
RESPONSE

POOR PITIFUL OR POTENTLY POWERFUL PREFERRED?

LEO E. STRINE, JR.[†]

In response to William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815 (2013).

Every policy proposal raises two questions. The first is whether there is a problem that requires a solution. The second is whether the proposed solution has more benefits than costs.

Because I am a judge, not a professor, my comments on Professors Bratton and Wachter's thoughtful Article¹ will be questioning rather than conclusory. Bratton and Wachter claim that the law lacks an adequate theory about preferred stockholders.² Specifically, they argue that this is problematic for society because preferred stockholders are deprived of the benefit of their bargain, a result that may imperil society as a whole because it undermines the ability of corporations to raise the capital needed for long-term investment.³

The solution to this problem is for corporate law to impose on directors the duty to protect the bargained-for expectations of preferred stockholders by somehow identifying the extra value—the lagniappe in more savory

[†] Chancellor, Delaware Court of Chancery; Adjunct Professor of Law, University of Pennsylvania Law School; Austin Wakeman Scott Lecturer in Law, Harvard Law School; Senior Fellow, Harvard Program on Corporate Governance; Adjunct Professor of Law, Vanderbilt University School of Law; Henry Crown Fellow, Aspen Institute. The author thanks Ian Nussbaum and Nick Walter for their invaluable help.

¹ William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815 (2013).

² *Id.* at 1817.

³ *See id.* at 1822.

terms—that preferred stockholders should receive over common stockholders. These bargained-for expectations are, interestingly, not in the written contract. Rather, they constitute some noncontractual expectation that should be enforced, not as a matter of contract law, but because preferred stockholders should be seen as some form of specially entitled stockholders who have extra rights that, although not existing in the detailed contracts they negotiate with issuers, should be identified and enforced by courts in equity.⁴ Equally interesting, Professors Bratton and Wachter admit that the extra rights can be and are frequently secured by preferred stockholders in their contracts, but they also contend that it is preferable to have courts enforce them as a matter of judge-made equity law than to require preferred stockholders to secure them in the contracts themselves.⁵ The premise seems to be that after-the-fact litigation presents less of an efficiency drag and fairness problem than requiring preferred stockholders to secure their “preferences” in contract, and otherwise assuming that they will be treated no better and no worse than common stockholders.⁶

Not only that, when preferred stockholders wield control of the corporation, they can cause the sale of the corporation whenever they wish to cash out; even if the corporation is solvent, there are plausible growth scenarios in which the corporation could succeed and the sale will yield no proceeds to the common stockholders.⁷ Put simply, if someone buys preferred stock in an early-stage company that is developing a potentially very valuable but also potentially worthless technology, at a discount to the liquidation preference payable in the event of a merger, and that preferred stock has

⁴ See, e.g., *id.* at 1841; *id.* at 1872-74; *id.* at 1900.

⁵ See, e.g., *id.* at 1835 (“Under the corporate paradigm, the court entertains the fiduciary claim—a decision that requires articulating a standard of review. Under the contract paradigm, the court withholds fiduciary scrutiny on the ground that the preferred could have contracted for protection.”); *id.* at 1839 (“Preferred stock arguably differs [from the common] because its preferences are contracted for and presumably can be protected with explicit provisions.”); *id.* at 1841 (“A penalty default [against the preferred] . . . makes theoretical sense. It does not necessarily follow, however, that it makes cost sense in the real world, even to a common stockholder.”); *id.* at 1847 (“In downside patterns, where the preferred’s market value is below its liquidation value, the holders have a right to liquidation value in a merger only if the charter explicitly so provides.”).

⁶ See, e.g., *id.* at 1858 (asserting that preferred stock contracts “make no business sense” if there is no judicial scrutiny, and suggesting that they be subjected to good faith review, with the burden on the board); *id.* at 1890-91 (rejecting as “superficial” the response that preferred stockholders who are “averse to litigation risk” can protect themselves by drafting their contracts carefully).

⁷ See generally *id.* at 1851, 1883 (criticizing the court’s decisions in *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997), and *In re Trados Inc. Shareholder Litigation*, No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009)).

board control rights, Bratton and Wachter say that the preferred stockholder may cause the corporation to be sold at fair market value, recover its liquidation preference, and leave the common with nothing, even if the company has two years of cash left to pay its bills and all of its common stockholders were sold stock on the basis that the company was a risky startup, steadfastly determined to see if the technology would pan out.⁸ After the purchase of control by a preferred stockholder and the preferred controller's dominance of the board, the only fiduciary duty inquiry is to determine whether the sale was at fair market value—there is no duty to consider the interests of the common in seeing the risk that was the company's touted strategy to hazard actually taken.⁹ So long as there is a market-based sale, the preferred can simply use its control of the board to secure its own desire for immediate payment, as if it were a creditor with a contractual right to demand repayment of its loan.

Having outlined Bratton and Wachter's thesis, I now return to my first question: Is there a problem? As an initial matter, I question whether preferred stock is undertheorized. The prevailing theory is simple: preferred stockholders are *preferred* to the extent that they secure *preferences* (i.e., additional rights that may have economic value) in their contract.¹⁰ To the extent preferred stockholders fail to extract contractual preferences, they are

⁸ See *id.* at 1886.

⁹ See *id.*

¹⁰ Chancellor Allen articulated this idea in *Jedwab v. MGM Grand Hotels, Inc.*:

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

509 A.2d 584, 594 (Del. Ch. 1986). *Jedwab* restates a long-held view of preferred stockholder rights. See, e.g., *Gaskill v. Gladys Belle Oil Co.*, 146 A. 337, 339 (Del. Ch. 1929) ("The holder of preferred stock must therefore refer to the appropriate language of the corporate contract for the ascertainment of his rights. . . . The statute . . . must be taken to mean that unless the preferences are stated in the certificate of incorporation, they shall not exist."). This principle was confirmed by Richard Buxbaum who showed how the drafters of company charters could grant preferred stockholders rights that they would otherwise not have by statute. Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 243-57 (1954) (discussing, for example, how corporate drafters may, by contract, confer dividend rights upon preferred stockholders). The same view still holds true. See, e.g., *Matulich v. Aegis Commc'ns Grp.*, 942 A.2d 596, 600 (Del. 2008) ("[T]he special rights and limitations of preferred stock are created by the corporate charter or a certificate of designation . . . [and] are primarily contractual in nature.").

entitled to no better treatment than other stockholders.¹¹ As preference holders, preferred stockholders are owed the duty the corporation owes to other contractual claimants, which is to honor their *legal* rights. Preferred stockholders are owed fiduciary duties by the board only insofar as they are like other stockholders. Thus, because preferred stockholders, like common stockholders, desire value from the company's performance, they may bring derivative suits if they suspect directors are self-dealing. Similarly, if the corporation is being sold, the preferred may bring a *Revlon* claim if they believe the board is not honoring its duty to maximize the sale value of the corporation.¹² But, the board owes no fiduciary duty to maximize the value of the preferred or to favor in any way the preferred over the common, except when contractually required. In fact, the law suggests that when push comes to shove, the board has a duty to prefer the common's interests, as pure equity holders, over any desire of the preferred for better treatment based on some generalized expectancy that they will receive special treatment beyond their contractual rights.¹³ Indeed, if the preferred stockholders actually secure control of the board, they are then expected to fulfill this fiduciary responsibility and to refrain from using their power selfishly to extract a return of their own investment, unless they do so on terms that are shown to be fair to the common.¹⁴

¹¹ See *Penington v. Commonwealth Hotel Constr. Co.*, 151 A. 228, 234 (Del. Ch. 1930) ("The general rule is that preferred stock enjoys only those preferences which are specifically defined and that as to all matters lying outside the field of defined preferences, preferred stock has no rights which are not shared equally with the common stock."), *modified by* 155 A. 514 (Del. 1931); *Rice & Hutchins, Inc. v. Triplex Shoe Co.*, 147 A. 317, 320 (Del. Ch. 1929) ("The preferred was simply called such; any description of preferences, however, was omitted. The word 'preferred' therefore meant nothing."), *aff'd*, 152 A. 342 (Del. 1930).

¹² See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986) (holding that when a company puts itself up for sale, the "duty of the board . . . change[s] from the preservation of [the company] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit").

¹³ See *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997) (stating that "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock . . . to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict").

¹⁴ See *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653, 658 (Del. Ch. 1975) (declaring that while "one purpose of allowing the preferred to elect a majority of the board may be to bring about a payment of the dividend delinquencies as soon as possible, . . . a preference board . . . in control [must also] . . . serve[] the corporation itself and the common shareholders"); see also *In re Trados Inc. S'holder Litig.*, No. 1512-CC, 2009 WL 2225958, at *5 (Del. Ch. July 24, 2009) (asserting that a "director is interested . . . if 'he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders'" (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993))).

Second, there are reasons to doubt that preferred stockholders lack sufficient market clout to protect their interests at the negotiating table. Preferred stockholders are not obviously the “poor pitiful preferred” that Bratton and Wachter describe. That proposition makes little intuitive sense. No one has to buy preferred stock. Those who do are quite sophisticated. Preferred stock issuances often involve provisions such as: (1) a requirement for a class vote on any issues affecting the preferred, including any merger, asset sale, charter change, or issuance of more preferred shares, and (2) a liquidation preference in the event of merger.¹⁵ In fact, Bratton and Wachter’s own research reveals that half of the new issuances of preferred since 2009 give the preferred effective approval rights over mergers.¹⁶ Although I am not sure what the authors consider “effective” protection, an earlier study of preferred contractual rights concluded that about eighty-one percent of preferred stockholders had negative covenants relating to business combinations.¹⁷ And the common feature of a class vote solves most of the problems Bratton and Wachter raise in their Article. Instead of viewing the absence of such a common provision as an indication that a particular preferred stock issue has no extra holdup value and is therefore subject to no better treatment than the common, Bratton and Wachter fill a gap that they have little evidence to claim is a gap, rather than an intentional contract omission. Although the authors fear that common contractual provisions giving preferred stockholders the ability to protect themselves in a merger, default, or other event endangering their investment will result in “holdups” (i.e., where preferred stockholders use their ability to vote as a class to impede valuable corporate transactions),¹⁸ they ignore the fact that such provisions are common and bargained for by issuers. Therefore, the

¹⁵ For example, one study revealed that eighty-one percent of investment contracts involved provisions that required preferred approval of business combinations, ninety-one percent involved provisions allowing the preferred to block adverse charter amendments, seventy-one percent involved restrictions on redemptions of common stock or payments of common stock dividends, and eighty percent involved restrictions on issuing more preferred stock. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 *UCLA L. REV.* 315, 346 (2005); *see also* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 *REV. ECON. STUD.* 281, 289, 291 (2003) (finding that venture capitalists negotiate, for example, optional redemption and put provisions in seventy-nine percent of cases); *id.* at 288, 290 (finding provisions granting additional voting rights if the target does not meet financial milestones in eighteen percent of cases); *id.* at 289, 292 (finding anti-dilution provisions in ninety-five percent of cases).

¹⁶ *See* Bratton & Wachter, *supra* note 1, at 1841 (“Fifty percent of the certificates provided for merger class votes . . . while the other 50% left the preferred unprotected.”).

¹⁷ Smith, *supra* note 15, at 346.

¹⁸ *See, e.g.*, Bratton & Wachter, *supra* note 1, at 1842 (“Class votes give preferred the ability to hold up a merger in moderate distress situations.”).

common stockholders have no just reason to complain about them (assuming the preferred was issued for proper corporate purposes), and such provisions give the real parties an incentive to reach a mutually acceptable compromise.

The proposition that, instead of extracting these specific contractual rights and risking holdup by the real parties in interest, the preferred should be able to look to judges to give them “noncontractual contractual” rights as a matter of equity, rests on the idea that litigation about a nebulous proposition is more efficient than a mutually bargained-for contract. By way of example, in their discussion of *SV Investment Partners, LLC v. ThoughtWorks, Inc.*,¹⁹ Bratton and Wachter arguably overstate the extent to which courts, rather than statutory corporate law itself, should affect the ability of preferred stockholders to get full redemption when the issuer does not have the funds statutorily required for it to do so.²⁰ To them, the court “strip[ped] away a promise’s contractual vitality by remitting the decision to perform the promise to pay to the discretion of the issuer’s board, thereby subordinating the preferred’s payment rights not only to the interests of the issuer’s creditors, but to those of its common stockholders.”²¹ The court was supposedly biased against the preferred in accepting the issuer’s position that there were no legally available funds unless the issuer had cash on hand (or the equivalent).²²

This reading is strained for a couple of reasons. First, the preferred stockholders’ right to mandatory redemption in the defendant’s charter was governed by language saying that the preferred “shall be entitled . . . to redeem [their stock] for cash out of any funds legally available therefor.”²³ This language presupposes that the corporation must have cash on hand before making any redemption. But, as the trial court in *ThoughtWorks* found, the plaintiffs’ own expert had “no thoughts” as to how the corporation might obtain the cash to finance a redemption, even though the size of the proposed redemption was approximately equal to the low end of the expert’s estimate of the corporation’s equity.²⁴ Furthermore, the corporation

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

²⁰ See Bratton & Wachter, *supra* note 1, at 1847-55.

²¹ *Id.* at 1860.

²² See *id.* at 1868 (“The reference to board process displaces the contract paradigm and restates the issue in corporate terms: the question is no longer, ‘Can the issuer pay?’ but, ‘Did the issuer’s board do an adequate job of justifying its decision not to pay?’”).

²³ *ThoughtWorks*, 7 A.3d at 978 (emphasis added).

²⁴ *Id.* at 989. The Delaware Supreme Court affirmed the case on these grounds. See *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 37 A.3d 205, 211-12 (Del. 2011) (“Because the Vice Chancellor

in *ThoughtWorks* had volatile cash flows, and management took care to “keep some funds on hand so that checks [didn’t] bounce during a dry spell.”²⁵ Because the plaintiffs introduced no evidence to show that the corporation could raise the funds for the redemption, and it was undisputed that the corporation needed to keep a cash cushion to operate as a going concern, Bratton and Wachter seem to be overstating the leeway *ThoughtWorks* grants the board by claiming that the *court* left the promise to redeem the preferred “to the promisor’s discretion.”²⁶

More importantly, Bratton and Wachter slight as ironic²⁷ the fact that *ThoughtWorks* cited a standard usually articulated by Delaware courts when upholding the redemption payments to the preferred against challenges by the common.²⁸ In these cases, the plaintiffs claimed that the boards of their respective companies acted outside their authority in determining that the corporation had the required legal funds to pay the preferred.²⁹ In rejecting those challenges and ruling for the preferred stockholders, the Delaware courts afforded reasonable deference to the boards in determining whether funds were available, and held that a board’s determination of available funds would not be set aside unless “the board acted in bad faith, relied on methods and data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud.”³⁰ There is nothing ironic about using that same standard to uphold a board’s decision *not* to make a payment to the preferred; it is simply evenhanded. Thus, *ThoughtWorks* was not, in the authors’ words, “tak[ing] a giant step away from contract into corporate territory.”³¹

determined that SVIP had failed to prove its case even under its own definition of ‘legally available funds,’ we need not reach or address the issue of whether SVIP’s definition is legally correct.”).

²⁵ *ThoughtWorks*, 7 A.3d at 977.

²⁶ See Bratton & Wachter, *supra* note 1, at 1868 (describing the promise as “not meaningful”).

²⁷ See *id.* at 1868 (“It is ironic, to say the least, to see a standard intended to facilitate payments to stockholders redeployed to protect a board wishing to duck a contractually undertaken stockholder payment.”).

²⁸ See *ThoughtWorks*, 7 A.3d at 988 (citing *Klang v. Smith’s Food & Drug Ctrs., Inc.*, 702 A.2d 150, 156 (Del. 1997), and *Morris v. Standard Gas & Elec. Co.*, 63 A.2d 577, 584-85 (Del. Ch. 1949)).

²⁹ See *Klang*, 702 A.2d at 152 (“Plaintiff in this purported class action alleges that a corporation’s repurchase of shares violated the statutory prohibition against the impairment of capital.”); *Morris*, 63 A.2d at 578 (“Plaintiff seeks . . . to prevent the defendant corporation from paying dividends declared on certain classes of its preferred stock on the ground that such action would violate the General Corporation Law of Delaware.”).

³⁰ *ThoughtWorks*, 7 A.3d at 988 (citing *Klang*, 702 A.2d at 156, and *Morris*, 63 A.2d at 584-85).

³¹ Bratton & Wachter, *supra* note 1, at 1868.

Relatedly, even if redemption of preferred stock is made difficult when there is a bona fide question as to whether the company's creditors, who are senior in priority, will get paid, Bratton and Wachter do little to show why this is a problem. The preferred stockholders have many options to be treated as pure creditors without having to straddle the equity–debt line. Instead of investing in stock with contractual rights, they could choose to invest with secured debt, subordinated debt, unsecured high-yield debt, mezzanine debt, or convertible debt, among other financial products. The provision of the Delaware General Corporation Law that prevents a corporation from redeeming its stock when such a redemption would impair the capital of the corporation is designed to protect the superior interests of creditors from being injured at the hands of the equity investors, just as liquidation preferences protect preferred stockholders over the common.³² It is therefore odd that preferred stockholders might champion a redemption of their class of *equity* when doing so risks *creditors'* ability to be repaid. The reality is that all Bratton and Wachter have shown is that the law is careful to make sure that a preferred stockholder is not paid his mandatory redemption unless the corporation has sufficient funds to pay more senior claimants. This is not a problem of contracting. It is the bargain the preferred make.

Finally, Bratton and Wachter seem troubled that preferred stockholders win very few litigated cases.³³ I do not have the training or resources to conduct a historical study of whether that is true, but even if it is, it does not necessarily prove their point. Even if Bratton and Wachter tallied the win–loss record—and they have not—that record may be affected by an overwhelming tendency of issuers to honor, not violate, the contractual rights of the preferred. The cases Bratton and Wachter cite are largely ones in which the preferred were asking courts to give them extra value, which they could have rooted in a written contract, but did not.³⁴ The refusal of

³² See DEL. CODE ANN. tit. 8, § 160(a) (2012) (stating that no corporation shall “purchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation”).

³³ See Bratton & Wachter, *supra* note 1, at 1901 (“The court’s disposition to favor the common is unsurprising . . . Senior security holders, conversely, have historically fared badly in the Delaware courts . . .”).

³⁴ For example, in *LC Capital Master Fund, Ltd. v. James*, the court, in refusing the preferred stockholders’ request to enjoin a transaction on the basis that the board did not allocate more of the merger consideration to the preferred than they would have received if they had converted to common (i.e., the merger agreement treated them equal to the common based on the conversion

courts to make up noncontractual contractual rights is not a reality that immediately suggests a problem. Indeed, it tends to suggest a rightful application of judicial discipline. The authors acknowledge this, claiming that “the preferred almost always lose[] and for a good reason: . . . [they] could have been protected at the drafting stage.”³⁵ But in any case, they admit that courts have in fact ruled for the preferred many times,³⁶ and in the brief period allotted to prepare this Response, it was not hard to find additional examples they failed to cite.³⁷

* * *

And what of Bratton and Wachter’s solution? In the context of mergers, the authors suggest that the preferred stockholders should have the protections of at least one director, who will be charged with vindicating their noncontractual contractual interests.³⁸ This is curious, because one of the traditional concerns of many corporate law scholars and economists has been whether an effective accountability system for boards can be maintained if the ultimate duty that the board owes to its stockholders is too diffuse.³⁹

ratio), noted that the preferred did not negotiate for veto rights over a merger and the board did not violate any of the preferred’s other extensive contractual rights. 990 A.2d 435, 438, 449 (Del. Ch. 2010). Under such circumstances, the court concluded that the board “need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common.” *Id.* at 449.

³⁵ William H. Bratton & Michael L. Wachter, A Theory of Preferred Stock 1 n.1 (Nov. 9, 2012) (unpublished manuscript) (on file with the University of Pennsylvania Law Review) (emphasis added).

³⁶ See Bratton & Wachter, *supra* note 1, at 1901-02 n.388 (citing cases where the preferred prevailed on their claims in Delaware).

³⁷ See, e.g., *Klang v. Smith’s Food & Drug Ctrs., Inc.*, 702 A.2d 150, 152 (Del. 1997) (affirming a lower court judgment in favor of the preferred because there were “no impairment of capital” or “disclosure violations” during the course of a merger); *Hokanson v. Petty*, No. 3438-VCS, 2008 WL 5169633, at *1 (Del. Ch. Dec. 10, 2008) (rejecting a claim that the board, which included preferred stockholders, breached its fiduciary obligations to the common stockholders “by not negotiating for a higher buyout price”); *Cannon v. Denver Tramway Corp.*, 373 A.2d 580, 581, 583 (Del. Ch. 1977) (ordering, contrary to the claims of the common stockholders, a trustee in dissolution to distribute remaining corporate funds proportionately to all stockholders including the preferred); *Morris v. Standard Gas & Elec. Co.*, 63 A.2d 577, 578, 585 (Del. Ch. 1949) (denying a preliminary injunction to prevent a corporation from paying dividends to certain classes of preferred stockholders).

³⁸ Bratton & Wachter, *supra* note 1, at 1857 (“[T]he independent committee should include at least one director charged with representing the interests of the preferred.”).

³⁹ The classic articulation of this view was made by Adolf Berle in 1932. See A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-68 (1932); see also, e.g., ROBERT C. CLARK, CORPORATE LAW 20 (1986) (“A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests Assuming shareholders have some control mechanisms,

Even when it is clear that the board's goal must be to pursue profit for the common stockholders within the limits of the law, there is room for debate about the proper means and whether the board's alleged focus on value for the stockholders is pretextual and a guise for pursuing other ends.⁴⁰ Bratton and Wachter would complicate this clear understanding of the board's end. And, as a practical matter, they do not explain how the directors are to fulfill their new duty.⁴¹

Why is this omission important to the workability of their policy proposal? Well, if preferred stockholders had a contractual right to a certain

better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently." (footnote omitted)).

⁴⁰ See Berle, *supra* note 39, at 1367; Leo E. Strine, Jr., Anton Phillips Oration: The Logical, But Often Overlooked, Consequences of Corporate Governance Reform and Prior Judicial Decisions for Current Corporate Law Litigation 1-3 (Nov. 4, 2011) (discussing directors' authority and the important safeguards on it under Delaware law).

⁴¹ The authors suggest that one way a board can satisfy this duty to defend the extra noncontractual contractual value due to the preferred is to guarantee that the preferred get at least the premerger market price for their shares. Bratton & Wachter, *supra* note 1, at 1857. This has an attractive facial tangibility. However, if the preexisting market price of the preferred is in fact related to actual contractual guarantees—such as a higher entitlement to share in the corporation's cash flows through a dividend preference or better treatment in a merger through a liquidation preference—then reference to the price will not be necessary because the contract will solve the problem itself. If, by contrast, there is no rational reason why the preferred is trading at a premium over the common other than the market's own perception of the lagniappe that will be given by courts for the noncontractual contractual value that supposedly comes with the name "preferred," the market price does not aid the board in any real way. Although it is difficult to gauge, it is likely that most preferred stock does not trade on a recognized market. In that respect, it is also uncertain how often there will be a reliable trading value for the preferred; in the cases on which the authors focus, the preferred shares seem to be privately held and not widely traded. For example, the preferred stock was not publicly traded in *LC Capital Master Fund, LTD. v. James*, 990 A.2d 435 (Del. Ch. 2010), a decision the authors criticize. See QuadraMed Corp., Preliminary Proxy Statement (Schedule 14A) 3 (Jan. 4, 2010), available at <http://www.sec.gov/Archives/edgar/data/1018833/000119312510000575/dpremi14a.htm> (stating that, in the event of an unsuccessful merger of the company in *James*, the common shares will continue to be traded on the NASDAQ, while the preferred will "remain issued and outstanding"). As a result, the market price tether that Bratton and Wachter suggest should limit the board's duty would have been of little use in *James*. Even so, it would be surprising if the authors found the market price for preferred shares reliable, given their doubts about the reliability of share prices for widely held and liquid common shares of corporations. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 723 (2010) (stating, with respect to the 2008 financial crisis, that "[a]t least in retrospect we know that the market underestimated the risk being taken and thus failed to provide an objective, critical reference point for monitoring purposes"); see also Robert W. Holthausen & Mark E. Zmijewski, *Pitfalls in Levering and Unlevering Beta and Cost of Capital Estimates in DCF Valuations*, J. APPLIED CORP. FIN., Summer 2012, at 60, 67-69 (discussing substantial valuation errors that result from the common practice of assuming that the betas of securities like preferred stock are equal to zero).

degree of extra value, there would be no need for a special director, and the corporation would just be obliged to honor those contractual rights. To assign a director to bargain for the preferred stockholders on the basis that they deserve some value, different from the value of the common stock into which their shares could convert, is to have that director bargain for something indeterminate. Once the focus on the specific terms of the preferred stock is rejected, Bratton and Wachter do not explain in detail how to quantify the extra noncontractual expectancy value. No obvious methodology comes to my mind.⁴² To this point, I note the absence of any clear way for a special committee to value a control premium in a merger where a controlling stockholder with actual voting control seeks extra compensation for that control, as the law putatively permits.⁴³ Thus, the noncontractual contractual value that the special committee should seek to protect becomes a matter largely influenced by judicial decisionmaking about the lagniappe that the preferred deserve in particular contests—decisionmaking untethered to any clear interpretive or valuation techniques.

Even with this gap in their proposal, I think it is fair to say that Bratton and Wachter advocate a litigious, fact-intensive solution to the problems they perceive. The authors propose various new standards of review, some of which place the burden of persuasion on the defendant, thereby making all motions to dismiss almost impossible.⁴⁴ Thus, cases will require discovery

⁴² Because the value of the cash flows realizable from preferred shares will depend on the occurrence or nonoccurrence of various scenarios in which the preferred may have different rights from and special entitlements over the common, distinguished scholars have pointed out the difficulty of valuing preferred shares. See Paul Glasserman & Zhenyu Wang, *Valuing the Treasury's Capital Assistance Program*, 57 MGMT. SCI. 1195, 1196-98 (2011) (noting the complexity in valuing TARP preferred shares that have cash flow outcomes based on decisions the issuer and holder may make); see also David Emanuel, *A Theoretical Model for Valuing Preferred Stock*, 38 J. FIN. 1133, 1137-39, 1149 (1983) (developing a valuation technique for preferred stock that pays dividends based on available funds and noting the limitations of such a technique).

⁴³ In *In re Tele-Communications, Inc. Shareholders Litigation*, the controlling stockholder demanded and received, from a third-party acquirer, ten percent more for his shares (a control premium) than the minority stockholders received for their shares. No. Civ.A. 16470, 2005 WL 3642727, at *1-2 (Del. Ch. Jan. 10, 2006). The Court of Chancery suggested that in such a case, an investment bank should deliver an opinion that the lower amount per share received by the minority was fair. *Id.* at *13. Commentators reacted with concern, noting that there was no recognized corporate finance theory an investment bank could apply to give such an opinion. See, e.g., Kevin Miller, *Delaware Court's Criticism of Special Committee in TCI Merger Provides Important Guidance But May Not Be Entirely Fair*, M&A LAW., Feb. 2006, at 1, 4 (noting that many financial advisors believe that relative fairness opinions and their inherent normative judgments "are beyond the scope of a professional opinion, particularly an opinion expressed 'from a financial point of view'").

⁴⁴ See, e.g., Bratton & Wachter, *supra* note 1, at 1833 (encouraging the placement of a burden of proof on the board of directors).

and will accrue holdup value. As a result, most cases will be expensive to resolve if tried.

As a judge, I suppose I should feel complimented that Bratton and Wachter regard the after-the-fact resolution of disputes by the judiciary as more efficient than honoring the before-the-fact specific written bargain between the sophisticated parties who entered preferred stock contracts. But I am perhaps more aware than most of how different an adjudication is from a creator's determination of ultimate truth. Judges do the best we can, trying in good faith to determine what happened and why from a record based on after-the-fact testimony about past events by witnesses who often have a bias. Many of us struggle to recall what we had for dinner last Thursday, much less what was said during that dinner, and two people without a reason to misremember will often recount a recent conversation in materially different ways. Adding to this inherent potential for error is the same factor that would afflict special committee members charged with bargaining on behalf of preferred stockholders, and which would make the judicial task an adventure in indeterminacy: once the inquiry is not whether the preferred's *contractual* rights have been honored, but whether the preferred's extra *noncontractual* expectancy has been honored, no reliable frame of analysis exists to guide judicial analysis. When we venture beyond the contractually enforceable and into valuing the subjectively expected, but not the contractually protected, we are on a speculative journey. Imposing liability on the basis of such a space mission potentially creates more fundamental unfairness than it prevents. And, of course, in many states, juries decide these questions, not judges.

To me, the point that Bratton and Wachter make that has the most policy force, if true, is that the law discourages innovation and, therefore, wealth creation by being too begrudging toward preferred stockholders.⁴⁵ Because preferred stock is often the favorite vehicle of venture capital, Bratton and Wachter contend that venture capitalists will be inhibited from investing the optimal amount unless they can be assured that whenever they secure board control, they can cash out whenever they want to, so long as they sell the company for its fair market value.⁴⁶ Rather than bargaining for a right to mandatory redemption on a particular date or using high-yield debt as their method of investing, venture capitalists should be able to secure board

⁴⁵ See *id.* at 1885-90.

⁴⁶ See *id.* at 1874 (“[A] court that inhibits [a redemption right’s] enforcement not only diminishes the utility of preferred, but also disables a productive mode of financing.”).

control rights and use those rights to determine, in their sole economic interest, when they want liquidity. Bratton and Wachter argue that this is good for wealth creation because venture capitalists will be encouraged to invest if they know that they, in essence, can act like a creditor when they are in control, subject only to the duty to market the company so as to secure a fair price.⁴⁷

Bratton and Wachter apparently have a high degree of confidence in markets and courts to determine the value of early-stage companies.⁴⁸ Their Article is replete with probability scenarios that highlight “problems” in order to offer solutions that are mainly judicial in nature.⁴⁹ But as a judge who must conduct appraisal proceedings and often sees two “experts” of “valuation science” with tenure at top universities come into court and swear under oath that their views of the DCF value under the CAPM model of the same established corporation with a sustained period of earnings vary widely, I am far less certain than the authors that their confidence in market-testing early-stage companies is well placed.

Venture-backed companies are the kind of companies that can become wildly successful or fail entirely. Venture capitalists have often claimed that they require strong contractual protections precisely because only a small percentage of the companies that they fund will pan out.⁵⁰ But, of course, they are not the only ones who take risks. Many early-stage companies have common stockholders who have made company-specific investments just as real as those made by the preferred, although not always in purely monetary ways. Employees work “on the come,” and even some suppliers do. And some investors buy common stock. Many of these equity holders accept risk on the promise that the company is going to do what it says and try to take a risky technology or service idea and turn it into a viable profit generator.

Thus, it is not obvious that the authors’ proposal is the one most consistent with promoting innovation.⁵¹ Perseverance has been critical to the

⁴⁷ See, e.g., *id.* at 1879-80.

⁴⁸ I note that this contrasts with their greater realism about the market’s wisdom in assessing the value of established companies. See Bratton & Wachter, *supra* note 41.

⁴⁹ See, e.g., Bratton & Wachter, *supra* note 1, at 1826-29.

⁵⁰ See George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1034 (1992) (noting that one-third of venture capital-financed companies go bankrupt, one-third “limp” along but are unable to go public, and one-third “succeed”).

⁵¹ Commentators have suggested that venture capitalists may be too narrowly focused on an “IPO or bust” strategy. See, e.g., Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 27-29 (2012) (arguing that, rather than pursuing an IPO, venture capitalists should sometimes sell their investments to other investors in secondary markets because this exit strategy can help avert a “premature exit that leaves money on the table”). Bratton and Wachter seem to encourage the emphasis on the IPO with their proposed revisions to the law.

success of many American companies. Bratton and Wachter would give venture capitalists the right to act as lenders, to end a company's pursuit of good-faith risk-taking, and to leave others who took critical risks with nothing. Although they cite no decisions in which any court has ever required preferred stockholders in control to engage in casino-like gambling and to pursue strategies without a bona fide potential for success that would leave creditors at unfair risk, Bratton and Wachter slight the fact that many early-stage companies cannot credibly project their future earnings because they are at a stage of their existence when developing their technology and products is a critical part of their business plan. Venture capitalists who buy stock in such companies know that the common stockholders are taking a big risk on whether that innovative design process will pan out, and those venture capitalists have specific tools of contracting to protect themselves if they want a firm date on which they can liquidate their investment.⁵² So, when venture capitalists fail to get such contractual guarantees, the notion that their interests as noncontractual contractual expectancy holders are paramount and supersede any duty that the board of directors would otherwise owe to the common seems to have as much potential to *discourage* innovation and wealth creation as it does to *encourage* it. The need for equity to protect the preferred's noncontractual company-specific investments over those of the entrepreneurs, employees, and investors who buy

⁵² See, e.g., *Hokanson v. Petty*, No. 3438-VCS, 2008 WL 5169633, at *1 (Del. Ch. Dec. 10, 2008) (permitting the preferred stockholders to cash out the common stockholders based on an amount determined by a buyout option, which was secured by the preferred stockholders in contract and exercised during the time period negotiated by the preferred stockholders and the board of directors). Some more common instruments that preferred stockholders use to protect their investment include mandatory redemption provisions or automatic redemption dates, which are akin to put options on their preferred shares, subject to the statutory requirement that a corporation may not redeem its shares when the redemption "would cause any impairment of the capital of the corporation." DEL. CODE ANN. tit. 8, § 160(a) (2012); see also Smith *supra* note 15 (citing other common instruments used by preferred to protect their investment, including preferred approval of business combinations). And courts recognize that there is real value in these contract rights. See, e.g., *Shifan v. Morgan Joseph Holdings, Inc.*, 57 A.3d 928, 941-42 (Del. Ch. 2012) (holding that, in an appraisal action for preferred shares, the court must consider all non-speculative contractual rights, and, in the context of that case, the preferred stockholders' "automatic redemption" must be included as part of their shares' fair value). The authors cite the sophisticated tools promoted by the National Venture Capital Association, but because they misconstrue the holding of *ThoughtWorks* as "impl[ying] a duty on the board's part to drag its feet about paying the redemption price," and because they overlook the cases discussed in this footnote, I question if they also underestimate the effectiveness of these tools. Bratton & Wachter, *supra* note 1, at 1893.

common stock remains questionable to me, given the abundant evidence of preferred stockholders' ability to get specific contractual protections.

In sum, Bratton and Wachter seem to sense that preferred stockholders should be able to have it all: the right to be equity when they wish to be, creditors when they wish to be, and not to be required to spell out this broad range of entitlements in their written contracts, but to simply have courts recognize their superior claim to an expectancy. Given both the proven ability of preferred stockholders to secure protections in writing and the reality of who buys preferred stock, it is unclear why the law should extend such a special solicitude to the preferred, as opposed to other important corporate constituencies like labor and home communities.

* * *

The world is messy. When an early-stage company has two years of cash on hand, there is no danger that its legal creditors will not be paid. It can continue to develop the technology or product that inspired its creation, and when that development has a bona fide chance to pan out in a way that will generate substantial value, Bratton and Wachter say that a preferred stockholder in control can simply call in its investment as if it were a creditor, regardless of the adverse effect that has on the common stockholders, and subject to the limited duty to market the company for sale in a competent way.

They say this in criticism of *Trados*, which suggests 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.⁵³ Thus, the common stockholders' expectations can be dashed, and an obligation of fairness toward them satisfied, if preferred stockholders market the company to fifteen buyers, and no one can credibly say for sure that the idea at the heart of the company will in fact pan out. The probabilities of the market protect the controller, the controller collects its liquidation preference, and the common stockholders can have the satisfaction of knowing that the market is always right. This is so even if the preferred stockholder bought its position at a discount from a prior preferred holder. This result, for Bratton and Wachter, is simply the hard cheese of capitalism.

A more conservative mind might question whether the simpler solution is to remind preferred stockholders of the long-standing principles applicable

⁵³ See *id.* at 1884-85.

to them. To the extent the preferred get a contract right, they are preferred. To the extent they do not, they are subject to the same risks as other stockholders and entitled to no extra value or rights. To the extent the preferred exercise contract rights, they have no duties to other stockholders and are entitled to those rights. To the extent the preferred assume control as fiduciaries, they owe the duties traditionally owed by the fiduciaries of corporations, including the duty to consider the best interests of the common stockholders in making decisions and, so long as the legal rights of other constituencies are not hazarded improvidently, the duty to pursue business strategies benefiting the common stockholders.

This well-understood incentive scheme has its own complications. But it creates good incentives for parties with the powerful leverage of preferred stockholders to get their rights where they should—in the contract. By contrast, the authors' thought-provoking proposals may promote uncertainty and excess litigation costs, and hazard genuine unfairness by charging boards and courts with a duty to discover and enforce "rights" for preferred stockholders that they could have, but did not, obtain in their contracts. Why, of all corporate constituencies, preferred stockholders should be so entitled, is but one of the many fundamental questions that requires an answer before the law moves away from its traditional approach.