common stock interest.[265] Convertible preferred stock is the dominant financial contract in the sector.[266]

1. The Upside and the Downside

The expectation is that if the project is successful, the venture capitalist will realize its investment yield by cashing out in an IPO of the investee company's common stock.[267] Thereafter the entrepreneur is left in control of the firm.[268]

The contract secures the venture capitalist its share of IPO proceeds through the conversion privilege attached to the preferred and facilitates later

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261 *See* BRATTON, supra note 23, at 741-42 (describing the Stock Purchase Agreement and Investor's Rights Agreement that enable an issue of venture capital and convertible preferred stock).

262 *Id.* at 741.

263 *See id.* at 742 ("When a particular investment does turn out to be a complete failure, the contract structures priorities to allocate any crumbs left on the table to the venture capitalist.").

264 *See supra* notes 248-49 and accompanying text.

265 *Id.*

266 *See supra* note 249 and accompanying text. There are important tax incentives for convertible preferred stock. *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 898-901 (showing that preferred stock provides "favorable tax treatment for the highly intense management incentives that are central to venture capital contracting").

267 *See supra* notes 251-52 and accompanying text.

268 *See supra* note 253 and accompanying text.

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exit via the public trading market by providing registration rights.[269] Conversion can be made mandatory where an IPO meets a financial qualification such as an offering price that is a specified multiple greater than the original selling price.[270] Mandatory conversion assures that the venture capitalist does indeed exit, leaving the entrepreneur in unchallenged control.[271]

Concerns about the entrepreneur's incentives also loom large on the upside. These concerns are addressed by allocating the entrepreneur's equity interest in the firm's growth in the form of common stock options that vest over time.[272] Sequential option vesting diminishes any temptation to abandon the project prior to the IPO phase.[273] Where the entrepreneur has traded away boardroom control, the contingent payoff arrangement also imports a high-powered incentive to remain in the good graces of the venture capitalist and any outside directors.

Venture capital contracts treat downside scenarios by shaping priorities. A startup that creates no value and runs out of capital goes into bankruptcy, probably to be liquidated. Alternatively, if the startup has no significant debt, it can be liquidated privately. Either way, contractual priorities will "allocate any crumbs left on the table to the venture capitalist. But these will not amount to much."[274] Indeed, "the risk of complete failure is intrinsic to venture capital investment. Venture capital firms moderate it by staging the entrepreneur's drawdowns of capital, diversifying their portfolios of investments in startup firms, syndicating investments in particular firms, and closely monitoring their positions."[275]

Poor or mediocre performance short of complete failure—the moderate downside—is not unusual.[276] It also presents a less tractable problem. Here

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269 BRATTON, *supra* note 23, at 741; *see also* NVCA, Model Term Sheet 5 (Mar. 2011), *available at* www.nvca.org/index.php?option=com_docman&task=doc_download&gid=75&Itemid=93 (mandatory conversion terms); NVCA, Model Investors' Rights Agreements 6-20 (Sept. 2012) (registration rights), *available at* www.nvca.org/index.php?option=com_docman&task=doc_download&gid=69&Itemid=93.

270 *See* NVCA, Model Term Sheet, *supra* note 269, at 5 (mandatory conversion terms).

271 *See* Black & Gilson, *supra* note 251, at 261 (noting that following an IPO, the venture capitalist's mandatory conversion provisions ensure that its control rights "diminish over time," eventually resulting in "[c]ontrol becom[ing] vested in the entrepreneur").

272 *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 131 (1999).

273 *See id.*

274 BRATTON, *supra* note 23, at 742.

275 *Id.*

276 Under a rule of thumb, "one-third of venture capital-financed companies end up in bankruptcy[;] . . . one-third end up . . . limping along[;] . . . [and o]nly one-third of the companies that use venture capital financing succeed," reaching the IPO stage. George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1034 (1992); *cf.* GOMPERS & LERNER, *supra* note 272, at 150 tbl.7.3 (showing that in a study of venture capital–backed firms, 22.5% reached the IPO stage, 23.8% either merged with another company or were acquired, 15.6% went bankrupt or were liquidated, and 38.1% were still private).

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the IPO route fails to open due to indifferent venture performance or adverse market conditions,[277] and the venture capital preferred remains unconverted. The preferred issue's duration looms large. "When . . . redemption rights become exercisable, . . . the mediocre performer still limping along either finds replacement capital," is sold to a third party, is liquidated, or defends itself in court.[278] Whichever the case, the interests of the entrepreneur and the venture capitalist can conflict sharply, with the former desiring continuation and a chance for an upside recovery and the latter desiring termination and the certain realization of any value on the table.[279]

2. Control Arrangements

Control in a venture capital relationship need not follow directly from ownership of a majority of the voting shares. Assume the venture capitalist owns 55% of the voting stock and the entrepreneur owns 45%. Parties in this posture often agree to share control of the board. Each party designates a fixed number of directors, and the parties agree on the remaining director(s). The third-party director takes the arbitrator's role in the event of a dispute. Given shared control, share ownership proportions can break in either direction with the venture capitalist or the entrepreneur holding a majority.[280] Relative stock ownership proportions also can vary over time. For example, the venture capitalist can take a minority share upon the first drawdown with its share growing to a majority as drawdowns proceed.[281] Contrariwise, the entrepreneur's share can grow as performance-based stock allocations come to vest.[282] One study finds that the venture capitalist has a majority of the votes in most of the cases.[283]

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277 The NVCA reports that from 1996 to 2004, "there were more exits by acquisition than by IPO in seven of . . . [nine] years." Thomas Hellman, *IPOs, Acquisitions, and the Use of Convertible Securities in Venture Capital*, 81 J. FIN. ECON. 649, 650 (2006).

278 *See* Bratton *supra* note 2, at 940.

279 *See* Fried & Ganor, *supra* note 2, at 994-97 (noting that "the divergence of interests between preferred and common shareholders will cause a preferred-dominated board to push for a liquidity event or other low-risk, low-value strategy that fails to maximize shareholder value," whereas "[a] common-dominated board might have an incentive to choose a high-risk strategy with less expected value for shareholders as a group").

280 *See* Stephen N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Study of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 289-90 (2003) (finding that control is shared between venture capitalist and entrepreneur in 61% of cases; that control is held by one of the parties in the remaining 39% of cases); *id.* at 288 tbl.2 (showing that the venture capitalist controls in two-thirds of cases with single party control).

281 *Id.* at 287-90.

282 *Id.* at 295.

283 *See id.* at 288, 290 (finding a venture capitalist majority in 69% of cases assuming no vesting of the entrepreneur stock allocations and a venture capitalist majority in 53% of cases given

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There is accordingly no one-size-fits-all control pattern. Sometimes the venture capitalist controls both the board and a majority of the stock; in a smaller number of cases, the entrepreneur clearly controls; lastly, in many cases, control is shared.[284] Overall, the implication is that entrepreneurs and venture capitalists are quite sensitive to control, its value, and the way in which its allocation interplays with the other terms of their financings.

Note, however, that the venture capitalist–entrepreneur bargaining dynamic just described is a simplification. Startup funding comes in different modes and from different sources. Venture capital funds also invest later on, after an IPO, with the degree of control dependent upon the situation.[285] Nor are venture capital firms the only source of startup capital. "Angel" investors[286]

full vesting; an entrepreneur majority in 12% of cases assuming no vesting and in 24% of cases assuming full vesting; and no party control in 19% of cases assuming no vesting and 24% of cases assuming full vesting); *see also* Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 388 (2010) (showing that among companies in the sample, "[a]t the time of sale, 56.5% of all directors are appointed by the VCs and 22.8% are appointed by common stockholders," and that the venture capitalist controls the board in 58% of companies); *id.* at 385, 388 (finding that in twenty-one out of the fifty firms sampled a combination of outside directors and common shareholders can block a venture capitalist initiative in the boardroom). Gordon Smith reviews another database and finds that "[s]ole control provisions appear in the contracts" of 38% of cases sampled, and that among those cases, the venture capitalist had control 77% of the time. *See* Smith, *supra* note 2, at 327. Smith finds that entrepreneurs tend to start out in control of the board with venture capitalists taking voting control through the accrual of board seats in subsequent financing rounds. *Id.* at 326-27. He finds no evidence of shared control arrangements because the documents provide for all shareholders voting as a single class on the open seat or seats. *See id.* at 326 ("In the contingent control provisions, votes cast by common stockholders and preferred stockholders typically are lumped together in a single tally, and formal power thus resides with whichever class of stockholders holds a majority of the votes."). Given a conflict, it follows that control ultimately goes to the party that possesses the voting majority.

284 While the venture capitalist often shares control in the boardroom, this shared control does not necessarily imply equal power. If the venture capitalist has greater influence over the tiebreaker director, the venture capitalist can dominate the board without outright control. *See* Bratton, *supra* note 2, at 921 (noting that under some arrangements, where the entrepreneur and venture capitalist disagree on a tiebreaking director, the party with the larger number of shares chooses the candidate, and thus, "in the event of disagreement, the party with the share voting majority controls all significant firm decisions"); Smith, *supra* note 2, at 320 ("Moreover, in the event of conflict between the venture capitalist and the entrepreneur, such outside directors may have a natural inclination to side with the venture capitalist."). For evidence that the tiebreaker director can opt instead to support the common shareholders on the allocation of sale consideration on fairness grounds, see Broughman & Fried, *supra* note 283, at 392-95.

285 *See* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1044, 1051-52 (Del. Ch. 1997) (describing a corporation already listed on the NASDAQ that received loans from investors in exchange for preferred stock).

286 The term originally described affluent individuals who financed Broadway plays. *See* COLLEEN DEBAISE, THE WALL STREET JOURNAL. COMPLETE SMALL BUSINESS GUIDEBOOK 49 (2009).

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provide funding to startups at earlier stages.[287] Angels are wealthy (often retired) individuals who invest personal funds in nearby companies involved in familiar lines of business.[288] Like venture capitalists, though in a somewhat different manner, angels provide entrepreneurs with advice and the benefit of their experience.[289] Amounts invested in "angel rounds" are smaller than in venture capitalist rounds, ranging only from $100,000 to $2 million, but the number of startups receiving angel capital is much larger than the number receiving venture capital.[290] Further, aggregate annual angel investment now equals or exceeds that of venture capital.[291] Significantly, angels tend to take common stock stakes, foregoing board seats, negative covenants, vetoes, and exit rights.[292] This is in part because angel-funded startups want to hold open a door for later venture capital financing.[293] An all-common capital structure amounts to a clean slate open to the addition of layers of venture preferred.[294]

B. *The* Trados *Intervention*

The leading Delaware case on venture capital preferred, *Equity-Linked Investors v. Adams*,[295] sends a stark message: The common stock–maximization norm protects the discretion of boards of directors that take action inimical to the interests of noncontrolling venture capitalists.[296] *In re Trados Inc. Shareholder*

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287 *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417-18 (2008) (noting that angel investors fund companies during their earliest stages, including their first year, while traditional venture capitalists typically wait longer before investing).

288 *Id.* at 1438-40.

289 *See id.* at 1419 ("While venture capitalists take a more formal role . . . angels provide informal advice and counseling.").

290 *Id.* at 1418-19.

291 *Id.* at 1419.

292 *Id.* at 1422-23.

293 *See id.* at 1428 ("Th[e] need for venture capital sets de facto limits on the terms of the angel investment contract.").

294 *See id.* at 1429 ("A start-up marred by a complicated angel round is unattractive to venture capitalists because it requires them to 'unwind' the nonstandard angel preferences in order to strike the venture capitalists' standard deal. . . . [T]his unwinding takes time, effort, and money . . . .").

295 705 A.2d 1040 (Del. Ch. 1997).

296 A noncontrolling venture capitalist investor sought to block a lowball control sale by an entrepreneur who was willing to do just about anything to prevent a control transfer to the venture capitalist. *See id.* at 1050-52 (describing the entrepreneur's disapproval of a restricting plan). Declining to come to the aid of the venture capitalist investor, the court stressed that the duty of the board was *not* to maximize the value of the company, as an economist might insist. *See id.* at 1058-59 (approving the board's goal to "maximize the possibility of the common stock participating in some 'upside' benefit from the commercial development of the company's intellectual properties"). The *legal* duty was to maximize the value of the common stock; and putting the assets to the preferred would risk liquidation, which would wipe out the common. *Id.*

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Litigation[297] presents a group of venture capitalists who got the message. They controlled the board[298] and drafted a liquidation preference triggered by a control transfer.[299] But board control vested in a majority shareholder implies fiduciary responsibilities to the minority. Therein lies the question: Which trumps, the contract paradigm and the allocation of risk bound up in venture capital contracting arrangements, or the corporate paradigm and the duty selflessly to treat the interests of the minority common stockholders?

The company in the case had been building itself up for an IPO for a number of years without success, in the process issuing several series of venture capital preferred.[300] Control had been surrendered to the venture capitalists, whose designees occupied four of seven board seats.[301] Two other seats went to the two top officers.[302] An independent director occupied the seventh seat.[303]

The venture capitalists, realizing no return on their investments, lost patience and decided to shop the company. They therefore brought in a new CEO to put the company in salable condition.[304] At approximately the same time, they received a $40 million offer but deemed it too low.[305] At their investment banker's suggestion, the board instituted a management incentive scheme designed to give the three top officers a cut of any merger proceeds.[306]

As a result, within one year, costs were cut, debt financing was secured, and the company's prospects were much improved.[307] The company was shopped again and the board approved a merger yielding $60 million.[308] The proceeds were allocated $7.8 million to the executives under the incentive plan and the rest to the preferred, with nothing to the common.[309] The preferred took the entire remainder because the charter provided that a merger be deemed a liquidation; therefore, the preferred's $57.9 million liquidation preference soaked up the remaining consideration without being satisfied.[310]

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297 Civ. A. No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

298 *Id.* at *1.

299 *Id.* at *4.

300 *Id.* at *1-2.

301 *Id.* at *1.

302 *Id.* at *2.

303 *Id.* at *1-2.

304 *Id.* at *2.

305 *Id.* at *3.

306 *Id.* More specifically, the plan consisted of a tiered incentive structure under which the management pool would receive 6% of a $30 to $40 million deal, 11% of a deal for $40 to $50 million deal, 13% of a $50 to $90 million deal and so on up to a 15% cut of a deal over $120 million. *Id.* at *3 n.5.

307 *Id.* at *3.

308 *Id.* at *3-4.

309 *Id.* at *4.

310 *Id.*

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A common stockholder responded with an appraisal action, but, apparently disappointed with its prospects, switched over to a complaint for breach of fiduciary duty.[311] The complaint alleged that the defendants had breached their fiduciary duty to the common shareholders because "there was no need to sell [the company] at the time," given that it was "well-financed, profitable, and beating revenue projections,"[312] and because, had the board waited, there might have been proceeds for the common.[313] The plaintiffs also argued that the common had priority fiduciary status, and yet that the board failed to take the common's interest into account.[314]

The Chancery Court denied the defendants' motion to dismiss the breach of fiduciary duty claim.[315] It analyzed the case as one of director self-dealing. The venture capitalists' director-designees were interested in the outcome of the transaction by virtue of their positions at the various venture firms;[316] the two officer-directors were interested under the bonus arrangement. The interest having been shown, the business judgment presumption was overcome,[317] and under the duty of loyalty, the burden shifted to the defendants to show entire fairness.[318] In other words, when controlling preferred cause the corporation to enter into a transaction that realizes their contractual preferences on the moderate downside, approval by controlled board members will be treated, at the behest of a complaining common stockholder, as engaging in a self-dealing transaction. The preferred's rights get no recognition under fiduciary law because they are contractual; the interests of the common, by contrast, do get recognition.[319]

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311 *Id.*

312 *Id.* at *6.

313 *See id.* at *7 ("[I]t is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred.").

314 *Id.* at *6.

315 *Id.* at *10.

316 *Id.* at *8.

317 *Id.*

318 *Id.* at *9 n.56.

319 *Id.* at *7 ("This Court has held that directors owe 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.'" (quoting Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986))); *id.* ("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.'" (quoting Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997))). Note that both *Jedwab* and *Equity-Linked Investors* arose on the converse fact pattern where a preferred stockholder claimed fiduciary protection against common in control, and in effect, remitted the preferred to the contract-drafting table to bargain for more protection the

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Apparently, the corporate paradigm trumps the contract paradigm even where the resulting fiduciary intervention disrupts a power allocation effected in a heavily negotiated deal between sophisticated parties. This result is questionable. Venture capital investment is a high-risk, high-return proposition for all participants.[320] The deal structure often allocates to the venture capitalist the power to detach the assets from the entrepreneur and deploy them somewhere (or with someone) else.[321] Infinite patience is not expected from the venture capitalist—the venture capitalist has investors of its own and is under pressures to yield returns in a competitive market. This all-or-nothing governance framework presumably yields a highly incentivized entrepreneur. *Trados* hobbles the incentive structure by handing the entrepreneur a fiduciary backstop in the teeth of the deal's allocation of risk.

The Sections that follow take up, in two phases, the problems *Trados* leaves behind. Section IV.C assumes fiduciary review under an intrinsic fairness standard and demonstrates the case's potential perverse effects. Section IV.D considers whether the contract paradigm should be invoked to block fairness scrutiny altogether.

C. Trados *and the Value-Maximizing Merger*

Trados is troublesome in four respects. First, its directive to maximize common stock value makes economic sense in some situations but not in others. Second, read literally, the case makes it impossible for preferred in control to effect a maximizing sale without surrendering holdup value to the common. Third, the case slaps down fairness scrutiny in the teeth of the risk allocation bound up in an antecedent bargain. Fourth, it fails to leave open a door through which parties negotiating future deals can contract out from under the scrutiny it imposes. This Section takes up these problems in turn.

1. Common Stock Maximization Versus Enterprise Value Maximization

Sometimes preferred in control has an incentive to sacrifice enterprise value. *Trados* scrutiny can make economic sense in such a case. In other

next time around. *Trados* is a case where the preferred had done exactly that. Significantly, these precedents had been thought to direct fiduciary duties in accordance with control. *See* Fried & Ganor, *supra* note 2, at 990-93 ("A common-controlled board owes a duty to common shareholders and is free to take steps to benefit the common, even at the expense of the preferred and of total shareholder value. However, under the courts' control-contingent approach to fiduciary duties, a preferred-controlled board is not obligated to serve common shareholders' interests." (footnote omitted)).

320 *See supra* note 246 and accompanying text.

321 *See supra* note 247 and accompanying text.

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situations, maximization of the value of preferred in control also maximizes enterprise value, while common stock maximization makes the enterprise less valuable. Here *Trados* scrutiny creates problems.

Preferred, as a senior claim, will avoid taking value-enhancing risk in a case where common, as the at-the-margin residual interest, would assume the risk. This standard incentive-incompatibility story can be told by tweaking the *Trados* fact pattern.[322] Assume that the venture capitalists' liquidation preference is $40 million and wind back the clock to the beginning of the sale effort. There is a $40 million offer on the table. The preferred can take it or hire a turnaround expert and try again the next year. There is a 75% chance that a turnaround will produce an offer of $60 million and a 25% chance that the turnaround will fail and market conditions worsen so that the best offer will be $30 million. The expected value of the company given the turnaround attempt is $52.5 million ($60 million x .75 + $30 million x .25). The venture capitalist, however, has no incentive to take the risk because its upside is capped at $40 million. It therefore takes the bird in the hand because the turnaround carries a $10 million downside risk—a classic case of a sacrifice of enterprise value stemming from a senior security holder's aversion to risk. In this scenario, maximizing for the common, which captures the risky marginal gain, also maximizes value for the enterprise as a whole.

But that is not always the case. *Trados*, by insisting on a preference for the common stock, holds out perverse incentives where maximizing for the common sacrifices enterprise value. To see why, go back to the case and assume that the $60 million offer is on the table and that there are two possible outcomes if the offer is not accepted. There is a 25% chance that a $70 million offer can be realized in the intermediate term and a 75% chance that the markets will turn down and $50 million will be the best offer available. The expected value of delay is $55 million ($70 million x .25 + $50 million x .75). Delay thus sacrifices $5 million of enterprise value in exchange for a chance to realize an expected $750,000 ($3 million x .25) for the common.[323]

The second set of numbers replays the familiar problem of debt and equity on the downside. In *Credit Lyonnais Bank Nederland v. Pathe Communications*

322 For another telling, see Fried & Ganor, *supra* note 2, at 994-97 ("[T]he debt-like nature of their cash flow rights may cause preferred shareholders controlling the board to choose lower-risk, lower-value business strategies over higher-risk strategies that would maximize aggregate shareholder value.").

323 Recall that, of the potential $70 million, $57.9 million goes to the preferred to satisfy their liquidation preference. *See supra* text accompanying note 310. Further, 13% of the $70 million will be paid to the management pool per the terms of the incentive structure. *See supra* note 306. Subtracting the aggregate of these two distributions ($57.9 million and $9.1 million) leaves $3 million for the common.

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Corp., Chancellor Allen famously suggested that fiduciary law should favor enterprise value maximization (and the creditor interest) over shareholder value maximization where extreme financial distress inclines the common interest to low return, speculative investment.[324] The suggestion opened up the possibility of liability for directors pursuing common stock returns in the "zone of insolvency," a possibility minimized by subsequent decisions.[325]

Trados reminds us that common stock–enterprise value conflicts can arise incident to any priority claim—senior equity claims as well as debt—and can arise on the moderate downside as well as in the zone of insolvency. *Trados*, however, implicates the converse problem. *Credit Lyonnais* opens a door to a creditor action against common-maximizing directors who sacrifice enterprise value. Conversely, *Trados* imposes potential fiduciary liability on directors who pursue enterprise value over suboptimal speculation for the common's benefit.

It follows that, depending on the facts of the case, *Trados* can push a preferred-controlled board away from an optimal result. Were that the only problem, we could stop here and recommend that the duty be reframed in terms of enterprise value—the common stockholder plaintiff would be required to plead and prove that the preferred holder's sale sacrificed enterprise value (as opposed to common stock value). But it is more complicated. *Trados* makes it harder for a venture capitalist in control to realize on its investment whatever the particular case's value posture, thus creating holdup value for the common.[326] Worse, *Trados* leaves no opening through which a venture capitalist can completely contract around the problem in advance.

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324 *See* Civ. A. No. 12150, 1991 WL 277613, at *1155 n.55 (Del. Ch. Dec. 30, 1991) ("But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only.").

325 *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 94 (Del. 2007) ("[T]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors.").

326 Broughman and Fried show that deviations from contracted allocations in favor of the common occur in eleven out of the fifty cases examined such that the venture capitalists in those cases realize eighty-nine cents on the dollar. Broughman & Fried, *supra* note 283, at 391. Even absent a fiduciary leg up from *Trados*, we attribute these findings to independent-director presence in the boardroom and California's provision of a mandatory class vote for the common. *See id.* at 392-95 (finding that lack of venture capitalist board control and incorporation in California are associated with lower realization rates). For the converse situation, in which a venture capitalist allegedly uses its control position to enhance its share of cash flows by engineering dilutive stock issues, see Carsanaro v. Bloodhound Tech., Inc., No. Civ.A. 7301–VCL, 2013 WL 1091048 (Del. Ch. Mar. 15, 2013) (denying venture capitalist defendants' motion to dismiss).

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2. Selling the Company Under *Trados*

For purposes of this discussion, assume the second situation described above: preferred control, and a $60 million immediate sale maximizes enterprise value, while common stock maximization dictates delay in search of a $70 million offer. How, given *Trados*, can the controlling venture capitalist effect the immediate sale? The case leaves the venture capitalist with a Hobson's choice: either sell into litigation risk or make a side payment directly to the underwater common in exchange for the holdup value the case creates.

Let us first try to process our way out of the problem. First, the venture capitalist will engage an investment banker to opine on the fairness of the sale price. Unfortunately, an opinion on the fairness of $60 million will afford little comfort given the threat of intrinsic fairness scrutiny under a common stock–maximization principle. Indeed, a fairness opinion that reports the numbers in the hypothetical and admits a 25% chance of a $70 million sale makes the plaintiff's case under a literal reading of *Trados*.

Let us accordingly process further and have independent directors manage the merger. Independent directors are, of course, a normal incident of today's fiduciary regime, especially during sale of a company. Even so, we make a considerable concession. The independent board regime was designed with public companies in mind, not startups unable to reach the IPO stage. The cost burden of a constructed negotiation accordingly is not *trivial* for a company like that in *Trados*, with one independent director out of seven.

Let us recruit a couple of new directors for the occasion. Next, a question will arise as to whether a special negotiating committee representing only the common interest is necessary, by analogy to the parent–subsidiary cashout merger cases. If it is necessary, we potentially arrive at the tripartite negotiation that so troubled the Chancery Court in *James*, with the venture capitalists and their designees negotiating the sale price with the third-party buyer and the common's directors interposing themselves to look for more money however they can get it.[327] Such a committee will be in an awkward position in our case: to satisfy the venture capitalist's liquidation preference and bring any capital home for the common, it would have to hold out for a deal priced higher than $66.55 million;[328] failing that, it would be negotiating for holdup value.

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[327] *See supra* notes 135-44 and accompanying text (discussing the difficulties that a committee of independent directors faced in satisfying both the common and the preferred in a potential merger deal).

[328] *Cf. supra* note 323. This figure is derived by subtracting 13% of itself (the board's share), since it will surely have to be greater than $60 million, but may still be less than $90 million, further subtracting the $57.9 million preferred liquidation preference, simply to reach the breakeven point

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Any result negotiated by a special committee entails a residuum of litigation risk, even a high-end settlement. Suppose, for example, that the merger is priced at $70 million after much pushing by the independent committee. This transaction yields $3 million to the common. The committee, advised by its own investment banker, finds the price fair. Yet nothing prevents a lawyer from drafting the same "might have waited" complaint that survived a motion to dismiss in *Trados*[329]—maybe waiting a year would have yielded $75 million. Such a claim is as hard to falsify as it is easy to draft. Even so, the process precautions strengthen the venture capitalist's hand—given an independent special committee with veto power representing the common interest, the common are deprived of the claim that the board engaged in self-dealing, which proved actionable in *Trados*.[330] It would seem to follow that the burden of proof regarding fairness shifts to the plaintiff.[331] Such a shift may suffice to baffle a "might have waited" pleading.

The foregoing amounts to cold comfort for the venture capitalist for all sale prices under $66.55 million. Under a common stock–maximization norm, *any* result that wipes out the common is vulnerable to a "might have waited" complaint. It follows that the "fair" return negotiated by the special committee comes out of the venture capitalist's liquidation preference, or in other words, holdup value.

Having arrived at this point, we ask whether we should dispense with the special negotiating committee and negotiate directly with the holder of the common. Direct negotiation seems sensible given a simple two-party case with a venture capitalist and an entrepreneur. A successful direct negotiation leads to a surrender of the fiduciary claim in connection with the payment, eliminating litigation risk. But suppose the company's buyer has no further use for the entrepreneur and the entrepreneur is looking for compensation for loss of position and will happily kill the deal for any return under $20 million. Here, constructed negotiation through a special committee might be cheaper for the venture capitalist, even given litigation risk. Alternatively, suppose that the company has gone through numerous rounds of angel financing and that a collection of wealthy individuals holds common in

(the point at which the corporation can satisfy its obligations to both the board and the preferred). Therefore, to reach this breakeven point the price must be at least equal to the sum of 13% of itself and $57.9 million. Solving using simple mathematics, x = .13x + 57.9; therefore, x = 66.55.

329 *See In re* Trados Inc. S'holder Litig., Civ. A. No. 1512-CC, 2009 WL 2225958, at *10 (Del. Ch. July 24, 2009) (denying motion to dismiss "with respect to the claim . . . for breach of fiduciary duty arising out of the board's approval of the merger").

330 *Id.*

331 This burden shifting follows by analogy to the cash out merger cases. *See supra* text accompanying notes 67-68.

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addition to the entrepreneur. The only way to eliminate litigation risk is to get all the parties on board. A secondary holdup problem results: less-than-angelic common holders may ask for more than a pro rata share of the settlement. Finally, it bears noting that common holders have an incentive to negotiate for more than their due even when they are not underwater. For example, although a merger priced at $70 million yields the common $3 million net of the venture capitalist's liquidation preference, nothing stops the common from negotiating for a higher figure.

In sum, the venture capitalist in control can succeed in selling the investee company post-*Trados*, but only at considerable additional cost.

3. Contracting Out of Fairness Scrutiny: Drag-Along Rights

There is a standard response to the complaint just registered. To the extent that the venture capitalist is averse to litigation risk or otherwise dissatisfied with the incentive effects of *Trados*, it can deflect the risk at the contracting stage.[332] The fiduciary common stock–maximization principle purports only to fill in a gap in an incomplete contract.[333] Typically, the burden to contract around the corporate law default falls on the preferred.[334]

The response has superficial credibility, for there is a standard contract that addresses this problem—a shareholders' agreement containing "drag-along rights."[335] The credibility is superficial because *Trados* disrupted the contracting field, *impairing* the operation of the drag-along rights. Indeed, on the facts of *Trados*, no available contractual circumlocution exists.

Drag-along rights appear in shareholder voting agreements, which are a standard feature of venture capital term sheets.[336] We have seen, for example, that a shared-control boardroom might consist of two venture capitalist designees, two entrepreneur designees, and a tiebreaker. A contract between the venture capitalist and the entrepreneur, entered into by both in their

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332 *See supra* notes 80-82 and accompanying text (discussing broadly classification of shares and penalty defaults at the contracting stage).

333 *See supra* notes 76-78 and accompanying text.

334 *See supra* note 79 and accompanying text.

335 *See, e.g.*, NVCA, Model Voting Agreement 5 n.11 (Sept. 2012) [hereinafter Model Voting Agreement], *available at* www.nvca.org/index.php?option=com_docman&task=doc_download&gid=76&Itemid=93 ("A drag-along right gives a defined group of stockholders the right to deliver all (or most) of the shares of a company without the need of effecting a freeze-out merger.").

336 *See id.* § 3 (providing a drag-along right provision in a model voting agreement).

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capacities as voting shareholders, assures that both shareholders cast their votes in the tiebreaker's favor at the annual meeting.[337]

Drag-along rights similarly seek to assure fulfillment of expectations respecting a future sale of the company by allocating the right to force a sale of the company to a stated threshold percentage of a class (or classes) of shareholders.[338] Assume by way of example a five-seat board with a tiebreaker director, a venture capitalist with 49% of the voting shares, and an entrepreneur with 51% of the voting shares. Assume that the venture capitalist's two directors plus the tiebreaker vote in favor of a merger. The merger, once approved by the board of directors, requires the confirming vote of a shareholder majority. Absent a contract, the entrepreneur can use its votes to veto the deal. The voting agreement avoids that result by securing the entrepreneur's advance promise to vote in favor of a merger having the preferred's support.[339] A promise not to seek appraisal can also be included.[340]

A caveat must be noted here: a shareholders' agreement only binds its signatories. Accordingly, it best suits a simple venture capitalist–entrepreneur fact pattern. Given layers of angel investors in the shareholder group, more complicated issues may arise. Assume that a venture capitalist sensibly conditions its provision of funds on 100% common assent to the shareholders' agreement. A less-than-angelic common holder might say no and ask to be removed with some of the proceeds of the financing. Therefore, once again, avoiding *Trados* means confronting holdouts.

Let us assume that all common shareholders will sign on. A question then arises: Does the drag-along just described completely solve the *Trados* problem for the venture capitalist? The issue is whether the shareholders' advance consent somehow obviates or excuses the self-interested breach of the duty of loyalty that occurs in the boardroom, when the venture capitalist's director designees approve a later deal. Arguably, no excuse follows because *Trados* situates the breach in the boardroom rather than framing the matter as a shareholder-level breach by a controller against a minority.[341]

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337 *See id.* § 1 (providing a shareholders' agreement that sets out promises to vote for one another's designees at elections of directors).

338 *See id.* § 3.2 ("[A drag-along right provision establishes that in] the event that . . . the holders of at least [some specified threshold] of the shares of Common Stock then issued or issuable upon conversion of the shares of . . . Preferred Stock . . . approve a Sale of the Company in writing[,] . . . then each Stockholder and the Company hereby agree . . . [to] take such . . . action in support of the Sale of the Company as shall reasonably be requested by the Company or the Selling Investors . . . .").

339 *Id.* § 3.2(a).

340 *Id.* § 3.2(e).

341 *See supra* notes 311-14 and accompanying text.

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The National Venture Capital Association (NVCA) revised its model version of the venture capital shareholders' agreement in response to *Trados*.[342] The revision seeks to square the circle by forcing the sale while simultaneously getting the self-interested approving directors off the *Trados* hook. The vehicle is a promise made by the issuer corporate entity to the shareholder parties. Under the promise, a designated threshold percentage of shareholders can direct the corporation to sell itself.[343] The drafter outlines a series of processes the company must undertake to effect the sale.[344] Thus, the initiation of a sale process triggers corporate-level contractual duties to take actions that facilitate the deal. Actual performance of these functions, in theory, cannot be characterized as a "self-dealing transaction."

But there is only so much a contract can do in advance to get a company sold. A merger ultimately requires the approval of the transferor's board of directors.[345] The new NCVA drag-along rights contemplate that this step be taken, but they provide in the alternative for a case where board approval is refused.[346] Such a situation is possible where directors are unwilling to stick out their necks and approve a merger threatened by a *Trados* claim holding out potential personal liability. Given a refusal, the agreement provides for redemption of the venture capitalist preferred at a price equal to the amount that would have been allocated to the preferred had the rejected transaction been consummated.[347] The idea is either to sell the company with the board's approval or, failing that, to substitute an automatic redemption obviating the need for board approval.

This is all very convoluted and clever, but unfortunately, it does not solve the *Trados* problem. Redemption in lieu of a merger is not the same as a merger, for absent the acquirer's cash, there is unlikely to be money on the table with which to redeem the preferred. The trigger does give the venture capitalist a viable threat, and this redemption threat presumably makes the

342 *See* Model Voting Agreement *supra* note 335, at add. n.29 (proposing "'Sales Rights' provisions . . . designed to insulate the Board from a *Trados*-type claim").

343 *See id.* at add. ("Upon written notice to the Company from the Electing Holders, the Company shall initiate a process . . . in accordance with this Section . . . intended to result in a Sale of the Company.").

344 *Id.* at add. § 1.2.

345 *See* DEL. CODE. ANN. tit. 8, § 251(b) (2011) ("The board of directors of each corporation which desires to merge or to consolidate shall adopt a resolution approving an agreement of merger or consolidation . . . ."). Absent a charter amendment that remits merger approval to shareholder governance, the Delaware Code still requires a board decision. *See id.* § 141(a) ("The business . . . of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided . . . in its certificate of incorporation.").

346 Model Voting Agreement, *supra* note 335, at add. § 1.3.

347 *Id.* at add. § 1.3(b).

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board members' action in approving the merger more reasonable. But it is hard to see how this background contractual maneuvering either makes the merger any less "interested" if the approving board members are also venture capitalist designees or makes the merger price intrinsically fair under *Trados*. If, in the alternative, the board simply rejects the venture capitalist's deal and redemption rights are triggered and exercised, we find ourselves back at *ThoughtWorks*, which, read together with *Trados*, implies a *duty* on the board's part to drag its feet about paying the redemption price![348]

4. Summary

Trados burdens venture capital finance. The burden is especially heavy on deals already in place at the time of the decision that did not have the benefit of the NVCA's redrafted shareholders' agreement. Given a merger that maximizes enterprise value, there are no cognizable countervailing economic benefits to justify the costs imposed. Nor does such a lawsuit vindicate any serious notion of fairness.

"Fairness" in the venture capital context cannot be determined by taking a snapshot of the board that approved the merger, as the court did in *Trados*. The causal chain needs to be considered in the wider transactional context. The common in the case came away with nothing because (a) venture capitalist designees dominated the board,[349] (b) the company earlier had surrendered a majority of the board seats to the venture capitalists in exchange for venture capital, and (c) the company gave up a $57.9 million liquidation preference to the venture capitalists in exchange for their capital.[350] A reference to the doctrinal framework that formerly came to bear on this fact pattern,[351] the majority–minority fiduciary duty as articulated in *Sinclair v. Levien*,[352] draws out the implications of the second and third links in the causal chain. Under *Levien*, self-dealing by a majority shareholder gives rise to intrinsic fairness scrutiny, with the burden of proof on the majority shareholder; self-dealing is implied if the majority takes value to the minority's exclusion and detriment.[353] Value was taken in *Trados*, but only pursuant to the ex ante contract. There was no failure to share and no breach up to $57.9 million. Any failure to share implicated only the timing—the board gave up the value of the option to

348 *See supra* notes 211-18 and accompanying text.
349 *See supra* note 298 and accompanying text.
350 *See supra* note 310 and accompanying text.
351 *See supra* note 258 and accompanying text.
352 280 A.2d 717 (Del. 1971).
353 *See supra* note 258 and accompanying text.

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delay. But, as we have seen, the option probably had no value from an enterprise perspective.

The only value protected is doctrinal—the positive (as opposed to normative) place held by the common stock directive, and that is not enough to justify the result. A common stock–maximization principle not only encourages sacrifices of enterprise value, but adds costs by encouraging underwater common to disrupt ex ante bargains in search of holdup value. An enterprise value–maximization principle presents a much stronger case for fiduciary scrutiny with a more balanced tradeoff of costs and benefits. It follows that a common stockholder challenging a sale effected by a preferred holder in control should be required to plead and prove a sacrifice of enterprise value.

D. Trados *and the Suboptimal Merger*

We return to the first merger described in the preceding section—a $40 million deal that pays the venture capitalist its liquidation preference but foregoes the opportunity to realize an expected value of $52.5 million, with the entire $12.5 differential borne by the common. Here, the litigation threat performs an efficiency function by ameliorating the structural tendency of senior security holders to make lowball deals. Investment banker opinions and independent directors now serve a function, and even a special committee charged with the common's interest makes sense—one is less worried about disrupting a deal that should be killed in any event.

The fairness posture also reverses. A merger below enterprise value is the archetypical appraisal case. But, by analogy to parent–subsidiary mergers, appraisal should not be the exclusive remedy and a door should be held open for a process complaint.[354] And, given a sale below enterprise value engineered by interested directors, there is a serious process complaint. Traditional majority–minority fiduciary duty applies with full force.

A question arises nonetheless: Is *Trados* scrutiny undesirable here as well because it disrupts a settled contractual risk allocation? Professors Baird and Henderson, in an article that anticipated *Trados*, opine that scrutiny is undesirable.[355] They advocate a contractual barrier to fiduciary review and argue that fiduciary law should demand neither common stock–value maximization nor enterprise value maximization in venture capital

354 *See, e.g.*, Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104-05 (Del. 1985) (stressing that a showing of procedural unfairness supports an action for breach of fiduciary duty and defeats appraisal exclusivity).

355 *See* Baird & Henderson, *supra* note 2, at 1328-33 (arguing, in light of *Orban v. Field*, Civ. A. No. 12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997), that courts should not stand in the way of venture capitalists deciding when to pull the plug on a struggling company).

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contexts.[356] Their theory rests on the assumption that parties can opt out of the applicable fiduciary duty, an assumption supported by close corporation cases on the majority–minority shareholder duty.[357] *Trados*, by resituating the fiduciary breach in the boardroom, blocks the possibility of opting out of such duty. In Delaware, charters can opt out of the board's duty of care, but not the board's duty of loyalty.[358]

It is not clear whether opting out would work in Delaware even if *Trados* had not moved the duty into the boardroom. Baird and Henderson's proposition is important nonetheless as a theoretical exercise pushing venture capital preferred to a contractual extreme. We consider it in this Section and find ourselves in partial disagreement. We recommend entertaining common stock complaints alleging sacrifices of enterprise value; but, in order to reduce costs to the venture capitalist and diminish the holdup threat, we would substitute good faith for intrinsic fairness as the standard of review. In addition, we recommend respect for venture capital deals that expressly contract out from under the duty.

Baird and Henderson acknowledge that senior security holders in control have imperfect incentives, and thus can be expected not only to fail to maximize the value of the common, but also rationally to sacrifice enterprise value.[359] Even so, Baird and Henderson, analogizing to an enforcing lender,[360]

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356 *Id.* at 1332-33.

357 *See* Gallagher v. Lambert, 549 N.E.2d 136, 137 (N.Y. 1989) (holding that an employee-shareholder waived fiduciary duties in his shareholders' agreement); Baird & Henderson, *supra* note 2, at 1319 n.50 ("A minority shareholder in a close corporation, by that status alone, who contractually agrees to the repurchase of his shares upon termination of his employment for any reason, acquires no right from the corporation or majority shareholders against at-will discharge." (citing Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1313 (N.Y. 1989))).

358 DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). Opting out is a topic of controversy in Delaware law today, but provisions of the Delaware Limited Liability Company Act favor freedom of contract and make fiduciary duties a function of the parties' choices. Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 864 (2008) ("[P]arties forming a Delaware limited liability company or a Delaware limited partnership are specifically authorized by statute to agree that the managers . . . will not owe any fiduciary duty of loyalty to the members or limited partners."); *see, e.g.*, DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) ("[A partner's duties to a limited partnership] (including fiduciary duties) . . . may be expanded or restricted or eliminated by provisions in the partnership agreement"); *id.* § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); *id.* § 18-1101(c) ("[A member's duties to a limited partnership] (including fiduciary duties) . . . may be expanded or restricted or eliminated by provisions in the limited liability company agreement . . . .").

For the view that fiduciary duties are hardwired into all Delaware business forms as a function of the constitutional vesting of Chancery Court jurisdiction, see Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 713-18 (2011).

359 *See* Baird & Henderson, *supra* note 2, at 1331 ("The business was worth enough to pay the preferred shareholders more than ninety percent of what they were owed if sold immediately.

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would have the contract paradigm trump the corporate paradigm as a structural proposition.[361] The common have given up contingent control rights—rights with the potential to "destroy firm value"—to the venture capitalist.[362] On the other hand, the common and their managers emerge with "just the right incentives . . . to operate the firm efficiently in the first place."[363]

Significantly, Baird and Henderson neither invoke the contract paradigm absolutely nor advocate a complete retreat from fiduciary scrutiny. Although they would eliminate intrinsic fairness scrutiny on a *Trados*-style fact pattern,[364] they pose a hypothetical on which such scrutiny should proceed.[365] Here, the venture capitalist dominates without controlling the board.[366] It encourages profligate spending even as the company turns down opportunities for additional financing, assuring the other board members that additional financing on better terms is readily available.[367] When the company runs out of cash and is desperate, the venture capitalist secures a bridge loan and takes, for its pains, bargain warrants that almost dilute the common out of existence.[368] According to Baird and Henderson, if the common can show that the board turned down legitimate deals on an insufficient process basis while dominated by a conflicted director, a fiduciary action should lie.[369]

But wherein lies the distinction? Baird and Henderson do not elaborate further. There are two possible ways to distinguish the cases: good faith or implied waiver.

From the perspective of the preferred stockholders, the additional energy and monies spent on finding a buyer would not be well spent. They faced all the downside from waiting, while someone else (the principal common shareholder) would enjoy most of the upside." (footnote omitted)).

360 *Id.* at 1332-33.

361 *Id.* at 1314 ("At first cut, we should respect the choices investors and directors make, even if they seem to create situations where the board acts in ways that appear to destroy firm value."); *id.* at 1332-33 (arguing that the "fact that [contracted control rights] are ubiquitous and have persevered in a highly competitive industry is enough to give corporate law pause before disrupting them").

362 *Id.* at 1332.

363 *Id.* at 1332-33.

364 *Id.* at 1331-33.

365 *Id.* at 1332-33 n.106 (preserving scrutiny in certain cases with self-dealing).

366 *Id.*

367 *Id.*

368 *Id.*

369 *Id.* The authors suggest that the case could overcome *Orban v. Field*, Civ. A. No. 12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997), a case the *Trados* court did not follow. *See In re* Trados Inc. S'holder Litig., Civ. A. No. 1512-CC, 2009 WL 2225958, at *8-9 (Del. Ch. July 24, 2009) (noting that in *Orban* the court assumed that the business judgment rule did not apply, whereas "the issue on the motion to dismiss [in the instant case] is whether plaintiff has rebutted the presumption of the business judgment rule").

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Let us first try good faith. The hypothetical poses a bad faith venture capitalist who, motivated by the chance of personal gain, sacrifices enterprise value at the expense of the other claimants. If we take the value-maximizing $60 million version of *Trados* and stipulate that the venture capitalists believe they have made the best possible deal, it is a case of good faith, distinct from Baird and Henderson's hypothetical. Unfortunately, however, the distinction lacks traction. If we switch to the $40 million version of *Trados* and stipulate that the venture capitalists are aware of a better deal or recklessly disregard chances to get a better deal, then the venture capitalists are no more in good faith than the venture capitalists in the hypothetical. Yet Baird and Henderson would block scrutiny.

Therefore, implied waiver holds out the better distinction. The common can foresee a below enterprise value sale by a venture capitalist in control looking for an exit when the deal is made. We accordingly could imply a waiver of scrutiny in the deal structure. Underhanded domination of the board on a going-concern basis to beat down the company to a fire sale price is sneakier, more contrived, and less easily foreseen. A waiver of scrutiny accordingly is less easily implied. Scrutiny arguably is blocked in the first, foreseeable case, but not in the second, unforeseeable case.

With waiver as the theory, we must confront the resulting problem of contract interpretation. Baird and Henderson in effect imply a waiver of objection to a sale as a structural proposition. As a theoretical matter, once the waiver is implied, the contract is completed with respect to a future sale of the company. With a complete contract, fiduciary duty has no place.

This goes against the doctrinal grain. In the context of limited liability companies where opting out of fiduciary duties is an active possibility, the opt-out must be explicit.[370] A question arises at this point: Should drag-along rights, in their pre-*Trados* form, be read to effect the waiver? Here, in relevant part, is the language from the NVCA Model Voting Agreement. The shareholder agrees

> to execute and deliver all related documentation and take such other action in support of the Sale of the Company as shall reasonably be requested by the Company or the Selling Investors in order to carry out the terms and provision of this [section], including without limitation executing and delivering

370 *See, e.g.*, Kelly v. Blum, Civ. A. No. 4516-VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) ("[U]nless the LLC agreement . . . explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members."); *see also id.* at *10 n.70 (asserting that drafters of limited liability company agreements "should be expected to provide . . . clear and unambiguous provisions when they desire to expand, restrict, or eliminate the operation of traditional fiduciary duties").

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> instruments of conveyance and transfer, and any purchase agreement, merger agreement, indemnity agreement, escrow agreement, consent, waiver, governmental filing, share certificates duly endorsed for transfer (free and clear of impermissible liens, claims and encumbrances) and any similar or related documents . . . .[371]

Under a literal reading, the waiver is there; indeed, the signatory agrees to deliver a waiver tailored to the occasion. If we ratchet up the drafting burden, however, the waiver does not succeed because the signatory gets no special notification of a surrender of fiduciary protection, a notice that arguably should be enshrined in block capitals and initialed in the margin.

It is a judgment call. For much the same reasons articulated by Baird and Henderson at a structural level,[372] we would hold the NVCA language to effect the waiver and block a fiduciary action by a drag-along signatory, even in the $40 million case. Absent a shareholder agreement, however, we would not block a *Trados* claim respecting a merger below enterprise value. We would, however, adjust the standard of review.

E. *Standards of Review*

We agree with Baird and Henderson that the *Trados* fact pattern calls for a considered accommodation between the corporate and contract paradigms. We have seen that rigid corporate treatment facilitates holdups by underwater common and destabilizes heavily negotiated transactions. Control having been given up at arm's length, interested director approval should not by itself trigger intrinsic fairness review. At the same time, absent a drag along, it is not clear that the common in a venture capitalist–controlled investee has bargained away its right to complain of a sacrifice of enterprise value.

We seek a point of accommodation on the corporate side of the paradigmatic divide. In our view, an adjustment of the standard of review will work better than an across-the-board contractual bar to suit.

There are four possible standards of review when a *Trados* plaintiff complains of a below enterprise value sale: (1) intrinsic fairness, burden of proof on the defendant; (2) intrinsic fairness, burden of proof on the plaintiff; (3) good faith, burden of proof on the defendant; and (4) good faith, burden of proof on the plaintiff. *Trados* appears to apply standard 1 by allowing the plaintiff's allegations by themselves to put the burden to prove intrinsic

371 Model Voting Agreement, *supra* note 335, § 3.2(c).

372 *See supra* notes 359-63 and accompanying text.

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fairness on the defendant.[373] Standard 2 applies when defendants take procedural steps to qualify the transaction in question—independent-director approval in the case of a manager self-dealing transaction, and negotiation by an independent directors' special committee in the case of a parent–subsidiary merger. Standard 3 asks for less than fairness by reviewing only for reckless disregard for the corporation's interests. We have noted here its invocation in preferred stock cases, reformulated as a reckless disregard for the interests of the preferred stockholders, and recommended its employment when a common majority imposes a merger allocation on a class of preferred. Standard 4 is the business judgment rule, which always yields to a plaintiff who meets the burden to show bad faith. While it might seem at first blush that business judgment treatment in a *Trados* case amounts to rejection of fiduciary scrutiny and corporate treatment, that is not the case. To impose standard 4 is to reject the contract paradigm: given an effective waiver of fiduciary duty, none of the standards would apply.

For us, the choice lies between standards 3 and 4. Putting the burden of proof on the defendant under standard 3 puts procedural pressure on the venture capitalist to examine alternatives and justify its choice. Switching the burden of proof to the plaintiff under standard 4 eases the pressure but enhances the chance that a value-destructive merger could survive a motion to dismiss, subject to an appraisal.

The precedent favors standard 3, which the court employed in *Orban v. Field*,[374] the leading Delaware preferred-in-control case prior to *Trados*. As in *Trados*, venture capitalists in control of a company in moderate distress arranged a sale.[375] The acquirer, for tax reasons, insisted on ratification by 90% of the common stockholders.[376] Unfortunately, an entrepreneur on the scrapheap had more than 10% of the common votes and attempted to leverage those votes to extract a substantial holdup payment.[377] The venture capitalist–controlled board responded with a series of transactions that diluted the entrepreneur's holdings to less than 10% of the stock.[378] The entrepreneur sued for breach of the duty to maximize for the common, but made no claim that the merger sacrificed enterprise value.[379]

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373 2009 WL 2225958, at *9. We say "appears" because the matter was decided on a motion to dismiss.

374 No. 12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997).

375 *Id.* at *4-5.

376 *Id.* at *5.

377 *Id.* at *6.

378 *Id.* at *7.

379 *Id.* at *7-8 & n.23.

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Chancellor Allen rejected the claim. A board seeking to realize enterprise value could act against its common stockholders, provided it could show that it acted reasonably and in good faith.[380] As the merger "appeared reasonably to be the best available transaction," the plaintiff had no claim.[381]

Orban is an easier case than *Trados*, for there was no claim that enterprise value was sacrificed; but we think it could be extended. The possibility of relaxed review puts the controlled board on notice that the company must be shopped and that outside confirmation respecting the quality of the price is necessary. Thus armed, it will sustain its burden on summary judgment.

V. TRAVERSING THE PARADIGMATIC DIVIDE

The law of preferred stock emerges much changed in the wake of *James*, *ThoughtWorks*, and *Trados.* Promises to preferred are harder to enforce. Fiduciary protection in situations of vulnerability, elusive before, now retreats even further. Yet contracted control rights are less effective than before. Preferred stock, always ambiguous, is now more problematic than ever. We have described and analyzed the issues the cases raise in terms of a paradigmatic choice between contractual and corporate treatment. This Section expands on our theme, considering patterns in the courts' choices, possible alternatives, and normative stakes.

A. *Doctrinal Overlap*

We start with some doctrinal observations. Disputes about preferred involve paradigmatic overlap, which imports conceptual instability. Resolving the dispute requires referencing one paradigm or the other. A court explaining and justifying a decision tends to make exclusive reference to whichever paradigm it has chosen. The one-sided explanation imports coherence in the context of a single opinion, but such opinions should be read and applied with caution.

We demonstrate the need for caution by pushing the approach taken in each of the cases to its logical conclusion. The *James* court's move to contract treatment, applied literally, implies an open field for dummy mergers that opportunistically recapture financial rights sold to preferred stockholders.[382] We do not think Delaware law would allow that result, and accordingly infer a good faith limitation regarding mergers and merger allocations. The

380 *See id.* at *8 ("A board may certainly deploy corporate power against its own shareholders in some circumstances[,] . . . but when it does, it should be required to demonstrate that it acted both in good faith and reasonably.").

381 *Id.* at *9.

382 *See supra* Section II.C.

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ThoughtWorks court's move to corporate treatment, applied literally, implies that a preferred issuer of means can indefinitely forestall a payment obligation.[383] We do not think Delaware law would allow that result either. The corporate treatment in *Trados*, applied literally, invites holdouts and value-sacrificing decisions and overrides existing drag-along rights.[384] We think the Delaware courts, squarely faced with such results, would contain the reach of the case. In the long run, preferred stock always involves paradigmatic overlap—it is structurally unavoidable.

B. *Delaware's Approach*

The score in our three cases is corporate, two (*ThoughtWorks* and *Trados*), to contract, one (*James*). But any apparent inconsistency is quickly dispelled by reference to the results: the preferred always lose.

The court's disposition to favor the common is unsurprising: Delaware sells a product, the buyers of which tend to be holders of common stock or their management representatives. Senior security holders, conversely, have historically fared badly in the Delaware courts;[385] drafters of debt contracts, therefore, overwhelmingly choose New York law.[386] With preferred stock provisions there is no option to split jurisdictions: Delaware for governance, New York for financial promises. The financial terms must go into the charter and take the law of the state of incorporation as it comes.

There are also important mitigating points. A general disposition to favor the common long predates the Delaware courts' emergence as the focal point for the law of preferred stock.[387] At the same time, preferred stockholders do not always lose in Delaware;[388] neither does Delaware single out the

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383 *See supra* Section III.B.

384 *See supra* Section IV.B.

385 *See, e.g.*, Shenandoah Life Ins. Co. v. Valero Energy Corp., Civ. A.No. 9032, 1988 WL 63491, at *409-10 (Del. Ch. June 21, 1988) (ruling that a refunding limitation covering indirect, cheaper borrowing did not apply to a simultaneous borrowing); Katz v. Oak Indus., 508 A.2d 873, 881-82 (Del. Ch. 1986) (refusing to find that a debt-exchange offer with an attached coercive-exit consent violated the contractual duty of good faith).

386 *See* Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 354-55 (2007) ("[N]early all bond indentures and underwriting contracts designate New York law as the governing law.").

387 See *supra* notes 38-49 and accompanying text.

388 *See, e.g.*, Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 844 (Del. 1998) (holding that preferred shareholders had the right to participate in a merger class vote provision against a dummy merger); Protas v. Cavanagh, Civ. A.No. 6555-VCG, 2012 WL 1580969, at *11-12 (Del. Ch. May 4, 2012) (rejecting a waste claim stemming from a closed-end fund's redemption of auction preferred stock); Shiftan v. Morgan Joseph Holdings, Inc., 57 A.3d 928, 938-42 (Del. Ch. 2012) (reading a corporate certificate to require mandatory redemption and holding that in an appraisal

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preferred for rough treatment. A case like *ThoughtWorks* is, at its foundation, a control contest, and when control is contested, Delaware courts tend to favor the discretion of the incumbent board of directors.[389] While we contest the result in *Trados*, we acknowledge that the court's application of intrinsic fairness scrutiny is in line with Delaware's treatment of minority stockholders more generally. The Delaware merger cases conduct an experiment in fiduciary protection for preferred that is unique among the states, and leave the door to fiduciary scrutiny open after *James*.

Still, we are left with corporate treatment when corporate treatment benefits the common and contract treatment when contract treatment benefits the common. The results stand in tension, triggering questions. Why, in particular, does the court refuse to extend majority–minority protection to the preferred minority against an imposed merger price in *James*[390] yet force such protection on a preferred majority imposing a merger price in *Trados*?[391]

We suggest a couple answers. First, the Delaware courts are unlikely to view themselves as wavering between contract and corporate treatment from case to case. Rather, they see their decisions as consistently contractual in preferred cases: if the preferred want a given result, they should contract for it specifically; if they fail to do so, the default corporate paradigm dictates the result. The preferred in *ThoughtWorks* could have procured upstream convertibility into a note; in *James*, either a class vote or liquidation treatment would have done the trick; in *Trados* they could have contracted for drag-along

action a court may properly consider a nonspeculative, contractually mandated redemption set to occur six months after the merger when valuing preferred stock); Fletcher Int'l, Ltd. v. ION Geophysical Corp., Civ. A. No. 5109-VCP, 2010 WL 2173838, at *1 (Del. Ch. May 28, 2010) (applying a covenant requiring the consent of preferred shareholders to an issue of securities by a subsidiary of the issuer); MCG Capital Corp. v. Maginn, Civ. A. No. 4521-CC, 2010 WL 1782271, at *15 (Del. Ch. May 5, 2010) ("[P]referred shareholders have standing to bring a derivative claim absent some express restriction or limitation in the articles of incorporation . . . ."); Matthews v. Groove Networks, Inc. Civ.A. No. 1213-N, 2005 WL 3498423, at *2 (Del. Ch. Dec. 8, 2005) (sustaining the application of a liquidation provision directing merger proceeds to the preferred); *In re* FLS Holdings, Inc. S'holders Litig., Civ. A. No. 12623, 1993 Del. Ch. LEXIS 57, at *3-4 (Del. Ch. 1993) (rejecting a nonpecuniary settlement of preferred rights respecting a merger payout); Dart v. Kohlberg, Kravis, Roberts & Co., Civ. A. No. 7366, 1985 WL 21145, at *1, *5 (Del. Ch. May 9, 1985) (denying a motion to dismiss a preferred fairness claim challenging a leveraged restructuring); Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 653, 660 (Del. Ch. 1975) (rejecting a common stock challenge to the validity of two board elections of a preferred-controlled board).

389 *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 954 (Del. 1985) (explaining that board decisions in the context of a takeover attempt "should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment").

390 *See supra* notes 146-51 and accompanying text.

391 *See supra* notes 315-19 and accompanying text.

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rights. Second, the difference between *James* and *Trados* is the difference between a merger allocation made by a disinterested board (*James*) and an interested board (*Trados*).

While the drafting burden response resonates nicely with prevalent views on the application and interpretation of financial contracts, we have some concerns. As applied in *ThoughtWorks* and *Trados*, it looks like a game played by secret rules. The drafter in *ThoughtWorks* tried hard to achieve enforceability, but despite the manifest intent of the parties, missed the technical trick—a trick not without enforceability problems of its own. *Trados* made drag-along rights intrinsically ineffective. As for *James*, the contractual alternatives are well established, but come at a price to preferred issuers. To insist on them as the exclusive means of protection against opportunism is to skew the bargaining space. It is accordingly not at all clear that courts should assume preferred stock contracts are complete. A presumption limiting preferred to explicit contractual protection is normatively robust but should be applied reasonably (without the "gotcha" aspect) and with sensitivity to facts.

A distinction emphasizing the independence of the directors on the cases' respective boards also has normative traction. The disinterested, independent director has risen to such prominence as a solver of corporate problems as to become the universal solvent in conflict of interest cases, and that is a good thing. But there is also a structural problem. In *Trados* we see the disinterested director in a new, quasi mandatory role. Formerly, a controlled board was assumed in majority–minority cases. The question was whether control and differential results turned an otherwise unobjectionable decision into a shareholder-level breach of duty. If the controlled outcome was uneven, intrinsic fairness scrutiny followed. *Trados*, however, skips a step in the sequence. Since a controlled board is not disinterested, its decision by itself triggers fairness scrutiny without a preliminary inquiry into the evenness of the outcome. In this exercise, the minority shareholder bore the burden of proof. The result is an easy complaint—perhaps too easy. At the same time, insistence on a majority disinterested board cuts against the practice. The venture capitalist template incorporates a different solution to the problem—the five-seat board with a tiebreaker fifth director. Were the *Trados* sale approved by such a board, the tiebreaker's approval should suffice as a process matter.

C. *Consistency as an Alternative*

Perhaps consistency has a virtue here. Let us compare regimes that strive for consistent treatments, either all corporate or all contract. A

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corporate regime would give us *ThoughtWorks* and *Trados* but would change the result in *James*, demanding a veto-bearing committee for the preferred on pain of intrinsic fairness scrutiny. On the other hand, a contract regime would enforce the promise in *ThoughtWorks* and dismiss the complaint in *Trados*, leaving *James* in place.

We are not entirely satisfied with either set of results. Across-the-board corporate treatment changes the Delaware outcomes to yield intrinsic fairness scrutiny in *James*, but overrides the risk allocation in two venture capital deals. We think that fairness review in *Trados* is overkill and likewise see no need for intrinsic fairness scrutiny in *James*. Forced to choose, we would more heavily weight respect for considered risk allocations than solicitude for the convenience of either the going concern or the interests of underwater common stockholders. This framework would enforce the redemption promise in *ThoughtWorks* and dismiss the self-dealing challenge from the common in *Trados*. Meanwhile, the preferred in *James* had an appraisal option and so were not without a remedy.

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. Nuanced mediation across the paradigmatic divide will work better. 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.

D. *Value Maximization and Paradigmatic Conflict*

When contract trumps corporate, notions about value maximization motivate the choice. Transactions are maximizing trades. The issuer gets capital to invest based on a stated return on stated terms and trades off future financial and control risks for reduced present financial obligation. Legal interventions that undercut these bargained-for risk allocations chill capital raising and, in the long run, raise the cost of equity capital at the shareholders' expense. Legal interventions that extend fairness protections to contract counterparties can do the same thing: when the relationship is contractual, the contract itself is the best vehicle for protecting counterparty interests.

Similarly, concerns about value motivate the choice when corporate trumps contract. Generally, senior security holders do not maximize enterprise value; residual interest holders do. When self-interested seniors liquidate their investment and extract return of invested capital, they can harm the value of the going concern. When seniors take control with a view to capital extraction they disrupt productive relationships amongst managers,

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employees, and firm specific capital. The corporate legal system owes them no special assistance in these pursuits.

The two paradigms' normative associations, thus stated as binary opposites, are descriptive of the conflicts presented in the cases. But the conflicts' description tends to be unhelpful for their resolution. The simple incentive depiction of seniors as conservative and risk-averse, and common stockholders as productive risk-takers does not necessarily apply to the investments at issue in *ThoughtWorks* and *Trados*.

With startups, every investor takes a lot of risk; there is no conservative way to participate. Given a conflict, there is no basis for an ex ante presumption that one or the other possesses the "correct" incentives. Indeed, where the venture capitalist has control and power to remove the entrepreneur, we get something approaching the incentive picture idealized in agency theory—a manager forced by the stick of potential removal and incentivized to produce by the carrot of a huge equity upside. It arguably follows that the transaction that creates the incentive arrangement not only has a strong claim to the solicitude of the contract norm, but that the corporate norm also comes to bear on the facts to support the preferred.

The norms also can be seen in alignment in *James*, but their direction can be reversed depending on the characterization of the facts. At first glance, both norms point to the result in the case—the explicit contract does not hold out any protection for the plaintiff (a result presumably contemplated by the parties), and the corporate paradigm likewise offers no clear-cut fiduciary protection. The normative posture changes once the contract is seen as incomplete: now judicial intervention on the preferred's behalf supports both the deal and the long-term interests of common stockholders.

These complications bring us back to the overlap point. Neither notion of value maximization is an effective universal trump. The implications of both need to be kept in mind on a case-by-case basis. It thus follows that the common stock–value maximization norm needs to be contained in this context. Given two classes of equity, the interests of which conflict, enterprise value maximization works better as the default norm.

CONCLUSION

We would modify the rules of each of *James*, *ThoughtWorks*, and *Trados*. Our modifications draw on both the corporate and contract paradigms.

Merger allocations to minority preferred should be subject to minimal scrutiny under the good faith rubric, with the burden of proof on the defending board. Approval by genuinely disinterested directors acting in the absence of any threat of lawsuits from the common should satisfy this

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burden. We would entertain appraisal exclusivity as an alternative approach if Delaware's corporate code allowed appraisal of preferred issues on a per se basis. Where appraisal is available, exclusivity should be the presumptive choice, absent a showing of bad faith.

Payment enforcement is intrinsically problematic due to legal capital and fraudulent conveyance constraints—constraints which can be ameliorated but not avoided through the ruse of upstream conversion to a promissory note. These legal barriers should be etched clearly and narrowly, otherwise, the promise to pay is negated. We accordingly would delimit the meaning of "funds legally available" to the literal terms of the background regime and put the burden on the issuer to show that payment would cause a violation.

Cases where controlling preferred stockholders sell the company are, as a practical matter, venture capital cases. We think the treatment should be tailored to the transactional context in light of the risk allocation effected in venture capital deals and the resulting incentive structure. It follows that scrutiny should be blocked where the entire class of common has waived the objection in a shareholders' agreement. Scrutiny should be available at the behest of nonwaiving common holders given a plausible allegation of a sacrifice of enterprise value. The standard of review should be good faith, with the burden of proof on the board.

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