

**ONE SIZE DOES NOT FIT ALL: A CONTEXTUAL APPROACH
TO FIDUCIARY DUTIES OWED TO PREFERRED
STOCKHOLDERS FROM VENTURE CAPITAL TO PUBLIC
PREFERRED TO FAMILY BUSINESS**

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ABSTRACT

This Article examines whether corporations should owe fiduciary duties to their preferred stockholders as preferred stockholders across all settings of preferred stock holding. In one context, sophisticated venture capitalists (“VCs”) purchase preferred stock after carefully negotiating the stock price, control over the corporate governance, and other key stipulations by contract. Additionally, because the initial preferred stockholder could protect its interests through staged financing or board control, the preferred stockholder might not discount the stock even if it lacked protection, since the other protective devices made the lack of such protections inconsequential, so the initial holders will not pay for these added fiduciary protections. In such settings it does not make sense for the corporation to owe fiduciary duties to the preferred stockholders as preferred. In fact, doing so rearranges the basis on which the initial stockholders purchased the stock, and implying a fiduciary term constitutes a hit to the common stockholders and thus ignores the terms of the claimants and the risk and targeted return for each of them. However, while it makes sense for sophisticated venture capitalists to rely only on bargained-for contractual protections, this Article identifies two specific contexts where a limited fiduciary obligation should be

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extended to preferred stockholders who lack bargaining power. The first is when non-working children are given preferred stock in a family business. The second is when a corporation takes on a new, unfamiliar product line, allowing common stockholders to wipe out the value of publicly traded preferred stock. When the preferred stock is purchased in the public marketplace, the preferred stockholders will not have any bargaining power in the preferred stock's contractual arrangement. Moreover, the additional terms routine in shareholder agreements between VCs and founders are almost never found in the charter documents, so those provisions will not be transferable. To the subsequent purchaser of preferred stock, the lack of such protections might call for a limited fiduciary duty if the markets for preferred stock are not as efficient as for common stock or if there are chinks in the efficient capital market hypothesis. Where the disciplining effects of the market are weaker, subsequent buyers of the preferred stock may not price the stock accurately to reflect the lack of transferable protections, providing a justification for a limited fiduciary duty in that context if implying the term would add value.

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INTRODUCTION

When conflicts between preferred and common stockholders arise, the key inquiry is whether the preferred stockholders must depend exclusively on the contractual protections that they have negotiated¹ or whether they should be protected by a fiduciary duty that goes beyond the fiduciary duty owed to all equity holders.²

Of course, in the ordinary course when the company is making money, the terms of the preferred stockholder will be honored.³ Absent a steady-state norm of paying preferred stockholders across a wide section of companies, there would no market for preferred stock and those preferring less risk than that offered by common stock would invest in debt rather than preferred stock. Conflicts between preferred and common stockholders only arise in the aberrant case where the company is declining in value and does not have enough money to satisfy obligations to the preferred and the common.

In these aberrant cases, Delaware courts have resolved that preferred stockholders must depend exclusively on those contractual protections and cannot rely on courts to imply fiduciary obligations in their favor.⁴ There is one exception: when the preferred are not

1. The bundle of contractual rights, privileges, and limitations are contained in the Stock Purchase Agreement; the agreement comprises additional covenants not found in the express shares.

2. Some commentators see the dual roots of the preferred in both corporate law and in contract cause the law to “vacillate[.]” See William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1820 (2013). However, this Article differs from that and finds that the results largely make sense and are consistent with a cost-minimizing, wealth-maximizing approach to firm value.

3. As Bratton and Wachter explain, “In this case [upside], the venture impresses the market and proceeds to an initial public offering (IPO). . . . The venture capitalist’s counterparty, the ‘entrepreneur,’ shares the jackpot and resumes control of the company” *Id.* at 1875 (footnotes omitted).

4. See, e.g., *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 600 (Del. Ch. 1986).

invoking their preferential, contractual rights, the preferred “are entitled to the same fiduciary duties as common shareholders.”⁵

This contractual approach to preferred stockholders has provoked varied reactions among commentators. Some allege that the preferred are vulnerable and oppressed and require additional fiduciary protections.⁶ Others embrace the categorical approach denying all fiduciary protection to the preferred regardless of whether the preferred or common control the board of directors.⁷

This Article argues that instead of using one approach for all cases involving preferred stockholders, either protecting all preferred stockholders or denying protection to all preferred stockholders who are not protected by contract, courts should instead differentiate and modulate the rule depending on the circumstances in which the preferred stock is issued. This Article argues that there can be no one size fits all solution to the fiduciary duty issue for the preferred stockholder.⁸

In some settings of venture capital where the preferred can easily arrange their transactions to avoid adverse outcomes either through contract, staged financing, discounted market pricing, or other protective strategies, a single analysis should be used to determine whether to imply a fiduciary duty or some other term in an exchange transaction.⁹ A legal adjudicator should only imply fiduciary protection

5. Melissa M. McEllin, Note, *Rethinking Jedwab: A Revised Approach to Preferred Shareholder Rights*, 2010 COLUM. BUS. L. REV. 895, 898; see also *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 116–17 (Del. Ch. 2007); 11 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5295 (perm. ed., rev. vol. 2010) (suggesting an equitable approach to rights preferred share with common stockholders). *But see* STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 255 (3rd ed. 2015) (“Delaware supreme court precedents . . . suggest that all of the rights of preferred stockholders are contractual . . . not just those relating to preferential rights . . .”).

6. Lawrence Mitchell would do so “incorporating a fairness notion into directors’ decision-making” to “provide preferred shareholders with meaningful fiduciary rights.” McEllin, *supra* note 5, at 923; see also Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 449, 473–74 (1996).

7. Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1166 (2013).

8. The law itself does not differentiate between different types of preferred stockholders.

9. The same analysis should govern whether courts add terms in other settings, such as adding implied terms in the contractual setting. For an application of the analysis developed in this Article in contract, see Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What to Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323, 325 (2004).

if doing so will minimize total costs¹⁰ and maximize the “long-run value of the firm.”¹¹ In determining whether the ultimacy of increased gains from trade at the lowest cost will be achieved by a particular legal intervention, the adjudicator must confront assumptions about reality,¹² address the use of private strategies that may be more cost effective than legal intervention,¹³ consider the reform effects on future parties subject to the legal intervention, and calculate the offsetting costs of legal intervention.¹⁴

One cost from supplying a fiduciary obligation to the preferred and implying additional protections after the fact is that there would be an immediate hit to the other claimant, the common stockholder, since the agent, the board, now owes an additional obligation to the preferred not bargained for.¹⁵ Another cost—and thus another potential downside to an implied fiduciary protection for the preferred—is that doing so increases uncertainty, and can thus destabilize voluntary arrangements and delicately balanced systems of incentives that the court does not understand.¹⁶ Since the claimants made their investments based on certain risks, and the price of the stock reflected those risks, including the lack of implied fiduciary protections except those shared with the

10. This analysis of judicial intervention therefore begins with the nature, function, and dynamics of exchange, and the ultimacy to be achieved by exchange. Cost minimization objectives in exchange transactions explain why parties adopt the arrangements they do. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 17 (1985). In some instances, the costs savings from adding a term may be less than other types of costs that would be generated by the addition so the added term would not be efficient.

11. See Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 *BUS. ETHICS Q.* 235, 235 (2002) (endorsing this objective as the appropriate framework for corporate decision-making). A similar analysis is used to determine whether to imply default rules in contractual contexts. See Kostriksy, *supra* note 9, at 329 (“Courts should decide whether legal intervention will increase gains from trade by projecting what consequences, both *ex ante* and *ex post*, legal intervention will produce.”).

12. Assumptions about reality include fundamental characteristics such as bounded rationality and opportunism as the likely incentive effects of certain legal rules. See WILLIAMSON, *supra* note 10, at 43–52 (discussing the traits of the “contractual man”).

13. Stewart Macaulay did pioneering work on contexts in which “legal sanctions are often unnecessary and may have undesirable consequences.” Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *AM. SOC. REV.* 55 (1963), reprinted in *REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY: ON THE EMPIRICAL AND THE LYRICAL* 1, 1 (Jean Braucher et al. eds., 2013). Macaulay explored why “[i]n most situations contract is not needed” since parties resort to other ways to solve problems. *Id.* at 12.

14. If offsetting costs outweigh the benefits, it would be perverse to intervene. See *id.* at 1.

15. Korsmo, *supra* note 7, at 1163–66.

16. *Id.* at 1167.

common,¹⁷ adding such protections after the fact would alter the essential terms of the deal and would not be cost minimizing as a legal strategy. Thus, even if one accepts that venture capital contracts are incomplete¹⁸ since “preferred stock certificates are by nature short and incomplete,”¹⁹ there is no reason that preferred stockholders in venture capital contexts have omitted anything that was important to them. If there are omissions, they have priced their shares to reflect the lack of specific contractual provisions, perhaps through a higher dividend. In either case, adding protections in such contexts would not be value maximizing. This is particularly true in the context of venture capital preferred stock or other sophisticated investor contexts because once an adverse decision to the preferred is rendered, a protective provision will become universal in the industry.²⁰

Moreover, if the investments of the preferred and common stock claimants are viewed through a principal-agent lens, then all stockholders take the risk that the agent, who represents dual classes of stock and is tasked with maximizing the value of the firm, might take actions from time to time that hurt one claimant and help another claimant so long as the action was “value-neutral” or more than “value-neutral for the firm.”²¹ To the extent that such shifts in wealth are anticipated, protections can be implemented by the preferred, once again suggesting that law-supplied terms for such preferred stockholders would not maximize wealth.

However, the ability of the preferred to protect themselves by contract or other private strategies will vary widely. This suggests that a different legal approach that does not uniformly relegate preferred to the contractual protections might be appropriate.

17. See Bratton & Wachter, *supra* note 2, at 1819–20.

18. See *id.* at 1857 (noting that incompleteness of preferred stockholders’ contracts renders them vulnerable to board opportunism).

19. McEllin, *supra* note 5, at 910.

20. Interview with David P. Porter, M&A Lawyer & Visiting Professor at Case W. Reserve Univ. in Sec. Regulation & M&A (May 22, 2015) [hereinafter Interview with M&A Lawyer] (Mr. Porter is a retired partner from global law firm Jones Day where he practiced corporate finance and M&A). This is because once the decision is known, it would be hard to imagine a founder, for example, in the preferred stock venture capitalist sector saying that although there is a recent court decision on point, we will refuse to include a provision to protect the preferred stockholder. See David Gammell et al., American Bar Association Business Law Section & Center for Professional Development, *Drafting a Stronger Preferred Stock: Responses to Recent Case Law Developments* (2014) (recording on file with publication) (detailing contractual protections for preferred stock that respond to recent court decisions).

21. See Ronald J. Coffey, *Firm Opportunities: Property Right Assignments, Firm Detriment, and the Agent’s Performance Obligation*, 13 CAN.-U.S. L.J. 155, 180 n.64 (1988) [hereinafter Coffey, *Firm Opportunities*].

In some contexts, such as public preferred stock relegating the preferred to a contractual solution or another private solution such as board control or a discount stock purchase, may not be feasible for large classes of preferred. In these cases, where the common controlled board might either intentionally elect to injure the preferred or engage in an outrageous or reckless investment strategy²² that would only be rational when viewed exclusively from the perspective of the common, and would be viewed as grossly irrational by a prudent investor, there should be an implied duty. Thus, a limited fiduciary protection for the preferred that rules out reckless investment should be implied. In such cases, even if the board's duty is to maximize the long-term wealth of the entity, there is some board action that is so reckless that no reasonable person would have taken the action and the board should not be immunized from liability. If no duty to the preferred is implied in such cases, the incentive to invest as preferred stockholders may be significantly dampened.

Moreover, in many contexts, even if the preferred wanted to bargain for protection against reckless behavior, and even if they had the clout to extract a promise against such behavior (an unlikely scenario where in many contexts the preferred have zero clout), structural barriers prevent the preferred from acting since the party that contracts with the preferred holders through selling shares—the firm—is not the perpetrator or beneficiary of the wrongful behavior. Further, neither the common stock nor the directors are in privity with the preferred. So, there is reason to think that a contractual solution is not feasible and that adding protection against reckless behavior would be consistent with maximizing value since retaining a right to act recklessly does not maximize firm value.

Another context in which the ordinary rules relegating preferred to their contractual solution involves a family business in which preferred is issued to certain family members who play an inactive role in a company founded by a parent and common stock is issued to the children playing an active role in management. The argument that no duties should be owed to those who purchased on the assumption that they would be afforded no protection beyond the contractual terms seems to make no sense at all since in such contexts, where the preferred are gifted preferred stock, they did not negotiate the terms of

22. See *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 151 (Del. Ch. 1943) (citing “reckless indifference to the rights of others”); see also Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law*, 83 S. CAL. L. REV. 1231, 1253 (2010) (discussing the fact “that courts generally do reserve the right to review the substance of business decisions, at least in the most extreme cases”).

their investment. Moreover, the key argument against implying terms—that it causes a hit to the other (common) stockholders—has less power here where the other (common) stockholders were given their stock by a parent and thus did not have their investment devalued by the imposition of additional burdens.

Thus, this Article will argue that the general rule relegating preferred exclusively to contractual protections should not govern all instances of preferred stockholding, but should depend on the context in which the stock is issued. Previous commentators have treated all preferred stockholders as a class without differentiating between the different contexts involving preferred stock.²³ This omission has caused many commentators to overstate the vulnerability of preferred and to advocate for protective strategies for all classes of preferred. However, the ability of preferred varies significantly in different contexts and those circumstances require a more nuanced approach to preferred shareholder protection.

Part I will lay out the general circumstances that warrant an implied fiduciary duty in the corporate context and use a principal-agent framework to assess whether and why an implied fiduciary duty will maximize wealth for equity holders. Part II then re-examines the fiduciary duty in the context of a corporation with multiple claimants to see how conflicts can arise between multiple constituencies—different classes of equity holders. It addresses what analysis should determine whether an action that adversely affects one class of equity holders, but is still in the best interests of the firm, is consistent with the agent's duties. It briefly discusses an early example of investor conflict in the *Dodge*²⁴ case to outline the proper role of an agent in such conflicts. Had the lawyer and client been more skilled in identifying the value of accumulating cash as an option for positioning the firm to seize on future opportunities, the board's decision might have been immune from the allegations of the minority common stockholder. Where the adversely affected party can protect itself through contract or other means, making the agent liable under a fiduciary obligation would not minimize costs. But where such contractual protections are not possible

23. See, e.g., Korsmo, *supra* note 7, at 1166.

24. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). *Dodge* is an example where had the lawyer or client wanted to do so, they could have convinced the court that even if the minority stockholder was adversely affected by the board's decision to retain cash, the decision was still consonant with a pursuit of long-term value for the firm and thus within the board's allowable discretion. Had the court focused on comparing the present value of alternative future return stream strategies embraced by the competing common stockholders, it might have reached a different result.

and there is an adverse effect on one claimant, a *limited* fiduciary protection for the preferred might be wealth enhancing.

Part III utilizes the analysis in Parts I and II to address fiduciary duty in the case of multiple claimants but no inter-investor conflict. It explains why all investors, regardless of type, are entitled to benefit from a rule against waste or depletion of the assets of the firm and against coercion.²⁵ It is a vertical duty owed by the firm's agents to all stockholders.

Part IV uses the prior analyses in Parts I–III to assess the results in several recent Delaware cases involving the fiduciary duty issue in conflicts between venture capitalist preferred and common stockholders. It concludes that the results maximize welfare since granting an *ex post* fiduciary protection to the preferred would likely be re-contracted around in future cases, whereas a contrary result would cause an immediate hit to the common stockholders and would not be cost minimizing. These cases should be easy cases to decide under a cost minimizing analytical structure.

Part V examines different types of preferred stock settings where the feasibility of contractual protection, pricing discounts, or yield adjustments may be particularly difficult or where contractual protection, if even feasible, would not offer an adequate remedy as where the preferred has no contract claim against the board. In such cases, if the board recklessly pursues a “Hail Mary” option with an infinitesimal chance of succeeding that might result in a payoff for the common but would certainly wipe out all value for the preferred, a narrowly tailored fiduciary protection should be adopted in that subset of non-VC preferred stock cases where contractual protection for the investor against wealth shifting is not realistic. In such narrow cases, a limited fiduciary protection against reckless investments would be wealth maximizing.²⁶

I. JUSTIFICATIVE FRAMEWORK FOR LAW-SUPPLIED TERM: THE FIDUCIARY DUTY

Before deciding whether the law should imply a fiduciary duty to the preferred beyond the duty owed to all stockholders, one must first understand the ultimate premise of any exchange—that parties to an

25. See *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 117 (Del. Ch. 2007) (“In that regard, this Court has recognized that preferred shareholders share the same right as common shareholders to be free from wrongful coercion in a stockholder vote.”).

26. See WILLIAMSON, *supra* note 10, at 20–22, 48–49.

exchange will seek to minimize the transaction costs of the exchange as a way of maximizing the surplus available. That premise, together with the reality that “a ‘fiduciary’ relation is a contractual one characterized by unusually high costs of specification and monitoring,”²⁷ explain why the law supplies a fiduciary duty²⁸ to govern an agent’s actions toward any investor when the agent has discretion over a pool of assets.²⁹ If that discretion is not constrained, there will be a contractual hazard—an agency cost—that will constitute a cost and decrease surplus from the exchange.

Agency costs affect all types of investors and stock.³⁰ When the investor furnishes resources and delegates discretion to make decisions over how to use the assets for a firm, there is necessarily a “separation of ownership and control.”³¹ Another critical component to this agency relationship “involves delegating some decision making authority to the agent.”³² The agent who receives a fixed wage may take actions that diverge from the principal’s interest, a type of agency cost. The agent may not exert as much effort as the principal would like (shirking) or may expropriate assets to his or her own private benefit. These risks can all be categorized as involving a propensity to diverge³³ or moral hazard.³⁴ These agency risks constitute costs that reduce the surplus

27. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) [hereinafter *Contract and Fiduciary Duty*].

28. “[T]he primary non-ballot box legal constraint on [the directors] is the enforcement of their equitable fiduciary duties.” See Leo E. Strine, Jr. et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 641 (2010). In Delaware it was developed as a means of “ensuring that the capacious authority granted to directors by the DGCL [Delaware General Corporation Law] was not misused.” *Id.* at 642.

29. The willingness of the law to supply a fiduciary obligation to constrain an agent with discretion over the assets of the principal goes back in time to the law of merchants and its custom to constrain agents by way of a performance obligation. See AVNER GREIF, *INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE* 70 (2006). The performance obligation adopted then was to enhance the growth, surplus, and wealth effects in the context of a particular instance of exchange of a commission paid by a delegating principal for the services rendered by the agent.

30. “[F]irms with lower expected agency problems have higher expected values.” DOUGLAS J. CUMMING & SOFIA A. JOHAN, *VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE* 56 (2d ed. 2014); see also Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09 (1976).

31. Jensen & Meckling, *supra* note 30, at 308–09.

32. *Id.* at 308.

33. E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case W. Reserve Univ. Sch. of Law, to Kenneth Davis, Professor of Law, Univ. of Wis. Sch. of Law (Jan. 27, 2005) (on file with author).

34. Moral hazard is a type of opportunistic behavior. In the context of insurance, it refers to the failure of insured persons “to behave in a fully responsible way and take

from any exchange involving a principal and agent.³⁵ Yet, since there is a benefit to giving the agent discretion over the assets, the discretion will persist.³⁶

In determining whether to supply a performance obligation that the parties did not bargain for in corporate contexts, the basic structure for implied terms is the same as in the context of contracts. We start with the question of why and “how . . . fiduciary duties sneak into these contracts”³⁷ between managers or directors and investors. In these consensual, bargained-for contexts, the answer to this fundamental question of why the law supplies a fiduciary duty depends on the recognition that corporations are “enduring (relational) contracts”³⁸ and “the proposition that people cannot see the future well enough to resolve all contingencies ahead of time.”³⁹ Between the managers and the equity holders of the residual claims, “[t]he only promise that makes sense in such an open-ended relation is to work hard and honestly.”⁴⁰

There is a recurring risk of opportunistic behavior or moral hazard. The question in the principal-agent context is always the same: why did the parties not reach a more pointedly reciprocal exchange? It may be because the very same terms of a generalized performance commitment are of such a general nature that the parties did not think it necessary to bargain to control the behavior. Parties would not think to bargain in instances where there is a recurring threat of opportunism that is virtually the same throughout a class of transactions, namely, those in

appropriate risk-mitigating actions” once covered under an insurance policy. See WILLIAMSON, *supra* note 10, at 47. Moral hazard problems also arise in the principal-agent context; the principal cannot directly see the agent’s actions and the agent cannot discern whether the poor outcomes are due to lack of effort or to exogenous events. See David E. M. Sappington, *Incentives in Principal-Agent Relationships*, 5 J. ECON. PERSP. 45, 46–49 (1991) (“[T]he principal can’t observe . . . the level of effort exerted by the agent.”); see also Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (“The principal cannot observe the actions themselves but may make some observations, for example, of the output.”).

35. See WILLIAMSON, *supra* note 10, at 17.

36. For a discussion of when optimal contracts can contain “two forms of incompleteness: discretion, meaning that the contract does not specify the parties’ behavior with sufficient detail; and rigidity, meaning the parties’ obligations are not sufficiently contingent on the external state,” see Pierpaolo Battigalli & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts*, 92 AM. ECON. REV. 798, 798–99 (2002).

37. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90 (1991) [hereinafter *ECONOMIC STRUCTURE*].

38. *Id.*

39. *Id.*

40. *Id.* at 91; see also *Contract and Fiduciary Duty*, *supra* note 27, at 426 (“When one party hires the other’s knowledge and expertise, there is not much they can write down.”).

which the agent is given discretion over a pool of assets and there is risk of a divergence between the interest of the agent and the principal.⁴¹

The commonplace nature of the threat of opportunism in a contract or a propensity to diverge in an agency context and the costs of negotiating express contractual controls that are meaningful may mean that the most cost-effective way of controlling the behavior is a law-supplied fiduciary obligation. To determine whether a law-supplied obligation is efficient in the principal-agent relationship within the corporate context using a welfare maximizing criterion—one that determines whether the intervention will be welfare maximizing after all costs of intervention are weighed against the cost of parties privately solving certain problems that act as a drag on gains from trade—one must first understand the nature of principal-agent relationship.

In addressing whether the law should intervene to supplement a contract by implying a term or a fiduciary obligation, the overarching question is: toward what ultimacy is the adjudicator justified in cancelling or modifying express terms of an exchange institution, given certain assumptions about reality?⁴² In the context of exchange transactions, the ultimacy would be the maximization of gains from exchange. Resolving the impact of an intervention on that ultimacy requires an analysis of the ex ante effects in future transactions and the effects on parties' contracts in the future. Additionally, in settings involving shareholders using the maximization directive, one must assess how the intervention will affect different constituencies/claimants with different risk/return features in their arrangement with the firm.⁴³

This Article assumes that the law in this context should act "as an instrument to promote the achievement of specifically identifiable ultimate goals . . . selected as worthy by the decision-maker."⁴⁴ The ultimacy here is to maximize gains from trade and to minimize the cost of transacting⁴⁵ (in short to maximize welfare) and to increase those

41. E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case W. Reserve Univ. Sch. of Law, to Juliet P. Kostritsky, Professor of Law, Case W. Reserve Univ. Sch. of Law (Aug. 19, 2008, 1:10 PM) (on file with author) [hereinafter Coffey E-mail] (discussing legislatively supplied default rules as an alternative).

42. Ronald J. Coffey, Perspectives on Legal Methods 1 (Feb. 4, 1992) (unpublished manuscript) (on file with author).

43. See *infra* Section IV.A.

44. See Coffey, *supra* note 42, at 3.

45. The efforts to minimize transaction costs by parties are driven by a desire to increase the surplus from exchange. These costs have been neglected. See WILLIAMSON, *supra* note 10, at 17.

gains using certain assumptions about reality. Assumptions about reality include the impediments to bargaining as well as the likely future effects of law-supplied intervention on parties' behavior—i.e., would they contract around the rule?

Parties will seek to minimize these agency costs to increase the surplus from exchange.⁴⁶ Yet, attempting to control the effort of the agent is costly or unobtainable through contract because one cannot contract on effort.⁴⁷ Effort remains unverifiable to a court even if it is observable by the principal.⁴⁸ Because a contracting solution is unobtainable, the principal will seek to reduce those costs in other ways, such as by monitoring the agent or devising incentive alignment schemes to better align the agent's efforts with the principal's objectives.⁴⁹ So while, theoretically, the parties could control agency costs through contract, financial economics suggests that "[c]ontracts can be designed to enable a principal to mitigate agency problems, but agency problems can never be fully eliminated."⁵⁰

In the context of a corporation/firm with common stockholders investing and delegating discretion to the agent, the law has resolved that the principal duty of the board is to maximize the firm's value and it furnishes a judicially supplied fiduciary obligation to constrain the actions of the agent.⁵¹ Section 379 of the *Restatement (Second) of*

46. The inability to control agency costs by contract leads Easterbrook and Fischel to embrace the hypothetical bargain contract as the basis for fiduciary duties. "A court setting out to protect principals from their agents *must* use the hypothetical contract approach; the only alternative is to injure the persons the rule makers want to help." *Contract and Fiduciary Duty*, *supra* note 27, at 431.

47. The inability of the principal to observe the effort of the agent and the implications of that fact for contracting schemes to incentivize agents is explored in Sappington, *supra* note 34, at 46–49.

48. For an insightful discussion of the non-verifiability of effort problem in the context of the principal agent relationship of employer and employee, see Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8, 20 (1993); see also Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 191 (2005) (explaining that "back-end obstacles have driven a large body of the theorists' models: namely, that some states of the world are not verifiable to a court, even though they may be observable to both the parties").

49. See Jensen & Meckling, *supra* note 30, at 308. These are known as mechanism design incentive alignment schemes in the agency literature. For a discussion of the difficulties of incentive alignment schemes, see Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621, 659 n.142 (1993) [hereinafter Kostritsky, *Bargaining with Uncertainty*].

50. CUMMING & JOHAN, *supra* note 30, at 44.

51. See *Contract and Fiduciary Duty*, *supra* note 27, at 426 (explaining the "fiduciary" package and the "duty of loyalty" as one that both principal and agent enter for gain).

*Agency*⁵² operates in a similar fashion. In such settings, there are pervasive barriers to common stock shareholders controlling, by express and detailed contracts, all of the various ways in which the agent may diverge and shirk due to the problems of bounded rationality and uncertainty. The prospect of this propensity to diverge, which is endemic to situations involving a separation of ownership and control⁵³ and a human tendency toward opportunism, has a downward effect on the present value of the exchange institution at the time of formation. In those circumstances, the law supplies the fiduciary obligation to prevent that loss in value. The assumption is that the parties themselves would have agreed to a fiduciary obligation to control the propensity to diverge were it not for barriers to including it expressly. As Easterbrook and Fischel assert, “[t]he fiduciary principle is an alternative to elaborate promises and extra monitoring.”⁵⁴

In addition to the problems of bounded rationality and uncertainty, common stock shareholders are dispersed.⁵⁵ Thus, it may be difficult for them to act together as a single holder capable of bargaining effectively to negotiate the contractual provisions that control agency costs. Moreover, in the case of a common stock shareholder principal delegating discretion to the agent, he may assume that the problem of agency costs is so pervasive and so obvious that courts will necessarily police against such behavior as part of its equitable jurisdiction. The commonplace quality of such terms may explain why the transactors—common stockholders—did not bother to explicate the risk in their bargain.

Of course, the principal could monitor or screen the agent to find out his or her “propensit[y] to diverge.”⁵⁶ The principal could also adjust the compensation paid to the agent to compensate for the divergence. The principal could use incentive schemes to compensate the agent for effort or results. These are all private strategies that the parties could use to control agency costs; however, they are all costly and subject to budget constraints. First, the agent may have information that the principal does not have about the actions taken. The agent may not

52. RESTATEMENT (SECOND) OF AGENCY § 379 (AM. LAW INST. 1958); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.08 (AM. LAW INST. 2006).

53. *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119 (1932).

54. *ECONOMIC STRUCTURE*, *supra* note 37, at 92.

55. *CORPORATE LAW AND ECONOMIC ANALYSIS* 91 (Lucian Arye Bebchuk ed., 1990).

56. For a discussion of these private devices to reduce the costs of unremedied shirking, *see* Kostritsky, *Bargaining with Uncertainty*, *supra* note 49, at 655–57, 655 n.126.

work for a knocked down wage.⁵⁷ Also, express contracts may be too costly because the agent's decision-making will depend on information not available at the time the agent is engaged. In adopting the fiduciary obligation to govern the discretion of the agent toward common stockholders, the law supplies a term to deal with a recurring problem of the "propensity to diverge"⁵⁸ and thus reduces agency costs. The issue for the courts or the legislature supplying a fiduciary obligation is whether the performance obligation introduces new costs that offset or exceed the benefits of the law-supplied term.

II. COMPLICATING THE PRINCIPAL-AGENT RELATIONSHIP; MULTIPLE CLAIMANTS

Understanding whether an adjudicator should add to or cancel terms in the corporate context—by implying a fiduciary duty to increase gains from trade, and maximize welfare by constraining shirking, moral hazard, and opportunism—requires an analysis of the principal-agent aspect of investment contracts: the delegation issue. This is the basic separation of ownership and control discussed in the preceding section.

When an investor furnishes resources (perhaps cash), the firm issues stock and gives the investors claims against the firm. Separate issues, apart from the basic fiduciary duty, arise from the fact that different classes of stockholders have different risk/return preferences.⁵⁹ Then, all investments, regardless of the risk/return profile differences, involve the investor in a principal-agent relationship with the management of the firm.⁶⁰ The agent begins controlling the asset pool and takes over management of the firm, which provides the source of return streams to the claimants or investors. The agent is also tasked

57. See Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367, 368 (1983) (noting that cutting the worker's wage will not solve the problem of shirking "because the gain to the shirker and therefore his acceptable compensating wage discount is less than the cost to the firm from the shirking behavior").

58. Coffey E-mail, *supra* note 41.

59. See, e.g., Korsmo, *supra* note 7, at 1179 (discussing different risk preferences between preferred and common). The conflict need not be there. One could have only a single class of stock or dual classes of common stock but the principal-agent framework would still be applicable. The divergence in risk/return preferences and the implications of those divergences will be explored in the section on horizontal conflicts. The common stockholder wants higher risk/higher return and the preferred stockholder wants lower risk/lower return.

60. See Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1310 (2008); see also ECONOMIC STRUCTURE, *supra* note 37, at 91 (1991) ("[T]he corporate contract makes managers the agents of the equity investors . . .").

with honoring the terms of the claims of the different types of investors.⁶¹ The agent's operation of the firm affects the total value of the firm and the aggregate value of the different types of claims against the firm.⁶²

Recognizing this agency relationship and the different risk/return features that each stakeholder has depends on the terms of her claims against the global return stream of the firm and the different set of variables in terms of timing, amount, and uncertainty for each stakeholder. This has ramifications for the types of obligations the agent owes the principals in the context of the agent making various decisions in the corporate context for multiple constituencies. The global value for the firm is the present value of a future stream of returns. One controversy is how the agent for principals with multiple competing objectives should act on behalf of the claimants and whether the court should imply terms for a set of claimants beyond: (1) the fiduciary duty applicable to all claimants, and (2) any specially negotiated contract provisions for particular claimants. The determining principle would be whether the intervention/rule maximizes value and welfare for the firm and equity value as a whole.

Understanding the centrality of the principal-agent relationship will helpfully reorient the thinking away from whether a board action "harms" one adversely affected class to analyzing what a board must do to fulfill its duties as agent for the firm when there are multiple constituencies. Even under the doctrine of common shareholder wealth maximization as a means of maximizing the long-term value of the firm, the board can shift value from present to future stockholders and can wipe out the value of the common when it is in the best interests of the firm.⁶³ As agent, the board can make changes in the asset pool that negatively affect some classes *without* sacrificing value.⁶⁴ In determining value one must be able to compare and compute the

61. All of these claimants or stakeholders have a different set of variables in terms of the projected timing, amount, and uncertainty depending on its claims against the global return stream from the firm. Under value maximization theory, "managers should make all decisions so as to increase the total long-run market value of the firm. Total value is the sum of all values of all financial claims on the firm—including equity, debt, preferred stock, and warrants." Jensen, *supra* note 11, at 236 (emphasis omitted).

62. See EUGENE F. FAMA & MERTON H. MILLER, *THE THEORY OF FINANCE* 67-77 (1972).

63. See *Orban v. Field*, No. 12820, 1997 WL 153831, at *8 (Del. Ch. Apr. 1, 1997) ("A board may certainly deploy corporate power against its own shareholders in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably.").

64. See Coffey, *Firm Opportunities*, *supra* note 21, at 168-69.

present values of alternative future return stream strategies.⁶⁵ To dutifully operate the firm and manage the asset pool, the board must be free to engage in strategies that adversely impact some classes of claimants if the strategy is minimizing the cost of exchange and maximizing the gains from exchange and production. Any other strategy would be disfavored *ex ante* by the claimants. One example involves common stockholders and a possible judicial rule outlawing corporate action that would wipe out the common stock. This option would outlaw such action even if such action were in the best interests of the corporation. Although *ex post* common stockholders would want such a rule, *ex ante* they would disfavor it since such a pro-common stockholder rule would actually make it harder to get financing from banks, debt, and preferred stock. Those costs might outweigh the benefits of the law-supplied protective rule.

Many possible combinations of investments exist and finding a breach of some non-contractual or fiduciary obligation whenever one class of investors would prefer a different choice would add significantly to the cost of exchange and thus would *not* be preferred *ex ante*, at least where the class of investors adversely affected could anticipate the risk and provide for it by contract or buy the stock at a discount to compensate for the risk.

III. WHEN ARE FIDUCIARY DUTIES OWED TO ALL SHAREHOLDERS AND WHY: THE VERTICAL CONFLICT WITH MULTIPLE CLAIMANTS BUT NO INTER-INVESTOR CONFLICTS

When there are multiple claimants who have furnished resources to a firm, they will hold different types of investments with different terms/claims. Some will invest with loans and take bonds in return. In that case, the bondholders' investments are governed almost entirely by detailed express contracts.⁶⁶ Others will take an ownership interest by investing and be furnished stock in return. Here, both common stockholders and preferred stockholders face the prospect of agency costs as they furnish resources to an agent who may have a propensity to diverge.⁶⁷ The inability to foresee all of the agent's possible choices

65. See Coffey E-mail, *supra* note 41.

66. See David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023, 1037-39 (1991) (referring to the ability of bondholders to achieve "optimal" contracts).

67. Coffey E-mail, *supra* note 41.

will interfere with the ability of a contract to expressly control all the potential varieties of agency costs.⁶⁸

If obstacles exist to contractual controls of agency costs of a principal (any furnisher of resources who receives stock in return), across different principal-agent relationships, two questions arise: (1) are there reasons to think that the law could have a beneficial welfare maximizing role to play in controlling agency costs by supplying a term to control the behavior of the agent by furnishing a rule whose content prevents risks such as the misappropriation or theft of the asset pool; and (2) would the answer to that question differ if it arose in the context of a board who was acting as an agent for two classes of shareholders who had different interests and different risk/return profiles and where the agent could take actions that had reverberative effects on one claimant while having no effect on the value of the firm?

In the case where the agent has been tasked with managing the asset pool and engages in actions that are wasteful or deplete the assets of the firm, all classes of claimants are protected.⁶⁹ Actions against directors for misappropriation make sense in terms of the principal-agent model and the fiduciary duty analyzed in the preceding section. Because the director is the agent for the resources furnished by different classes of investors, all investors are equally entitled to sue the director/agent for breach of the duty of loyalty when assets are misappropriated.⁷⁰ That type of conduct would be contrary to the agent's fundamental duty of loyalty to care for assets and invest them for the firm. This type of lawsuit against a firm's agent for waste is classified as a vertical conflict.⁷¹ Each class of preferred or common is owed a duty of loyalty by the agent (a vertical relationship) not to misappropriate or steal assets from the firm.⁷² A duty of loyalty "demands that a fiduciary make a good faith effort to advance the best interests of the corporation and its stockholders."⁷³ All who have

68. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1048 (1991).

69. Professor Coffey explains the particular harm suffered by the "disposition of firm assets" as follows: "[T]he firm is necessarily exposed to the possibility not only of surrendering a portion of the total gains from exchange that may inhere in the transaction, but also of suffering outright wealth transfers." Coffey, *Firm Opportunities*, *supra* note 21, at 159-60 (footnote omitted).

70. See Mitchell, *supra* note 6, at 463 (citing *Rosan v. Chi. Milwaukee Corp.*, C.A. No. 10526, 1990 WL 13482, at *7-8 (Del. Ch. Feb. 6, 1990) ("[T]he court [in *Rosan*] refused to dismiss the preferred stockholder's derivative claim of corporate waste . . .").

71. *Id.* at 449-50.

72. *Id.* at 463.

73. Strine et al., *supra* note 28, at 635. The Model Business Corporation Act stresses that "a lack of good faith is presented where a board 'lacked an actual *intention to advance*

invested in a pool of assets to produce a future stream of returns for the claimants are entitled to expect that the agent will use the assets for the firm and not misappropriate them.

In this class of cases, the law intervenes with implied duties to prevent waste and misappropriation of assets. The conduct is so pervasive that one would anticipate that the law would intervene to control it rather than making every stockholder negotiate directly for such protection when the risk is endemic and a result of the structural separation of ownership and control and of the risk of opportunism. The same justification may explain why the law supplies bankruptcy protections to all holders of debt rather than forcing each to negotiate for bankruptcy priorities.⁷⁴ Forcing such bargaining to gain protection against a common and recurrent risk, such as expropriation (or a fight for the assets among creditors faced with an insolvent company), would be costly and might deter parties from investing *ex ante* and act as a drag on gains from trade that would discourage investment.

Implying a duty that protects against waste is consistent with the duty to maximize welfare, and the risk/return profile differences among different classes of claimants would not alter the nature of the duty owed to protect the asset pool. Both classes of stockholders, whatever their risk/return profile, would not want the firm to have the assets depleted since those assets will furnish the pool from which each claimant calculates value.

IV. HORIZONTAL CONFLICTS BETWEEN PREFERRED AND COMMON STOCKHOLDERS

A. *The Basic Approach to Preferred Shareholder Rights: Contractual Rights Plus Implied Duties to All Shareholders*

If the furnishers of resources—the principals—are preferred stockholders, do they, and should they, get the benefit of *any* law-supplied rules in their favor? According to case law, courts find that if the preferred are invoking rights that they share with the common stockholders, then they benefit from a law-supplied rule in their favor

corporate welfare." *Id.* at 665 (quoting the MODEL BUS. CORP. ACT § 8.31(a)(2)(i) cmt. at 8-68 (AM. BAR ASS'N, 2005)).

74. See Stanley D. Longhofer, *Bankruptcy Rules and Debt Contracting: On the Relative Efficiency of Absolute Priority, Proportionate Priority, and First-Come, First-Served Rules* 1–5 (Fed. Reserve Bank of Cleveland, Working Paper No. 9415, 1994), <https://www.clevelandfed.org/en/newsroom-and-events/publications/working-papers/working-papers-archives/1994-working-papers/wp-9415-bankruptcy-rules-and-debt-contracting-on-the-relative-efficiency-of-absolute-priority.aspx>.

that extends to common and preferred shareholders alike.⁷⁵ Thus, in cases of vertical conflict, where the agent misappropriates or wastes assets, the preferred can sue just like common stockholders. The justification for the law-supplied rule lies in the supposition that an implied duty to control that behavior is wealth enhancing for the firm. As one scholar has noted, courts in confronting implied duties must always ask: "Improvement in the achievement of what ultimacy justifies an adjudicator's addition, cancellation, or modification of express terms negotiated during an exchange and what assumptions about reality⁷⁶ must be entertained to demonstrate the improvement? This is hereinafter referred to as the vaulting question ("VQ")."⁷⁷

However, the preferred stockholders may want a court to go beyond both the duties owed to all stockholders, including the common, not to waste assets and to maximize value for the firm and the common stockholders. Preferred holders may want protections beyond the express terms negotiated in their preferred stock agreement that imply additional protections for the preferred. Preferred stockholders will likely seek such protection when their interests diverge from those of common stockholders.

Whether the law should intervene to supplement the preferred stock's bargain, which consists of statutory terms, additional contract terms, and regulatory rules that govern such stock, has prompted a flurry of different approaches. Some authors urge courts to employ a good faith scrutiny to conflicts between preferred and common stock to

75. See *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]here however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.").

76. Assumptions about reality must include an assessment of what goals parties have and how they will react to legal rules. This Article assumes that rational actors will seek to maximize the joint benefits of their exchanges. Under neoclassical economics, actors exhibit a "maximizing orientation." WILLIAMSON, *supra* note 10, at 44-45.

77. See E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case W. Reserve Univ. Sch. of Law, to Juliet P. Kostritsky, Professor of Law, Case W. Reserve Univ. Sch. of Law (July 20, 2015, 10:44 AM) (on file with author). In several instances, authors writing about preferred stock have argued for additional legal protection to prevent oppression of the preferred or to police against specific types of bad conduct, such as opportunistic amendment, see, e.g., Bratton & Wachter, *supra* note 2, at 1856-57; Mitchell, *supra* note 6, at 473, without addressing the VQ, so it is unclear under such analyses if the protection would be welfare enhancing *ex ante*. Without using the analysis suggested here, one cannot decide whether intervention would be value enhancing, so it would be premature to decide whether protection is needed. Of course, *ex post*, the preferred want additional protection. A court however must address whether *ex ante* the parties would have bargained for such protection and, if so, what would they have given up to secure that protection? Would the tradeoff have been worth it?

avoid results that are not value maximizing in the aggregate.⁷⁸ Others argue that courts should never afford preferred protection beyond the ordinary fiduciary protection afforded all stockholders or the special contractual provisions—known as the contractual rights, limitations and preferences, (“CRPLs”)—negotiated by the issuer and the preferred stockholder.⁷⁹ One critic argues for a “division of board control between the two classes of equity . . . to ensure their harmonious co-existence.”⁸⁰ Chancellor Strine, of the Delaware Court of Chancery, however, opposes such suggestions and argues that subjecting agents to heightened scrutiny under new standards of review will start courts on an unguided “speculative journey.”⁸¹

To determine which of these approaches should govern or whether a new approach is called for, the next section of the Article will develop a framework for analyzing this question of duties of the board between two sets of claimants, who have different risk/return profiles and who have accordingly negotiated different terms of their claims (in their contracts) on the asset pool to reflect those differences. The Article will revisit a case involving dual classes of common stock and then examine several recent cases involving conflicts between preferred and common stockholders. Reforms affecting preferred should be evaluated using the analytical tools outlined for all law-supplied terms. The principal components which will resolve these conflicts are the principal-agent frame, the VQ—an analysis of whether an implied term’s benefits will exceed any costs from the term—and a recognition of the different risk/return profiles held by different claimants.⁸² When there are multiple competing objectives or multiple constituencies, as with preferred and common stock, there are two dominant theories of what should govern the director’s duty: (1) value maximization for the firm;

78. Bratton and Wachter want a protective good faith obligation to ensure that the common cannot force the preferred to *wait* to cash out. See Bratton & Wachter, *supra* note 2, at 1906. Of course, as Chancellor Strine points out, the preferred could avoid the wait by negotiating a provision that forced a liquidation. Whether good faith is really an additional obligation or is subsumed under the larger duty of loyalty is explored by Strine et al., *supra* note 28. See Leo E. Strine, Jr., *Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025, 2035 (2013), for a discussion of the difficulties with an untethered good faith scrutiny of board action toward the preferred.

79. Korsmo, *supra* note 7, at 1166.

80. Ben Walther, *The Peril and Promise of Preferred Stock*, 39 DEL. J. CORP. L. 161, 165 (2014).

81. Strine, *supra* note 78, at 2036.

82. Differences exist as to the claimants’ present value of the stream of returns from the asset pool based on the individual preferences on timing, uncertainty, and amount of those returns. The firm has a present value of that income stream based on global values assigned to timing, uncertainty, and amount of returns for the firm.

or (2) value for a stakeholder who has a different set of variables in terms of timing, amount, and uncertainty than the firm. This Article endorses (1). Other issues which bear on the horizontal conflicts include: which class of investors controls the directors, the effect of the tradeoff between risk and return under conditions of uncertainty on the agent's decisions for the firm, the duties owed to all equity holders, and the effect of express terms on the resolution of conflicts between investors. These issues all surface in the context of whether the law should add to or cancel terms negotiated by the parties, particularly preferred shareholders. The effects of any judicial intervention on the capital markets will also be considered, as an integral part of any wealth enhancing analysis.

Potential conflicts between the interests of the preferred and the common may arise in cases where: (1) the preferred has voting control of the company's board and takes action favoring the preferred so that the concern is for ill treatment of the common; (2) the same case as (1), but the directors, once elected, act against the preferred in favor of the common but not in direct violation of any contract rights; or (3) same as (2), but the directors act against the common and the preferred. In a second class of cases: (B1) the common has voting control of the company and the board takes action favoring the common, so there is concern that the board is abusing the preferred; (B2) the common has voting control and the directors, once elected, act against the interest of the common; or (B3) same as (B2), but the directors, once elected, act against the common and preferred. In a third scenario there is a standoff as no one class controls the directors and the directors favor one class or another, or favor themselves.

All of these scenarios raise the issue of what principles and armature should govern the board as it acts as an agent for both preferred and common when their interests conflict. In analyzing how these conflicts should be resolved, one should consider the statutory directives that the board must act in the best interests of the corporation. The language in the Model Business Corporations Act ("MBCA"), for example, is in section 8.30(a) and reads "[e]ach member of the board of directors, when discharging the duties of a director, shall act (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation."⁸³ Despite many

83. MODEL BUS. CORP. ACT § 8.30(a) (AM. BAR ASS'N, 2005); *see also* OHIO REV. CODE ANN. § 1701.59 (LexisNexis 2009) (Supp. 2014) ("(B) A director shall perform the director's duties as a director, including the duties as a member of any committee of the directors upon which the director may serve, in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and

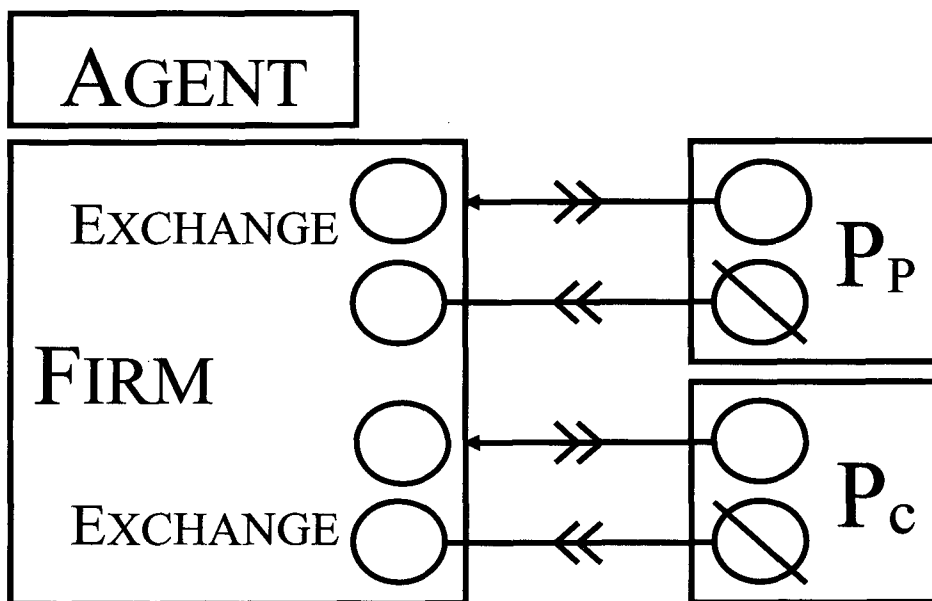
opportunities to amend that language,⁸⁴ the drafters have not added language saying that the director should act to maximize the interests of one class of claimants or the other, so acting in the best interests of the corporation is the key important factor. This fact may help to resolve whether a cause of action should exist or a term should be added to constrain the agent—the board—to protect one class from another when the action taken by an agent does not negatively impact the asset pool or the firm. Regardless of which investor class controls the board, is there a cause of action when the agent—the board—takes actions that negatively impact one group of stockholders? How does the answer change if the negatively affected class is in control of the board? How does the answer change if the agent is not disinterested because of a conflict of interest?⁸⁵

When there are two investors rather than a single claimant, an agent is making all the tradeoffs that a single investor would make if he were both operating the firm and investing. In the process of making choices about how to invest the pool of assets and what projects to pursue for the firm, the agent—the board—considers all sort of combinations of investment strategies. In making these determinations about the asset pool, the agent might consider the different characteristics of investors, wealth shifting issues, and the agent's duties to the firm and to the pool of assets.

with the care that an ordinarily prudent person in a like position would use under similar circumstances. A director serving on a committee of directors is acting as a director.”).

84. There are many opportunities to amend the MCBA and the MCBA is amended regularly just as there are multiple opportunities to amend the tax code. See, for example, the proposed 2016 revision of the MCBA. See also J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1057 (2007) (discussing an amendment to the DGCL).

85. In resolving these conflicts, one must also consider whether the board is disinterested enough to make a decision. If the directors own a particular type of stock and the decision they are making will have a material effect on their wealth, then the directors are not disinterested as they will profit if one class of claimants is favored over another. In such cases the transactions must meet an entire fairness standard. The entire fairness standard applies “[b]ecause even a subjectively well-motivated fiduciary might deal with himself less aggressively than he would with a third party.” Strine et al., *supra* note 28, at 643.

Figure 1⁸⁶

86. Figure 1 is a diagram from Professor Ronald J. Coffey. He explains:

1. Any four-cornered box . . . is a person, either a natural or a non-natural person.

2. Any circle . . . is an asset (property: tangible, intangible, real, financial—including claims, of various terms, against another person). It is an asset of the person inside whose box it is located. The terms of the claims need to be elaborated for each type of claim. Terms fall into two basic categories: right of control . . . and rights to distributions, both presently and in the future.

3. A single arrowhead pointing up against a person is a claim (set of rights terms) held by some other person against the person to whom the arrow points (obligor). At the other end of the shaft of the arrow is a circle in the box representing the claimant, showing that the claim against the pointee (obligor) is correlatively an asset of the person who holds (owns) it. Along the shaft of the claim is a double arrow showing the direction of the transfer . . . to the person who becomes the holding claimant.

4. In general, then, double arrows . . . along lines . . . represent[] the direction of movement in the transfer of an asset (upon origination or subsequently from one holder to another).

5. There are four persons shown in the below very spare picture of the resourcing (capitalization) of a firm. One may assume that it is in the corporate form but a generalization beyond the corporate form is trivially easy, as can be seen by reference to other versions of the delegation model, starting with a sole proprietorship

6. In the topmost exchange institution, the symbols reflect the components of the exchange and the resultant relationship. . . . The first line shows the issuance (transfer) by the firm of a claim against the firm to P_P (Principal in the form of a

In managing assets, the agent may consider that different classes of investors have different desired outcomes in part influenced by the investors' risk tolerance/risk aversion, linked to a targeted return. The agent also considers the timeline of the investors, with common stock and preferred stock having perpetually infinite investment periods.⁸⁷ In the diagram above involving a single agent and a common stockholder and preferred stockholder, the agent is the delegate of two different principals, who to suit (match) their diverse preferences, endowments, and beliefs, have chosen to hold different types of claims with disparate terms regarding control over the assets of the firm and over distributions (particularly the time, amount, and uncertainty of the latter).

Other factors drive investor differentiation. Employee/stock investors prefer continuing employment—a non-monetary return. Another non-monetary return often focuses on the founder's control of the destiny of its "child" when it founds a company. Even preferred investors may differ markedly, with late round investors looking for a lower risk investment than earlier rounds.⁸⁸

Differentiation among investors may affect the negotiated terms in their contracts and the decisions the agent makes when it operates the firm. It may also affect how courts evaluate the key question of whether

holder of preferred claim terms), which is shown as an asset (circle) of Pp (in Pp's box). The other piece of the exchange is the transfer from Pp of something (cash, nonservice intangibles, or human capital intangibles) to the firm, which thereafter holds those things as its assets. Hence, the line through the asset circle in the box representing Pp because the value furnished to the firm is no longer, his, hers or its. The second exchange is "ditto" to the first. Pc (Principal who is issued and becomes the holder of a residual (nonpreferred, common) claim against the firm and, in exchange, transfers something. Ditto, therefore, except as to the precise terms of the claims that are issued to Pc by the firm.

6. Agent is a person . . . given plenary and discretionary decisionmaking with respect to the operation of the assets and the firm's financial matters.

7. This institution is at least one remove away from more primitive ones. An agent here is the delegate of at least two different principals who, to suit (match) their diverse preferences, endowments, and beliefs, have chosen to hold different types [of] claims having disparate terms regarding control over the assets of the firm and execution of the terms of claims . . . and distributions . . .

Diagram and Comments by Professor Ronald J. Coffey, Professor Emeritus of Law Emeritus, Case W. Reserve Sch. of Law (Feb. 19, 2016) (on file with author).

87. It is for this reason that preferred stockholders "ultimately need an exit vehicle." See JOSEPH W. BARTLETT, *FUNDAMENTALS OF VENTURE CAPITAL* 87 (1999).

88. For a discussion of the differences between earlier and later rounds of VC financing, see *id.* at 4 ("Some venture pools focus in whole or in part on late-round investments: infusions of cash shortly before the company is planning to go public, for example.").

intervening to protect a particular class of investors will be efficient and maximize total wealth.

In managing assets among classes of investors, the agent must not only consider the differentiation among investors but also that the agent has been tasked with managing the assets for the firm. That means that the agent must be free to engage in projects because they are in the best interests of the firm, even if there are some reverberative, negative effects on different classes of investors.⁸⁹ Insights on the wealth shifting that can occur when agents make choices help to make sense of the case law, statutory law, the business judgment rule, and section 379 of the *Restatement (Second) of Agency*.⁹⁰ These insights may also help a court understand how horizontal conflicts between preferred stockholders and common stockholders should be resolved, when the board is considered the agent of both classes of investors investing in a single firm, under different state regimes⁹¹ and under judicial case law refining which constituencies should be viewed as first order beneficiaries and why.⁹²

If a firm has a project with a steady stream of returns and decides to invest in a project with a higher risk profile, such as a hydrogen car, there may, as far as the firm is concerned, be no value sacrificed in terms of the asset pool. As one commentator noted, “firm pursuit of an asset-side opportunity might be merely value-neutral for the firm and simultaneously more-than-value-neutral for shareholders . . . where the risk associated with returns to the firm from its operations is increased.”⁹³ However, there may be profound effects on the claimants. In such a case the value of the senior claimants may go down while the value of the common stock goes up. In these cases involving one or more classes of investors, should the law intervene to protect one claimant against the actions of the agent, and how does the principal-agent frame affect the analysis? Further, how does an understanding of an

89. Coffey, *Firm Opportunities*, *supra* note 21, at 172–73.

90. RESTATEMENT (SECOND) OF AGENCY § 379 (AM. LAW INST. 1958).

91. States might differ as to the primary purpose of a corporation. Over thirty states have some version of a constituency statute that allows directors to consider factors other than shareholder wealth maximization. See David P. Porter, *Institutional Investors and Their Role in Corporate Governance: Reflections by a “Recovering” Corporate Governance Lawyer*, 59 CASE W. RES. L. REV. 627, 639–45 (2009).

92. E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case W. Reserve Univ. Sch. of Law, to Juliet P. Kostritsky, Professor of Law, Case W. Reserve Univ. Sch. of Law (May 27, 2015) (on file with author).

93. Coffey, *Firm Opportunities*, *supra* note 21, at 173.

agent's duty to maximize value for the firm⁹⁴ determine the content of the performance obligation owed to each stockholder? The answer depends on the terms of the claims against the global return stream, which will have a different set of variables (timing, amount, and uncertainty).

The following sections will address how the justification-based framework for implying fiduciary duties between the agent and investor should be applied when there are horizontal conflicts between two types of investors (preferred and common) under the direction of the board of directors as agent in two vastly different settings. The first setting is that of the venture capital context and other preferred stock contexts where the VCs have significant clout to negotiate contractual protections. The second context is where preferred stockholders have no direct bargaining power and there is no underwriter massaging terms on their behalf and significant barriers to self-protection exist and there the market price may not account for the weaknesses in contractual protection. Finally, there will be some contexts involving sophisticated buyers and publicly traded preferred shares where these buyers lack the power to negotiate contractual protections and the market can correctly value the weaknesses of the particular express terms.⁹⁵

B. Where Preferred Stockholders Have Clout or Context Makes Implied Protections Unnecessary or Costly

In determining whether there are reasons to supply an implied term beyond the terms expressly bargained for in the VC context, one should confront whether adding terms will enhance wealth, given certain assumptions about reality. The adjudicator should first determine whether the preferred stockholders have effective clout to bargain over the terms and whether, even if a contractual protection is lacking, the preferred stockholder had alternative ways of having

94. In most states the directors are not bound to act in the best interests of the shareholders but in the best interests of the corporation. See Bratton & Wachter, *supra* note 2, at 1822.

95. See Michael L. Hartzmark & H. Nejat Seyhun, *Understanding the Efficiency of the Market for Preferred Stock*, 8 VA. L. & BUS. REV. 149, 164 (2014) (identifying six factors that determine the price and yield of preferred stock: “[1] [t]he expected rate of return on long-term, riskless debt . . . ; [2] [v]arious covenants, provisions, and restrictions associated with the particular preferred stock . . . ; [3] [t]he default risk or the probability that the company will be unable to satisfy some or all of the preferred stock indenture requirements . . . ; [4] [t]he likely recovery rate of the preferred stock in the case of bankruptcy or liquidation given current and expected future economic conditions; [5] [t]ax considerations . . . ; and [6] [l]iquidity risks or likelihood of being able to sell the preferred stock in a liquid market”).

control over the board. Finally, the adjudicator should resolve inter-investor conflicts in the VC context using a firm wealth-maximizing perspective. There, whether an agent should be prevented from shifting wealth from one class of claimants to another should depend on the ultimacy of the agent's duty to advance the best interests of the firm.

For protections beyond the law-supplied fiduciary obligations, the default rule in corporate law is that the preferred stockholder must negotiate through express contracts so omissions are likely to be deliberate.⁹⁶ Is there a reason that preferred stockholders would not have arranged to maximize wealth while minimizing transaction costs because of bargaining impediments? In determining whether or not a term was omitted by the preferred due to bargaining impediments, one must take account of the preferred stockholders' ability to consider negative court decisions. Presumably, if the preferred want to counteract adverse court decisions, many such preferred stockholders have the knowledge and clout to know what provisions to add. There is little need to add a term by law when parties can contract around negative court decisions.

In the context of preferred shares, the ability to bargain over the terms of the PSA—the CRPL's—may vary across contexts. In some instances, as when preferred buy shares in the secondary market, there may be no opportunity for the preferred to bargain. In other contexts, such as venture capital, preferred stockholders may have a greater opportunity to bargain over terms. The preferred stockholders are generally more monolithic and less diverse a group than common stockholders and are thus able to negotiate effectively for their interests. This would be true for VCs, but it would also be true for privately placed financing by a single purchaser who buys preferred stock. Such purchases occur where a large publicly traded company finds it needs a lot of cash to fend off a takeover and issues preferred shares on financial terms that are attractive to the single purchaser.⁹⁷

96. In some settings, of course, the obstacles to express contracting may be greater, as when the preferred buy in the secondary market. In that context, they are not negotiating for contractual protections since they have already been negotiated. Interview with M&A Lawyer, *supra* note 20; see also Virginia B. Morris, *Little Common About Preferred Stock*, BETTERINVESTING (last visited Apr. 1, 2018), <http://www.betterinvesting.org/public/startlearning/bi+mag/articles+archives/0908abpublic.htm> (discussing right to sell preferred stock in the secondary market).

97. Interview with M&A Lawyer, *supra* note 20; see also Sean Ross, *How Can a Company Resist a Hostile Takeover?*, INVESTOPEDIA, <https://www.investopedia.com/articles/investing/041913/warding-hostile-takeovers.asp> (last updated Mar. 22, 2018). One such example involved Diamond Shamrock's decision to conduct a huge buyback of common stock to fend off a takeover by T. Boone Pickens. The company needed cash and issued preferred shares to a single investor. Douglas Martin, *Shamrock and Sigmor in*

Because the company needs a cash infusion, the preferred has clout *ex ante*. In such cases, there should be little concern that the investor/preferred shareholder will not secure appropriate protection. The contract will typically not provide the preferred shareholder with voting power. However, the investor in such situations is typically not looking for voting power, but for a stable monetary return.

Similarly, there is little reason to be concerned with the protections offered to the preferred stockholders when they buy into a financing preferred arrangement. There, a late stage company sells preferred shares to raise capital through either a private placement or a public offering.⁹⁸ Although the investor/preferred shareholder does not participate directly, the private placement agent or the underwriter negotiates contractual protections for the preferred shareholder.⁹⁹

There are still other contexts in which, although the preferred stockholders do not have great leverage to negotiate over the dividend rate or other protective provisions (covenants, preferences), there is little need for those contractual protections, so a judicial rule of implied protections would not be cost-minimizing. This would be the case, for example, where a large public utility issues preferred stock in a publicly underwritten transaction. The terms would likely be standardized in the marketplace (that is, one utility's preferred looks like any other utility's preferred issued at the same time) and the preferred would likely be unable to negotiate special terms. However, because the utility has a huge asset base and a fairly steady stream of revenue, the covenant package is slender and the absence of protective covenants would and should not be a basis for implying additional terms; such additions would likely be costly.¹⁰⁰ The preferred investors in that context are making a lower risk investment. If protections were implied

\$160 Million Merger, N.Y. TIMES (July 8, 1982), <http://www.nytimes.com/1982/07/08/business/shamrock-and-sigmar-in-160-million-merger.html>. The investor buying preferred shares is not looking for control but will secure financial terms it cares about, such as a class vote on articles amendments pertaining to the preferred.

98. See JANET KIHOLM SMITH ET AL., *ENTREPRENEURIAL FINANCE: STRATEGY, VALUATION, AND DEAL STRUCTURE* 53–54 (2011) (discussing private placements of convertible preferred stock and its advantages over a public offering). Financing preferred is often issued in a leveraged buyout, as part of financing for an acquisition, and is sometimes issued to refinance debt or to make major capital investments like a power plant.

99. See Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461 (1995) (discussing staged financing as a means of controlling agency costs). The only constraint might be the placement agent's customer relations with some preferred stockholders. Of course, in large private company offerings of preferred stock, the placement agent is obtained by the issuer/the company.

100. Interview with M&A Lawyer, *supra* note 20.

on behalf of the preferred who took a low risk investment, the result would add to transaction costs as future parties would recontract around the outcome. It is only higher risk issuers who need to offer investors more protective provisions. Adding protections would increase the burdens on the low risk utility and rearrange the risk allocation between the parties. Future utilities might have to offer lower rates to investors since they would be saddled with additional burdens.¹⁰¹

In resolving the key question of intervention beyond the contract, one must look beyond the bargaining power issues. If the preferred have bargaining power, the absence of protective terms may be a deliberate choice. Even in cases where the preferred lack bargaining power to extract protection, to determine whether legal intervention would be value maximizing, one should determine if there are other private strategies beyond contract that offer alternative protection at a lower cost. One of the private mechanisms that may work as a protective mechanism when the parties lack the clout or foresight to bargain for express provisions is the traditional diversification strategy of making many small investments, expecting at least some to pay off, while many others will lose or at best break even.¹⁰² For some early round investors (angels or some VCs), the preferred may adopt a mixed investment policy, partly driven by economic value and a desire for their own wealth but partly also eleemosynary as part of an effort to grow the greater economy.¹⁰³ This differentiation can affect the terms negotiated with an issuer and might affect the willingness of a court to imply protective terms since the investors may consider themselves better off even when their investments fail.

Another private strategy would be relying on the market itself. The market would discount preferred stock whose contractual protections were weak, signaling caution to buyers of preferred stock.¹⁰⁴ For publicly traded shares, one would need to ascribe to the efficient market theory proposition that the current trading price works and correctly values the weakness of the particular express terms (including having the foresight to correctly price future changes in circumstances that undermine the preferred shares). Another strategy that some preferred

101. *Id.*

102. Preferred stockholders commonly use this strategy. BAINBRIDGE, *supra* note 5, at 257.

103. Interview with M&A Lawyer, *supra* note 20.

104. For example, in considering whether to mandate a rule prohibiting brokers from recommending stocks that they have not personally investigated, parties might prefer a court not to add such a term since it "raises the price the broker will charge and diminishes the investor's benefit from the transaction." *Contract and Fiduciary Duty*, *supra* note 27, at 428.

use is staged financing.¹⁰⁵ Venture capitalists often arrange the financing so that if the entrepreneur is not performing or is diverting assets for his private benefit, the venture capitalist can simply withhold financing at the next successive entry point.¹⁰⁶ In addition, the venture capitalist can arrange for board control or voting control, other private strategies that act as a means of protecting the preferred's interests.

Finally, in deciding whether to imply a non-negotiated protection for the preferred in the VC or other context, the adjudicator must account for the conflict as a principal-agent problem.¹⁰⁷

Investors are principals who have furnished resources to a designated agent who then makes decisions about how to manage a pool of assets for a firm.¹⁰⁸ The principal-agent aspect of these horizontal conflicts has been neglected. That neglect makes it harder to resolve horizontal conflicts between preferred and common stockholders given the agent's responsibilities.

The key insight from financial economics is that an agent's decision can produce different and even negative reverberative effects on different claimants (one class may benefit and another class may be harmed by the agent's actions) without resulting in any sacrifice to the asset pool.¹⁰⁹ Moreover, if the claimants can anticipate that the firm's agent will shift wealth to maximize the value of the firm, there should be no need to protect an adversely affected claimant who could negotiate contractual protections or rely on other means such as board control or staged financing.

If firms shift wealth in this way under wealth-maximizing principles,¹¹⁰ one must address whether there is a reason to prevent the

105. See generally Gompers, *supra* note 99.

106. See *id.* at 1463–67 (discussing staged financing as a means of controlling agency costs).

107. For a discussion of the incentive problems in principal-agent relationships, see Sappington, *supra* note 34. Sappington's article usefully examines "the sources of friction between principal and agent that typically preclude this ideal arrangement." *Id.* at 46.

108. When an agent accepts that position of having control over the assets of the firm, it is truly an agent in the economic sense. See Cooter & Freedman, *supra* note 68, at 1050–51; *supra* Figure 1 and note 86.

109. Coffey, *Firm Opportunities*, *supra* note 21. As Professor Coffey explains:

The strategies by which wealth shifts in favor of shareholders can be implemented are quite varied, but all achieve their effects by changing the marketable-value-significant risk (called systemic risk) and expected-return features of stock in a favorable direction, while simultaneously moving the same attributes of debt in an unfavorable direction.

Id. at 173.

110. "If we assume rationality, then it follows that, regardless of the risk attitudes of particular parties, the dominant strategy for contractual risk allocation is to maximize the expected value of the contract for both parties." Robert E. Scott, *A Relational Theory of*

board of directors, as the agent, from shifting wealth, and if so, under what circumstances. The ultimacy of the director's obligation under most state statutes—to advance the best interests of the corporation—must also be addressed.¹¹¹ Further questions include whether a law-supplied rule should prevent such wealth shifting that advantages one claimant at the expense of another, and why and when that rule would be supplied, and what the costs of such a rule would be.

Crafting a rule preventing wealth shifting would introduce substantial costs. First, it would put the manager in an untenable position of having no way “to make tradeoffs between” the two competing claimants.¹¹² Second, this rule would create uncertainty for the manager tasked with making a decision.¹¹³ A third cost would be the manager's inability to decide in cases whenever one class of claimants is adversely affected, possibly leading to a standstill for the company. Resolving these issues may depend on the particular state statute governing the purpose of a for-profit corporation and on the articulation of the director's duties. Are they phrased in terms of advancing the best interests of the corporation¹¹⁴ or of advancing the interests of a particular class of claimants?¹¹⁵

Recognizing the inevitable wealth shifting¹¹⁶ that can occur as agents manage assets under conditions of uncertainty and the possible mismatch in risk preferences between different classes of investors should help determine what strategy the agent of the claimants should pursue as well as the limits that should be imposed on such choices. In making these determinations, one should recognize that, to the extent

Default Rules for Commercial Contracts, 19 J. LEGAL STUD. 597, 602 (1990); see also WILLIAMSON, *supra* note 10, at 63 (recognizing the parties' “long-term interest in effecting adaptations of a joint profit-maximizing kind”).

111. See, for example, section 1701.59 of the Ohio Code and section 8.30 of the MBCA. The MBCA provides in the Standards of Conduct for Directors that: “(a) Each member of the board of directors, when discharging the duties of a director shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.” MODEL BUS. CORP. ACT. § 8.30(a) (AM. BAR ASS'N 2005); see also OHIO REV. CODE ANN. § 1701.59 (LexisNexis 2009) (Supp. 2014).

112. Jensen, *supra* note 11, at 237.

113. *Id.*

114. See Strine, *supra* note 78, at 2028.

115. The general linguistic gloss in the case law urging the board to favor the common, thus furnishing an example of protecting a particular class of claimants, goes back to the duty of the agent to foster the long term value maximization of the firm since the interests of the common stock are generally more aligned with that goal because of the risk/return reward with common stock.

116. One such suggestion to prevent wealth shifting would be a covenant that “would simply prohibit a corporation from acting in a way that reduces the value of the preferred stock.” See McEllin, *supra* note 5, at 924.

that wealth shifting is anticipated, parties can prevent it by contract or can protect themselves through a discounted initial purchase price.¹¹⁷ Thus, in the context of VCs, where everything is thought out and anticipated, there may be little reason to imply terms protecting the preferred beyond the contractual protections negotiated. This is especially true since there are costs to the firm of preventing wealth shifting between the common and the preferred, and the wealth shifting possibility is factored into the price of the stock or prevented by contract. In other contexts, where the preferred lack the ability to negotiate directly over terms or there is no market price discount for lack of protective provisions, a different response to the legal intervention beyond the terms of the contract might be more justifiable.¹¹⁸

C. Venture Capital Cases

1. *Trados*

An important case involving conflict between the preferred and the common was *In re Trados Inc. Shareholder Litigation*.¹¹⁹ The first question in reviewing any board action is whether the board owed a duty to the common stockholders. If yes, the second question is what standard of review should apply when reviewing the breach of fiduciary duty claim. In *Trados*, the court found that the directors “have the legal responsibility to manage the business of a corporation for the benefit of its shareholder[] owners,”¹²⁰ including the plaintiff common stockholders. Then, because the plaintiff proved a conflict of interest¹²¹ under the governing duty of loyalty owed by the board, the court held that the business judgment rule did not apply and instead applied the

117. See Coffey, *Firm Opportunities*, *supra* note 21, at 173. For example, bondholders anticipate that shareholders will take actions that benefit themselves at the expense of bondholders and sometimes at the expense of the firm. Bondholders seek to control such behavior by various indenture provisions, and evidence suggests that such indenture controls raise the value of the firm. See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–24 (1979).

118. See *supra* Section IV.B.

119. 73 A.3d 17 (Del. Ch. 2013).

120. *Id.* at 48 n.3, 36 (quoting N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007)).

121. *Id.* at 47. For a discussion on conflicts of interest, see *supra* Section IV.A.

burden of proving the entire fairness of the transaction—the most rigorous standard of review—to the defendant.¹²²

The court articulated a two-part test for fairness: fairness of the process and fairness of the price.¹²³ The court found significant flaws in the process, including the failure to consider any possible conflict between the preferred and the common.¹²⁴ However, under an entire fairness review, the court found that because the defendant proved a fair price, the process flaws by themselves did not warrant a finding of a breach of fiduciary duty.¹²⁵ Based on a comparison of the value of the common stock before and after the merger—both had a value of zero dollars—the fairness standard was easily satisfied.¹²⁶

In its fairness scrutiny, the court looked at the kinds of tradeoffs the board must make to determine whether a particular strategy should be pursued.¹²⁷ The court affirmed the *Orban* test of proving fairness where “there was no future for the business and no better alternative for the unit holders.”¹²⁸

a. Criticisms of Trados: Lack of Fiduciary Protection for Preferred as Preferred

Critics of *Trados* bemoan the decision on several grounds. The first set of criticisms aims at the lack of fiduciary protection for the preferred and the relegation of the preferred to their contractual rights.¹²⁹ Other critics argue it was a mistake for the *Trados* court to find that the preferred in control had a fiduciary duty to “consider the best interests of the common stockholders in making decisions.”¹³⁰ These critics argue that if the preferred want to sell the company, they need to pay

122. *Trados*, 73 A.3d at 42–46. Under this standard, “Delaware law requires that the interested party prove that the transaction was entirely fair to the corporation, in the sense that it was on terms as favorable as could have been achieved in an arms-length deal subject to market competition.” Strine et al., *supra* note 28, at 643.

123. *Trados*, 73 A.3d at 44, 66.

124. *Id.* at 63–65.

125. *Id.* at 66, 78; see also *id.* at 76 n.48 (citing *Orban v. Field*, No. 12820, 1997 WL 153831, at *1–9 (Del. Ch. Apr. 1, 1997)) (discussing the ability of the board to promote the interest of one class of shareholders at the expense of another class of shareholders as long as it is in the corporation’s best interests).

126. *Id.* at 77.

127. See *id.* at 76.

128. *Id.* at 76 & n.48 (first quoting *Blackmore Partners v. Link Energy LLC*, 864 A.2d 80, 86 (Del. Ch. 2004); and then citing *Orban*, 1997 WL 153831, at *1–9).

129. Bratton and Wachter criticize the fact that the law does not recognize a fiduciary obligation to the preferred “because [the preferred’s rights] are contractual.” Bratton & Wachter, *supra* note 2, at 1884.

130. Strine, *supra* note 78, at 2040.

attention only to “whether the sale was at fair market value”¹³¹ and should not owe a duty to maximize common stock value or to consider common stockholder interest. Under these views, the *Trados* court improperly handed “the entrepreneur [common stockholder] a fiduciary backstop” which overcame the deal’s risk allocation.¹³² Invoking a non-contractual expectation, critics argued that that the preferred should not have to wait patiently for the company’s prospects to pan out¹³³ but should be able to cash out without considering the common stockholder, even in cases where the preferred did not secure a contractual protection to force a liquidation.¹³⁴

In deciding whether the preferred in *Trados* should be able to force a sale that they did not bargain for as a contractual right, thus garnering extra-contractual protection beyond the fiduciary protection offered to all stockholders and beyond the contractual protections actually negotiated by the preferred, one should use a three-pronged analysis. First, one should ask whether there are substantial impediments to bargaining that interfere with the preferred’s achievement of their goals. This will rarely be the case in the VC context. Second, regardless of any impediments, would a law-supplied rule to protect the preferred be cost-justified and promote value maximization? Third, how does the principal-agent analysis help?

The first prong asks: is there a total cost minimizing or wealth enhancing reason to imply additional protections for the preferred? One would first address whether the preferred could have protected themselves. Were they beset by the types of collective action problems that beset common stockholders? If not, there may be little reason to supply a default rule.

We will assume that most, but not all, preferred stockholders have the clout to protect themselves. Moreover, because legislatures provide that preferred stock gets additional protections—rights, preferences, and limitations—only if expressly bargained for, the parties know that they need to bargain for extra-contract protection.

The second prong asks: even if they lack that clout, does the price at which the stock trades reflect the degree of protection offered by the contract? If so, that would argue against further protecting preferred bought at a discount due to the lack of protective provisions.¹³⁵ Thus, unless the market does not accurately reflect the degree of protection

131. *Id.* at 2027.

132. Bratton & Wachter, *supra* note 2, at 1885.

133. *See id.* at 1904–05.

134. *See id.* at 1889–90.

135. *See* discussion *supra* notes 2–4.

for particular preferred, there is no reason to allow the preferred to ignore the effect on the common because doing so would ignore the initial bargain and force re-contracting in future deals.

Therefore, lack of bargaining clout itself would not resolve whether additional protection should be implied. One would need to know whether the market accurately reflected the lack of protective provisions for the preferred. Moreover, protection can exist even without legal protection due to structural protections such as board control and staged financing negotiated by preferred.

The third prong asks whether adding protection for the preferred under which the board would have a fiduciary duty to the preferred beyond any stipulated contractual terms and beyond the fiduciary duties owed to all stockholders—such as not to commit waste or divert assets—would ignore the nature of the agent's responsibility to act for all principals to manage assets for the firm. Recognizing a non-contractual duty to the preferred as preferred would not be helpful in achieving the ultimate goal of maximizing value for *the firm* and thus should not be adopted for that reason. There is no reason that adopting it would do any more than offset the costs of its adoption. The essence of an agent acting for dual principals is to take actions in the best interests of the corporation and not to maximize the value for one set of claimants while ignoring another set of claimants or the effect on the value of the firm.¹³⁶ Restraining the board's discretion and carving out a duty to the preferred would run counter to the view that agents should be able to take actions that harm one set of claimants when such actions are in the interest of the corporation. Further, this duty to the preferred would unduly hamper the board, forcing it into a straightjacket. Creating a judicially supplied rule to protect the preferred as preferred would divide up the agent's responsibilities and give one class of claimants—the preferred—the ability to restrain any action of the board because it was not in the interest of a single claimant. Courts are comfortable supplying a performance obligation of the agent because doing so controls an endemic risk that is inevitable given the separation of ownership and control. This separation is

136. See *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593–95 (Del. Ch. 1986). The judicial formulations of fiduciary duty often emphasize the need to act for maximizing common stock shareholder wealth as a linguistic shorthand for what will best serve the interests of the firm since the risk/return for the common stock will generally yield the highest return for the firm. The common stockholder is being used to depict the risk/return profile that will yield the highest value. The common stock is not being favored as a single claimant when its interests would diverge from those of the firm. See, e.g., Strine et al., *supra* note 28, at 631–34 (discussing this concept as applied in Delaware corporate law).

omnipresent but difficult and costly to control by contract; courts intervene because they are convinced that the parties would have bargained for the fiduciary obligation were it not for transaction costs.

In *Trados*, had the court allowed the board to ignore the deal's effect on the common by carving out extra-contractual protection or a quasi-fiduciary duty to the preferred that would have allowed it to exit, it would have ignored the fact that dual principals had both furnished assets to the agent. By endorsing the proposition that "the board owes no fiduciary duty to maximize the value of the preferred," the *Trados* court was implicitly underlining that an agent's duty is to manage the assets for the firm as a whole.¹³⁷ Implying a fiduciary duty of the agent to generate value for the firm is consistent with the principal-agent model described above. However, allowing the preferred to prevail and gain a judicial right to exit would ignore the fact that the agent's duty is to the firm itself, not to any claimant—preferred or otherwise. The costs imposed on a board from a rule permitting it to ignore the common to secure a right not bargained for by the preferred would include a disinclination for the common to furnish assets to such agents. That would not be value maximizing for the firm.

Ignoring the effects on the common would overlook the basic premise that the principal—here the preferred—sought a type of claim that matched its preferences, endowments, and beliefs, and that the terms negotiated did not include a right to a forced liquidation. Therefore, if the court were to allow the preferred to force liquidation without considering the effect on the common, it would be overriding the basic risk/return profile of the initial investment whose terms the preferred plaintiffs negotiated.

The *Trados* court, while affirming the principle of common stock maximization, actually analyzed the board's role in a way that reflects the thesis of this Article that, in deciding conflicts between investors who might have conflicting interests, the court should consider the board an agent with two furnishers of resources and two claimants on the pool of assets managed by the agent/board of directors. Although recognizing that "it is possible that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders,"¹³⁸ at the same time, the court gave the board latitude to make tradeoffs in the best interests of the corporation despite the adverse effects on a single class of claimants,

137. Strine, *supra* note 78, at 2028; see also *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 36–41 (Del. Ch. 2013).

138. *Trados*, 73 A.3d at 41–42 (emphasis omitted) (quoting *In re Trados Inc. S'holder Litig.*, No. 1512–CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009)).

including the common stockholders. This is clear from both the *Trados* result itself, validating a decision that wiped out the option value for the common stockholders, and from the *Trados* court's approval of the *Orban* case,¹³⁹ which involved a similar destruction of value for the common stockholders.¹⁴⁰

The court recognized the directors' need to "exercise their independent fiduciary judgment" rather than "cater to stockholder whim."¹⁴¹ Under this standard, the board is afforded the discretion to determine whether the common's hope for a future is realistic or not. In upholding the board's right to determine the company's lifespan as an independent entity and to decide on an appropriate time to pursue a merger, the court was validating the right of the agent overseeing a pool of assets to determine the value of waiting and to decide when waiting no longer makes sense.¹⁴² Managers of company assets are constantly making these tradeoffs, determining whether to invest now or to take an option on waiting to develop the project until more uncertainties are resolved. Although a board must consider the effect on the common, it will not be found in breach merely because one claimant, a common stockholder, wanted to preserve the option of waiting and did not want a merger or exit.

This opinion upholds the board's right as an agent managing a single pool of assets to manage the pool as it deems reasonable. The *Trados* court's affirmation of the *Equity-Linked* principle that "[t]hey [the board] have every right to send no good dollars after bad ones"¹⁴³ recognizes that the timing of investment and exit decisions are complicated decisions that boards have to make. The court in *Trados*, in tracing the board's decision on why the continuation would yield no return for the common, gave latitude to the board and rejected the plaintiff's central argument that the board must keep the company alive if that was what the common stockholders wanted.¹⁴⁴

139. *Id.* at 38, 42, 76 n.48.

140. *Id.* at 76 n.48 (citing *Orban v. Field*, No. 12820, 1997 WL 153831, at *1-9 (Del. Ch. Apr. 1, 1997)).

141. *Id.* at 38 (citing *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1989)).

142. See *supra* note 24 and discussion in *Dodge* comparing alternative present values.

143. *Trados*, 73 A.3d at 77 (quoting *Equity-Linked Inv'rs, L.P. v. Adams*, 705 A.2d 1040, 1057 (Del. Ch. 1997)).

144. See *id.* at 76-78.

b. *Negative Effect on Corporate Value? None Where Contractual Protections Can Be Negotiated by the Preferred*

Two critics, Professors Bratton and Wachter, have voiced concern that the common stock maximization principle endorsed by *Trados* can make a corporation “less valuable” and result in “perverse incentives.”¹⁴⁵ Bratton and Wachter were also concerned that the case “imposes potential fiduciary liability on directors who pursue enterprise value over suboptimal speculation for the common’s benefit.”¹⁴⁶

But if *Trados* is read properly, and if the principal-agent model and the vaulting question of determining implied duties based on whether adding them will achieve benefits that exceed costs are addressed in the case analysis, one can see that *Trados* does not propose that the board must sacrifice enterprise value for the common. As Chancellor Strine suggests, *Trados* stands for the proposition “that a traditional duty of loyalty toward the interest of the common must be observed and that a preferred controller cannot disregard the best interests of the common in its effort to exit its investment.”¹⁴⁷

If the preferred were not in control as in *Trados*, and the board decided that the best interests of the firm required that the interest of the common be wiped out, one might think that the board would have that discretion. No one, not even common stockholders, would want a rule preventing certain corporate decisions that wipe out the common’s interest but are in the best interests of the firm. Common shareholders might appear to benefit from such a rule, but that kind of rule could make it harder for the firm to access financing from banks, debt, and preferred stock, which harms common stockholders and the firm as a whole. The board is generally under a “duty to pursue business strategies benefiting the common stockholders”¹⁴⁸ but, at a certain point, that strategy makes no business sense and the interests of the firm will be best served by declaring bankruptcy. Consistent with its duties to the common, “[a] board may certainly deploy corporate power against its own shareholders [the common] in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably.”¹⁴⁹ Thus, the duty toward the common does not trump the

145. Bratton & Wachter, *supra* note 2, at 1885–86.

146. *Id.* at 1887.

147. Strine, *supra* note 78, at 2039.

148. *Id.* at 2040.

149. *Orban v. Field*, No. 12820, 1997 WL 153831, at *8 (Del. Ch. Apr. 1, 1997).

duty toward the firm and it should not prevent a merger that is in the best interests of the firm.

If the role of the board is traced back to the principal-agent model with dual furnishers of resources, the board's role is one of making constant tradeoffs between long-term and short-term gains and making choices that will not be wealth sacrificing but will all fall on a line of non-wealth sacrificing choices, each of which will have a different risk and return profile. If this is the case, then the *Trados* case, even with its emphasis on common stockholder wealth maximization, seems to be wealth enhancing rather than "ex ante value destroying."¹⁵⁰

The example given by Bratton and Wachter in which the *Trados* common stock maximization principle will result in a sacrifice of enterprise value involves a company that has received a \$60 million offer.¹⁵¹ In their hypothetical, "the venture capitalist's liquidation preference is \$40 million."¹⁵² They envision two scenarios: one with an upside and one with a downside. If the board waits, there is a 25% chance of getting a better offer of \$70 million but a 75% chance of receiving a worse \$50 million offer. "The expected value of delay [cost] is \$55 million (\$70 million x [25%] + \$50 million x [75%])," and Bratton and Wachter think that *Trados* scrutiny would cause a board to misallocate resources to the common because it would prompt the board to reject the current \$60 million offer and pick the delay option, since that is the only scenario under which the common will have any value. Delay would cost the enterprise \$5 million.¹⁵³ Under their view, the common stock maximization principle will cause the board to pick the option that favors the common (25% of \$3 million or \$750,000), and that is the delay strategy since under the other option, cashing out now for \$60 million will leave the common \$0.¹⁵⁴

This example seems fraught with difficulties. First, the board would have to compare whether potentially gaining \$750,000 would be worth the potential loss of waiting to the common. There is a 75% chance of the company receiving a worse offer of \$50 million under which the common would receive nothing. Bratton and Wachter seem to think that if there is any chance of the common receiving any value, then the board must take that option.¹⁵⁵ This does not seem compelled by *Trados* or by conceptions of the role of the agent to consider tradeoffs and weigh

150. Walther, *supra* note 80, at 192; *see also* Bratton & Wachter, *supra* note 2, at 1886.

151. Bratton & Wachter, *supra* note 2, at 1886.

152. *Id.*

153. *Id.* ("Delay thus sacrifices \$5 million of enterprise value in exchange for a chance to realize an expected \$750,000 (\$3 million x [25%]) for the common.")

154. *Id.* at 1883.

155. *Id.* at 1886.

options, taking into account the risk and targeted return of the investor, the value of waiting, the uncertainty, other possible options to delay taking action now, and comparing present values of alternative future return stream strategies.

Second, if the preferred had secured a liquidation value as well as a contractual right to compel a sale at the liquidation value, then there would be no sacrifice of enterprise value.¹⁵⁶ The preferred could compel the company to sell, and there would be no delay and no loss of \$5 million in value. However, since the preferred lacked any contractual right to compel a sale and payment of the liquidation value, there would be no sacrifice of enterprise value as outlined by Bratton and Wachter.¹⁵⁷ The pricing of the preferred stock would be discounted to reflect the fact that the preferred lacked a right to compel a sale, and the potential loss in enterprise value would be priced *ex ante*.

Moreover, the concerns over *Trados* seem overblown given the concept of an agent for many classes of claimants with decisions being made all the time that are value-neutral in terms of the asset pool but that have a reverberative effect on one class of claimants. The board may have a certain offer of \$60 million now, but the timeline of both the preferred and the common is perpetuity and the calculations of the cost of waiting or delay might change over time. The value of waiting might increase. There might be a 25% chance of an offer of \$70 million in the near term and a 75% chance of \$50 million in the near term, but there might be other offers if the board waits an additional amount of time. In addition, the board might be able in this situation to take an option for the \$60 million deal rather than an option of delay. It might not take the \$60 million deal right now but might acquire an option on that deal. It could exercise the option depending on how the uncertainties resolved. If the board was convinced that the delay, even with the 25% chance of \$3 million,¹⁵⁸ would result in a negative effect on the asset pool as a whole, perhaps because the waiting would reflect negatively on perceptions of the company's worth (a signal), and if the board decided that the best option of all the alternatives was to sell now to avoid those negative effects, presumably the board could choose the \$60 million offer without liability.

Finally, the board might choose the delay even with a projected loss of \$5 million because of non-monetary returns which might lead to an overall greater value for the common than the \$750,000 figure

156. See Strine, *supra* note 78, at 2029–30 (discussing protection offered through liquidation provisions); see also Bratton & Wachter, *supra* note 2, at 1882–85.

157. Bratton & Wachter, *supra* note 2, at 1847.

158. See *supra* note 153–54 and accompanying text.

represents. It might decide that those non-monetary returns include the value of keeping the entity alive. Just as a single investor without an agent can make tradeoffs including non-monetary returns that would otherwise seem like an irrational sacrifice of dollar returns, so too can the agent acting for dual investors take non-monetary returns into account in reaching a rational or optimal decision for the company.

The board must be able to decide whether cashing out at \$60 million now is the right course of action for a company with a perpetual existence. If an independent board not subject to a conflict of interest decided to cash out, would the common have been able to complain, alleging that the board must always take steps to sabotage the preferred? Probably not—instead, the court would likely defer to the board's ability to determine the timeline for liquidating the company rather than second-guessing it.

Cost minimization/wealth maximization also suggests that the *Trados* result is correct.¹⁵⁹ Had the court adopted the view that the preferred should be able to exit without considering the effect on the common and be able to do so whenever it is advantageous, the court would be bestowing a gift that the preferred did not bargain for. This would immediately have negative effects on other shareholders that must be accounted for in any cost/benefit analysis of the legal intervention.

Finally, protecting the preferred through a rule allowing the preferred to exit whenever it is advantageous could have negative effects on the capital markets. It could potentially negatively affect the ability of issuers to raise capital, since investors would no longer have any confidence that agents would consider the effect on different classes of investors and the firm.

2. *ThoughtWorks*: Calculating the Wealth Effects

Cases involving preferred stock that pose the question of whether to offer judicial protection beyond the contractually negotiated terms should be assessed in two ways: (1) using the framework of the agent (the board) acting for multiple principals (classes of investors) in the best interests of the corporation and to maximize the value of the equity, and (2) asking the key question of whether judicial intervention of a particular type would gain more than it costs.

159. See *supra* Section IV.C.1.a.

Without that framework, critics become too easily convinced that the case illustrates the bias against preferred stockholders.¹⁶⁰ Bratton and Wachter criticize the court for “stripping away a promise’s contractual vitality by remitting the decision to perform the promise to pay to the discretion of the issuer’s board.”¹⁶¹

With the framework outlined here, the board of directors must manage a corporation with a perpetual existence in the best interests of the corporation, even if a particular action adversely impacts a particular class of investors at a particular time.

In *SV Investment Partners, LLC v. ThoughtWorks, Inc.*,¹⁶² the preferred wanted to force a redemption of its preferred stock.¹⁶³ The board was willing to engage in periodic small redemptions of preferred stock but refused the large redemption of preferred stock on the ground that the company lacked the necessary cash to meet the requirement of legally available funds.¹⁶⁴ The preferred challenged that refusal, arguing that the certificate of incorporation’s language entitled the preferred to a mandatory redemption since the preferred investor could “require [the company] to redeem for cash out of any funds legally available therefor.”¹⁶⁵ Mandatory redemption provisions of this kind are one of the protective provisions preferred stockholders put in their preferred stock contracts as a kind of “downside protection for the VCs as a way to salvage the remains of an unsuccessful investment.”¹⁶⁶

The *ThoughtWorks* court consulted both the Delaware statute and the certificate of incorporation. Title 8, section 160 of the Delaware Code provides: “Every corporation may purchase, redeem, receive, take or otherwise acquire . . . its own shares”¹⁶⁷ That permissive right to redeem shares, however, is subject to restrictions that make the redemption contingent on the action not impairing the capital of the corporation. The Delaware statutory restrictions on redemptions constituted a creditor protection against the extreme moral hazard of a corporation redeeming all of its stock, leaving no capital at all to pay its debt.¹⁶⁸

160. See Strine, *supra* note 78, at 2030 n.22 (citing Bratton & Wachter, *supra* note 2, at 1868) (explaining that Bratton and Wachter see the use of the “corporate paradigm” to the exclusion of contract analysis as exhibiting such bias).

161. Bratton & Wachter, *supra* note 2, at 1860.

162. 7 A.3d 973 (Del. Ch. 2010), *aff’d*, 37 A.3d 205 (Del. 2011).

163. *Id.* at 978–80.

164. *Id.* at 979–80.

165. *Id.* at 982.

166. Korsmo, *supra* note 7, at 1179.

167. *ThoughtWorks*, 7 A.3d at 981 (quoting DEL. CODE ANN. tit. 8, § 160(a) (2010)).

168. See *id.* at 982.

The preferred stockholders argued that because the company had a "surplus," the redemption in the certificate of incorporation was mandatory since it provided them "the right to have their stock redeemed 'for cash out of any funds legally available therefor.'"¹⁶⁹ However, the court interpreted that language differently from the preferred stockholders. First, it found that the term "funds legally available" meant a realistic "available source of cash" rather than an accounting finding of a surplus.¹⁷⁰ Second, it pointed to a panoply of judicial doctrines that constrain "a corporation's ability to use funds, rendering them not 'legally available.'"¹⁷¹ These doctrines prevent a corporation from executing stock redemptions where the effect would be to cause insolvency. Looking at these strictures, the court found that the board was within its rights to refuse the redemption of the preferred despite the language apparently mandating redemption.¹⁷²

Preferred stock exists within the larger framework of both contractual rights owed to the preferred and the corporate context of the board of directors acting as an agent for multiple classes of investors. If one focuses only on the contract and the contract language, one might criticize *ThoughtWorks* for narrowly interpreting the language to "hurt" the preferred.¹⁷³ But the preferred invested in, and furnished resources to, an agent who is committed to the best interests of the corporation. Moreover, once the value is furnished to the firm by the preferred investor, the asset is no longer his. The preferred investor knows that resources from other investors with different risk and return profiles will be furnished and also knows that its agent, the board, is given plenary discretionary decision making with respect to the operation of the firm's assets and financial matters. The preferred is halfway between common equity, which has a high risk and high

169. *Id.* at 976.

170. *Id.* at 984.

171. *Id.* at 985.

172. *Id.* at 989–90 ("The Board's process has been impeccable, and the Board has acted responsibly to fulfill its contractual commitment to the holders of the Preferred Stock despite other compelling business uses for the Company's cash. This is not a case where the Board has had ample cash available for redemptions and simply chose to pursue a contrary course.").

173. See, e.g., Bratton & Wachter, *supra* note 2, at 1860 (stating that *ThoughtWorks* "radically expanded the zone of enforcement constraint, stripping away a promise's contractual vitality by remitting the decision to perform the promise to pay to the discretion of the issuer's board"). Bratton and Wachter also argue that the denial of redemption rights to the preferred would "disable[] a productive mode of financing." *Id.* at 1874. That result would only occur if venture capitalists were unable to arrange matters to protect themselves through contract or other means—board control, voting control, staged financing, etc.

return, and debt, which has a low risk but low return. If that role is understood, then the board of directors must manage a corporation with a perpetual existence in the best interests of the corporation, even if a particular action adversely impacts a particular class of investors at a particular time. Debtholders and preferred stockholders know and anticipate that there will be these kinds of wealth effects or transfers when they buy the stock or make the loan. Similarly, the preferred have chosen to hold yet a different type of claim to match their diverse preferences, endowments, and beliefs.

When the company started to flounder and attempted to acquire cash to redeem the preferred failed, the preferred wanted to force a redemption.¹⁷⁴ However, the preferred failed to build in more protective provisions to allow them to force an exit, such as a drag along right.¹⁷⁵ The board had a duty to act in the best interests of the corporation. In the context of *ThoughtWorks*, that might mean that when a company is subject to volatile cash flows, the board might choose to maintain a cash cushion if that is critical for the corporation's existence, even if it interferes with the preferred's ability to exit through redemption, unless the preferred specifically negotiated for the right to exit on an unrestricted basis.¹⁷⁶ In addition, since the board has to act to preserve the company's ability to borrow in the future, the board should be able to preserve the cash cushion.¹⁷⁷ Had the court interpreted the language "funds legally available" to permit capital impairment, and in effect gone beyond the language and converted the mandatory redemption provision that was subject to the qualifying language restricting redemption to cases where funds were legally available into a provision that would have forced a liquidation of the firm, the court would have been ignoring the limiting language and all of the associated case law "for the board to use in determining when a payment to the preferred is required."¹⁷⁸ Future creditors might refuse to lend the corporation needed cash, fearing that even where the language subjects the

174. *ThoughtWorks*, 7 A.3d at 978–80.

175. *Id.* at 991–92.

176. See Korsmo, *supra* note 7, at 1226–27.

177. Bratton and Wachter would see *ThoughtWorks* as a case where "the corporate paradigm trumps the contract paradigm," since they assert that the contract language was present and sufficient to protect the preferred and the court upended that contractual protection in favor of allowing the board to decide whether there were funds legally available to redeem the preferred stock. See Bratton & Wachter, *supra* note 2, at 1865–74, 1885. However, once the contract protection is fully interpreted as a qualified right to redeem, the role of the corporate board in deciding on whether sufficient funds existed to redeem the preferred cannot be seen as trumping the contract, since the contract itself referenced corporate limits on redemption.

178. Korsmo, *supra* note 7, at 1227.

redemption to a condition of having funds legally available, the court will force a company to redeem anyway, as though the preferred negotiated for an unqualified mandatory redemption. Even though, ex post, the preferred want to cash out when the company flounders, ex ante the preferred would want the board to have the discretion to determine an adequate cash cushion. Finally, given the nature of the business, with the major assets of the company tied up in employee compensation for a service business, rather than tangible assets, the redemption of the preferred stock would have had disastrous consequences, eliminating the surplus “even for the purposes of redeeming the shares.”¹⁷⁹ Thus, a decision depriving the board of its discretion to resist a redemption when, in the board’s judgment, it did not have the funds needed, would likely have negative wealth effects.

If one applies the agency model to the facts in *ThoughtWorks*, one would argue that, as the agent for dual classes of shareholders, the agent must be able to resist the demands of one class of shareholders—such as a redemption demand—if that demand would interfere with the agent’s ability to maintain a viable company. The agent must consider the value-maximizing effect first and never do anything to sacrifice the value of the global firm, which would not be served by depriving the company of the ability to operate once redemptions were made to the preferred.¹⁸⁰

On appeal, the court held that the board’s determination of whether funds were legally available is a matter of business judgment.¹⁸¹ In deciding whether to limit the board’s discretion in future deals and make the decision not a matter of business judgment for the board, and to force redemption when the board interpreted the language to preclude redemption, one should consider whether that decision would be wealth-enhancing or whether the costs would more than offset the benefits. A decision for the preferred by implying fiduciary protection to limit the board’s discretion would result in an immediate re-contracting around the results in future deals. Issuers would insist on protection against judicial rewriting of the certificate of incorporation and expressly negotiate contracts that define “funds legally available” to be a matter for the board’s business judgment.¹⁸²

In making this decision, the court should consider whether the preferred’s failure to force an exit was a gap or whether, ex ante, the

179. *Id.* at 1198, 1226–27.

180. *Id.* at 1183; see also 1 JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 4.07 (2003).

181. SV Inv. Partners, LLC v. ThoughtWorks, Inc., 37 A.3d 205, 211–12 (2011).

182. Korsmo, *supra* note 7, at 1228–30.

preferred might have decided that the costs of forcing an exit on the issuer through a drag along right was not advantageous because of the other effects it might have had on the deal with the issuer. Thus, the decision to include the “funds legally available” language was done with the full knowledge that it left the preferred vulnerable to the board’s discretionary limits. Presumably, the parties negotiating these deals are doing so in an ex ante cost-minimizing way to maximize the gains from trade. They are relying on their own estimates of the likelihood of an IPO, their pricing of the deal and the protective provisions that it has, the reputational norms that might constrain the board from opportunistically gouging the preferred, and other factors. The preferred are also presumably deciding to forego other more protected investments, such as convertible debt. Additionally, they may forego a protective provision that gives them the power to force liquidation when redemption was sought but refused.¹⁸³

The vaulting question of all judicial interventions is whether an implied judicial term, such as one limiting the board’s right to make determinations about redemption, has greater benefits than costs. The cost would include the immediate re-contracting costs for parties who do not want their boards to be restricted in making stock redemption decisions to consider not only available accounting surplus but also whether cash is realistically available to fund a redemption. The cost would also include the immediate hit to other outstanding securities that would now be subject to the unanticipated and unpriced risks of capital impairment needed for creditor protection or perhaps for the future growth of the company.¹⁸⁴

In cases where there is a wide appreciation of the more protective devices available to the preferred, including drag along rights and other non-contractual rights like staged financing and board-control rights, intervention to interpret the term to “protect” the preferred would in effect protect the preferred against its own risk-taking.¹⁸⁵ The preferred had other alternatives to taking preferred stock, including debt,¹⁸⁶ and they presumably traded off greater control¹⁸⁷ with preferred stock to determine that the risks were worth it, despite the potential uncertainties of the company and the potential waywardness of its

183. See Strine, *supra* note 78, at 2038–39 (discussing a variety of alternative strategies to force a redemption that would be more protective of preferred stockholders).

184. Korsmo, *supra* note 7, at 1197–98.

185. As Chancellor Strine points out, “the preferred stockholders’ right to mandatory redemption in the defendant’s charter was governed by language” predicated on available cash. Strine, *supra* note 78, at 2030.

186. *Id.* at 2032.

187. With debt, debtholders cannot actively manage a company.

directors and officers. Presumably, they made a rational tradeoff given the risks and uncertainty and priced the deal accordingly.¹⁸⁸ It was rational behavior, despite the risk that the mandatory redemption provision might not be very meaningful as protection, because redemption was qualified by the need for legally available funds. Depriving the board of the ability to make a judgment about whether funds were legally available, and deferring to the preferred's interpretation and mandating redemption wherever there was an accounting "surplus," might negatively impact the company's ability to operate after making a large redemption payment.¹⁸⁹ The ex ante prospect of this interpretation would make it more costly to secure financing from various investors who would worry that even when there was no cash readily available, any finding of a surplus would require that the company honor a redemption even if it adversely affected the company's ability to continue operating. A court deciding to ignore the case law on "funds legally available therefor" and substitute its judgment for that of the board might add to the costs of all transactions in the future.¹⁹⁰ There would be the uncertainty of the court choosing to ignore language such as "funds legally available" that had a meaning defined by precedent.¹⁹¹ In addition, because the "funds legally available" language had been adopted rather than a provision forcing a liquidation without constraints, the court would be giving the preferred a better deal than they negotiated.¹⁹²

Looking at *ThoughtWorks* as rendering the preferred vulnerable to transfers of wealth to the common ignores the ex ante perspective of investors of all types who furnish resources to an agent who will manage a pool of assets for the firm. Ex ante, the investors will all want the board to have the discretion to act to protect the firm's ability to operate. To deprive the board of the maintenance of the cash cushion needed to operate a profitable business would presumably depress the market for the firm's securities and debt. So ex ante, the investors, even the preferred, would want the board to be able to make decisions to maintain that cushion even if ex post, when certain circumstances

188. Support for the rationality of the tradeoffs that preferred make can be seen in the ways that venture capitalists, one class of preferred, negotiate for "control rights [that] evolve over time." Armin Schwienbacher, *Venture Capital Exits*, in *VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES* 389, 392 (Douglas J. Cumming ed., 2010). Since the preferred negotiate carefully on control rights, there is reason to think that agreement to a redemption right that was qualified was not considered.

189. See Korsmo, *supra* note 7, at 1198.

190. Interview with M&A Lawyer, *supra* note 20.

191. Korsmo, *supra* note 7, at 1227.

192. *Id.*

make a redemption preferable, the preferred would choose that outcome despite the adverse impact on the ability to operate. Presumably we should be asking whether the costs of depriving the board of the ability to make decisions about the cash cushion required for a firm to prosper would result in a net improvement in wealth.

Had the *ThoughtWorks* court been willing to ignore the case law precedent meaning of “legally available” and forced a redemption on the basis of the preferred’s argument that there was a surplus, the court would have been extending a kind of fiduciary protection to the preferred. But under the vaulting question framework discussed above, it is not clear that the benefits would be worth the legal intervention, especially since, as Professor Charles Korsmo points out, “if ThoughtWorks attempts to redeem the preferred [shares], the surplus no longer exists, even for the purposes of redeeming the shares.”¹⁹³ An effort to protect the preferred by interpreting the redemption to be mandatory and unqualified might be wasteful and futile. It might also be costly if the exact parameters of judicial efforts to protect the preferred are uncertain. Moreover, court intervention to make the redemption unqualified would restrict the ability of preferred stockholders to craft the exact level of protection that they wanted. Had they wanted the unqualified right to redemption, they could have easily demanded such a right. The lesser protection that the preferred negotiated in *ThoughtWorks* was presumably priced accordingly. Interpreting the provision to give the preferred an unqualified mandatory redemption would have ignored the limits imposed by the “legally available” qualification and given the preferred more than they bargained for contractually. Judicially intervening when the preferred have the clout to negotiate, or when the preferred buy stock that is priced according to the risk undertaken, might not outweigh the costs of a reduced choice of a spectrum of protection. Moreover, the ex ante wealth-destroying effects of depriving the board—the agent—of the ability to operate the firm using its discretion to preserve the firm’s ability to operate by keeping a necessary cash cushion in a volatile business might not be worth the particular protection afforded these preferred stockholders. The *ThoughtWorks* court situated the decision about the surplus within the realm of the board’s business judgment,¹⁹⁴ perhaps sensing the wealth-destroying effects of a contrary decision.

193. *Id.* at 1198.

194. *Id.*

3. *Equity-Linked Investors, L.P. v. Adams*¹⁹⁵

The conflict between preferred and common stockholders is likely to be particularly acute when the liquidation preference held by the preferred is less than the value of the company if immediately liquidated. At that juncture, the common would like to keep the company going, because if the company can generate cash flows, the upside will flow to the common stock.¹⁹⁶ However, losses will fall disproportionately on the preferred,¹⁹⁷ and they will not benefit from the upside since they have no equity interest.

Equity-Linked presented that type of scenario. The biopharmaceutical company in *Equity-Linked* had "several promising technologies" but showed no profit.¹⁹⁸ The preferred's liquidation preference was above the value of the company and they wanted to liquidate and distribute the proceeds amongst themselves. The common, however, sought additional sources of funding to develop the technologies the firm had.¹⁹⁹ They successfully secured funding from Aries, an investor group, in the form of a \$3 million loan in return for the firm issuing a \$3 million bridge note accompanied by warrants that could be exercised into common stock, making it convertible debt.²⁰⁰

The preferred then sought an injunction against the Aries borrowing. The court recognized that this real difference in the economic interests of the preferred and common stockholders caused a conflict, but the legal issue that formed the preferred stockholders' claim centered on a type of fiduciary duty owed to all equity holders in a change of control situation.²⁰¹ It then proceeded to address the legal theories that might allow the preferred to challenge the board decision approving the loan transaction.

The importance of the principal-agent frame for analyzing the case and the vaulting question analysis of whether the benefits of implying the term exceed the costs, given certain assumptions about human behavior and the effects of legal rules prospectively on behavior, will be

195. 705 A.2d 1040 (Del. Ch. 1997).

196. *Id.* at 1041. The common stock would keep any residual after claims of debtholders and fixed amounts due to the preferred had been satisfied.

197. *Id.* This results because "the current net worth of the company would be put at risk in such an effort." *Id.*

198. *Id.*

199. *Id.*

200. *Id.* at 1051-52. As Walther explains, the company "obtained convertible debt financing from an asset management fund (Aries), conditional on giving Aries the right to appoint the majority of the board." Walther, *supra* note 80, at 190-91.

201. *Equity-Linked*, 705 A.2d at 1042-43.

examined following a discussion of the facts and the court's legal analysis of the fiduciary duties of the board.

The essence of the preferred's argument was that the board erred in approving the loan transaction with Aries by not allowing the preferred stockholders to bid at an auction for the firm. While it recognized that the board's decision placed "economic risks upon the preferred stock," it found no breach of any fiduciary duty, even though the board's decision "was taken for the benefit largely of the common stock."²⁰² As equity holders of stock, the preferred, like the common, are owed the same fiduciary duties owed to all stockholders.²⁰³ The court found no breach "of any residual right of the preferred as owners of equity."²⁰⁴ When judging the fiduciary duty to holders of equity, the board's "discretionary judgment is to be exercised[] to prefer the interests of common stock."²⁰⁵

In *Equity-Linked*, the particular legal issue that the preferred raised was that the board violated its duty to receive the best price in a change of control situation.²⁰⁶ The *Revlon* case imposes that duty and is interpreted to forbid a board, when choosing between all cash offers, to choose the lower cash offer.²⁰⁷ The board in *Equity-Linked* was choosing to accept the Aries offer or to negotiate with the preferred in an auction.²⁰⁸ If one looks at *Equity-Linked* and thinks about the case in the context of dual principals and a single agent operating the firm, it makes sense that in interpreting the scope of the agent's duty to the stockholders, the agent would have no duty to favor the preferred merely because that particular claimant wanted to liquidate. The agent's duty is to operate the firm and to manage the assets for the firm and its stockholders. However, the agent would also be empowered to act in the best interests of the firm by wiping out common stockholders in bankruptcy and continuing the firm. The board should not be *required* to fulfill its *Revlon* duty to allow the preferred to bid in an auction (even where the preferred might have the highest bid) if the preferred plan to gain control and liquidate the company.²⁰⁹ If the courts were to interpret *Revlon* to require the board to favor the preferred, it would be contravening the most basic duty of the board to

202. *Id.* at 1042.

203. *See* *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593-94 (Del. Ch. 1986).

204. *Equity-Linked*, 705 A.2d at 1042.

205. *Id.*

206. *Id.* at 1042-43.

207. *Id.* at 1053-55 (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)).

208. *Id.* at 1056.

209. *See id.* at 1059.

operate the firm to maximize the return stream that will be available to various classes of investors over the long term.

The court analyzed the board's decision by determining whether the board owed a duty to preferred claimants and what that duty consisted of. The court then analyzed whether there was a breach under two different standards of review. It first analyzed the board's approval of the loan transaction using ordinary business judgment rule scrutiny.²¹⁰ Under that general standard, which is applicable to the board's approval of all transactions, the court found:

[The board] did not, therefore, breach a fiduciary duty owed to the corporation or any of its equity security holders. . . . [Since] the board was independent[,] it was motivated throughout by a good faith attempt to maximize long-term corporate value[,] and . . . the board and senior management were appropriately informed of alternatives available to implement the business plan that the directors sought to achieve.²¹¹

Next, the court recognized the plaintiff's central argument that the board had special augmented duties since there was a change in control. Once conceptualized in that way, *Revlon* duties apply to the board and impose a duty to "search for the best deal."²¹² The court then faced whether a different, more stringent standard applied to the board,

210. The standard of review in stockholder litigation is deferential to the directors. To violate their duty of care to stockholders, directors must act in violation of the standard of review, which is the business judgment rule. "The business judgment rule . . . is a presumption that 'in making a business decision the directors of a corporation acted on an informed basis, . . . and in the honest belief that the action taken was in the best interests of the company [and its shareholders].'" *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746-47 (Del. Ch. 2005) (alteration in original) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)), *aff'd*, 906 A.2d 27 (Del. 2006). The rationale for the business judgment rule is the reason for a deferential reason of care, that "directors are not liable for losses due to imprudence or honest errors of judgment." *COX & HAZEN*, *supra* note 180, at 482-83. The fiduciary duty of care can be likened to the corporate waste standard in stockholder litigation. In Delaware, corporate waste is akin to bad faith. *See Disney*, 907 A.2d at 749. "In other words, waste is a rare, 'unconscionable case[] where directors irrationally squander or give away corporate assets.'" *Id.* (alteration in original) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)). The deferential standard of review for directors in the duty of care context is easily distinguished from the entire fairness standard applied in the duty of loyalty context. The duty of loyalty requires that directors use their position of trust to further the corporation's best interests, and not any of the directors' private interests. *Id.* at 751. In conclusion, the duty of care standard of review is much less deferential to directors in the duty of loyalty context than it is with the business judgment rule and waste standard.

211. *Equity-Linked*, 705 A.2d at 1053.

212. *Id.* at 1043.

which depended on whether the *Revlon* duty applied because it was a change of control case. *Revlon* imposes a duty to search for the best deal, which means that when choosing between two all cash offers, the board cannot fulfill its duties if it chooses the lower cash offer. The court found that the board had fulfilled its duty. The court found that even if the more stringent standard of review applied, the board's approval of the loan satisfied the board's duty "to reasonably attempt to advance the current interests (or value) of the holders of the corporation's equity securities."²¹³

The preferred sought a court-ordered auction at which the preferred would bid. They argued that "the board's failure to afford the preferred stock an opportunity to meet or exceed the Aries proposal" meant that "the board failed reasonably to maximize the current value of the firm's equity."²¹⁴

However, in *Equity-Linked*, the board was not deciding between two cash offers. Had the board pursued the preferred offer in an auction, it may have outbid Aries. However, the court determined that the "preferred's aim might be simply to liquidate the company and take all of the net proceeds and apply it to its preference."²¹⁵ Thus the board was weighing the value offered by the Aries deal, which included the value of being able to pursue its technologies, which would permit the company to continue with Aries owning all common stock so that "its economic incentives [were] more aligned"²¹⁶ with the board's long-term vision for the company than the preferred's own offer. The board—as agent—must be able to determine whether the preferred bidding in an auction for the distressed firm would not be in the long-term interests of the firm, especially when their only interest was in liquidating the firm and receiving their preference. In evaluating these offers, the court held, the board met its enhanced duties triggered by the change of control under *Revlon* "to have the single aim of maximizing the present value of the firm's equity."²¹⁷

Some have attacked the decision refusing to find that a fiduciary duty required the board to order the auction requested by the preferred as an "ambush" on the preferred and as a decision that "casts the board as a bully."²¹⁸ Critics find there is oppression of the preferred and that *Equity-Linked* stands for the proposition that "the board may even have

213. *Id.* at 1056, 1058.

214. *Id.* at 1056.

215. *Id.* at 1057–58.

216. *Id.* at 1058.

217. *Id.*

218. *See, e.g.,* Walther, *supra* note 80, at 190.

a *fiduciary duty* to siphon value from the preferred when the opportunity arises.”²¹⁹ Others, such as Chancellor Strine, think denial of the injunction against the loan makes sense since “the board owes no fiduciary duty to maximize the value of the preferred or to favor . . . the preferred over the common, except when contractually required.”²²⁰

The holding of *Equity-Linked* is that there is no fiduciary duty to favor the preferred as preferred and that when “push comes to shove,”²²¹ the board has a duty to favor the common over the preferred when exercising discretionary judgment. This makes sense under the principal-agent, cost-minimizing, and value-maximizing frameworks for the firm analysis articulated here. Under the principal-agent framework, the preferred and common both furnish resources to an agent who is going to act to further the interests of the firm. The agent makes the necessary tradeoffs between present and future value, acquiring options on future investment opportunities, investing in new projects, and deciding between actions on the contract curve that are not wealth-sacrificing. The risk-return profile of the decisions, however, is different and may affect different classes of claimants differently. Under this framework, the preferred are not able to argue that there is a duty to favor the preferred as preferred beyond the duty owed to all equity stockholders. The general linguistic gloss in the case law urging the board to favor the common goes back to the duty of the agent to foster the long-term value maximization of the firm, since the interest of the common stock is generally more aligned with that goal.

Under this principal-agent model, it would be strange if the *Equity-Linked* court decided that the board’s duty included favoring the preferred over the common without taking account of the effect on the *firm* of favoring the preferred over the common. The duty is to favor the common over the preferred generally because, given the risk-return profile of the common, that strategy is thought to favor the long-term growth of the firm. But that duty to favor the common is not without limits and must be read against the background of the board’s duty to the firm. Thus, contrary to Professor Walther’s suggestion, this Article rejects reading *Equity-Linked* to sanction an invariable principle warranting the siphoning of value from the preferred to the common. That reading of *Equity-Linked* would violate the agent’s duty to the firm and thus would not pass muster.

219. *Id.* at 164 (emphasis added).

220. Strine, *supra* note 78, at 2028.

221. Korsmo, *supra* note 7, at 1176 (“When push comes to shove, any preference granted to the preferred stockholders must necessarily come at the expense of the common stockholders.”).

Alternatively, if the board were under a duty to sabotage the preferred from day one (as Professor Walther alleges *Equity-Linked* does) to subtract value from the preferred in favor of wealth transfers to the common, would that pass muster? Would the duty to favor the common mean that the board must carefully scrutinize the contract terms of the preferred and use various techniques like subsidiary mergers²²² to reduce the power of the preferred?²²³ Although critics suggest that the board is incentivized by *Equity-Linked* to “siphon” off value from the preferred, in fact the board’s fiduciary duty is to manage assets to maximize the value of the firm. In most cases, this duty will mean favoring the common over the preferred. But presumably it would be a violation of the board’s duty to siphon off value from the preferred from day one, regardless of whether that wealth transfer was in the interest of the firm. For similar reasons, it would be a violation of the board’s fiduciary duty if it decided that it would never act against the common, even if it were in the best interests of the firm. For that reason, we assume it would be a violation to conclude that the board must elect to sabotage the preferred if there is any chance of helping the common. Sabotaging the preferred is only allowed if it is in the best long-term interest of the firm.

Conducting the firm’s business always to sabotage the preferred would deprive management of the ability to perform certain actions, such as effectuating an out-of-court restructuring to dilute the existing common shareholders and replace them with new common shareholders, even when doing so would be in the best interests of the firm. It should not be harder for the board to manage the corporation so it can survive as an entity. Were the board to act in that manner and engage in any action to disfavor the preferred and to favor the common, the board would be violating its fiduciary duty to manage the resources of the claimants for the best interests of the firm. Moreover, depriving the board of the discretion to take actions in the interests of the firm, even when claimants are adversely affected, would be wealth-destroying rather than wealth-enhancing. The agent is being hired to exercise its business judgment, not to favor one class of claimants regardless of the effects on the firm. Moreover, the costs of interpreting fiduciary duty to allow the board always to act to disfavor the preferred and to favor the common is a rule that would not be preferred by common stockholders, since it might make it harder to get financing

222. See generally David Feirstein, *Parents and Subsidiaries in Delaware: A Dysfunctional Standard*, 2 N.Y.U. J.L. & BUS. 479, 481–87 (2006).

223. Another technique would be to use its power to refuse to grant the preferred concessions in the express terms designed to prevent such wealth transfers.

from banks and from preferred stock. Moreover, banks and debtholders, as well as many preferred stockholders, would not prefer an interpretation of fiduciary duty that mandates wealth transfers to common, as it would wipe out the firm's value.

The critics who see *Equity-Linked* as an abuse of preferred stockholders²²⁴ seem to remove the conflict from the principal-agent context in which the agent is tasked with the operation of the firm. The agent must be able to wipe out the common if it is in the firm's best interests or similarly be able to take actions that hurt the preferred if that is in the firm's best interests.

Viewing *Equity-Linked* through the principal-agent lens helps one to understand why the case's outcome makes sense. It also helps to rule out the more extreme readings of what conduct would be allowable under the court's holding. Contrary to Walther's suggestion, the decision cannot be read as requiring the board to siphon value from the preferred "when the opportunity arises."²²⁵

This Article's analysis also helps to make sense of the case. The court holding can be read as a decision which refuses to impose an additional fiduciary duty on the board to favor the preferred at the point in time they want to exit. But since the preferred could easily have negotiated for a provision that would have forced liquidation in such circumstances, there do not seem to be compelling reasons to adopt it, especially since that adoption would have a negative effect on the other securities of the issuer that would be subject to this additional non-bargained-for protection, thereby making the costs of adoption greater than its benefits.

V. NON-VC CASES WHERE OBSTACLES TO BARGAINING ARE FORMIDABLE: A DIFFERENT APPROACH FOR PREFERRED STOCKHOLDERS

There are other situations outside the VC context where the barriers to negotiating contractual protections for the preferred are much more substantial. Therefore, the general rule that preferred stockholders must depend exclusively on negotiated contractual protections seems problematic, especially where the shares are not publicly traded. Preferred stockholders in the VC context can presumably bargain for all the protections they want, and they are compensated for any additional risk by the lower market price or higher dividends even if they do not have contractual protections.²²⁶

224. See Bratton & Wachter, *supra* note 2, at 1820, 1851.

225. Walther, *supra* note 80, at 164.

226. Strine, *supra* note 78, at 2028.

Preferred stock is often issued where the holders have no direct bargaining power and there is no underwriter massaging the terms on their behalf.²²⁷ The legal adjudicator must recognize that the barriers to self-protection through contractual provisions may be significantly greater than if the preferred shares were issued to a sophisticated counterparty in a VC financing or financing preferred arrangement.

These other settings in which preferred stock is issued suggest that an adjudicator should analyze the legal intervention differently depending on the particular context of the preferred stock. Even with a lack of clout or no direct negotiation and no underwriter, legal intervention for the preferred may not be efficient. If there are sophisticated buyers and publicly traded preferred shares, then even without the power to negotiate contractual protections, the market price can correctly value the weaknesses of the particular express terms. In such cases, the market price discount will achieve the ultimacy of maximizing the gains from exchange. What the preferred give up in express contractually negotiated provisions because they lack bargaining power will be compensated for in the exchange by a lower price for the shares.

In other instances, there might not be publicly traded preferred shares. If the preferred do not have the opportunity to negotiate directly and there is no market trading price accounting for weaknesses in contractual protections because the stock is not publicly traded, then the intervention analysis would be different.

For example, imagine that a father owns a company. The parents have four daughters. Two daughters follow Dad into the business while two daughters start different careers. Dad sets up his estate plan to give the two daughters in the company common stock and the two other daughters preferred stock, giving them a stream of dividends and providing for mandatory redemption/buyout terms, and he thinks that the daughters with preferred stock are protected. Then Dad dies and the common stock gives two daughters absolute control. They enrich themselves through inflated salaries and spin off of assets to themselves, which Dad did not adequately guard against with express contract terms for the preferred.

This scenario raises the question of whether the daughters, who hold preferred shares, should have any claims against the daughters holding common stock, and under what legal theory. For example, should the daughters with preferred get any additional protections beyond the negotiated contract terms of the preferred stock and beyond

227. Interview with M&A Lawyer, *supra* note 20.

the fiduciary duties owed to all stockholders? Or are they limited to what the contract provides?²²⁸

Whether the law should intervene to supply an additional fiduciary duty to the preferred as preferred in the case to protect the daughters holding preferred stock should depend on whether this type of law-supplied rule would maximize welfare. That depends on whether the particular suggested intervention—expanding the performance obligation to create protection for the preferred as preferred—would achieve the ultimacy of maximizing gains without negative offsetting effects. If the daughters with preferred demonstrate that the daughters with common stock have control and used it to deplete the company's assets, that may constitute a waste of assets and the daughters with preferred would be able to recover under the fiduciary duty owed to all stockholders, including preferred under *Jedwab*, and intervention to create additional fiduciary protection might not be needed. Similarly, if the daughters with preferred can protect themselves through the implied covenant of fair dealing applicable to all contracts, the costs of the law intervening with a special protective fiduciary duty may not be efficient.

To determine if the law should imply a fiduciary protection provision for the preferred stockholder daughters, one needs to ask whether the imposition of this additional duty, *not bargained for*, would cause harm to the remaining common stockholders. If so, it would not be value-maximizing. In cases involving sophisticated investors who bought and negotiated claims that met their risk/return profile, adding fiduciary protection *ex post* would change the risk/return value for the future returns of the common stockholders in ways that could not be anticipated,²²⁹ saddling them with the additional burden of the fiduciary duty for the preferred. This would give the preferred more protection than they actually paid for and ensure them a higher return than the risk/profile associated with their purchase of preferred stock.

These projected costs to the common stockholder are a negative effect of adding a fiduciary protection for the preferred. It seems less compelling or nonexistent where the stock is created as part of an estate

228. The normal rule applicable to preferred shares relegates the preferred to their contractual rights unless the preferred can demonstrate a violation of a duty owed to all stockholders. See *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

229. See Coffey, *Firm Opportunities*, *supra* note 21, at 160 n.19. The hit to the common from additional protection to the preferred would be unanticipated because the essential nature of the preferred investment is that all protections must be contractually negotiated or they will not be recognized.

plan and the children are being *given* stock.²³⁰ The argument that adding fiduciary protection will cause a hit to a class of stockholder, such as the common stockholder, who purchased on the assumption that the preferred would be afforded no protection beyond the contractual terms, seems less compelling, since in the case of a gift to the common they did not negotiate the terms of their investment. Even where the insider pays for the common stock, it is really a gift,²³¹ though structured differently for tax reasons, and not a third-party negotiated transaction. And since the common stock insiders did not invest dollars, it is hard to posit a hit to their investment by a change in the risk/return for the common from implying a duty on the part of the board to the preferred stockholders. Moreover, in such cases, adding additional fiduciary protection for a class of preferred from the board might be welfare-maximizing because: (1) it might disincentivize common stockholders from depleting the assets of the company; (2) it might disincentivize them from acting opportunistically; (3) doing so would not result in a hit to an investment purchased on a certain risk/return profile or assumptions about the limits of protection for the preferred; and (4) the common stock insiders might anticipate that family members would owe extra obligations to other family members so that even if the common stockholders paid for the stock, they presumably paid for the stock with the anticipation that they would not be able to enrich themselves through inflated salaries and spin off of assets to themselves to the detriment of their family members (sisters) holding preferred stock. The fourth point reinforces the concept that “[s]hifts of wealth . . . in favor of” one class of claimants can occur only where the parties “do not perfectly anticipate future wealth-shifting probabilities.”²³² Where the common stockholder can anticipate that a court would police against this and protect preferred stockholders in the family setting, the wealth-shifting would be anticipated and priced into the investment. Thus, there would be no loss in wealth from a rule protecting the preferred through a good faith obligation.

Another case in which the ordinary rule relegating preferred to their contractual protections and denying all fiduciary protection to the preferred should be questioned occurs in the public preferred stock context. Once the initial stock is sold and then resold, there is no opportunity for the subsequent purchasers of preferred stock to

230. A different calculus would obtain where the insider paid to acquire stock from the parent/owners.

231. It might be structured differently for tax reasons. See Dwight Drake, *Transitioning the Family Business*, 83 WASH. L. REV. 123, 132 (2008).

232. Coffey, *Firm Opportunities*, *supra* note 21, at 173.

negotiate any contractual protections.²³³ The company may have normal *public finance* preferred stock terms from a deal in which a “blue chip” placement agent found more than fifty large institutional purchasers; the debentures were subsequently registered for public resale and have been resold into both bond mutual funds and to individuals of unknown sophistication or wealth. Thus, it may not make sense for those holders to rely on the contract protections negotiated at the initial sale, particularly in cases where the market might not signal the lack of protection through a discount.

This case is illustrated by a company investing in a new line of products. For example, as a direct result of the normal business operations seeking to improve product performance, the management team discovers a concept for a potential new product line of Wowies, a small device that tracks the location of the company’s products geographically (where on Earth) and spatially (how high off the earth)²³⁴ and monitors the efficiency of the products in use. Wowies, if affixed to all of the company’s products, would allow the company to track the usage of their products throughout their life cycle, allowing the company to better service the customers by recommending repairs, maintenance, and, ultimately, replacement. And the firm sees value-maximizing potential, since it could enable the company to sell its products for increased prices. Wowies would also be useful to many other manufacturers. There would be no more guesswork about how customers are using or abusing products like airplanes, trains, buses, trucks, and automobiles. If first to the market, the company could transform its business from industrial manufacturing to information technology.

Development of Wowies is clearly outside the primary skillset of the company’s managers, and although the company’s research engineers include folks who can initiate the Wowie development, they must be supplemented by new specialists. It is also going to be hugely expensive. It will, however, drain the company’s cash resources to a degree that could threaten the company’s ongoing business flexibility, reduce the amount of dollars available for research and development of its aerospace parts, and could, in the worst case, threaten its survival in a cyclical downturn. The charter provides, as normal, that the corporation may engage in any lawful act or activity that corporations may be formed for. There are no specific covenants in the preferred

233. Even preferred stock issued by large private companies can resemble these characteristics of public preferred stock.

234. *Mobile Asset Tracking System and Method*, GOOGLE PATENTS (July 17, 2012), <https://www.google.com/patents/US8223009>.

stock terms covering changes in business model. The preferred has a liquidation preference over the common stock, as well as various rights of redemption and class voting rights, none of which are triggered by a change in the business model²³⁵ (one potential basis for a class vote is eliminated because the company's "purpose clause" is broad enough to preclude the need to amend the charter).

So far, this example illustrates a potential risk to the company from entering a new venture with little background and a largely uncertain payoff. The company has a few large common shareholders who control the company's voting power and the board. There are several independent directors, people who have social relationships with management and/or the large shareholders, but also some who were found through normal director search mechanisms in advance of a possible IPO.

The corporation has issued a \$10,000,000 liquidation preference of preferred stock and has \$10,010,000 in net assets, sufficient to pay off the preferred in liquidation and leaving \$10,000 for the common. Further, imagine Carl Icahn has bought common stock for \$10,000 as an option on a corporate recovery.

The controlling common shareholders look at the business opportunity and decide that it is worth taking. The board decides that the risk/reward of throwing money at the new idea justifies spending ninety percent of the company's profits on the new venture, instead of stockpiling half of those monies to cover business downturns, because the business move is the only way to create value for the common and for the firm, even though it risks the preferred's recovery. If successful, they may have a new Google, and in the worst case they lose and the company goes bankrupt. But the company thinks it is more likely to suffer some hard times during the next (inevitable) business downturn. The company has a virtually zero chance of bankruptcy absent this decision; it has a dominant, near monopoly on a key industrial component, and it has a strong track record of incremental growth over seventy-five years. The role of the board is to identify opportunities that will provide long-term growth through investment in new ventures but also to be prudent and avoid taking gambles that will bankrupt the company.

A few years later, the company goes bankrupt because of the sudden advent of an adverse business cycle. The company is unable to meet its debt obligations as they are due (its refinancing sources dried

235. If this were an early stage venture capital scenario, there is virtually zero chance that the preferred stock would not have specific protection against changes in the business model.

up, and its cash reserves had been sunk into the development of Wowies, which have not yet paid off). There are sufficient assets to pay off the company's debt, but the preferred gets nothing. *Can the preferred sue the board for breach of fiduciary duty?*

This type of fact pattern raises a horizontal conflict between the preferred and the common.²³⁶ The ordinary view is that there is no special duty to the preferred and that the preferred have to depend on their contractual protections or price downward for greater risk. But where the ability to build in contractual protections is not realistic, one begins to question whether the principle of common value maximizing is best for the firm. This may be the precise case where no rational investor would view the investment in a positive way and would view any investment in such a new venture as reckless. Only when looked at exclusively from the perspective of the common does the investment appear rational, especially when the chances of success are very low and may precipitate the firm's bankruptcy.

In this kind of case it is difficult to put a real value on proceeding with the investment for the firm. There is no track record. There is great uncertainty as to whether another entrepreneur will beat the firm and invent its own version of Wowies. So valuation in such cases is a matter of guesswork. Of course, the firm could get a valuation done, but it may not be accurate or realistic. Here, the company is proposing to invest its own money so its valuation is not likely to be nearly as accurate as when someone proposes to invest newly in such a venture.

In such a case, contract protections are not realistic because of the lack of a real opportunity to negotiate for terms and because the market's inability to account for the risk may be non-existent due to the stock being held in a mutual fund, where the lack of protective terms may not be salient enough to affect the price. More importantly, as discussed earlier, the stock price may not reflect the lack of protection for the preferred stockholder for an important reason: the preferred stockholder may fail to discount the price paid for the stock. Even though the stock agreement might lack protections, the preferred stockholder has other protections. Thus he will only fund in stages,²³⁷ and the lack of contract protection will not cause the initial purchaser to discount the price, causing the later purchaser to buy at a price that

236. It may seem like an unlikely scenario since a large established company would seem to have other avenues for raising the necessary dollars other than through issuing preferred stock. Normally, such an established company could borrow money through a bank loan. However, the bank may be reluctant to lend when the business model changes, thus necessitating the resort to preferred stock.

237. See generally Gompers, *supra* note 99 (discussing staged financing as a protective device for venture capital).

does not fully reflect the lack of protection. Moreover, even if the initial agreement contains protections and the preferred stockholder pays a price to reflect those protections, they may be negotiated in a side deal between the VC preferred stockholder and the founders, or between a company and a preferred share investor in a side deal whose terms do not find their way into the express terms of the preferred. So the VCs agree to certain terms (voting power, dividends, conversion, liquidation, etc.) that will live on always and forever, and these are in the amendment to the articles of incorporation or certificate of designation (in Delaware), and can only be later changed with the requisite shareholder vote and also may require board approval if that is a state law requirement.

Shareholder agreements, however, routinely provide for additional terms between the contracting parties.²³⁸ These could include registration rights, for example, requiring the issuer to file a registration statement with the SEC. But others may include negative covenants or even positive covenants affecting the makeup of the board, or rights of first refusal, or other rights personal to the VCs. Some of these rights may be transferable, but others may not be except by operation of law (merger, for example).²³⁹ These shareholder agreements will not transfer to subsequent purchasers of the preferred stock.

This means that the price of the securities should be higher to reflect less risk due to protections such as staged financing or contractual protections that sophisticated market participants have that other subsequent buyers will not have.

With subsequent purchasers who lack the original protections that the VCs have, one needs to determine whether the lack of protections

238. One might ask: why not put these terms into the charter? Because they are often complex and are usually viewed as personal to the party demanding them, not something that any and all unknown strangers should be given. Here is an example of a clause in a Stock Purchase Agreement that would keep the benefit of the protection personal as between the original contracting parties:

This STOCK PURCHASE AGREEMENT, dated as of November 23, 2015, (this "Agreement"), is made and entered into by and among Pro Star Freight Systems Inc. and Pro Star Truck Center Inc. (collectively, the "Company")

. . . .
... Third Party Beneficiaries. This Agreement is solely for the benefit of the parties hereto and no provision of this Agreement shall be deemed to confer upon third parties, either express or implied, any remedy, claim, liability, reimbursement, cause of action or other right.

Stock Purchase Agreement by HydroPhi Technologies Group, Inc., LAW INSIDER: CONT. DATABASE & SEARCH ENGINE (Nov. 24, 2015), <https://www.lawinsider.com/contracts/3FLslY8Mw2rC06kvVGed8z/hydrophi-technologies-group-inc/new-york/2015-11-24>.

239. Interview with M&A Lawyer, *supra* note 20.

will be priced into the securities of subsequent purchasers. It will be lower than the price paid by the original purchasers. If the market is pricing in the lack of such protections, then arguably there is no need for fiduciary protections for the subsequent purchasers as they will pay a discounted price. This would be true under the efficient capital market hypothesis, under which the pricing of a security reflects “all available information about the security.”²⁴⁰

If there is a well-developed and thick market for preferred shares, and if all subsequent purchasers will lack the original protections, then the market price to those purchasers should reflect the lack of such protections.

However, the disciplining and market pricing effects may be attenuated for two reasons. First, the market for preferred stock may be harder to price and not as efficient as the market for common stock.²⁴¹ If that is the case, and if the market pricing is less efficient, then there may be a greater need for a fiduciary protection for the subsequent purchasers of preferred stock.

Even if market pricing of the stock for subsequent purchasers of preferred stock is accurate, if everyone involved would still want a limited fiduciary obligation of the kind suggested in this Article, there might be reason to adopt it as a majority preferred default rule. The initial VC entrepreneurs would conceivably lower their cost of capital if people would pay more for preferred stock with a limited fiduciary protection. Preferred investors would presumably like the protection against expropriation.

However, to justify an implied term of limited fiduciary protection suggested here, one must ask: why do issuers not include the protections voluntarily? If such limited fiduciary protections would add value, presumably investors would be willing to pay for them and companies that did not offer them would be at a competitive disadvantage and would have a higher cost of capital. The answer is that the initial holders of preferred stock (the VCs) have other protections that render fiduciary duty protection superfluous. So, the initial VCs and issuers will not include them, and if subsequent purchasers trade in a relatively inefficient market where the price

240. Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1606–07 (2017); see also Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383, 388 (1970).

241. See Don Wenk, *Valuation Issues with Respect to Preferred Stock*, KOTZIN VALUATION PARTNERS (Oct. 2006), <https://www.kotzinvaluation.com/articles/preferred-stock>.

signals are attenuated and do not accurately reflect the lack of protections, limited fiduciary protection might be justified.

Another issue that might impact the accurate pricing of the lack of fiduciary protections for subsequent purchasers is the costliness of getting that information to the market. As Professors Gilson and Kraakman have argued, “information costs determine how widely particular information is distributed in a market, and therefore the relative efficiency of the market mechanism that incorporates it into price.”²⁴² In the case of a company that issues initial stock to large institutional investors and then registers those securities for public resale, or when stock initially sold to VCs is then later resold to later purchasers, the fundamental question is whether the market will take account of the lack of fiduciary protection as an element of the pricing at the resale point. Initially, the institutional investors or VCs have other means of protecting themselves that cause them not to discount the stock for lack of any fiduciary protection. But when the securities are resold, the market would have to focus on the lack of fiduciary protection as a new piece of information justifying a repricing of the securities. However, since the ordinary rule is a lack of any fiduciary protection for preferred, the market may fail to price that, even though the fact that the public investors are buying the stock without other protective devices such as staged financing may make the lack of such fiduciary protection a more important factor. However, it may remain non-salient due to its background as the ordinary rule which denies fiduciary protection to preferred. In addition, the market would have to account for the fact that the protective provisions that extended to the initial purchasers are no longer available to the public investors. The market may have difficulty pricing the fall-off or absence of initial protections which make the absence of fiduciary protection more critical.

A key argument that supports the imposition of a limited fiduciary duty in the particular context of publicly traded preferred shares goes back to Professors Merrill and Smith. They argue that when information costs are too great, there are great reasons to adopt standardization and limit individually crafted terms. At other times, when the information costs are lower, the benefits of customization may outweigh the benefits of standardization. They argue “that the *numerus clausus* [limiting the creation of new property rights] strikes a rough

242. Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L. REV. 313, 330 (2014).

balance between²⁴³ the effort “to minimize the sum of measurement (and error) costs, frustration costs, and administrative costs.”²⁴⁴ Courts will be drawn to recast new interests as “one of the recognized forms.”²⁴⁵ Courts hesitate to recognize new property rights and embrace standardization due to the information costs that courts “must expend . . . to determine the attributes of these rights.”²⁴⁶ Standardization saves on these information costs.

These information costs similarly can help explain why standardization in the form of a limited fiduciary duty may make sense, since the benefits of customization and individually crafted protections would be outweighed by information costs. The information costs are those identified earlier, namely the costs of the subsequent purchasers and third parties of determining that the lack of fiduciary protection is a new piece of information justifying a repricing of the securities given the absence of transferable customized protections, such as staged financing, that are not available to the subsequent purchasers. On the other hand, when sophisticated VCs are involved, the benefits of customization will outweigh the costs of information, so it will make sense to restrict the original VC purchasers of preferred stock to their contracts.

Thus it might make sense to create a limited fiduciary duty to protect against (1) intentional destruction of the value for the preferred, and (2) reckless investment. As one colleague pointed out, my proposal applies a deferential duty of care standard to a specific species of duty of loyalty context: where the board’s self-interest problems are not necessarily as acute as in other duty of loyalty contexts where the directors are alleged to be favoring themselves. Thus, the stringent intrinsic fairness standard that would normally apply seems inapt.²⁴⁷ Implying such limited fiduciary obligations would create value by discouraging reckless investment behavior. Such a limited right would not decrease the value of the firm or add to transaction costs. It would not put the board in the position of balancing the interests of the stockholders in a way that might lead to a standstill or discourage prudent risk-taking by agents. The fiduciary obligations would simply

243. Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1, 38–40 (2000).

244. *Id.* at 38.

245. *Id.* at 3.

246. *Id.* at 8.

247. There may be some overlap with the idea of a conflict of interest, that of a common controlled board favoring the common stockholders over the preferred stockholders, but only when it is in the best interests of the firm, not simply in favor of the common stockholder interest.

rule out investments that would be considered grossly irrational unless they are evaluated solely from the perspective of the common stockholder who has already lost the bet on the company. One could look to other contexts such as insurance companies, which are limited to legal investments,²⁴⁸ as a standard by which to judge whether the investment was grossly irrational.

Why imply such an obligation? First, the parties may not be able to contract on a solution to reckless action by the board, as explained below; the contracting difficulties are just too great. Second, the parties who buy preferred stock subsequently in mutual funds had no opportunity to bargain for contractual protection against a change in business, and other types of contractual protections, such as a right to a put²⁴⁹ whenever the preferred wants to exit, would not be enforceable. Even if there were an opportunity to bargain, unsophisticated parties might assume that a specific contractual protection would be unnecessary. They might assume that boards constrained to act for the firm could not act recklessly and thus would not include a provision. Third, the alternative protection of buying at a discount may not work because the unsophisticated buyer would not know how to assess the risk of the lack of fiduciary protection against waste and reckless investment, and thus the market would not price the risk accurately. Finally, for the reasons discussed earlier, the pricing signals may be attenuated, and thus one cannot depend on market pricing to give the subsequent purchaser an accurate signal of the true value of the stock given its lack of contractual protections.

The counterargument to implying a fiduciary duty is that once a fiduciary duty is imposed *ex post*, the other claimant, the common stock, is saddled with a new and unanticipated obligation.²⁵⁰ That adds costs and thus implying the obligation would not necessarily result in lower total costs. Here, if there is a broad obligation to refrain from acting recklessly against the preferred in a limited set of contexts where the preferred could not contractually protect themselves, would there be a reaction by the common to immediately recontract around the result

248. *See, e.g.*, OHIO REV. CODE ANN. § 3907.14 (LexisNexis 2018).

249. The owner of a put option has the right to sell an underlying security at a specified price within a specified timeframe, and often to a specified buyer. *See* IAN AYRES, *OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS* 15 (2005) (discussing origin of put options).

250. It would be unanticipated under the general rule that the only duties to the preferred are to honor the terms of the contractual agreement with the preferred and the duty owed to all stockholders (enforceable through a derivative action) to refrain from wasting corporate assets or to engage in self-dealing.

and to include language in future deals to expressly allow the board to act recklessly against the preferred?

In order to determine the recontracting costs, one must focus on the two junction points at which parties buy preferred stock and the role of the common stockholders. At the initial purchase, the common stockholder would buy the common stock on the expectation that the board could act recklessly against the preferred and that the preferred would have bought on that assumption and paid a discounted price to reflect that lack of fiduciary protection. However, the unsophisticated investor buying preferred stock has no ability to contract over such matters, and the buyer of public preferred stock may not know enough to deal with the risk of the lack of fiduciary protection. The public buyers of such preferred stock know that they do not know enough. Thus, the underwriters will have to knock the price down even further to cause them to buy such stock. Therefore, imposing a restraint against such behavior would not depress the value of the firm or add to recontracting costs. Moreover, there is reason to believe that had the unsophisticated buyers of preferred stock been able to bargain for an implied obligation against reckless action against the preferred, they would have done so or would have decided not to purchase, or they would have paid a highly discounted price.

Moreover, as pointed out earlier, the lack of protection against waste might not be priced into the stock initially, especially where the preferred stockholders have other protections such as staged financing. This may make the pricing of the stock inaccurate as the preferred stockholder will ignore the lack of protection against waste due to other non-contractual devices for protection.

If the price does not accurately reflect the risk the subsequent preferred is taking, and there is no implied fiduciary protection of any kind, then the preferred must depend on the contract. However, as outlined below, there are reasons to question whether a contract solution makes sense. One reason for questioning the contract solution to the situation of directors favoring the common by pursuing a reckless option is that the party (the corporation) in certain public preferred contracts with the preferred holders (through selling the shares) is *not* the perpetrator or beneficiary of the "wrongful behavior" if there is any. The "wrongdoers" are the directors, and the beneficiaries of the "wrongdoing" are the common holders. But neither the common holders nor the directors are in privity with the preferred shareholders. So there is a contract attempting to limit "wrongful" behavior by people (the directors) that the entity does not control (indeed, it is the one controlled by the wrongdoers and their beneficiaries). The alternative suggestion for a contract solution in which the preferred can require the

directors and common holders to sign on as guarantors would not occur in the public corporate finance setting.²⁵¹

Contract solutions are also problematic because the “wrongful” action by the directors may be irreversible, and the negative impact on the preferred may result in the destruction of the entity’s entire value so that payment of damages by the entity to restore the status quo ante is impossible. And if the Hail Mary investment fails, the common will not actually receive any benefits, so there is nothing to recoup from them even if a viable cause of action could be found (if the Hail Mary succeeded, there would be no complaint by the preferred since the assets were not lost). And absent finding a fiduciary duty owed to the preferred, there is no direct claim against the directors.

Although there is no special “self-dealing” other than benefitting common shareholders in general, the board recognizes that the preferred shares are taking the same risk as the common (buffered to a small degree by the value of the common), but will receive no direct reward for the new venture. And although the preferred took that risk when they bought stock without the upside that the common would have, they risk that the agent will act to benefit the common at their expense. This risk of adverse action is magnified when the ability to negotiate contractual protections is assumed not to be possible.

Perhaps the only solution to this situation might be to imply a fiduciary duty to the preferred. This duty would protect the preferred against reckless behavior by the board. It would be harder to argue on these facts that the preferred should be relegated solely to contract protections, because many preferred bought after the initial issuance and the opportunity to negotiate for protection against reckless behavior would be nonexistent. Even if one argues that the preferred who bought subsequently should discount the price to reflect the absence of protection against reckless behavior, the preferred would not have thought there was a need to discount the purchase price for the stock; unsophisticated purchasers might assume that the board is constrained from reckless behavior, and therefore they might pay a price premised on non-reckless behavior by the board or, knowing that they do not know enough, would be reluctant to buy until the price was knocked down even below the price that reflects the lack of fiduciary protection against reckless investment.

Finally, implying a limited fiduciary duty against reckless action (such that no reasonable investor would take looking at the valuation question for the firm in an objective fashion and not solely from the

251. Interview with M&A Lawyer, *supra* note 20.

perspective of the common) would incentivize investment. Otherwise, investors in preferred stock who buy in the secondary market with no opportunity to negotiate contractual protections will be wary of investing.

One objection is that this proposal would require judges to make case-by-case determinations as to whether fiduciary review is appropriate. There are normally costs associated with judicial determinations that are contextually based, but in this case the judge would be looking at readily ascertainable factors. The judge would need first to determine whether the stock was issued in the family context where the preferred were family members who lacked the ability to negotiate the terms of an illiquid security. Second, the judge would determine if the purchaser was a subsequent purchaser of preferred stock without any ability to negotiate terms in situations where the initial price might have been inaccurate due to other non-contractual protections that made the preferred stockholder confident in the investment, even without protection against reckless investment.

Would issuers of preferred stock in this narrow group of settings (not the VC context, etc.) react to such a rule by contracting around it because its addition would add to transaction costs or fail to maximize value? It would seem that if the board wishes to retain the ability to pursue investments that would be considered reckless when considered in an objective fashion and would only be considered to have a positive value when considered solely from the perspective of the common stock, the issuer should be bound by a default rule of limited fiduciary protection against reckless investment. Or the issuer should have to opt out and have to disclose to preferred investors who lack bargaining power that the board intends to retain the power to: (1) intentionally destroy the preferred wherever possible and siphon off value from the preferred from the start in order to benefit the common, and (2) retain the right to act recklessly and to pursue investments that would be considered irrational except when viewed from the point of view of the common stock alone. Failure to do so in certain settings would lead to the application of this limited right of fiduciary protection.

Of course, perhaps there is no need for a fiduciary duty to the preferred. This is because action by the board in acting recklessly to pursue a negative valuation opportunity might be grounds for a derivative action.

The suggestion in this Article—that there should be a limited fiduciary protection for the preferred in the narrow settings where the ability of the preferred to bargain for contractual protections is nonexistent—proposes an approach that depends on judges making case-by-case determinations as to whether fiduciary review is

appropriate. Such case-by-case determinations may add to expense since there could be uncertainty engendered by such judicial decisions, and one might consider whether a legislative solution would be feasible as a less costly alternative. However, the entire argument denying protection for preferred is built on the assumption that the preferred can and do arrange either for contractual protections or a variety of other alternative private mechanisms for protection, such as staged financing or board control. What this Article suggests is that context matters, and there are categories of cases outside the VC or other specialty contexts where the barriers to negotiating contractual protections are much more substantial. That determination seems to be one that inevitably demands the fine-grained expertise of courts in assessing the bargaining power of the preferred to negotiate contractual protections and would seem ill-suited to a legislative solution since it would be difficult to identify the context that suggests when a departure from fiduciary protection is warranted.

CONCLUSION

For decades, commentators have debated whether courts should imply protection to the preferred that goes beyond their contractually negotiated protections and beyond the scope of the fiduciary protections owed to all stockholders. This Article argues that the traditional rule limiting preferred to their contractual protections makes sense in certain contexts such as venture capital. An implied protection would not be value-maximizing or cost-minimizing. First, since venture capitalists and certain other preferred stockholders can bargain for contractual protection or arrange alternative private strategies, there is reason to suppose that the lack of protections is an "omission." Second, where an agent such as the board represents multiple constituencies, the agent will take steps from time to time that will advantage one claimant and disadvantage another. So long as the wealth-shifting is anticipated and can be bargained against by the adversely affected claimant, the law should not intervene. Doing so would upset the risk allocation of the parties and would likely add to costs of the exchange.

However, in certain limited contexts the preferred do not have the opportunity to negotiate any of the contract terms, either because it occurs in the context of a gift of preferred stock or in the context of public preferred stock bought subsequent to the initial issuance. These contexts are ones in which we can no longer be certain that the preferred can anticipate or negotiate for protections against wealth-shifting to the common. Moreover, if the extra protection is limited to constraining intentional destruction of the preferred or against reckless

investment, then the benefits of encouraging investment by investors would be chilled by a contrary result. Common stockholders should be bound by such a default rule or opt out and thereby signal that the board will retain the right to intentionally destroy the preferred's value or pursue investments that would be considered irrational except when considered solely from the perspective of the common stockholder. Additionally, because the initial preferred stockholder could protect its interests through staged financing or board control, it might not discount the stock even if it lacked protection, since the other protective devices made the lack of such protections inconsequential. But to subsequent purchasers, the lack of such protections for them of the preferred stock might call for a limited fiduciary duty. Finally, because VCs routinely provide for additional terms in shareholder agreements with founders that are almost never found in the charter documents, those provisions will not be transferable. The initial holders of the preferred stock (the VCs) have other protections that render fiduciary duties superfluous so the initial holders will not pay for these added fiduciary protections. But if the markets for preferred stock are not as efficient as for common stock, or if there are chinks in the efficient capital market hypothesis, then the disciplining effects of the market are weaker. Thus, subsequent buyers of the preferred stock may not price the stock accurately to reflect the lack of transferable protections, providing a justification for a limited fiduciary duty in that context since implying the term would add value.

These may be the cases where maximizing the value of the common will not maximize the value of the firm.