Rights Offers and Delaware Law

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Abstract

Under Delaware law, a securities issuance in which all existing investors may participate pro rata (a "rights offer") is often seen as treating insiders and outsiders equally, making it difficult for nonparticipating outsiders to prevail on a claim that insiders sold themselves cheap securities. I show that insiders can use rights offers to sell themselves cheap securities, even if outsiders are sophisticated and well-capitalized. My analysis suggests courts applying Delaware law should more aggressively probe rights offers for substantive fairness. I conclude by describing red flags indicating a heightened risk of expropriation.

Keywords: Delaware, Rights Offer, Controlling Stockholder, Insider Trading, Dilution, Equity Issuances

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Abstract

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*Dane Professor of Law, Harvard Law School. David Kirk, Jake Laband, Sam Learner, Leeor Ofer, Amanda Tuninetti, Brandon Une, and Kevin Zeng provided excellent research assistance. For helpful discussions and suggestions on earlier iterations of this paper, I thank Bobby Bartlett, Brad Bernthal, Brian Broughman, Bob Clark, John Coates, Mihir Desai, Bala Dharan, Allen Ferrell, Joel Friedlander, Erik Gerding, Joan Hemenway, Scott Hirst, Jack Jacobs, Louis Kaplow, Reinier Kraakman, Adam Levitin, Mark Roe, Gordon Smith, David Skeel, Guhan Subramanian, Amy Simmerman, attendees at the 2013 Law and Society and the 2017 American Bar Association Meetings, and seminar participants at Berkeley Law School, Colorado Law School, Harvard Law School, and Oxford University. Special thanks to Travis Laster, Katie McCormick and Steve Shavell for detailed and helpful comments. This paper builds on and benefits from joint work with Holger Spamann, for whose collaboration I am extremely grateful. Disclosure: I served as an expert in Flying Disc Invs. Lp v. Baker Communs. Fund II, No. CGC 05-447293, 2009 LEXIS 6367 (Cal. Super. Sept. 10, 2009), discussed herein, on matters unrelated to the contents of this paper.

I. Introduction

Under Delaware law, a securities issuance by a public or private firm in which all investors may participate pro rata (a "rights offer"[1]) is generally seen as treating corporate insiders ("insiders"[2]) and existing non-insider investors ("outsiders") alike. This view makes it difficult for nonparticipating outsiders to prevail on a "cheap-issuance" claim: that the insiders sold themselves cheap securities via the rights offer.

Delaware judges do understand that a rights offer does not protect what I call "impeded" outsiders: outsiders who face barriers to participation. Thus, Delaware judges have been reluctant to insulate insiders from cheap-issuance claims arising out of a rights offer when insiders allegedly knew the outsiders lacked adequate capital or faced procedural hurdles to participating.[3] But rights offers are otherwise generally seen as fair to *un*impeded outsiders.[4]

I show, however, that rights offers fail to put even unimpeded outsiders on an equal footing with insiders, and that insiders can use rights offers to engage in cheap-issuance expropriation.[5] In particular, information asymmetry can make

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[1] The term "rights offer" is often used to mean a pro rata distribution of rights to a firm's shareholders entitling them to purchase additional securities (often common shares) for a particular strike price. Such rights issuances are commonly used by public companies outside the U.S., and sometimes by public firms in the U.S. *See infra* notes x, y. However, I use the term "rights offer" to mean any offer to purchase securities extended to existing investors pro rata, whether or not rights are distributed, and whether the firm is public or private.

[2] I use the term "insiders" to mean those calling the shots at a firm, whether or not they enjoy uncontestable control (e.g., a single controlling stockholder, a coalition of stockholders that collectively exercises control, or a powerful coalition of directors and managers). Under the corporate laws of Delaware and other states, the issuance of securities is generally within the purview of the board, unless shareholder approval is needed to amend the charter to increase the number of authorized shares. *See* Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701 (2011). Insiders controlling the board can generally initiate a securities issuance, and a controlling shareholder (or shareholder group) can always initiate an issuance as it controls both shareholder and board votes. Throughout the paper, I assume insiders have the power to conduct a particular securities issuance.

[3] *See infra* Part II.C.

[4] That said, one Delaware judge, Vice Chancellor Travis Laster, has been generally skeptical of rights offers' ability to protect outsiders. *See infra* notes x, y.

[5] This paper draws from, and builds on, prior work: Jesse M. Fried, *Powering Preemptive Rights with Presubscription Disclosure, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 79–104 (Luca Enriques & Tobias H. Troger, eds., 2019) [hereinafter Fried, *Powering*]; Jesse M. Fried & Holger Spamann, *Cheap-Stock Tunneling around Preemptive Rights*, 137 J. FIN. ECON. 353 (2020) [hereinafter Fried & Spamann, *Cheap-Stock Tunneling*].

outsiders rationally reluctant to participate in an issuance that, unbeknownst to them, is cheap, thereby enabling insiders to buy a disproportionate amount of underpriced securities. [6]

The inability of rights offers to protect outsiders is likely to be greater if the firm is private (and thus not subject to disclosure requirements applicable to public firms). It is also likely to be greater if the offer or the capital structure of the firm is particularly complex. Thus, the problem is likely to be most severe in a private firm with a complex capital structure, such as a VC-backed startup with multiple classes of preferred stock.[7]

My analysis suggests that courts applying Delaware law should more closely probe rights offers for substantive fairness toward outsiders. I close by describing various features of rights offers, outsiders, and firms that increase the risk of expropriation and thus raise red flags about an issuance's effects on outsiders.

The remainder of the paper proceeds as follows. Part II describes the insider-protective effect of rights offers under Delaware law, reflecting the law's view that a rights offer tends to put insiders and outsiders on equal footing. Part III explains why, with respect to any given issuance, outsiders are unlikely to know whether the issuance price is cheap or inflated. Part IV shows that, when insiders fail to disclose their participation, outsiders' fear of overpriced-issuance expropriation—the possibility that insiders are trying to lure outsiders to buy overpriced securities—undermines rights offers' ability to protect outsiders from cheap-issuance expropriation. Part V describes the economic costs of cheap-issuance expropriation. Part VI offers suggestions to courts about how to probe the fairness of rights offers. Part VII concludes.

Before proceeding, I wish to note that rights offers can harm outsiders even absent cheap-issuance expropriation. Insiders can use rights offers to sell outsiders

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[6] A rights offer can also *indirectly* protect outsiders from expropriation by preserving ownership-based control rights. For example, outsiders owning more than a specified percentage of shares may, under mandatory corporate law or a firm's governance arrangements, have veto rights over certain transactions. In such a scenario, the ability to participate pro rata through a rights offer might not only reduce losses from cheap-issuance expropriation but also preserve outsiders' veto rights (that are necessary to avoid other types of dilution down the road). For simplicity, I generally ignore control-related effects of issuances. For a discussion of the use of rights offers to obtain control, see Jesse M. Fried & Leeor Ofer, *Takeover via Rights Offe*r (working paper, 2021).

[7] Rights offers are often used in Chapter 11 bankruptcy proceedings, where capital structures may be particularly complicated, and the rights offers themselves are often highly structured. *See, e.g.*, David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L. J. 366, 416-21 (2020) (describing rights offer used in Peabody reorganization). I do not explicitly address Chapter 11 rights offers in this paper, but much of my analysis would be applicable in that setting as well.

overpriced securities;[8] to sell securities at a "fair price" and then divert the proceeds, reducing the value of outsiders' existing equity; to sell securities at a price chosen solely for the purpose of triggering anti-dilution provisions in insiders' convertible securities;[9] to sell securities structured to subordinate outsiders' existing securities in the firm;[10] or to extract a gratuitous payment for backstopping an offer in scenarios where they would have bought the unpurchased shares in any event. These types of harms are beyond the scope of this paper, which focuses on the use of rights offers to sell cheap securities to insiders.

II. Insider-Protective Effects of a Rights Offer under Delaware Law

Under Delaware law, a transaction (such as a securities issuance) allegedly benefitting insiders at outsiders' expense can give rise to "entire fairness" review, under which insiders must prove that both price and process were fair.[11] However, by structuring an issuance as a rights offer, insiders seek to gain legal insulation from claims of cheap-issuance expropriation. Certain cases suggest that the use of a rights offer could lead to review under the much more lenient business judgment rule (Section A). When the issuance is followed by a merger, insiders may well be able to avoid any judicial review (Section B). And, even if fairness review cannot be avoided, the use of a rights offer may well go far to help satisfy entire fairness

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[8] *See infra* Part ___.

[9] Robotti & Co., LLC v. Liddell, No. 3128-VCN, 2010 LEXIS 4 (Del, Ch. Jan. 14, 2010) (plaintiff asserted that the subscription price of a rights offering was deliberately set at an inadequately low price, in order to trigger anti-dilution provision in insiders' stock option agreements and warrants).

[10] *See* Quietagent v. Bala, Tr. of Record, C.A. No. 10813-VCZ, at 54–57 (Del. Ch. Jan. 3, 2019) (applying entire fairness to rights offer, and refusing to dismiss outsiders' complaint, largely because the securities issued in the rights offer created a new waterfall structure unfavorable to outsiders). *Cf.* Watchmark Corp. v. ARGO Global Capital, LLC, No. 711-N, 2004 LEXIS 168 (Del. Ch. Nov. 4, 2004) (dismissing complaint by a single VC investor against a recapitalization-and-issuance transaction that subordinated existing equity in a VC-backed firm because all other VC investors, including those similarly situated to the plaintiff, favored it); MKE Holdings Ltd. v. Schwartz, No. 2018-0729-SG, 2020 LEXIS 37 (Del. Ch. Jan. 29, 2020) (dismissing claim by plaintiff LLC members against LLC managers for conducting a rights offer of new units that subordinated plaintiffs' units and benefitted insiders because the operating agreement explicitly permitted managers to make conflicted decisions unless there was "bad faith," which plaintiff failed to demonstrate).

[11] *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). Certain cleansing procedures can lead the transaction to be reviewed under the more lenient business judgment rule (BJR). Absent a controlling stockholder, BJR applies if either an independent special committee or disinterested fully-informed stockholders approve the transaction. Otherwise, BJR applies if the transaction is both negotiated by a special committee and conditioned on support of a majority of the minority (that is, it meets the requirements of *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014)). *See* In re EZCORP Inc. Consulting Agreement Derivative Litig*.,* 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016). Firms conducting issuances will generally not condition them on minority-of-the-majority approval, and often lack independent directors. Thus, I assume throughout that the standard used in evaluating an issuance-expropriation claim is entire fairness, not the BJR.

(Section C). However, Delaware judges recognize that rights offers do not protect outsiders whose ability to participate is impeded by cash constraints or the terms of the offer (Section D).

A. Business Judgment Review via Use of Rights Offer?

Corporate lawyers have argued that a rights offer can, and should, take a challenged issuance completely outside of entire fairness review.[12] The idea: a rights offer is analogous to a dividend or other kind of pro rata transaction that is generally subject to business judgment review, even if initiated by a controlling stockholder.[13]

For support, corporate lawyers can point to WatchMark Corp. v. ARGO Global Capital.[14] WatchMark was a private company backed by VC funds, including ARGO.[15] Five of its six board members were designees of these funds, one of which was ARGO's designee.[16] WatchMark's board approved an acquisition of another firm, and began negotiating terms for a planned issuance of Series F preferred stock to raise capital for the acquisition.[17] The Series F issuance featured a "pay-to-play" provision under which all existing VC investors that did not participate would have their existing preferred shares involuntarily converted to common.[18]

All of the funds represented on the board, except ARGO, indicated that they favored the transaction.[19] ARGO owned 40% of the Series B shares.[20] A charter

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[12] *See* Meredith E. Kotler & Mark E. McDonald, *Chancery Court Suggests Rights Offerings May Limit Liability in Certain Transactions*, HARV. L. SCH. F. CORP. GOVERNANCE (June 16, 2017) (suggesting that, under Delaware law, potential liability for a controller might be substantially reduced if not eliminated through the use of a rights offer in which the controller does not receive a unique benefit), https://corpgov.law.harvard.edu/2017/06/16/chancery-court-suggests-rights-offerings-may-limit-liability-in-certain-transactions/.

[13] *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (finding that a dividend initiated by a controlled firm that allegedly benefited the controller was subject to business judgment review because it affected all shareholders pro rata).

[14] Watchmark Corp. v. ArgoGlobal Cap., LLC, C.A. No. 711-N, 2004 WL 2694894 (Del. Ch. Nov. 4, 2004), *opinion clarified sub nom*. WatchMark Corp. v. ARGO Glob. Cap., LLC, C.A. No. 711-N, 2004 WL 3029915 (Del. Ch. Nov. 15, 2004).

[15] *Watchmark*, 2004 WL 2694894, at *1.

[16] *Id.*

[17] *Id.*

[18] *Id.* at *1 & n.7.

[19] *Id.* at *1.

[20] *Id.* at *1 n.8.

provision required holders of 80% of the Series B shares to approve any change to the "preferences, rights, privileges, or power" of the Series B (including, of course, an involuntary conversion of the shares to common).[21] Other Series had analogous protective provisions.[22] ARGO indicated it would use its 40% Series B stake and the Series B protection provision to block the Series F transaction.[23]

Faced with ARGO's threatened veto, WatchMark's non-ARGO directors decided to merge the company into a wholly-owned subsidiary and use the merger process to change the charter to eliminate ARGO's veto right.[24] In particular, the 80% approval requirement would be eliminated for each series of preferred stock and replaced with a 70% approval requirement for all preferred stockholders, voting together as a single class.[25] Once the merger is completed, the board would present the Series F financing proposal (including the pay-to-play provision) to all preferred stockholders, who could participate or have their existing stock forcibly converted to common.[26]

WatchMark sought a declaratory judgment regarding the legality of the proposed merger and subsequent financing.[27] ARGO counterclaimed and sought to enjoin the transactions.[28] It alleged WatchMark was violating its charter, and sued four members of its six-member board, alleging they breached fiduciary duties in approving the two transactions.[29]

ARGO argued that the Series F financing, including the pay-to-play provision, should be reviewed under entire fairness.[30] The court declined to do so, concluding that ARGO failed to rebut the strong presumption that the business judgment rule applies.[31] Why? Because ARGO failed to show that the other VC investors, through the acts of their director representatives, obtained a benefit to the exclusion or

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[21] *Id.* at *2 & n.11.

[22] *Id.* at *2.

[23] *Id.* at *1 n.8.

[24] *Id.* at *2.

[25] *Id.*

[26] *Id.*

[27] *See id.* at *1.

[28] *Id.*

[29] *Id.*

[30] *Id.* at *4.

[31] *Id.*

detriment of ARGO.[32] All VC investors would have their series-based 80% protective provisions eliminated, and replaced with a 70% protection provision where all preferred stockholders would vote as a class.[33] All VC investors would then vote together whether to allow the Series F financing with its pay-to-play provision, and all VC investors would choose whether to participate, with "any disparate treatment . . . a self-imposed consequence and not the result of self-dealing."[34] The court then concluded that the transactions were subject to business judgment review, which they passed with flying colors.[35]

In *WatchMark*, there were no "insiders," as both sides were identically informed: ARGO, like the opposing VC funds, had a representative on the board.[36] And ARGO's opponents were not seeking to enrich themselves at ARGO's expense; the other funds wanted ARGO to participate alongside them.[37] Rather, the dispute involved an inter-fund disagreement about whether to pursue a particular financing undertaken to fund an acquisition apparently supported even by ARGO.[38]

By contrast, a cheap-issuance claim arising out of a rights offer involves a scenario where (i) insiders have more information than outsiders and (ii) profit at outsiders' expense when outsiders do not participate.[39] Thus, entire fairness is the appropriate standard of review for alleged cheap issuance via a rights offer. But to the extent insiders accused of cheap-issuance expropriation via a rights offer can convince a court that *Watchmark* applies and any disparate treatment is a "self-imposed consequence and not the result of self-dealing," the insiders can dodge entire fairness review.

B. Eliminating Any Review of Cheap-Issuance Claims via Rights Offer?

The use of a rights offer can enable insiders to avoid not only entire fairness review of cheap-issuance claims, but also any review—either entire fairness or BJR—when, post-issuance, the firm merges into another firm. Understanding how this works requires a rather long detour through Delaware doctrine.

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[32] *Id.* at *5.

[33] *Id.* at *2.

[34] *Id.* at *5.

[35] *Id.*

[36] *Id.* at *1.

[37] *Id.*

[38] *Id.* at *1 & n.5 ("It remains uncontested that . . . ARGO's delegate to WatchMark's board . . . does not dispute the benefit the . . . merger will have on WatchMark.").

[39] *See infra* Part II.

1. Cheap-Issuance Claim Generally Terminated by Merger

Under Delaware corporate law, claims are generally classified as either "direct" or "derivative." A *direct* claim is brought by a shareholder alleging injury to herself that is unique to her rather than an injury suffered pro rata by shareholders as a group.[40] A direct claim may include interference with the voting rights of a particular shareholder or subset of shareholders. A *derivative* claim is a claim arising from an "injury to the corporation" brought by a shareholder on behalf of the firm against the party (typically an insider) that allegedly caused the injury.[41]

Generally, a plaintiff faces much greater (and often fatal) initial procedural hurdles if the court considers the claim to be derivative rather than direct,[42] and often subsequent procedural hurdles as well.[43] However, even if a plaintiff overcomes these hurdles, a subsequent merger of the firm will in most circumstances deprive the plaintiff of standing to assert the derivative claim while leaving her standing to bring a direct claim unscathed.[44] Once the plaintiff loses standing to sue derivatively, the plaintiff's only option is to file an entirely new lawsuit challenging the merger itself as unfair, which can include the theory that the merger consideration was unfair because it failed to provide consideration for the

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[40] *See* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

[41] For example, suppose a director caused the corporation to purchase an asset from the director at an inflated price. The claim is "derivative" because it derives from the corporation's right to sue the alleged wrongdoer (here, the director), and technically "belongs" to the corporation, not the suing shareholder. A derivative claim essentially consists of two distinct rights: (1) a stockholder's equitable right to sue on the corporation's behalf when the board has failed to take action (often, against one of its own members or a controlling stockholder); and (2) the corporation's direct claim against the alleged wrongdoer. *See id.*; Gentile v. Rossette, 906 A.2d 91 (Del. 2006).

[42] A plaintiff suing derivatively must not only make allegations sufficient to survive a Rule 12(b)(6) motion (as they would if suing directly), but also meet the demand requirement of Court of Chancery Rule 23.1 by demonstrating that the corporation's directors are incapable of impartially considering whether to pursue the litigation on behalf of the corporation. *See* Ct. Ch. R. 22.1; Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Rales v. Blasband, 634 A.2d 927 (Del. 1993); *see also* United Food & Com. Workers Union v. Zuckerberg, C.A. No. 2018-0671-JTL (Del. Ch. Oct. 26, 2020), https://courts.delaware.gov/Opinions/Download.aspx?id=312280. Namely, the plaintiff must use particularized allegations to show that a majority of directors lack independence and/or disinterestedness. *See Aronson*, 473 A.2d at 814–15.

[43] Even if the plaintiff can satisfy the derivative claim's higher initial pleading standard, the board can assemble and use a "special litigation committee" to later get the claim dismissed. *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[44] *See* Lewis v. Anderson, 477 A.2d 1040 (Del. 1984). The rule has two narrow exceptions: "first, if the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of the standing to bring a derivative action; or second, if the merger is in reality merely a reorganization which does not affect the plaintiff's ownership in the business enterprise." *Id*. at 1046 n. 10.

derivative claim. To succeed, such a challenge must allege credibly that the value of the claim was material and that the board breached its fiduciary duties in connection with the merger.[45] Absent such allegations there is no fairness review or, indeed, the possibility of *any* judicial review.[46] Thus, in many cases the designation of a particular claim as direct or derivative is outcome-determinative.

In *Tooley v. Donaldson, Lufkin & Jenrette, Inc*,[47] the Delaware Supreme Court sought to clarify the distinction between direct and derivative claims, setting out the requirement for a claim to be considered direct:

> The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.[48]

Under *Tooley* and prior caselaw, cheap-issuance claims against insiders would generally be considered derivative, not direct, because the alleged injury arose out of a transaction that arguably harmed the corporation: it issued securities without receiving enough consideration in exchange.[49] Thus, a stockholder

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[45] *See* Morris v. Spectra Energy Partners (DE) GP, LP, 2021 WL 221987 (Del. Jan. 22, 2021) (finding that the plaintiff had sufficiently pled a direct claim attacking the fairness of the merger and thus reversing the Chancery court's dismissal of plaintiff's claims on the grounds that the likely value of a successful action was still only 1% of the total value of the merger); In re Primedia Inc. S'holder Litig., 67 A.3d 455, 483 (Del. Ch. 2013) (finding that a potential total recovery of $56 million was material when compared to the plaintiff's $133 million share of the proceeds of the merger); *see also* S. Michael Sirkin, *Standing at the Singularity of the Effective Time: Reconfiguring Delaware's Law of Standing Following Mergers and Acquisitions*, 69 BUS. LAW. 429 (2014) (explaining the "paradoxical outcome" that results at the intersection of Delaware law governing derivative actions and mergers and acquisitions, including the "materiality" element).

[46] The derivative claims of the target corporation become assets of the acquiring corporation. In theory, the acquirer could continue the derivative litigation against the insiders of the target firm. However, this does not happen. One reason: it was these insiders and/or controllers who negotiated the acquisition (or permitted it to go forward), and they would not have done so absent an understanding, at least implicit, that the acquirer would drop such claims. The practical result is that derivative claims will not be litigated after the merger – and, in the unlikely event they were to be litigated, the original stockholder plaintiff and her lawyers will not get any of the recovery. The elimination of derivative claims in a merger is, like most corporate-law doctrines, not an unavoidable feature of corporate law but rather a judicial "policy choice" whose wisdom can and should be questioned. *See* Jesse M. Fried & Ed Rock, *Disappearing Derivative Suits* (working paper, 2021).

[47] 845 A.2d 1031 (Del. 2004).

[48] *Id.* at 1039.

[49] *See* Feldman v. Cutaia, 956 A.2d 644, 655–56 (Del. Ch. 2007) (Lamb, J.), *aff'd*, 951 A.2d 727 (Del. 2008); El Paso Pipeline v. Brinckerhoff, 152 A.3d 1248 (Del. 2016).

plaintiff's standing to pursue a cheap-issuance claim can be terminated in a merger, generally leaving plaintiffs unable to recover for the alleged wrong-doing.[50]

2. *Gentile* "Escape Hatch" Avoids Cheap-Issuance Claim Termination

In *Gentile v. Rossette*,[51] the Delaware Supreme Court confronted a case in which a controlling stockholder (CS) of a private firm (1) appeared to issue himself very cheap stock and (2) subsequently arranged for the firm to be acquired by a third party in a merger. Following *Tooley*, the Court of Chancery ruled that the cheap-issuance claim against CS was derivative and thus terminated by the merger.[52] Plaintiffs appealed.[53]

CS' alleged behavior was egregious. It involved not only the purchase of cheap stock but also the failure to disclose critical information to other shareholders at the time of the merger, including CS' negotiation for a material side payment in connection with the merger.[54] Upholding the trial court's decision would have meant letting an apparent wrongdoer escape unpunished. Perhaps for that reason, the Delaware Supreme Court fashioned a narrow escape hatch through which this particular cheap-issuance claim could wriggle: citing pre-*Tooley* cases, it held that a claim against a "controlling stockholder" for issuing herself cheap stock can be considered both derivative *and* direct, and thus survive the merger.[55] Plaintiffs could thus proceed,[56] and eventually won a judgment against CS.[57]

To fashion this escape hatch, the Delaware Supreme Court ruled that a claim arising out of an issuance of cheap stock to a controller can be considered a direct claim (in addition to being derivative) because voting-power dilution claims are classic direct claims, and the issuance of cheap stock to the controller increases the

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[50] This, of course, leads to an undesirable result: insiders who deliberately expropriate outsiders via cheap-issuance expropriation can generally escape liability if the company subsequently merges, thus undermining deterrence *ex ant*e against insider misbehavior. *See* Fried & Rock, *supra* note x.

[51] 906 A.2d 91 (Del. 2006).

[52] Gentile v. Rossette, No. 20213-NC, 2005 LEXIS 160, at *19–22 (Del. Ch. June 2, 2005).

[53] *Gentile*, 906 A.2d at 93.

[54] *Id*. at 94–96.

[55] *Id*. at 99–100.

[56] *Id.* at 103.

[57] *See* Gentile v. Rossette, No. CIV.A. 20213-VCN, 2010 WL 2171613, at *14 (Del. Ch. May 28, 2010).

voting power of the controller and diminishes that of the minority.[58] By its terms, the *Gentile* exception to issuance-dilution claim termination is limited to issuance-dilution claims (1) brought against a "controlling stockholder" and (2) arising out of an issuance that increases the controller's voting power.[59]

Since *Gentile,* some Delaware judges have expanded the case's reach, most importantly by extending it beyond single controlling shareholders to a group that collectively controls the firm, such as the firm's directors.[60] However, most Delaware judges have confined *Gentile* to its facts, rejecting its application when there is no single controlling stockholder,[61] when minority shareholders' voting power does not decrease,[62] when the issuance does not immediately increase the controlling stockholder's voting power,[63] or when the controller receives

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[58] *Gentile*, 906 A.2d at 99–100.

[59] *Id.* at 99–100, n.20 (citing Turner v. Bernstein, 1999 WL 66532, at *11 (Del. Ch. Feb. 9, 1999)). One might reasonably wonder how minority shareholders could prevail on a direct claim that an issuance harmed them by increasing the voting power of the controlling shareholder. The shift in voting power would not empower the controller at the minority's expense unless the latter has blocking rights that depend on owning a certain percentage of shares and the issuance reduces their ownership below that level.

[60] *See* Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618 (Del. Ch. 2013) [hereinafter *Bloodhound*] (holding that *Gentile* also applies to self-interested stock issuances effected by a board that lacks a disinterested and independent majority); In re Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 LEXIS 171 (Del. Ch. Sept. 4, 2014) (agreeing with *Bloodhound*'s approach); *see also* Gazt v. Ponsoldt, 925 A.2d 1265 (Del. 2007) (applying *Gentile* when the direct beneficiary of the alleged expropriation was a third party that did not own any stock before the challenged transactions, but which effectively benefitted the controlling shareholder); Dubroff v. Wren Holdings, LLC, No. 3940-VCN, 2011 LEXIS 164 (Del. Ch. Oct. 28, 2011) (applying *Gentile* when the controlling shareholders' voting percentage did not increase but minority shareholders' decreased).

[61] *See, e.g.*, Feldman v. Cutaia, 956 A.2d 644, 657 (Del. Ch. 2007) ("Thus, it is clear from [*Gentile*] that the Delaware Supreme Court intended to confine the scope of its rulings to only those situations where a controlling stockholder exists."), *aff'd,* 951 A.2d 727 (Del. Sup. 2008); Sheldon v. Pinto Tech. Ventures, L.P., No. 2017-0838-MTZ, 2019 LEXIS 34 (Del. Ch. Jan. 25, 2019) (VC investor directors on board did not collectively constitute a controlling shareholder), *aff'd*, 220 A.3d 245 (Del. 2019); Silverberg v. Padda, No. 2017-0250-KSJM, 2019 LEXIS 997 (Del. Ch. Sept. 19, 2019) (same); Carr v. New Enter. Assocs., No. 2017-0381-AGB, 2018 LEXIS 100 (Del. Ch. March 26, 2018) (rejecting application of *Gentile* because controlling stockholder must have control before the time of the challenged transaction); Cirillo Family Trust v. Moezinia, No. 10116-CB , 2018 LEXIS 230 (Del. Ch. July 11, 2018) (same); Almond v. Glenhill Advisors LLC, No. 10477-CB, 2018 LEXIS 280 (Del. Ch. Aug. 17, 2018) (declining to find that a group of shareholders were part of a control group necessary for *Gentile*); Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2018 LEXIS 252 (Del. Ch. July 26, 2018) (declining to apply *Gentile* because large shareholders were not controllers).

[62] El Paso Gasline GP Co., L.L.C. Brinckerhoff*,* 152 A.3d 1248, 1263 (Del. 2016) (declining to apply *Gentile* because outsiders' voting rights were not reduced).

[63] Daugherty v. Dondero, No. 2019-0101-KSJM, 2019 LEXIS 1288, at *6 (Del. Ch. Sept. 27, 2019) (finding that *Gentile* did not apply to a rights offering because controller's ownership declined).

convertible preferred stock.[64] The tendency to narrowly read *Gentile* increased after *El Paso*,[65] where then-Justice Strine harshly criticized *Gentile* and urged his colleagues to overrule it.[66] The Delaware Supreme Court recently accepted an interlocutory appeal by defendants in *Terraform* arguing that *Gentile* should be reversed.[67] But for now, *Gentile* remains Delaware law.

3. A Rights Offer May Close the *Gentile* Escape Hatch

Since *Gentile*, courts applying Delaware law have enabled insiders to seal the *Gentile* escape hatch when an issuance takes the form of a rights offering.[68] In other words, if a controlling stockholder does not give minority shareholders the right to participate pro rata in an equity issuance, the *Gentile* escape hatch can remain open: a cheap-issuance expropriation claim will be considered both direct and derivative and therefore survive a merger.[69] However, a rights offer keeps the hatch sealed shut: a cheap-issuance claim will be considered solely derivative and die with the merger.[70]

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[64] Klein v. H.I.G. Capital, LLC., No. 2017-0862-AGB, 2018 LEXIS 577 (Del. Ch. Dec. 19, 2018) (issuance of preferred stock did not justify application of *Gentile* because minority retained the same amount of common stock before and after issuance); Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 LEXIS 244 (Del. Ch. June 8, 2019); Riskin v. Burns et al., No. CV 2019-0570-KSJM, 2020 WL 7973803 (Del. Ch. Dec. 31, 2020) (same).

[65] El Paso Gasline GP Co., L.L.C. Brinckerhoff, 152 A.3d 1248, 1263 (Del. 2016).

[66] *Id.* at 1266 (Strine, C.J., concurring). *See also Dougherty*, 2019 LEXIS 1288, at *6 ("[i]n the wake of *El Paso*, [the Court of Chancery] has exercised caution in applying the *Gentile* framework, commenting in one case that '[w]hether *Gentile* is still good law is debatable' and finding in another '*Gentile* must be limited to its facts'") (citing Klein v. H.I.G. Capital, L.L.C., No. 2017-0862-AGB, 2018 LEXIS 577, at *7 (Del. Ch. Dec. 19, 2018), which in turn first quotes *ACP Master, Ltd. v. Sprint Corp.*, No. 9042-VCL, 2017. LEXIS 125, at *26 (Del. Ch. July 21, 2017), *aff'd*, 184 A.3d 1291(Del. Apr. 23, 2018), and then quotes *Almond v. Glenhill Advisors LLC*, No. 10477-CB, 2018 LEXIS 280, at *24 (Del. Ch. Aug. 17, 2018))).

[67] In re Terraform Power, Inc. Stockholders Litig., 2020 LEXIS 344 (Del. Ch. Nov 24, 2020).

[68] Flying Disc Invs. Lp v. Baker Communs. Fund II, No. CGC 05-447293, 2009 LEXIS 6367, *41 & n.6 (Cal. Super. Sept. 10, 2009) [hereinafter *Flying Disc*] (finding that a cheap-issuance claim was derivative because the issuance was structured as a rights offer)*;* Joe W. & Dorothy Dorsett Brown Found. v. Frazier Healthcare III, L.P., 889 F. Supp. 2d 893, (W.D. Tex. 2012), *aff'd,* 538 Fed. App'x. 484 (5th Cir. 2013) [hereinafter *Dorsett*] (concluding that plaintiffs' claim is derivative and therefore is eliminated by a merger because plaintiffs "have not, and cannot, allege they were excluded from any benefit: they could have participated [in the rights issuance], but chose not to," *id.* at 901).

[69] *See, e.g.*, *Bloodhound,* 65 A.3d 618.

[70] *Dorsett*, 889 F. Supp. 2d 893.

The leading Delaware case is *Feldman v. Cutaia*.[71] Feldman co-founded Telx Group, Inc. in 2000, where he served as chief technology officer and as a director until he resigned in July 2002.[72] In March 2002, while Feldman was still a director, Telx offered senior secured and convertible notes at a 16% interest rate ("16% notes") in a private placement and issued $7.05 million in face value of the notes for $5.08 million.[73] Many (and perhaps all) other members of the Telx board (the "Director Defendants") and their affiliates (collectively with the Director Defendants, the "Telx Defendants") participated; Feldman did not.[74]

Feldman did not allege that he was precluded from participating in the offering.[75] However, Feldman was unaware that the Telx Defendants had participated until he sought access to Telx's books and records in mid-2005.[76] The 16% note offering was followed by an exchange transaction and then a recapitalization transaction, the cumulative effect of which was to convert the 16% notes into Telx stock.[77] Both subsequent transactions occurred in 2003 after Feldman had left the board, and he did not learn about the details until long after the fact.[78] As a result of this series of transactions, the Telx Defendants ended up with 60% of Telx's equity and Feldman's stake fell from roughly 10% to 1.5%.[79] In the decision, the court denoted the 16% note offering and the subsequent two transactions as the "Dilutive Transactions."[80] In 2006, Telx was acquired in a merger and its stockholders received a total of $213 million.[81]

Feldman alleged (among other things) that the Dilutive Transactions harmed him economically by delivering cheap stock to the Telx Defendants.[82] The Delaware Court of Chancery dismissed this claim on the grounds that it was derivative and

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[71] 956 A.2d 644 (Del. Ch. 2007) (Lamb, J.), *aff'd*, 951 A.2d 727 (Del. 2008).

[72] *Feldman*, 956 A.2d at 648.

[73] *Id.*

[74] *Id*. at 648–49.

[75] *Id.* at 648.

[76] *Id*.

[77] *Id.* at 649.

[78] *Id.*

[79] *Id.*

[80] *Id.*

[81] *Id.* at 652.

[82] *Id.* at 656.

thus eliminated by the merger.[83] In reaching its conclusion, the court considered the applicability of the *Gentile* exception. That exception, the court said, is limited to a situation in which "a controlling stockholder, with sufficient power to manipulate the corporate processes, engineers a dilutive transaction whereby that stockholder receives an *exclusive benefit* of increased equity ownership and voting power for inadequate consideration."[84]

The court then rejected *Gentile*'s applicability to the Dilutive Transactions for two reasons. First, the court decided that Feldman did not sufficiently allege that the Defendant Directors were (collectively) a "controlling stockholder."[85] In particular, while Feldman alleged that the Defendant Directors owned 40% of the stock directly and controlled the board, and their families and affiliated trusts owned another 20% of the stock, he did not allege that there was a "voting agreement or 'blood pact' among them."[86] Absent such an agreement or blood pact, the *Gentile* escape hatch remained closed.

Second, even if the Telx Directors had collectively constituted a "controlling stockholder," the Court ruled that the fact that Feldman *could* have participated in the 16% note offering, but did not, meant that the putative controlling stockholder did not receive the "exclusive benefit" necessary to pry open the escape hatch:

> [Feldman failed] . . . to allege that the Telx directors exclusively benefited from the Dilutive Transactions. Notably, Feldman does not allege that he had no prior knowledge of the private placement. Nor does Feldman allege that he, or any other person who was a Telx stockholder at the time, was barred from participating in that transaction. Indeed, it is apparent that a great number of stockholders other than the Telx directors and their affiliates purchased notes in the private placement, and reasonable to infer that the same opportunity was available to Feldman.
>
> These same deficiencies in Feldman's pleading not only undermine his assertion of inequitable dilution in the private placement, they are fatal to his claims that the exchange transaction and the recapitalization [which were derived from the private placement and were not challenged in their own right] were unfair as well. . . The complaint, therefore, does not adequately allege that the Telx directors received an exclusive benefit from the Dilutive Transactions.[87]

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[83] *Id.* at 657.

[84] *Id. at* 657 (emphasis added).

[85] *Id.*

[86] *Id.* at 658.

[87] *Id.* at 658–59.

Since *Feldman*'s affirmation by the Delaware Supreme Court, many courts in Delaware and elsewhere have concluded that a controller using a rights offer did not receive an "exclusive benefit," thus making a cheap-issuance claim purely derivative under *Gentile*,[88] and eliminating plaintiff's standing to pursue the claim in the event of a merger.

C. Satisfying Entire Fairness via a Rights Offer?

If a rights offer does not enable insiders to avoid entire-fairness review under *Watchmark*, or any review under *Feldman*, *Feldman's* holding that insiders did not receive an "exclusive benefit" in the private placement because it was open to Feldman and other investors has implications beyond the merger-specific *Gentile* escape hatch context. In particular, it suggests that the use of a rights offer may well go far in helping satisfy entire fairness in any judicial review of a security issuance.

No Delaware court has yet ruled that, when cheap-issuance expropriation is alleged and entire fairness is applied, that the use of a rights offer creates substantial evidence of fairness.[89] However, a California court adjudicating a dispute in a California-based, Delaware-domiciled startup (Wine.com) has leaned heavily on the *Feldman* to find, in connection with a cheap-issuance expropriation claim, that an issuance conducted via a right offer was entirely fair.[90]

The facts were as follows: In 2004, Baker Communications Fund II ("VC Fund"), managed by Baker Capital ("VC"), invested $17 million in Wine.com via a Series F round at an approximately $40 million post-money valuation.[91] Before that round, the company was entirely owned by the founder (Chris Kitze), existing management, and a few individual investors (collectively, "Founders").[92] In 2005, VC

[88] *See Flying Disc*, 2009 LEXIS 6367; *Dorsett*, 889 F. Supp. 2d 893*; Daugherty*, 2019 LEXIS 1288. Indeed, other courts have followed *Feldman* in concluding there is no "exclusive benefit" even absent a formal rights offer, as long there are other participants in the financing round besides the controller. *Sheldon*, 2019 LEXIS 34, at *23 (noting that the alleged controllers "were not the only participants in the [challenged financing rounds]"); Bomberger v. Benchmark Builders, Inc., No. 11572-VCMR, 2016 LEXIS 130, at *9 (Del. Ch. Aug. 19, 2016) (noting that plaintiffs complaint conceded that plaintiff "was given the opportunity to participate in [the company's] subsequent equity offerings"). *But see Dubroff*, 2011 LEXIS 164, at *9 ("…as long as the controller's holdings are not decreased, and the holdings of the minority shareholders are, the latter may have a direct equity dilution claim").

[89] *Cf.* Cancan Development, LLC v. Manno, 2015 WL 3400789 (unreported decision) (applying entire fairness to a series of capital calls that functioned as serial rights offerings and, based on an extensive analysis of the circumstances, determining that the rights offers were entirely fair).

[90] *Flying Disc*, 2009 LEXIS 6367, at *33.

[91] *Id.* at *13.

[92] *Id.* at *3.

Fund gained control of the entire board from Founders in connection with a $10 million Series G round at a $35 million pre-money valuation.[93]

In 2006, VC arranged a $6 million round of financing (denoted as "A-1") at a pre-money valuation of $120,000,[94] less than 0.5% of the Series G round valuation. The A-1 round was conducted as a rights offer, but there was virtually no participation by any party other than VC Fund.[95] All pre-round shares were converted to common.[96] At the end of the A-1 round, VC Fund owned over 99% of Wine.com's equity.

Founders sued, alleging (among other things) that they were diluted by the Series A-1 round.[97] The California court first considered whether Founders' dilution claims arising from the Series A-1 round could be brought directly under *Gentile*, as VC Fund was a controlling stockholder. Applying *Feldman*, the court answered in the negative:

> [w]here the plaintiffs and defendants alike have participated in the potential benefits of a given transaction, or at least had the opportunity to do so, plaintiffs cannot maintain a direct action because they cannot point to an "improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling shareholder," on which a *Gentile* claim depends. . . In such a situation, the plaintiff can point to no "exclusive benefit" obtained by the defendants, as plaintiffs have benefited from the transactions in question in the same manner as defendants.[98]

The Court then ruled that, whether founders' dilution claims were direct or derivative, the Series A-1 round satisfied the entire fairness standard.[99] In reaching this conclusion, the Court relied heavily on *Feldman* and the fact that the A-1 round was open to other investors:

> the Series A-1 was open to all Wine.com shareholders who could thereby avoid having their interest in the Company diluted by purchasing their pro rata share of

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[93] *Id.* at *28–30.

[94] *Id.* at *33–34.

[95] *Id.* at *33.

[96] *Id.* at *33–34.

[97] *Id.* at *34.

[98] *Id*. at *39–40.

[99] *Id*. at *91–96.

> the offering. In other words, the Series A-1 transaction was not for the "exclusive benefit" of defendants, a circumstance which is "fatal" to claims of unfairness.[100]

Since 2006, Wine.com has apparently flourished. In 2020, it was reportedly seeking an investment of about $50 million at a $1 billion valuation.[101] Founders owned 100% of the firm before VC Fund invested. Their nonparticipation in the Series G round (also structured as a rights offer[102]) and the Series A-1 round, followed by their legal loss, might turn out to be quite costly.

To the extent *Feldman* is used not only to eliminate the *Gentile* escape hatch for cheap-issuance expropriation claims, but also to treat securities issuances via rights offers as "fair," insiders using rights offers can all but insulate themselves from cheap-issuance expropriation liability.

D. Potential Impediments to Outsider Participation

Under ideal conditions, including those in which outsiders know that an issuance is cheap, a rights offer can prevent cheap-issuance expropriation.[103] However, as this Section explains, a rights offer cannot prevent cheap-issuance expropriation even if the issuance is clearly cheap if outsiders (1) have limited capital; (2) are unsophisticated; or (3) face procedural obstacles to participating. These problems are likely to be more significant in private (unlisted) firms. When Delaware courts show skepticism about a rights offer's ability to prevent cheap-issuance expropriation, they typically cite such impediments.

1. Outsiders' Lack of Capital

In a private firm, insiders might have deeper pockets than outsiders. When there is such capital asymmetry, outsiders may lack the means to participate in a rights offer, even if they know with (near) certainty that the issuance is underpriced and that they will be subject to cheap-issuance expropriation.[104]

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[100] *Id*. at 93.

[101] *See* Gillian Tan and Scott Deveau, *Wine.com Seeks Funding at Valuation of More Than $1 Billion*, BLOOMBERG (Jul. 31, 2020), https://www.bloomberg.com/news/articles/2020-07-31/wine-com-seeks-funding-at-a-valuation-of-more-than-1-billion?sref=IrXjXN7s.

[102] *Flying Disc*, 2009 LEXIS 6367, at *28–29.

[103] *See* Fried, *Powering*, *supra* note x; Fried & Spamann, *Cheap-Stock Tunneling, supra* note x. See also Appendix A.2 (providing numerical example).

[104] *See* Bennett v. Breuil Petroleum Corp. et al., 99 A.2d 236, 240 (Del. 1953) (denying motion to dismiss claim by plaintiff-shareholder in close-corporation seeking to void sale of cheap stock in which plaintiff was permitted to participate pro rata, in part because the right could not be assigned and plaintiff had only 15 days to decide whether to participate by trying to borrow against the stock). *See also* Telephonic Oral Argument And Rulings of the Court at 53, Brad Perry v. Brian N. Sheth, et al., C.A. No. 2020-0024-JTL (Del. Ch. Jan. 16, 2020) [hereinafter *Perry v. Sheth*] ("Some folks may not be

In a public firm, lack of capital is much less likely to be a problem. About 50% of public companies conducting a rights offer make the rights tradable;[105] they can be sold by a shareholder without capital to other investors who can then exercise them.[106] And even if rights are not tradable, a cash-strapped shareholder can sell some of the underlying shares to raise capital.[107]

2. Outsiders' Lack of Sophistication

Insiders can also use a rights offer to engage in cheap-issuance expropriation if outsiders are unsophisticated: they are not capital-constrained, but fail to participate in an issuance that other outsiders know is worthwhile.

Many shareholders are in fact unsophisticated. One study reports that 36% of shareholders do not participate in rights offers by U.S. public firms even when rights are priced below the post-offer trading price and therefore obviously profitable to exercise. On average, 7% of the value of the offering is transferred from these non-participating shareholders, mostly to insiders and other large stockholders.[108]

3. Procedural Obstacles to Participation

Procedural obstacles to participation can also undermine the ability of a rights offer to protect outsiders from cheap-issuance expropriation. For example, insiders could deprive outsiders of adequate information about how to exercise rights. Insiders could also impose a very short deadline. Even if outsiders have

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able to exercise rights in a rights offering to preserve their position…[a] fiduciary doesn't get to exploit its beneficiaries simply because its beneficiaries simply its beneficiaries are . . . less well capitalized. . .").

[105] Massimo Massa et al., *Choices in Equity Finance: A Global Perspective* (working paper, 2016) (reporting that out of approximately 8,000 rights offers made during 1995–2011 in countries where firms need not use tradable rights, firms decline to do so in almost 40% of the offers).

[106] *See* Kotler & MacDonald, *supra* note x (noting that Vice Chancellor Laster, in *In re Sears Holdings Corporation Stockholder and Derivative Litigation*, C.A. No. 11081-VCL, indicated that the transferability of rights in a public firm rights offer made the offer more likely to be fair to public investors).

[107] In theory, capital asymmetry could still be a problem to the extent that (1) rights are not tradable and (2) the sale of shares would trigger large capital-gains tax for a shareholder, in which case a public shareholder might not take steps to avoid (some) cheap-issuance expropriation.

[108] *See* Clifford G. Holderness & Jeffrey Pontiff, *Shareholder Nonparticipation in Valuable Rights Offerings: New Findings for an Old Puzzle*, 120 J. FIN. ECON. 252, 253 (2016) (finding evidence that shareholders in U.S. public companies often fail to exercise rights to purchase shares below their trading prices, even though the shareholders could clearly profit from doing so).

capital, are sophisticated, and know that the issuance is cheap, such obstacles could effectively eliminate their right to participate in the issuance, thereby enabling insiders to sell themselves cheap securities.[109]

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Rights offers cannot prevent cheap-issuance expropriation when outsiders lack adequate capital, are unsophisticated, or face complicated procedures for exercising their rights. When any of these *non*-informational impediments are present, I refer to outside investors (and their rights) as "impeded."

However, the analysis that follows abstracts from these impediments to focus on a different problem: the *informational* barrier to the effective use of rights offers caused by outsiders not knowing whether the securities offered by a firm are cheap or overpriced. To isolate this informational effect, I will generally assume that outsiders and their rights are *un*impeded.

III. Information Asymmetry and the Inevitable Zone of Uncertainty

This Part explains why information asymmetry matters (Section A), and then why there is an inevitable zone of uncertainty around the value of a firm's securities (Section B).

A. Why Information Asymmetry Matters

Insiders can expropriate value from outsiders via mispriced issuances in two ways: by selling themselves cheap securities (cheap-issuance expropriation), or by selling outsiders inflated-price securities (overpriced-issuance expropriation).

Cheap-issuance expropriation economically dilutes outsiders by not increasing total equity value sufficiently to offset the reduction in outsiders' percentage equity ownership.[110] It has the same redistributive effect as a transaction in which insiders forcibly acquire a portion of outsiders' common stock for a cheap price.[111] Overpriced-issuance expropriation economically dilutes

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[109] *Cf.* Strategic Value Opportunities v. Permian (Transcript Opinion, 12) (Del. Ch. 2019) (despite use of rights offering to issue notes, transaction was still a related-party-transaction because some shareholders might have difficulty coming up with cash given the tight time frame). *See also* Vladimir Atanasov et al., *How Does Law Affect Finance? An Examination of Equity Expropriation in Bulgaria,* 98 J. FIN. ECON. 155 (2010) (describing the effect of fixing inadequate preemptive-right procedures on Bulgarian controllers' ability to engage in cheap-stock expropriation).

[110] *See* Fried, *Powering, supra* note x, at ___; Fried & Spamann, *Cheap-Stock Tunneling, supra* note x. *See also* Appendix A.1 (providing numerical example).

[111] *See* Fried, *Powering, supra* note x; Fried & Spamann, *Cheap-Stock Tunneling, supra* note x.

outsiders by increasing their percentage equity ownership by less than the increase in total equity value. It has the same redistributive effect as causing outsiders to buy insiders' existing equity at an inflated price.

But if outsiders are unimpeded and know whether the issued securities are cheap or overpriced, neither type of mispriced-issuance can occur in a rights offer. If outsiders know the securities are cheap, they participate pro rata, preventing expropriation.[112] On the other hand, if outsiders know the securities are expensive, they refrain, and protect themselves from overpriced-issuance expropriation. The rights offer will thus fail, as neither insiders nor outsiders participate.

However, as I explain in more detail below, information asymmetry creates a "zone of uncertainty"—a range of offer prices in which outsiders cannot tell whether the securities are cheap or overpriced, making it easy for insiders to expropriate them via a mispriced-issuance.

B. The Inevitable Zone of Uncertainty

Outside investors have much less information than insiders about the value of the firm and its securities, whether the firm is unlisted or listed. They may thus not know whether the stock on offer is cheap or overpriced, and whether they should participate in a rights offer.

Unlisted firms. Outside investors in unlisted firms are often completely in the dark. Such firms are generally not subject to mandatory periodic disclosure requirements either under the federal securities laws or state corporate law.[113] Even when a sophisticated outside investor in an unlisted firm carefully negotiates informational rights, these rights are not self-enforcing; the investor may need to engage in expensive litigation to get access to the most basic information, including the identities of the firm's officers and directors, the firm's balance sheet and income statement, and the firm's capital structure.[114]

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[112] *See* Fried, *Powering, supra* note x; Fried & Spamann, *Cheap-Stock Tunneling, supra* note x. *See also* Appendix A.2 (providing numerical example).

[113] *See* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 138-140 (2009) (describing mandatory periodic disclosure requirements imposed on firms trading on the New York Stock Exchange and Nasdaq).

[114] *See, e.g.*, KT4 Partners LLC v. Palantir Techs., Inc,No. 2017-0177-JRS, 2018 LEXIS 59 (Del. Ch. Feb. 22, 2018) (involving a major investor in Silicon Valley "unicorn" which sues for—and is granted—the right to inspect the firm's books and records under Section 220 of the Delaware General Corporation Law, after the firm failed to hold several annual stockholder meetings mandated by Delaware law and refused to provide financial information allegedly required under the parties' Investors' Rights Agreement).

U.S.-listed firms. These firms, subject to mandatory disclosure and more vigorous enforcement of anti-fraud laws, usually provide much more information to outside investors. But information asymmetry persists, as made clear by the abnormal profits executives make trading in their own firms' shares.[115] The reason is simple: even if a firm could be compelled to disclose all "material" facts, insiders would still have unique access to "sub-material" facts and other "soft" information (such as their own plans for how to run the firm) that often give them a much better sense of firm value.[116]

Information asymmetry in both unlisted and listed firms leads to a "zone of uncertainty"—a range of prices in which outsiders cannot tell whether securities offered by a firm are cheap or overpriced.[117] As asymmetry increases, this range of prices widens. Prices far enough beyond the boundaries of the zone will be sufficiently high or low that outsiders can easily figure out whether the offered securities are overpriced or cheap. But within the zone, outsider will be uncertain. Suppose, for example, that outsiders in an unlisted firm believe that the firm's shares are worth between $5 and $15 each. If insiders have the firm offer additional shares for $10 each, outsiders will not know whether the offered shares are cheap or overpriced.[118]

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[115] *See, e.g.*, Lauren Cohen et al., *Decoding Inside Information*, 67 J. FIN. 1009 (2012) (finding that executives generate abnormal returns via opportunistic insider trading).

[116] *See* Jesse M. Fried*, Insider Trading via the Corporation,* 162 U. PENN. L. REV. 801, 808–810 (2014) (explaining how the interpretation and enforcement of Rule 10b-5 under the securities laws often enables insiders to trade legally and illegally on important private information). Information asymmetry may be particularly severe in a controlled firm, as the controller can and will use her power to manipulate the flow of information to depress or increase the stock price, in accordance with her interests. *See, e.g.*, In re Dole Food Co., Inc. Stockholder Litig., No. 8703-VCL, 2015 LEXIS 223, at *104 (Del. Ch. Aug. 27, 2015) (finding that Dole Food controller and board chair David Murdock, who was also CEO, and another director, who was also President, COO, and General Counsel, took steps to drive down Dole's stock price prior to a merger by which Murdock took Dole private).

[117] Recall that "cheap" (or, alternatively, "overpriced") means that insiders know the offer price for a security is below (or, alternatively, above) post-issuance value. Of course, an issuance might be neither cheap nor overpriced: insiders either know the price is fair or lack enough information to assess the relationship between price and post-issuance value. But I ignore such issuances, as they do not systematically transfer value from outsiders to insiders.

[118] If outsiders know that the issuance could affect control, outsiders might be able to infer whether the securities are cheap or overpriced. Consider the scenario in which insiders own 51% of the firm's voting securities and the firm is offering additional voting securities for $10 each. Outsiders will assume that insiders wish to preserve control and will thus seek to buy at least 50% of the issued securities. If insiders intend to buy that many securities, outsiders can infer that the securities are unlikely to be overpriced and in fact are likely to be cheap. In other words, the zone of uncertainty will no longer be between $5 and $15, but rather between $10 and $15. But I continue to abstract from the possibility that control could shift in an issuance.

IV. Cheap-Issuance Expropriation in the Zone of Uncertainty

This Part explains that an issuance priced within the zone of uncertainty enables insiders to engage in cheap-issuance expropriation against unimpeded outsiders.[119] It considers two scenarios. First, insiders do not disclose their participation plans, leaving outsiders to guess whether insiders are buying or (indirectly) selling (Section A). Second, insiders disclose that they will buy securities but outsiders still cannot figure out whether the securities are cheap or expensive for *them* because insiders' purchases are subsidized, either explicitly or implicitly by their economic interests in the firm, so even though the securities are effectively cheap for insiders they might still be expensive for outsiders (Section B).

A. Insiders Fail to Disclose Their Purchase Plans

Delaware law does not necessarily require insiders to disclose their subscription intentions in a rights offer.[120] Insiders who are not required to disclose their subscription plans often decline to volunteer these plans when they seek to engage in mispriced-issuance expropriation.

Absent such disclosure, an offer price within the zone enables insiders to put outsiders between a rock and a hard place, as it forces outsiders to choose between two options, each of which (in expectation) leads to expropriation: (1) exercise rights to buy, risking overpriced-issuance expropriation or (2) refrain, risking cheap-issuance expropriation.

For example, suppose again the zone of uncertainty is between $5 and $15 per share, and the issuance is for $10 per share. Because there is a risk of cheap-issuance expropriation *and* a risk of overpriced-issuance expropriation, there is no surefire way to protect against expropriation. Outside investors must decide which

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[119] Insiders conducting an issuance for a different purpose (a goal other than mispriced-issuance expropriation against unimpeded outsiders) might use an offer price below or above the zone of uncertainty. Insiders will use an offer price below the zone if (a) outsiders are impeded, and thus will not purchase their pro rata share of the cheap securities or (b) the controller needs outsiders to participate heavily in the issuance because the firm must raise a certain amount of capital and the controller is unable or unwilling to contribute the entire amount herself. *See* Fried, *Powering*, supra note x, at ___. Quasi-controlling insiders will use an offer price above the zone if they wish to use the rights offer to acquire control of the firm. By using an offer price that is clearly high (or at least appears high) to deter other investors, including any potential rival, from participating, insiders can increase their percentage ownership and achieve actual control. *See* Fried, *Powering*; Fried & Ofer, *supra* note x.

[120] In a number of Delaware cases where a rights offer insulated defendants from liability, the plaintiff did not know that insiders were participating. *See, e.g.*, *Feldman*, *supra* note x, at ___. It appears no other jurisdiction requires such disclosure for unlisted firms and only one (the People's Republic of China) requires such disclosure for listed firms, at least for certain kinds of equity issuances. *See* Fried, *Powering*, *supra* note x, at 99.

risk they fear more and expose themselves to the other. Those outsiders more fearful of cheap-issuance expropriation will choose to buy at $10 per share, putting themselves at risk of buying overpriced securities. Those more fearful of buying overpriced securities will not subscribe, eliminating *that* risk, but then making themselves vulnerable to cheap-issuance expropriation. If $10 is actually cheap, and at least some outsiders refrain, cheap-issuance expropriation occurs.[121] In a "game" between rational insiders and outsiders, it can be shown that there is only one possible equilibrium: the offer price is at least sometimes cheap, and at least some outside investors refrain from participating, thereby enabling cheap-issuance expropriation.[122]

Delaware Vice Chancellor Travis Laster characterized a key problem of rights offers as follows:

> [a] fiduciary isn't supposed to put their beneficiary in a position where the beneficiary has to exercise self-help to protect themselves. A fiduciary is actually supposed to be looking out for the beneficiary, not creating a situation where the beneficiary has to act at arm's length *vis-à-vis* the fiduciary and exercise self-help for self-protection.[123]

Laster implicitly assumes that outsiders know the securities are cheap, and are forced to protect themselves by participating. But the situation is actually worse than that. In the zone of uncertainty, the beneficiary has no clue whether to "exercise self-help" and buy stock, or run in the other direction. She could be damned if she does, or damned if she doesn't.

B. Insiders Disclose Their Purchase Plans

Although not necessarily legally required to do so, insiders do sometimes disclose that they will participate in many rights-offers for various reasons – because they want to encourage outsiders to participate or reduce litigation risk, or because they are required to disclose that they are backstopping the offer.[124] I thus now consider this situation.

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[121] *See generally* Fried & Spamann, *Cheap-Stock Tunneling*, *supra* note x.

[122] *Id.* For a discussion focusing on listed firms, see Fried, *Powering*, *supra* note x, at 88–89. For a similar analysis of controller-outsider interactions around repurchase tender offers (RTOs) by listed U.S. firms, see generally Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 453–69 (2000) (hereinafter Fried, *Insider Signaling*).

[123] *Perry v. Sheth*, at 53.

[124] *See, e.g.*, *Robotti,* 2010 LEXIS 4 (where the controller guaranteed to backstop the offer); OTK Assocs. v. Friedman, 85 A.3d 696 (Del. Ch. 2014) (same).

For simplicity, assume that insiders commit to purchase their pro rata share of the offered securities and any securities not purchased by outsiders.[125] Disclosure reduces insiders' ability to engage in cheap-issuance expropriation by forcing them to indirectly share some of their private information about the securities' value, as I explain below.[126] I consider two situations: (1) insiders and outsiders are identically situated and (2) insiders' purchases are subsidized, implicitly or explicitly, so that outsiders cannot infer that the securities, while effectively cheap for insiders, are also cheap for outsiders.

1. Outsiders and Insiders Are Identically Situated

If insiders and outsiders are identically situated with respect to the issuance—they pay the same amount for the securities and derive the same benefit from the proceeds paid for them—insider disclosure fully protects outsiders; they can reliably infer that the offered securities are cheap and participate.

Suppose that, absent such a disclosure, outside investors believe that the shares on offer for $10 each are worth between $5 and $15 apiece. If insiders disclose that they are seeking to buy a large number of shares, and insiders are paying the same amount for the shares and deriving the same economic benefit from the shares, outsiders can infer shares are worth more than $10 each, thus shrinking the zone to $10-$15. More importantly, outsiders can *correctly* conclude that the stock is cheap, and thus participate pro rata and thwart cheap-issuance expropriation.[127]

2. Outsiders and Insiders Not Identically Situated

Unfortunately, outsiders generally cannot infer from insiders' disclosure that the offered securities are cheap because the structure of the rights offer or the firm itself make insiders and outsiders differentially situated so that the offer price can be cheap for insiders but expensive for outsiders. Below, I first explain why

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[125] Advance disclosure would reduce mispriced-issuance expropriation regardless of the actual amount of securities the controller commits to purchase, as long as outsiders can mimic the controller's disclosed participation and thereby participate pro rata with the controller.

[126] In the unlikely event that insiders disclose that they are not participating, outsiders can simply mimic the insiders and avoid expropriation via either overpriced-issuance expropriation (because outsiders don't buy) or cheap-issuance expropriation (because insiders don't buy either). As noted earlier, for simplicity I assume that the offered securities are either cheap or overpriced. In the real world, there may well be offers in which the insiders do not know whether the securities' price is below or above post-issuance value. Outsiders learning that the insiders are refraining would thus infer that the insiders either (i) know the securities' price exceeds their value or (ii) does not know the relationship between their price and value. Outsiders would thus not know that the securities are overpriced, but rather that the offer price exceeds the *expected value* of the securities.

[127] *See* Example 2 in Appendix.

persistent information asymmetry may prevent outsiders inferring from insiders' participation that the securities are cheap. I then explain how this asymmetry reduces the ability of disclosures to prevent cheap-issuance expropriation.

a. Persistence of Asymmetric Information

To the extent the firm either explicitly subsidizes insiders' participation in the rights offer by financing their purchases or implicitly subsidizes their participation by providing insiders with a disproportionate share of the issuance proceeds, outsiders cannot reliably infer from insiders' participation that the securities are cheap.

1. Insiders' Stock is Subsidized

If insiders arrange to have their purchases subsidized by the firm (by, for example, the grant of non-recourse loans to purchase the stock[128]), then the fact that insiders are buying shares does not necessarily signal that stock is cheap for outsiders. The subsidy may make an overpriced stock effectively cheap for insiders. Consider **Example 1** below.

Example 1. Insider Stock Subsidy and the Signal Sent by Participation

DEF Corp. ("DEF") has 2 shareholders: Insider and Outsider. Suppose DEF offers common shares for $10 apiece to Insider and Outsider pro rata. Suppose that if Outsider does not know whether Insider is participating, the zone of uncertainty is between $5 and $15; however, Outsider knows that Insider is participating and that DEF is subsidizing Insiders' share purchase by $3 per share.[129] Taking into account this subsidy, each share's post-issuance value will be $V. For Outsider, it costs $10 to acquire a share worth $V. But for Insider, the $3 subsidy lowers its *effective* price to $7. Thus, Outsider cannot infer that the stock is cheap (i.e., $10 < $V < $15). All Outsider can infer is that $V exceeds Insider's *effective* price of $7 (i.e., $7 < $V < $15).

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[128] *See Daugherty*, 2019 LEXIS 1288 (describing a rights offer in which certain insiders received potentially forgivable non-recourse loans to cover pass-through tax liability on shares, but others did not). A payment to insiders to backstop the offer would similarly subsidize their purchases of securities.

[129] Obviously, in real-world settings outsiders are unlikely to know the precise amount of the subsidy to be received by insiders. Thus, outsiders would need to form an estimate of (or determine the range of plausible values for) the rebate, based on available information.

2. The Possibility of Issuance-Proceeds Expropriation

Outsiders cannot infer from insiders' participation that the securities are cheap when insiders might get disproportionate benefits from the issuance.[130] For example, the arrival of fresh cash might increase insiders' ability to get excessive compensation.[131] Or the proceeds could be used to increase the value of insiders' other securities in the firm. [132] Any such benefits would generate a per-share "rebate" on the price paid for the securities by the controller, reducing the securities' *effective* price (for insiders).[133] In this situation, insiders' participation will fail to clearly signal that the securities are cheap, as the securities could be overpriced but, after the rebate, still *effectively* cheap for insiders. Consider **Example 2** below.

Example 2. Private Benefits and the Signal Sent by Advance Disclosure

DEF Corp. ("DEF") has 2 shareholders: Insider and Outsider. Suppose that DEF offers common shares for $10 apiece to Insider and Outsider pro rata. Suppose that if Outsider does not know whether Insider is participating, the zone of uncertainty is between $5 and $15. Suppose that Outsider knows Insider is participating and that $3 per share will flow exclusively to Insider via private benefits. [134] Suppose that, taking into account this subsidy, each share's post-issuance value will be $V. For Outsider, it costs $10 to acquire a share worth $V. But for Insider, the $3 rebate lowers a share's *effective* price to $7. Thus, Outsider cannot infer that the stock is cheap (i.e., $10 < $V < $15). All Outsider can infer is that $V exceeds Insider's *effective* price of $7 (i.e., $7 < $V < $15).

In **Example 2**, I assumed that Outsider knows that $3 per share of the issuance proceeds will be diverted. But suppose that Outsider only knows that between $0 and $10 per share of the issuance proceeds will be diverted. Outsider's problem will be even worse, for two reasons. First, DEF's per share value might drop below $5 if all of the proceeds of the issuance are diverted, increasing the zone

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[130] *See generally* Fried & Spamann, *supra* note x.

[131] In Hong Kong and China, controllers of listed firms often use issuance proceeds to engage in related-party transactions that appear value-shifting. *See* Fong & Lam, *supra* note x, at 774 (study of CS firms listed in Hong Kong); E. Han Kim et al. *Expropriation Proceeds from Seasoned Equity Offering: The China Experience*, 16–21 (working paper, 2015) (study of CS firms listed in PRC).

[132] *See* Appendix A.4 for an example.

[133] *See generally* Fried & Spamann, *supra* note x; Fried, *Powerin*g, at 100–101.

[134] Obviously, in real-world settings outsiders are unlikely to know the precise amount of the rebate to be received by the controller. Thus, outsiders would need to form an estimate of (or determine the range of plausible values for) the rebate, based on the information available to them.

of uncertainty downwards. Second, Outsider can no longer figure out Insider's effective price.

Perhaps having this scenario in mind, Delaware Vice Chancellor Travis Laster opined:

> A large stockholder benefits by proposing a nominally pro rata offering at a dilutive price because there is a strong disincentive for minority stockholders to participate. . . The disincentive . . . is simply "don't hit me anymore" and the idea of throwing good money after bad. The minority stockholders are already facing a transaction that they view as oppressive. They're facing a situation where they think that expropriation is going on. The idea that a stockholder would voluntarily seek to address that by offering the controller, who's perceived as being abusive, more of their money is counterintuitive. The economic setup, the incentives in a rights offering for the minority are against participation.[135]

b. Disclosure's Diminished Ability to Reduce Cheap-Issuance Expropriation

When outsiders cannot reliably infer from insiders' disclosure that the securities are cheap, disclosure cannot eliminate cheap-issuance expropriation; outsiders know the securities are effectively cheap for insiders but may suspect that they are overpriced. As a result, outsiders may refrain from participating and, if the securities are in fact cheap, suffer cheap-issuance expropriation. Consider **Example 3** below.

Example 3. The Possibility of Cheap-Issuance Expropriation Despite Advance Disclosure

Setup is the same as Examples 1 and 2: Outsider learns that Insider commits to buy shares at $10 each, and thus that $V exceeds $7 (Insider's effective price after the $3 subsidy or rebate). If Outsider mimics Insider and participates, and $V happens to be between $7 and $10, Outsider will purchase overpriced shares and suffer a loss. Fearful of such a loss, Outsider might refrain. But if Outsider refrains, and $V exceeds $10, Outsider suffers cheap-issuance expropriation.

Nevertheless, disclosure reduces insiders' ability to engage in cheap-issuance expropriation. By revealing that insiders are participating rather than refraining, the disclosure informs outsiders that the securities are not so overpriced that, even taking into account any subsidy or rebate to insiders, they are effectively overpriced for insiders. Outsiders can thus form a more accurate (and lower) estimate of the expected loss from buying overpriced securities. This, in turn, increases the

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[135] *Perry v. Sheth*, at 51–53.

likelihood of their participation, which would reduce expected losses from cheap-issuance expropriation.[136] Consider **Example 4** below.

Example 4. Advance Disclosure's Ability to Reduce Cheap-Issuance Expropriation

Setup is the same as Example 3, but now consider DEF's $10 share offer under two different regimes: "No-Disclosure" (Outsider does not know Insider's participation in advance) and "Disclosure" (Outsider does know it). As before, the zone of uncertainty for Outsider is between $5 and $15, and Outsider knows that, if Insider participates, Insider's effective price is $7.

<u>No-Disclosure Regime.</u> Outsider knows that Insider will subscribe if $V exceeds $7—Insider's effective price. But Outsider, when deciding whether to participate, does not know if Insider will subscribe or refrain. Because DEF shares could be worth as little as $5, Outsider might be quite reluctant to buy shares. If Outsider refrains, and $V happens to exceed $10, Outsider suffers cheap-issuance expropriation.

<u>Disclosure Regime.</u> Outsider learns whether Insider commits to buy shares in the $10 offer before Outsider makes her own decision. If Outsider learns that Insider will subscribe, Outsider will know that $V exceeds $7. Thus, the zone of uncertainty will no longer be between $5 and $15, but rather between $7 and $15. The most Outsider can lose from buying a $10 share is now $3 ($10–$7), not $5 ($10–$5). Less fearful of buying overpriced shares than in the No-Disclosure Regime, Outsider is less likely to refrain and thus more likely to avoid cheap-issuance expropriation.

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[136] To the extent outsiders are more likely to participate in the insider-subscribe scenario, they are less likely to suffer from cheap-issuance expropriation but *more* likely to lose from buying securities that are overpriced (but effectively cheap for insiders). However, outsiders' expected combined losses from cheap-issuance expropriation and buying overpriced securities will be lower when outsiders have more information about the value of the firm's securities (*see generally* Fried & Spamann, *supra* note x), which disclosure provides.

V. Economic Costs of Cheap-Issuance Expropriation

From an economic perspective, cheap-issuance expropriation via rights offer would not be troubling if it merely transferred value from outsiders to insiders without reducing the size of the total pie; parties would rationally anticipate the expected expropriation, and adjust the terms of their dealings appropriately.

For example, outsiders buying shares in an insider-controlled firm while expecting to lose $10 through such expropriation would pay $10 less for their shares; insiders would then recoup the $10 *ex post* through the dilution. Aside from transaction costs, there would be no economic loss. Nor would there be a redistributive effect (at least *ex ante*). However, both *ex post* costs (Section V.A) and *ex ante* costs (Section V.B) are likely to arise.

A. *Ex Post* Costs

When insiders divert value from outsiders, the corporate pie tends to shrink as the value-diverting transactions themselves generate costs.[137] Such costs would include transaction costs, conducting issuances when they are not value-increasing, using the "wrong" type of security because it maximizes insiders' private benefits, and running the firm inefficiently to create more opportunities for disproportionate benefits or increase the information asymmetry that facilitates cheap-issuance expropriation.[138]

B. *Ex Ante* Costs

In addition, the prospect of cheap-issuance expropriation is likely to further reduce the size of the pie that can be shared by all the parties by giving rise to three types of *ex ante* economic costs.

1. Lemons in the Capital Market

The prospect of cheap-issuance expropriation exacerbates the "lemons problem" in the capital markets. Consider a market in which insider-held firms seek to raise capital from outsiders. Suppose there are both "good" insider-held firms and "bad" insider-held firms that would like to raise outside capital. The "good" firms will not subsequently engage in cheap-issuance expropriation; the "bad" ones will. There are no other forms of expropriation. If outsiders cannot differentiate between good and bad firms, they will lower the price they are willing to pay for securities

[137] *Cf.* Luca Enriques, *Related Party Transactions: Policy Options and the Real-World Challenges*, 16 EUR. BUS. ORG. L. REV. 1, 8 (2015).

[138] *See supra* Part ___.

issued by *all* insider-held firms—including "good" ones. If the discount is too steep, good insiders (who do not expect to subsequently recoup value from outsiders via cheap-issuance expropriation) will find financing too expensive and exit the market. This in turn will lead the market to unravel; as more good insiders exit the market, the discount will increase, and more good insiders will be forced out. Thus, unless insiders can credibly commit *ex ante* not to divert substantial amounts of value *ex post* from outsiders, capital formation is difficult and desirable projects do not get funded.

2. Overinvestment in Contractual Protections

Fear of cheap-issuance expropriation can lead parties to adopt restrictive contractual arrangements that give rise to coordination and hold-up costs. For example, fearing cheap-issuance expropriation, VCs investing in startups generally negotiate the right to block subsequent security issuances (in addition to rights to participate pro rata should equity issuances occur). When there is a single VC investor with such a blocking right, coordination and hold-up costs may well be low.[139] However, the typical startup ends up attracting investment over multiple rounds of financing from multiple VCs, with participants in each round of financing generally getting their own blocking rights.[140] Over time, as the ranks of the VCs grow, hold-up costs can increase, financing might be delayed or fall through, and firms can lose value. While litigation *among* VCs is quite rare, some of the most prominent inter-VC legal fights have arisen from hold-ups around equity issuances.[141]

3. Underuse of "Shared Control" Arrangements in VC Financing

[139] But such hold-ups do appear to happen. *See Watchmark,* 2004 LEXIS 168 (describing attempt by one VC fund to hold up a financing, which was eventually overcome).

[140] *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups,* ___ N.Y.U. L. Rev ___ (2006) [hereinafter, Fried and Ganor, *Agency Costs*]; Brian Broughman & Jesse M. Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. Fin. Econ. 384 (2010)(hereinafter, Broughman & Fried, *Renegotiation*]; Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 Cornell L. Rev. 1319 (2013) [hereinafter, Broughman & Fried, *Carrots*].

[141] *See, e.g.*, *Watchmark*, 2004 LEXIS 168 (dismissing complaint by a single VC investor against a recapitalization-and-issuance transaction that subordinated existing equity in a VC-backed firm because all other VC investors, including those similarly situated to the plaintiff, favored it); Benchmark Capital Partners IV, L.P. v. Vague, Del. Court of Chancery, 2002 WL 1732423 (2002) (refusing to grant preliminary injunction to VC firm that sought to block a new financing that involved a reduction in its liquidation preferences and subordination of its existing claims); Pine River Master Fund Ltd., et al. vs. IntelePeer Holdings, Inc., C.A. No. 2017-0388-SG, 2017 WL 5133328 (Del. Ch. Nov. 3, 2017) (dismissing an action because the parties settled a similar suit).

The possibility of cheap-issuance expropriation can also interfere with an important feature of the U.S. venture capital ecosystem: facilitating the creation of the "shared-control" arrangement between VCs and founders. Under this arrangement, founders give initial VC investors powerful legal rights in exchange for financing. The grant of these rights leaves neither party with outright control (hence, control is "shared")—each depends on and is vulnerable to other. Over time, however, VCs end up acquiring outright control in most startups.[142] There is an implicit understanding that the transition from shared control to outright VC control, if it occurs, will happen organically through a generally "consensual" process.[143] However, coerced power grabs by VCs are alleged to occur.[144]

VCs will generally not invest in startups without powerful control rights. Founders are usually inexperienced, and more often than not are replaced.[145] Even if they need not be replaced, other managerial agency costs will need to be controlled.[146] In addition, VCs invest through convertible preferred stock, creating a potential divergence of economic interests with common stockholders, including founders.[147]

However, giving powerful control rights to VCs makes founders vulnerable, as VCs who end up getting control (either "consensually" or "unreasonably") may then expropriate value from the founders, including through cheap-issuance expropriation. Lawsuits by founders are rare (for many reasons, including their lack of resources and fear of getting blacklisted by VCs). However, among those lawsuits that are filed, there is often an allegation that VCs engaged in cheap-issuance expropriation after obtaining control of the company.[148] To the extent founders fear

[142] By the time of exit, VCs usually control a majority of the board seats, and the founder has been replaced as CEO. *See, e.g.*, Broughman & Fried, *Carrots, supra* note x, at 123 (reporting that, in a sample of 50 VC-backed Silicon Valley firms that were sold in 2003 and 2004, VCs had board control in 58% of the firms); Brian Broughman & Jesse M. Fried, *Do Founders Control Startups that Go Public?* 10 HARV. BUS. L. REV. 50, 51 (2020) (by IPO, the likelihood that a founder will be in the CEO position and have a voting interest of at least 30% is about 7%) [hereinafter, Broughman & Fried, *Founders Control*].

[143] In fact, founders who have been replaced as CEO and end up with very little payout on exit generally (although not always) report that they were not mistreated by the VCs. *See* Broughman & Fried, *Carrots*, at 1354-1355.

[144] *See Flying Disc (Wine.com)*, discussed *supra* Part ___.

[145] Broughman & Fried, *Carrots*; Broughman & Fried, *Founders Control.*

[146] Fried & Ganor, *Agency Costs*, at ___.

[147] Fried & Ganor, *Agency Costs*, at ___.

[148] Kalashian v. Advent VI Ltd. P'ship, No. CV-739278, 1996 WL 33399950 (Cal. App. Dep't Super. Ct. Oct. 4, 1996) is the first well-known case involving a claim by the founders that they suffered cheap-issuance expropriation at the hands of the VCs; the VCs settled for $15m after trial. *See* Kenton J. King, *Warning: Rescue May Raise Risks*, 20 NAT'L L. J. B9 (Nov. 24, 1997). *See also Flying*

cheap-issuance expropriation or other types of dilution, they will refuse to give powerful legal rights to and share control with VCs, who in turn may refuse to invest because of their own fears of founder/common-stockholder misbehavior. Thus, founders' fear of expropriation dilution by VCs could prevent founders and VCs from engaging in an otherwise mutually beneficial financing and control arrangement that would boost the value of the startup.

In short, VCs must be able to credibly commit *ex ante* not to exploit their control to extract value from the founders, including through cheap-issuance expropriation.[149] Corporate law can assist the VCs in making such a commitment by giving founders the ability to sue and recover damages for cheap-issuance expropriation. More broadly, corporate law can assist all insiders *ex ante,* including those raising capital from outsiders, in making a commitment not to engage in cheap-issuance expropration *ex post*. To the extent Delaware law enables insiders to use rights offers for cheap-issuance expropriation, Delaware law does not help insiders in making such a commitment.

Disc, 2009 LEXIS 6367. More recent cases include *Carsanaro v. Bloodhound Technologies, Inc.*, 65 A.3d 618 (Del. Ch. 2013) (concerning a founding team alleging that VCs diluted them by issuing themselves excessive common shares); and *Dorsett*, 889 F.Supp. 2d 893 (same).

However, cheap-issuance expropriation is unlikely to be systematic. *See* Broughman & Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some Evidence from Silicon Valley,* 18 J. CORP. FIN. 1104–20 (2012) (finding, in a sample of 50 start-ups that exited in M&A transactions in 2003 and 2004, that valuations in inside rounds—financings in which only current VCs participate and where the risk of expropriation is highest—were higher, not lower, than in outside rounds).

[149] Founders could, in theory, get protection from cheap-issuance expropriation by bargaining for the same issuance blocking rights that VCs typically receive. But, such blocking rights carry with them their own costs, including coordination costs and hold-up costs. These costs could be particularly high when the rights are in the hands of a founder who, at the time he must decide whether to exercise them, might have been replaced as CEO and not be in the most cooperative frame of mind.

VI. Guidance for Courts

A rights offer, even if it is not as protective as widely believed, does reduce insiders' ability to engage in cheap-issuance expropriation. All else equal, outsiders are thus better off when insiders use a rights offer to issue securities rather than a transaction that excludes outsiders. Delaware law should thus encourage insiders to use rights offers by giving them *some* degree of legal insulation or "credit" for their use. The question is how much.

Right now, the law may well give insiders alleged to have engaged in cheap-issuance expropriation too much credit. To the extent rights offers are treated as presumptively pro rata transactions protected by the business judgment rule (as in *WatchMark*), insiders can escape the entire fairness review to which they should be subject. To the extent a court holds that a rights offer eliminates a controller's "exclusive benefit" from the issuance, thereby treating the issuance-expropriation claim as derivative and cutting off standing through a merger (as in *Feldman*), insiders can avoid any accountability. To the extent the use of a rights offer provides substantial evidence of fairness in an entire-fairness analysis (as in *Wine.com*), insiders can too easily satisfy entire fairness. The upshot is that Delaware law, as applied by Delaware and other courts, may allow insiders to get away with cheap-issuance expropriation.

This Part explains that the degree of insulation accorded by a rights offer should take into account how the rights offer is structured (Section A); the characteristics of outside investors (Section B); and the firm's governance and financial characteristics (Section C); and insider and outsider participation in the issuance (Section D).

A. Structure of the Rights Offer

The extent to which a rights offer protects outsiders from cheap-issuance expropriation will depend on how insiders choose to structure the rights offer along the following four dimensions: (1) disclosure of insider participation and other information; (2) transferability of rights; (3) ease of participation; and (4) complexity.

1. Disclosure

a. Participation by Insiders

Insiders' refusal to disclose in advance the precise details of their participation in a rights offer facilitates the use of the rights offer to engage in cheap-issuance expropriation. If outsiders do not know that insiders are participating, they may fear that insiders are planning to abstain, hoping to sell outsiders overpriced securities. Outsiders may then decline to participate, thereby enabling insiders to scoop up more cheap securities.[150]

Disclosure by insiders of the precise details of their participation eliminates this particular problem. If insiders disclose that they are not participating, outsiders can mimic them and avoid any kind of issuance expropriation. If insiders disclose that they are participating fully, but insiders' participation appears subsidized (or partially rebated), outsiders may still fear that the stock is overpriced. But at least they will know that the stock is not overpriced from insiders' perspective. Outsiders will thus be more likely to participate.[151] To the extent insiders and outsiders participate on the same terms (there is no subsidy or rebate), the more protective is advance disclosure.

Thus, in considering the protection offered by a rights offer, courts should give insiders more protection, all else equal, when insiders clearly disclose their participation decision in advance, and they are participating on the same terms as outsiders.[152] Such disclosure reduces the likelihood that the rights offer was intended to enable insiders to engage in cheap-issuance expropriation, or had that effect.[153]

Even better, Delaware courts could simply hold that (i) a rights offering involves a request for stockholder action to which the duty of disclosure applies and (ii) whether or not insider fiduciaries intend to participate is material information that must be disclosed.[154]

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[150] This information asymmetry can also cause outsiders to buy out of fear of cheap-issuance expropriation, and then be expropriated via the sale of overpriced securities. *See supra* Part IV.

[151] For a description of how this rule would work, including anti-circumvention measures, see Fried, *Powering*, *supra* note x, at 97–98.

[152] *See supra* Part V.

[153] Elsewhere, I have proposed that, whenever outside investors have pro-rata participation rights, the firm be required—by applicable securities laws, listing rules, or corporate law—to disclose insiders' participation before outsiders' participation deadline. *See* Fried, *Powering*, *supra* note x, at 97–98. For a similar proposal in the context of RTOs by listed CS firms, see Fried, *Insider Signaling*, *supra* note x, at 470–73. In a similar vein, I have long argued for requiring advance disclosure of officers and directors of listed firms with respect to all their transactions in firm shares, including trades in the open market. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure,* 71 S. CAL. L. REV. 303, 348–64 (1998).

[154] *Cf.* Gantler v. Stephens, 965 A.2d 695, 710 (Del. 2009) ("It is well-settled law that 'directors of Delaware corporations [have] a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action.'"); Dohmen v. Goodman, 234 A.3d 1161, 1168 (Del. 2020) (for purposes of triggering Delaware's disclosure requirement, shareholder action includes "making investment decisions (purchasing and tendering stock or making an appraisal election).").

b. Other Information

Insiders announcing a rights offer, and planning to engage in cheap-issuance expropriation, have an incentive to omit information that would cause outsiders to participate, and include tainted information that would cause outsiders to refrain from participating. Thus courts should consider the information omitted and disclosed by insiders for indications that insiders were trying to steer outsiders away from participating.[155]

Here too, Delaware courts could start from the premise that a rights offering involves a request for stockholder action to which the duty of disclosure applies. The courts then could take an expansive view of what constitutes material information for purposes of a rights offering.

2. Transferability of Rights

In private firms, and perhaps even in public firms, outsiders may decline to participate in a rights offer because they lack capital, thereby enabling insiders to engage in cheap-issuance expropriation.[156] This problem is alleviated if the rights are made transferable (and in the case of a public firm, transferable and easily tradable), enabling an outsider without adequate capital to transfer participation rights to a party with adequate capital. In taking into account the protection provided by a rights offer, courts should thus give less insulation when the right to participate is not transferable.

3. Ease of Participation

A court should inquire into the ease with which outsiders can participate in a rights offer. If the insiders appear deliberately to make participation difficult, it is more likely they were trying to engage in cheap-issuance expropriation and that cheap-issuance expropriation in fact occurred.[157]

4. Complexity

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[155] *Cf.* In re Nantucket Islands Assocs. P'Ship Unitholders Litig., 810 A.2d 351 (2002 Del. Ch. 2002) (declining summary judgment motions in a case where insiders purchased 83% of the securities in a rights offer before the firm was sold at a high price, and outside investors claimed that insiders failed to disclose material information bearing on the value of the securities); *Perry v. Sheth* (granting TRO against rights offer in which minority stockholders claimed they were given "minimum, bare-bones information" and only one day to decide whether to exercise their rights, *id.* at 47).

[156] *See supra* Part II.

[157] *Perry v. Sheth* (granting TRO against rights offer in which minority stockholders claimed they had only one day to decide whether to exercise their rights, *id.* at 47).

Insiders may make rights offers complicated, perhaps to discourage outsider participation but perhaps solely for other reasons. Whatever the motivation, a complicated rights offer will discourage participation, and therefore facilitate cheap-issuance expropriation. The more complex the offering, the less a rights offer should count in insiders' favor.[158] And a negative inference should be drawn if insiders deliberately complicated the rights offer to discourage outsider participation.

B. Outsiders

Holding the structure of the rights offer constant, insiders are more likely to engage in cheap-issuance expropriation if they expect outsiders not to participate, even at what might appear to be a low price. The more capital-constrained and unsophisticated outsiders are as a group, the less likely they will be expected to participate. Thus, the less capital-constrained and the more sophisticated are outsiders, the lower the likelihood of cheap-issuance expropriation (everything else equal), and the more legal insulation insiders should receive for using a rights offer.

C. Firm Characteristics

Courts should also take into account various governance and financial features of the firm in determining the extent to which a rights offer is likely to protect outsiders.

1. Degree of Information Asymmetry

The greater the degree of information asymmetry between insiders and outsiders, the easier it is for insiders to use a rights offer for cheap-issuance expropriation,[159] and the more likely cheap-issuance expropriation has occurred. Public companies will generally have the least amount of information asymmetry because of the disclosure requirements mandated by the securities laws. Private companies with outside investors who are not involved in the business may have the most information asymmetry. The more information asymmetry, the greater the likelihood that a rights offer was intended to effect cheap-issuance expropriation,

[158] *Cf.* Stepak v. Tracinda Corp., No. 8457, 1989 LEXIS 95, at *8–9 (Del. Ch. Aug. 18, 1989) (declining to approve a settlement in a case where United Artists was sold by MGM/UA to its controller Kirk Kerkorian for $9 per share, and the minority was given the right to participate pro rata, after court found "most coherent" the claim that "the offer to minority shareholders was a . . . complex pretext to permit [Kerkorian] to increase its proportionate ownership of the UA assets at a cheap price . . . [as minority shareholders] were not in a position to know that the $9 price was a bargain . . . [and Kerkorian] . . . designed and implemented a complex confusing procedure with the intention and effect of impeding of discouraging and impeding minority . . . participation.").

[159] *See* Fried & Spamann, *Tunneling, supra* note x.

and the more closely courts should scrutinize the effects and fairness of the issuance.

2. Capital Structure

The more complex a firm's capital structure, the more likely it is that a securities issuance will disproportionately benefit insiders, all else equal. In particular, the proceeds of a securities issuance are likely to be used to beef up, preferentially, the value of other securities in the capital structure that are disproportionately held by insiders. For example, if insiders hold debt (or senior equity securities) and common stock, and outsiders hold only common stock, insiders are likely to deploy the proceeds of the issuance of additional common stock to increase the value of the debt.[160] This provides a "rebate" to insiders, reducing their effective price of the common stock, and making outsiders more reluctant to participate even when the stock is, in fact, cheap.

Because the mere possibility of such disproportionate benefit can facilitate cheap-issuance expropriation, courts should "kick the tires" of the rights offer more thoroughly when insiders and outsiders have significantly different exposure to the firm's future cash flows because of their diverging cash-flow rights.

3. Private Benefits Expected to Arise from the Issuance

Insiders can often extract private benefits through their positions in the firm, such as compensation and profits from self-dealing transactions. The magnitude of these private benefits will depend on the particular circumstances of the firm. For purposes of evaluating a rights offer, the key question is the extent of additional private benefits the issuance is likely to generate.

If insiders' future private benefits may (or will) increase as a result of the issuance, then the rights offer's ability to protect outsiders is lessened. To the extent outsiders do not know the amount of private benefits arising from the issuance, outsiders might overestimate the level of private benefits and not participate, thereby enabling insiders to engage in cheap-issuance expropriation. Courts should thus consider, in determining how much legal insulation a rights offer provides, the degree to which that issuance could have increased insiders' private benefits.

4. Issuance Frequency and Magnitude

The extent to which a firm has issued securities, or is expected to continue to issue securities, should also be considered by the courts in determining how much legal protection the use of a rights offer should afford insiders. The greater the frequency and magnitude of a firm's securities issuances, the more any given rights offer should be scrutinized, for two reasons.

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[160] *See* Appendix A.4 (providing example).

First, a greater issuance frequency/magnitude gives insiders greater ability to divert value from outsiders via cheap-issuance expropriation. To the extent outsiders believe that any given rights offer will be followed by another, and then perhaps another, they may believe that the proceeds of the current issuance are more likely to be diverted. This may cause them to refrain from participating, enabling cheap-issuance expropriation in the current rights offer.[161]

Second, if outsiders are capital-constrained, the expectation or fear of serial (and potentially more dilutive) issuances may cause outsiders to refrain from participating in the current rights offer (even if they have reason to believe it is cheap) so that they can reserve capital for later rounds.

Even if outsiders have the means to participate in the current rights offer, they might fear subsequent follow-on rights offers at an even larger discount, for which they would not have adequate capital if they invest in the current issuance. They may thus decline to participate in the current issuance, which they believe to be cheap, in order to save "dry powder" for later rounds of stock issuance, which might be cheaper.[162] Whether outsiders abstain because they have no capital for the current round or because they are saving capital for a subsequent round, insiders can engage in cheap-issuance expropriation via the current rights offer even if outsiders know that the issuance is underpriced.

D. Insider/Outsider Participation

If the rights offer has been completed, the court can examine the extent to which outsiders and insiders participated. If insiders buying shares did not maintain their pro rata share, or barely increased it, the issuance was unlikely to be motivated by cheap-issuance expropriation.[163] If insiders did fully participate (i.e., buying as many securities as they could) and outsiders also overwhelmingly participated, the price was unlikely to have been in the zone of uncertainty where

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[161] *See supra* note x.

[162] In VC-backed firms, it is common for there to be multiple rounds of financing, and future rounds may well be more discounted than the current round, as appeared to happen at Wine.com. *See supra* Part ___.

[163] *See, e.g., Dougherty,* 2019 LEXIS 1288, where outsiders invoked *Gentile* to bring a direct cheap-issuance expropriation claim in connection with a rights offering, the controlling-stockholder group's equity interests marginally declined in one challenged stock offering (from 85.32% to 84.94%) and marginally increased in a second offering (to 85.72%). Vice Chancellor McCormick applied *Feldman* to deem the claim derivative and dismissed it for failure to plead derivatively. But one could infer from the change in the controlling-stockholder group's ownership that cheap-issuance expropriation was unlikely to have occurred. Apparently, the real problem (from outsiders' perspective) was that directors and officers received non-recourse loans (which might have been forgiven) to buy stock, which would normally give rise to a purely derivative claim.

cheap-issuance expropriation is most likely to occur. In these situations, claims of cheap-issuance expropriation should be treated skeptically.[164]

VII. Conclusion

Under Delaware law, a rights offer is often viewed as treating corporate insiders and outsiders alike, making it difficult for nonparticipating outsiders to prevail on a cheap-issuance claim: one in which the insiders sold themselves cheap securities via the rights offer. Delaware judges understand that rights offers do not protect outsiders when they lack capital or are otherwise constrained from participating. I have shown, however, that rights offers fail to put insiders and outsiders on equal footing, and that insiders can use rights offers to engage in cheap-issuance expropriation. In particular, information asymmetry can make outsiders rationally reluctant to participate in an issuance that, unbeknownst to them, is cheap, enabling insiders to buy a disproportionate amount of underpriced stock. My analysis suggests that courts applying Delaware law should more closely probe rights offers for their substantive fairness toward outsiders.

[164] The rights offer might be unfair to outsiders for other reasons. *See supra* TAN x (describing ways in which a rights offer can harm outsiders even if there is no cheap-issuance expropriation).

Appendix

This Appendix uses numerical examples to illustrate cheap-issuance expropriation (A.1); a rights offer's ability to prevent such expropriation when outsiders are unimpeded and fully informed (A.2); overpriced-issuance expropriation (A.3); and how insiders' ownership of other securities in a firm's capital structure can facilitate cheap-issuance expropriation (A.4).

A.1 Cheap-Issuance Expropriation

Suppose insiders cause the firm to sell securities that are "cheap": insiders know the price is less than post-issuance value.[165] The cheap issuance transfers value to buyers ratably at the expense of current investors in aggregate (including insiders). Insiders can thus profit at outsiders' expense by buying a disproportionate percentage of the securities.

For simplicity, consider a "basic" firm: one that, before and after the issuance, has only common stock outstanding and whose insiders do not receive a disproportionate benefit from the issuance proceeds. A sale of cheap stock by a basic firm would transfer value to the buyers from all existing investors pro rata, including insiders. If insiders buy more than their ratable portion of the offered stock, value shifts to insiders from outsiders. Consider **Example A.1** below.

Example A.1. Cheap-Issuance Expropriation

Insider and Outsider each own 1 share of ABC Corp. (ABC).[166] Upon Liquidation Date, ABC's value will be distributed ratably to shareholders.[167] Assuming no equity issuance, ABC's Liquidation-Date value will be $30 and each of ABC's 2 shares will be worth $15 ($30/2).

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[165] I assume that insiders have the legal power to cause the firm to conduct a particular securities issuance.

[166] All examples assume that Insider and Outsider each initially own 50% of ABC's equity. Of course, if ABC's equity were 1-share/1-vote and no other control-affecting arrangements were in place, Insider would not control ABC. Thus, assume that Outsider is not a single shareholder, but rather a collection of many uncoordinated outside investors.

[167] In this and subsequent examples, "Liquidation Date" is the future period when ABC has a liquidity event in which (a) its assets are sold for a price equaling their actual value (which could be going-concern value) and (b) the sale proceeds are distributed to ABC's investors (Insider and Outsider) in accordance with their rights (e.g., ratably if both own only common shares), terminating their equity investment in ABC. Purely for expositional convenience, I assume that there is no expropriation of value until Liquidation Date, except directly via a securities issuance.

Insider has ABC offer 2 new shares for $10 each. Any issuance proceeds will increase ABC's Liquidation-Date value dollar-for-dollar.[168] Issuing 2 new shares for $20 in total will increase ABC's Liquidation-Date value from $30 to $50; each of ABC's 4 shares will thus be worth $12.50 ($50/4). Each new share, offered for $10, is thus cheap.

Outsider does not purchase any of the 2 new shares, because Outsider either does not know the shares are cheap or is not offered the right to participate, enabling Insider to acquire both.[169] Outsider loses $2.50, as the value of its 1 (and only) share declines from $15 to $12.50. Pre-issuance, Insider has 1 ABC share worth $15. Post-issuance, Insider has 3 ABC shares worth $37.50 (3 x $12.50) in total, but $20 less cash (net total of $17.50). Cheap-issuance expropriation shifts $2.50 from Outsider to Insider.[170]

A.2 Rights Offers' Potential Power

A rights offer that enables investors to participate pro rata in securities issuances should, in theory, thwart cheap-issuance expropriation. If outsiders know the securities on offer are cheap, they would participate pro rata, preventing expropriation. Consider **Example A.2** below, which replicates the scenario in **Example A.1** but assumes the existence of a rights offer.

Example A.2. Pro Rata Rights Block Cheap-Issuance Expropriation

Setup is the same as Example 1, except Outsider now has pro rata rights and is aware the shares are cheap. Outsider thus buys 1 of the 2 shares; Insider purchases the other. Pre-issuance, Outsider and Insider each own 1 ABC share worth $15. Post-issuance, Outsider and Insider each own 2 ABC shares worth $25 (2 x $12.50), but $10 less cash (net total of $15). Each shareholder's wealth remains unchanged, and there is no transfer of value from Outsider to Insider. Outsider's use of pro rata rights to buy its ratable portion of cheap securities thus thwarts cheap-issuance expropriation.

[168] In this and subsequent examples I assume that ABC's securities issuance does not create or destroy economic value. That is, the total ABC pie shared by Insider and Outsider is equal to the pre-issuance value of ABC's assets plus issuance proceeds.

[169] In this and subsequent examples I assume that Insider and Outsider have sufficient cash to acquire as many of the offered securities as they are permitted and wish to purchase.

[170] The $2.50 corresponds to the difference between the price ($10) and value ($12.50) of the second cheap share in the offering, which Insider acquires rather than Outsider.

A.3 Overpriced-Issuance Expropriation

Insiders may cause a firm to offer securities that are "overpriced": insiders know the price exceeds post-issuance value.[171] Such an issuance transfers value ratably from buyers to current investors, including insiders. Insiders' gain (if any) would be maximized if outsiders buy all of the offered securities.

For simplicity, consider again a basic firm (one that has only common stock outstanding and whose insiders cannot get private benefits from the issuance). In such a firm, the sale of overpriced stock transfers value to all existing shareholders pro rata, including insiders, from buyers. If insiders buy less than their ratable portion of issued shares, value will be transferred to insiders from outsiders. Consider **Example A.3** below.

Example A.3: Sale of Overpriced Securities

Insider and Outsider each own 1 share of ABC Corp. (ABC). Upon Liquidation Date, ABC's value will be distributed ratably to shareholders. Assuming no equity issuance, ABC's Liquidation-Date value will be $5 and each of ABC's 2 shares will be worth $2.50 ($5/2).

Insider causes ABC to offer 2 new shares for $10 each. Any issuance proceeds will increase ABC's Liquidation-Date value dollar-for-dollar. If both new shares are purchased, ABC's Liquidation-Date value will increase by $20 to $25, and each of the 4 shares will be worth $6.25 ($25/4). If only one of the two shares is purchased, ABC's Liquidation-Date value will increase by $10 to $15, and each of the 3 shares would be worth $5 ($15/3). Thus, in either case, the shares are overpriced.

Insider and Outsider both have pro rata participation rights. Insider refrains from participating, as buying even 1 share means losing.[172] Suppose Outsider, unaware the shares are overpriced, buys 1 share.[173] Pre-issuance, Outsider and Insider each own 1 share worth $2.50. Post-issuance, Outsider owns 2 shares worth $5 each and has $10 less cash (net total

171 For evidence that insiders frequently use issuances to sell overpriced securities, see Fried, *Powering*, supra note x at 86–87 (describing empirical studies of equity issuances indicating overpriced-issuance expropriation).

172 The examples assume that the allocation of control rights within the firm and parties' private benefits are not directly affected by whether a party participates in an issuance. In other words, I assume that the pre-issuance allocation of voting power is such that there is no scenario in which the issuance can shift control. In Example A.3, for instance, one might imagine that Insider maintains control even if her equity falls to 25% or 33% because (a) Insider's share of stock carries multiple votes (or, similarly, other shares have 0 votes) or (b) a shareholder-level voting agreement gives Insider the right to control Outsider's vote. This assumption, made solely for simplicity, enables me to focus on the direct value-shifting effects of a mispriced issuance. Of course, when the securities being issued have voting rights, insiders' desire to maintain control may well limit the size of an issuance when insiders know they will purchase less than their pro rata portion.

173 Outsider will not seek to buy 2 shares, as the second would be available only if Insider refrains because the stock is overpriced.

of $0) and Insider owns 1 share worth $5. Overpriced-issuance expropriation shifts $2.50 from Outsider to Insider.[174]

A.4 Complex Capital Structure Facilitates Cheap-Issuance Expropriation

In most private companies, especially VC-backed startups, insiders will own a different mix of securities than outsiders before the issuance occurs. The proceeds of the issuance may thus benefit insiders disproportionately, giving them an effective rebate on the per-share price and making an overpriced issuance effectively cheap for them.

Example A.4. Complex Capital Structure Facilitates Cheap-Issuance Expropriation

HIJ Corp. ("HIJ") has 2 shareholders each owning 1 share: Insider and Outsider. Insider is also owed $20 by HIJ. There is a 50% probability of failure: HIJ will yield $0, wiping out the value of its debt and equity. There is a 50% probability of success: HIJ will yield $V, where $V is either $104 or $56. Insider knows $V, Outsider does not. Suppose HIJ offers common 2 shares for $10 apiece. The $20 in proceeds will increase HIJ's value by $20 in both the failure and success scenarios. Insider says it will buy both shares, unless Outsider wants to participate pro rata.

Should Outsider participate pro rata, buying 1 share? If $V=$104, each share is worth $13 [(50%)($124-$20)(1/4)]; Outsider should buy. If $V=$56, each share is worth $7 [(50%)($76-$20)(1/4)]. Outsider should not buy.

However, Outsider cannot infer from Insider's willingness to buy both shares that $V=$104 Insider gains even if $V=$56. Pre-issuance, Insider owns debt worth $10 [50% x $20] and 1 share worth $9 [(50%)($56-$20)(1/2)]; total value is $19. If Insider buys both shares for $20, she will own debt worth $20 (it will now be paid with certainty) and 3 shares worth $7 each; total value is $41. Insider has paid $20 to increase the value of its securities by $22 ($41-$19), coming out ahead.

Another way to put it: of the $20 Insider pays for 2 issued shares, $10 (in expected value) flows back to Insider via her debt. Thus, her effective cost of buying 2 shares is only $10, or $5 per share. Her effective price per share is $5, less than the $7 in the $V=$56 scenario.

Thus, Outsider may refrain from participating, fearing that $V=$56, and then be subject to cheap-issuance expropriation if in fact $V=$104.

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[174] Outsider overpays by $5 for 1 new share whose price is $10 and whose value is $5, but 50% of the value transferred to existing investors flows back to Outsider through its original 1 share.

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