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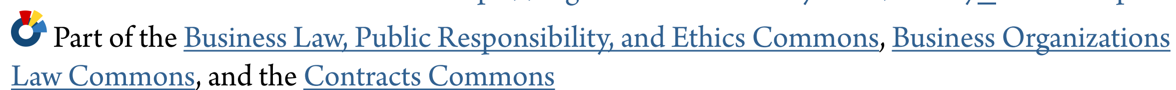
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INDEPENDENT LEGAL SIGNIFICANCE, GOOD FAITH, AND THE INTERPRETATION OF VENTURE CAPITAL CONTRACTS

D. GORDON SMITH*

INTRODUCTION

Benchmark Capital (hereinafter Benchmark) ensured its position among the elite venture capital firms in Silicon Valley when it made one of the most storied venture capital investments ever: a $5 million investment in eBay that ultimately returned more than $4 billion.[1] Benchmark also drew attention in 1999, when it raised the enormous sum of $1 billion for a single venture capital fund.[2] But its most lasting impression on venture capital investing may be the result of a lawsuit that Benchmark filed against one of its portfolio companies, as well as that company's founders, officers, directors, and one of its other investors. In *Benchmark Capital Partners IV, L.P. v. Vague*,[3] the Delaware Court of Chancery considered Benchmark's claim that it was entitled to veto a merger constructed for the sole purpose of stripping bargained-for rights and preferences from two series of pre-

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1. Russ Mitchell, *Too Much Ventured, Nothing Gained*, FORTUNE, Nov. 25, 2002, at 135. Benchmark has had other successes, including 1-800-Flowers, Ariba, Handspring, and Red Hat Software. It also has had some spectacular flops, most notably WebVan. One of its most discussed investments was Loudcloud, Inc., which changed its name to Opsware, Inc. in 2002. Loudcloud was Marc Andreesson's effort to follow his success with Netscape.

2. George Anders et al., *Digits*, WALL ST. J., Sept. 19, 1999, at B6. At the time, some people viewed billion-dollar funds as a symbol of elite status. *See, e.g.*, Lawrence Aragon, *Benchmark Forms Billionaire Boys Club*, RED HERRING, Sept. 15, 1999. Three years later, however, Benchmark decided to allow investors in the fund to opt out of capital calls because Benchmark lacked adequate investment opportunities. *See* Ann Grimes, *Venture Capital Had a Meager Year*, WALL ST. J., Jan. 2, 2003, at R4.

3. No. CIV.A.19719, 2002 WL 1732423 (Del. Ch. July 15, 2002).

ferred stock owned by Benchmark.[4] The case ultimately was decided on the basis of the arcane doctrine of independent legal significance, which is described below.[5] The court did not mention the contractual duty of good faith, and this Article explores the intersection of this duty and the doctrine of independent legal significance in the context of venture capital contracts.

The proposed merger at issue in *Benchmark* had been originated by Juniper Financial Corporation, a credit card issuer based in Delaware, and Canadian Imperial Bank of Commerce (CIBC), Juniper's largest investor.[6] The primary purpose of the merger, described in more detail below,[7] was to amend Juniper's certificate of incorporation, creating a new series of preferred stock with priority over the preferred stock owned by Benchmark.[8] CIBC intended to purchase shares of the new series of preferred stock, and Benchmark —a minority investor in Juniper—wanted to prevent the transaction.[9]

Until the late 1800s, most corporation statutes in the United States required the unanimous consent of stockholders to authorize a merger.[10] While protective of minority stockholders, this rule had a disabling effect on many corporations and gave minority stockholders enormous clout by permitting holdups.[11] Gradually, state legislatures changed the voting rules for mergers, initially requiring a supermajority vote and later allowing for majority rule.[12] Thus the modern rule for voting on mergers attempts to balance the legitimate interests of the majority stockholders in flexible administration of the firm against the legitimate interests of the minority stockholders in protecting their

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4. *Id.* The Delaware Supreme Court subsequently affirmed "on the basis of and for the reasons assigned by the Court of Chancery in its opinion." Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp., 822 A.2d 396 (Del. 2003).

5. *See infra* Part II.

6. *Benchmark*, 2002 WL 1732423, at *1.

7. *See infra* Part I.

8. *Benchmark*, 2002 WL 1732423, at *1; *see also* DEL. CODE ANN. tit. 8, § 251(e) (2003) ("In the case of a merger, the certificate of incorporation of the surviving corporation shall automatically be amended to the extent, if any, that changes in the certificate of incorporation are set forth in the agreement of merger.").

9. *Benchmark*, 2002 WL 1732423, at *1-*2.

10. Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 12 (1995).

11. *Id.* at 13 ("Any one shareholder could hold up a beneficial change or force the enterprise to reassemble the financial investors in a new venture with the attendant costs that would drain money from the evolving business.").

12. William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69 (1980).

investment.[13] Absent contractual override, these voting rules would enable Juniper and CIBC to pursue the merger transaction without interference from Benchmark because CIBC controlled a majority of the votes.[14]

Presumably recognizing its vulnerability under the applicable legal rules, Benchmark bargained for additional protection against preference stripping.[15] This bargained-for protection took the form of a contract provision prohibiting corporate actions that "materially adversely change the rights, preferences and privileges" of the Series A or Series B Preferred Stock.[16] Unfortunately for Benchmark, this protective provision did not perform up to expectations. Benchmark argued that this provision allowed them to thwart *any* transaction that impaired their stock, including the proposed merger.[17] In response, Juniper and CIBC observed that the language of the contract was similar (though not identical) to the language of § 242(b) of the Delaware General Corporation Law, which describes the procedure for amending the charter outside the context of a merger. Juniper and CIBC argued that the similarity between the contract and the statute suggested that the drafters of the contract intended to allow Benchmark to veto charter amendments but not mergers.[18] The court agreed:

> Where the drafters have tracked the statutory language relating to charter amendments in 8 Del. C. § 242(b), courts have been reluctant to expand those restrictions to encompass the separate process of merger as set forth in 8 Del. C. § 251, unless the drafters have made clear the intention to grant a class vote in the context of a merger.19

In short, the court held that (1) the harm to Benchmark was caused by the merger, not by a charter amendment, and (2) Bench-

13. In addition to the right to vote, minority stockholders have the right to receive an appraisal of the value of their shares. DEL. CODE ANN. tit. 8, § 262 (2003).

14. CIBC and Benchmark both held shares of preferred stock in Juniper. In this instance, both CIBC and Benchmark were entitled to vote by virtue of voting rights specified in Juniper's corporate charter. *Benchmark*, 2002 WL 1732423, at *3; *see also* DEL. CODE ANN. tit. 8, § 251 (requiring a majority vote of "the outstanding stock of the corporation entitled to vote" on the merger).

15. *Benchmark*, 2002 WL 1732423, at *3-*4 (Benchmark sought to ensure that Juniper did not issue any additional equity security that would be senior to the shares owned by Benchmark.).

16. *Id.* at *4.

17. *Id.* at *2, *5.

18. *Id.* at *6.

19. *Id.* at *7.

mark had no separate voting rights—either by statute or by contract—with respect to the merger.[20] This result reflects the workings of the doctrine of independent legal significance, which holds that a transaction structured in compliance with one section of the Delaware corporation statute is valid, even if it leads to a substantive result that would not be allowed by another section of the statute.[21] More particularly in the context of *Benchmark*, the merger provision of the Delaware statute is independent of the provision on charter amendments.

When law students and nonlawyers first encounter cases like *Benchmark*, they are often struck by the apparent unfairness of the result. To the extent that the parties negotiated Benchmark's status, they explicitly prohibited this sort of preference stripping.[22] Unfortunately for Benchmark, the contract was incomplete. It prohibited preference stripping using language that failed to identify mergers as the potential mechanism.[23] Had the parties focused on this gap in the contractual protections, would they would have filled the gap with a provision that protected Benchmark? The answer to that question is difficult to know. Nevertheless, the Delaware court appears to be elevating form over substance in a most dramatic way.

Most lawyers, by contrast to law students and non-lawyers, readily accept the formalism of *Benchmark*.[24] Lawyers may debate the wisdom of the doctrine of independent legal significance, but those debates are rarely cast in terms of fairness. As long as the rules of the game are stated openly, lawyers are not too concerned by decisions that enforce those rules strictly. Indeed, given the long line of precedents dealing with exactly this sort of preference stripping, lawyers might go so far as to assume—contrary to non-lawyers—that the parties to any contract failing to provide for a veto in the event of a charter amendment via merger must have intended implicitly to allow

20. *Id.* at *9-*10.

21. *See, e.g.*, Orzeck v. Englehart, 195 A.2d 375 (Del. 1963) ("[A]ction taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.").

22. *See Benchmark*, 2002 WL 1732423, at *1, *4.

23. *Id.* at *9.

24. While law students are often taught to view formalism as a sin, it plays an important role in contemporary law. And while formalism can be difficult to define, the doctrine of independent legal significance would seem to qualify under any conception of that word. *See* Paul N. Cox, *An Interpretation and Partial Defense of Legal Formalism*, 36 IND. L. REV. 57, 68 (2003) (citing the doctrine as an example of the proposition that "a rule's addressee may with impunity circumvent the rule though strict compliance with it, as by engaging in the evil, or a substantially similar evil, targeted by a rule while nevertheless simultaneously adhering to the rule").

such a merger.

But there is the rub: To the extent that there is concern about the intent of the parties, one must recognize that such intent is not always readily discernable from the terms of a contract or other communications. As observed recently by Robert Scott, "All contracts are incomplete."[25] Indeed, people often act in offensive ways that are not expressly regulated by any legal commands. In resolving contract disputes, courts rely on the duty of good faith to fill in the gaps in incomplete contracts.[26]

This Article begins in Part I with a brief description of the *Benchmark* case. Part II describes the origins and development of the doctrine of independent legal significance and illustrates its role as a doctrine of judicial abstention. Part III examines the method used by Delaware courts to interpret the terms of preferred stock agreements. The interpretive rule of strict construction described in this part combines with the doctrine of independent legal significance to make a formidable hurdle for holders of preferred stock. Part IV explores the contract doctrine of good faith, with special attention to the common law of Delaware, and shows its importance as a doctrine of judicial intervention. Part V employs comparative institutional analysis[27] and the incomplete contracting theory to examine the appropriate role for courts in disputes like *Benchmark*.

I. THE *BENCHMARK* CASE

In June and August 2000, Benchmark made two investments in Juniper.[28] In exchange for $25 million, Benchmark received shares of Juniper's Series A and Series B Preferred Stock.[29] Within months Juniper was back on Benchmark's doorstep, asking for an additional investment. Benchmark refused, but CIBC agreed to contribute $145 million in exchange for a convertible note worth $27 million and shares of Series C Preferred Stock, which resulted in CIBC owning a majority of the voting power in Juniper. In addition, CIBC was enti-

25. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1641 (2003).

26. *See, e.g.*, Market St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) ("The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule.").

27. *See* NEIL K. KOMESAR, LAW'S LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS (2001) [hereinafter KOMESAR, LAW'S LIMITS].

28. *Benchmark*, 2002 WL 1732423, at *2.

29. *Id.*

tled to elect six of Juniper's eleven directors.[30]

As is common in companies that have multiple series of preferred stock, Juniper's Certificate of Incorporation granted each series a vote on corporate actions that would "'[m]aterially adversely change the rights, preferences and privileges'" of the series.[31] In addition, each series was entitled to a series vote before Juniper could "'[a]uthorize or issue, or obligate itself to issue, any other equity security . . . senior to or on a parity'" with the series.[32] When CIBC negotiated its investment in Series C Preferred Stock, however, it obtained the right to waive these protective provisions,[33] as long as the waiver did not "diminish or alter the liquidation preference or other financial or economic rights" of the Series A or Series B preferred stockholders or enable a breach of fiduciary duty.[34]

In early 2002, Juniper started seeking another round of funding. The desire for more money was not driven by whim, but rather by the need to comply with the capital requirements under applicable banking regulations.[35] After contacting all of its initial investors, Juniper concluded that CIBC was the only viable option. Juniper wanted CIBC to invest an additional $50 million, but CIBC was willing to make that investment only if it could obtain a dividend preference, a liquidation preference, and certain other rights over the shares of Series A and Series B Preferred Stock.[36] Under the rules of Delaware's corporation statute, however, such preferences must appear in Juniper's Certificate.[37] As a result, that Certificate would need to be amended.

The only problem with this plan was that Benchmark objected to

30. *Id.*

31. *Id.* at *4 (quoting Art. IV, § C.4.c of Juniper's Certificate of Incorporation).

32. *Id.* at *1 (quoting Art. IV, § C.6.a(i) of Juniper's Certificate of Incorporation).

33. *Id.* at n.4 ("The protective rights at issue here may be waived by a majority vote of a class consisting of the holders of the Series A, Series B and Series C Preferred shares on an as-converted to common stock basis. Because of CIBC's holdings of Series C Preferred Stock, it is able to cast a majority of the votes of this class on its own.").

34. *Id.* at *1 (quoting Art. IV, § C.4.c of Juniper's Certificate of Incorporation. The actual waiver provision allowed CIBC to exercise the waiver, unless such action:

> [W]ould (a) diminish or alter the liquidation preference or other financial or economic rights, modify the registration rights, or increase the obligations, indemnities or liabilities of the holders of Series A Preferred Stock, Series A Prime Preferred Stock or Series B Preferred Stock or (b) authorize, approve or waive any action so as to violate any fiduciary duties owed by such holders under Delaware law.

Id. at *3.

35. *Id.* at *4.

36. *Id.* at *4-*5.

37. DGCL § 102(a)(4).

having its Series A and Series B Preferred Stock subordinated to the proposed Series D Preferred Stock.[38] Even though the contractual protections described above could be waived by CIBC in some instances, they could not be waived for the purpose of diminishing or altering Benchmark's dividend preference, liquidation preference, or other financial rights.[39]

Because direct amendment of the Certificate via board and stockholder approval was impossible, Juniper and CIBC decided to pursue a different strategy. They used one of the oldest tricks in the book for stripping rights from preferred stock—a merger.[40] Juniper formed a wholly-owned subsidiary for the sole purpose of merging it into Juniper;[41] and under the terms of the merger agreement, Juniper would emerge as the surviving corporation with a restated Certificate containing all of the terms that would have been contained in an amended Certificate.[42] Shortly after learning of this proposed transaction, Benchmark sued in the Delaware Court of Chancery and requested that the court issue a preliminary injunction.[43]

II. THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE

The gist of Benchmark's claim was that Juniper and CIBC were about to violate the provisions of Juniper's charter by diminishing or altering Benchmark's dividend preference, liquidation preference, and other rights, albeit through merger rather than through direct charter

38. *Benchmark*, 2002 WL 1732423, at *5.

39. *Id.* at *7.

40. *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 936-37 (2002) (describing the process of preference stripping through a merger).

41. *Benchmark*, 2002 WL 1732423, at *3. By using a wholly-owned subsidiary, Juniper evaded the limitation in the Certificate that gave the Series A and Series B Preferred stock veto rights whenever Juniper wanted to "'consolidate or merge into any other Corporation (other than a wholly-owned subsidiary Corporation)'" (quoting Art. IV, § C.6.a(ii) of Juniper's Certificate of Incorporation).

42. *Id.* at *5. Pursuant to the merger agreement, the shares of existing Series A and Series B Preferred Stock would be converted into shares of new Series A and Series B Preferred Stock. The new shares would have smaller dividend and liquidation preferences and would have more limited redemption rights. Most importantly, they would be subordinated to the new Series D Preferred Stock.

In addition to receiving new shares of Series A and Series B Preferred Stock, the holders of existing Series A and Series B Preferred Stock were to receive a small fraction of a share of Juniper common stock, a warrant to purchase an additional fraction of a share of Juniper common stock, and a small amount of cash.

43. *Id.*

amendment.[44] This was not the first time such a claim had come before the Delaware courts, and like prior attempts to invoke the protections of the courts, Benchmark's claim would ultimately founder on the doctrine of independent legal significance.

The origins of the doctrine of independent legal significance lie in the Delaware common law. The doctrine is most commonly associated with cases involving claims of de facto merger,[45] but it appears to have originated in cases of rights stripping from preferred stock. In other words, the origins of the doctrine of independent legal significance seem to lie in cases that resemble *Benchmark*. In this section, we examine those cases for clues about the rationale for the rule, a rationale that we will later employ to evaluate the modern usage of the rule.

We begin our study of the doctrine of independent legal significance with de facto mergers, which are reorganizations accomplished by contract (a series of asset sales and related governance changes), rather than in accordance with the merger provisions of the state corporation law. In the well-known Pennsylvania case of *Farris v. Glen Alden Corp.*,[46] for example, two corporations entered into a "reorganization agreement" that required one corporation (List) to sell all of its assets to the other corporation (Glen Alden).[47] In exchange for the assets, Glen Alden assumed List's liabilities and issued shares of Glen Alden stock, which were then distributed to List's shareholders.[48] List was subsequently dissolved, and the result was a corporation (rechristened "List Alden") owned by former shareholders of Glen Alden and List.[49] In other words, this series of transactions produced a result that was exactly the same as a merger, but the parties did not comply with the formalities of the merger statute.

The motivation for structuring the reorganization in this way is clear: Minority shareholders of a Pennsylvania corporation obtained dissenters' rights—including, most importantly, the right to receive the appraised value of their shares, rather than the value offered by the majority shareholders—if the transaction fell within the merger statute, but they did not receive dissenters' rights for a sale of the cor-

44. *Id.*
45. Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963).
46. 143 A.2d 25 (Pa. 1958).
47. *Id.* at 27.
48. *Id.*
49. *Id.*

poration's assets.[50] According to the Pennsylvania Supreme Court, the origin of statutory dissenters' rights lie in the common law. More specifically, in *Lauman v. Lebanon Valley R.R. Co.*,[51] an 1858 decision, the Court ordered an appraisal for a minority shareholder in the absence of a statute.[52] The *Farris* Court reasoned that the modern statute embraced the rationale of *Lauman*, which was that minority shareholders should not be required to continue their relationship with an entity that has lost its "essential nature and alter[ed] the original fundamental relationships of the shareholders among themselves and to the corporation."[53] As a result, the *Farris* Court granted appraisal rights.[54]

What is most interesting for the present analysis is that the *Farris* Court did not betray any awareness that institutions other than the Court might address the problem of minority rights more effectively. For example, the defendants offered strong evidence that the Pennsylvania legislature had denied appraisal rights for asset-sale transactions, thus overruling some prior cases.[55] However, the Court countered that "divest[ing] shareholders of their right to dissent under such circumstances would require express language which is absent from the [statute]."[56] The Court added, "we will not blind our eyes to the realities of the transaction,"[57] thus justifying a course of judicial intervention.

The Delaware Supreme Court faced this same issue five years later in *Hariton v. Arco Electronics, Inc.*,[58] and took the alternate path of judicial abstention. *Hariton* involved a reorganization that was very similar to the transaction in *Farris*.[59] In this instance, however,

50. *Id.* at 28, 30.

51. 30 Pa. 42 (1858).

52. According to Bayless Manning, this was the first appraisal statute in the United States. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 246 n.38 (1962). However, Melvin Eisenberg has argued that Ohio enacted appraisal statutes in 1851 and 1852. MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION 75 (1976).

53. *Farris*, 143 A.2d at 29.

54. *Id.* at 31.

55. *Id.* at 30.

56. *Id.* at 31.

57. *Id.*

58. 188 A.2d 123 (Del. 1963). At roughly the same time, the Delaware Supreme Court was using the doctrine of independent legal significance to decide that a company did not carry out a de facto merger merely by purchasing the shares of another company. Orzeck v. Englehart, 195 A.2d 375 (Del. 1963).

59. The Delaware Supreme Court addressed a similar situation in *Heilbrunn v. Sun Chemical Corp.* 150 A.2d 755 (Del. 1959). In that case, however, the claim to invalidate the

the Court denied appraisal rights, citing the equal dignity rule:

> We now hold that the reorganization here accomplished through §271 [the asset sale provision] and a mandatory plan of dissolution and distribution is legal. This is so because the sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end.60

The *Hariton* Court was more reflective than the *Farris* Court about the institutional impacts of its decision. Responding to the plaintiff's contention that the Court should grant appraisal rights in some asset sales but not others, the Court stated that "[t]o attempt to make any such distinction between sales under § 271 would be to create uncertainty in the law and invite litigation."[61] Standing alone, this rationale does not travel very far. *Every* judicial intervention invites future litigation. The important question is whether such litigation is worthwhile, and deciding whether litigation is worthwhile requires more searching consideration of the options.[62]

The equal dignity rule is also known as the doctrine of independent legal significance, a term that predates *Hariton*; it first appeared in *MacCrone v. American Capital Corp.*[63] The *MacCrone* Court was asked to evaluate the fairness of a merger.[64] Among other arguments leveled against the merger was the claim that several of the directors of the merged company benefited financially from the merger.[65] The Court declined to inquire into the directors' motives, observing that "the merger is an act of independent legal significance, and the mere fact that those who initiate it will receive some benefit does not make it fraudulent."[66] In its initial incarnation, the term "independent legal significance" might seem to bear little relation to the modern doctrine, but it is similar in one crucial aspect, namely, that both the *MacCrone* Court and the modern doctrine of "independent legal significance" attempt to draw boundaries around the permissible scope of judicial

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transactions was brought by shareholders of the purchasing company. According to the Court, embracing the reasoning of the *Farris* court, these shareholders were not "forced to accept stock in another corporation. Nor has the reorganization changed the essential nature of the enterprise . . . ." *Id.* at 758.

60. 188 A.2d at 125.
61. *Id.*
62. *See infra* Part V.
63. 51 F. Supp. 462 (D. Del. 1943).
64. *Id.* at 464, 466.
65. *Id.* at 469.
66. *Id.* at 469-70.

inquiry. In both contexts, compliance with the merger statute is a formal requirement that precludes judicial intervention.[67]

A more modern use of "independent legal significance" appears a few years later in *Langfelder v. Universal Laboratories*.[68] The *Langfelder* case resembles *Benchmark* in that it involved a claim by preferred stockholders who had been victimized by a merger. Prior to the merger, the preferred stockholders had accrued more than $28,000 in dividends.[69] Pursuant to the merger agreement, the old preferred stock was exchanged for new preferred stock carrying a much smaller cumulative dividend than the old preferred stock.[70] Moreover, the dividends accrued on the old preferred stock "were wiped out."[71]

The plaintiffs claimed that they were entitled to the benefits of a charter provision that was triggered by a reduction of the preferred stock of the corporation."[72] Under that provision, the preferred stockholders were entitled to receive 110 percent of "the amount of the reduction . . . and . . . all cumulated and unpaid dividends thereon," plus additional dividends since the last dividend date.[73] The question before the court, therefore, was whether the share exchange accomplished pursuant to the merger was a reduction of the preferred stock.[74] Because a merger is of independent legal significance from the preferred stockholders' contractual rights, the court reasoned that the exchange did not trigger those rights.[75] Instead the merger "provides for an exchange of all the old preferred's rights and privileges . . . for stock in the resultant corporation."[76] The court opined that the preferred stockholders "ought either to have accepted the provisions of the merger agreement . . . or they should have sought an appraisal."[77]

Langfelder invoked the term "independent legal significance" as follows:

67. The *MacCrone* Court added a telling footnote to its discussion: "May it be said that if a jural act is lawful, i.e., if the merger is lawful, no one can claim that the motive which generated it rests on bad faith." *MacCrone*, 51 F. Supp. at 470 n.10.

68. 68 F. Supp. 209 (D. Del. 1946), *aff'd*, 163 F.2d 804 (3d Cir. 1947).

69. *Id.* at 209.

70. *Id.* at 210.

71. *Id.*

72 *Id.*

73. *Id.* at 209.

74. *Id.* at 210-11.

75. *Id.* at 213.

76. *Id.* at 212.

77. *Id.*

> [T]he right to be paid in full for [accumulated] dividends, notwithstanding provisions in the charter contract, may be eliminated by means of a merger which meets the standard of fairness. The rationale is that a merger is an act of independent legal significance, and when it meets the requirements of fairness and all other statutory requirements, the merger is valid and not subordinate or dependent upon any other section of the Delaware Corporation Law.78

While the phrasing was new, the concept was already well established. In *Federal United Corp. v. Havender*,[79] the Delaware Supreme Court confronted facts that were very similar to those in *Langfelder*—a merger of a parent corporation with a wholly-owned subsidiary, having the effect of stripping rights from the preferred stock. The Court asserted that preferred stockholders with accumulated dividends were not creditors of the corporation "in the ordinary and usual meaning of the word."[80] As a result, the corporation was allowed to deprive the preferred stockholders of their accumulated dividends by virtue of a merger.[81] The justification for this position was simply that the preferred stockholders knew what they were getting into when they made the investment.[82] As in *Langfelder*, the

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78. *Id.* at 211.

79. 11 A.2d 331 (Del. 1940).

80. *Id.* at 336.

81. *Id.* at 343-48. The Court was required to distinguish *Keller v. Wilson & Co.*, which held that a corporation could not destroy a preferred shareholder's right to accumulated dividends by amending the corporate charter. *Keller* did not involve an amendment by merger, but rather an amendment under the amendment section of the DGCL. *Id.* at 323-34 (citing *Keller v. Wilson & Co.*, 190 A. 115 (Del. 1936)). Bayless Manning commented on the reconciliation of these two cases:

> The court in Havender purported to find other grounds for distinguishing the two cases, but it paused to note that under the Delaware corporation statute the plaintiff in Keller did not have the appraisal remedy available to him while the plaintiff in Havender did. Most observers have felt that this was the key difference . . . .

Manning, *supra* note 52, at 228.

82. *Havender,* 11 A.2d at 333-43.

> The shareholder has notice that the corporation whose shares he has acquired may be merged with another corporation if the required majority of the shareholders agree. He is informed that the merger agreement may prescribe the terms and conditions of the merger, the mode of carrying it into effect, and the manner of converting the shares of the constituent corporations into the shares of the resulting corporation. A well-understood meaning of the word "convert," is to alter in form, substance or quality. Substantial rights of shareholders, as is well known, may include rights in respect of voting, options, preferences and dividends. The average intelligent mind must be held to know that dividends may accumulate on preferred stock, and that in the event of a merger of the corporation issuing the stock with another corporation, the various rights of shareholders, including the right to dividends on preference stock accrued but unpaid, may, and perhaps must, be the subject of

Court relied on appraisal as the fundamental remedy for dissatisfied preferred shareholders.[83]

As is clear from this brief history, the doctrine of independent legal significance was formed in cases involving rights stripping of preferred stock, like *Benchmark*. The doctrine has continued to flourish in this setting, but modern application of the doctrine often revolves around the merger provision and the amendment provision of the Delaware corporation law. Delaware corporation law permits changes to be made to the corporate charter via approval of a merger agreement by a majority of the outstanding stock of the corporation.[84] This merger section does not provide for a separate class vote on the merger agreement, even if the merger agreement adversely affects one or more classes. This process stands in marked contrast to § 242(b)(2), which governs charter amendments and provides for a separate class or series vote on any amendment that would "alter or change the powers, preferences, or special rights of the shares of [any] class [or series] so as to affect them adversely."[85] The Delaware courts have consistently held that the merger provision and the amendment provision of the DGCL have independent legal significance.[86]

In a modern twist, the Delaware Supreme Court has changed the doctrine of independent legal significance from a rule of statutory interpretation into a rule of contract interpretation. This transition can be traced to the important and well-known case of *Warner Communi-*

> reconcilement and adjustment; for, in many cases, it would be impracticable to effect a merger if the rights attached to the shares could not be dealt with.

Id.

83. *Id.* at 343 ("The complainants were put to their election, either to demand payment in money of the value of their preferred shares as agreed upon, or as ascertained by an appraisement, or to accept the exchange of securities offered by the merger plan.").

84. DEL. CODE ANN. tit. 8, § 251(b) (stating that "[t]he [merger] agreement shall state . . . such amendments or changes in the certificate of incorporation of the surviving corporation as are designed to be effected by the merger . . . ."). The corporation law adds that "[i]f a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement . . . by each constituent corporation, it shall then be filed and shall become effective . . . ." DEL. CODE ANN. tit. 8, § 251(c). *See also* DEL. CODE ANN. tit. 8, § 251(e) ("In the case of a merger, the certificate of incorporation of the surviving corporation shall automatically be amended to the extent, if any, that changes in the certificate of incorporation are set forth in the agreement of merger.").

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

86. *See, e.g.*, Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 845 n.6 (Del. 1998); Warner Communications Inc. v. Chris-Craft Indus., 583 A.2d 962, 970 (Del. Ch. 1989), *aff'd*, 567 A.2d 419 (Del. 1989).

cations Inc. v. Chris-Craft Industries, Inc.[87] The plaintiffs in this case—the parties to the Time-Warner merger agreement—brought this declaratory judgment action against holders of preferred stock in Warner, who were asserting veto rights over the merger.[88] The basis for their assertion of rights was Warner's certificate of designation, which contained the terms of the preferred stock. That certificate contained two provisions that, according to the preferred stockholders, provided veto rights over the merger.[89]

One provision required the approval of two-thirds of the preferred stockholders before the company could "alter or change any rights, preferences or limitations of the Preferred stock so as to affect the holders of all of such shares adversely."[90] The other provision prohibited Warner from acting to "amend, alter or repeal any of the provisions of the Certificate of Incorporation or By-laws of the Corporation so as to affect adversely any of the preferences, rights, powers or privileges of the Series B Stock or the holders thereof" without first obtaining the consent of at least two-thirds of the affected shareholders of then outstanding stock.[91] In this instance, the parties stipulated for purposes of a motion for judgment on the pleadings that the Series B Preferred Stock of Warner would be adversely affected by the consummation of the Time-Warner merger, which contemplated the conversion of those shares into shares of a new series of Time preferred stock.[92] The issue, therefore, was whether that merger triggered either of the protective provisions just described.[93]

The defendants argued that any corporate action—including a merger—should be subjected to the two-thirds voting requirement under the first provision. Chancellor Allen of the Court of Chancery of Delaware rejected this suggestion, noting "the close similarity between the operative language of Section 3.3(i) of the corporation's certificate of designation and Section 242(b)(2) of the General Corporation Law."[94] From this observation, Chancellor Allen made the

87. 583 A.2d 962 (Del. Ch. 1989).

88. *Id.* at 963.

89. *Id.* at 964-65.

90. *Id.* at 964.

91. *Id.* at 965.

92. *Id.*

93. *Id.* at 965-66.

94. *Id.* at 969. Section 3.3(i) of the certificate of designation states that "the affirmative vote of at least two-thirds of the . . . outstanding shares of Series B Stock . . . shall be necessary *to alter or change any rights, preferences or limitations of the Preferred Stock so as to affect* the holders of all such stock *adversely*." *Id.* Section 242(b)(2) of the General Corporation Law states that "[t]he holders of the outstanding shares of a class shall be entitled to vote

critical—and, in my view, unjustified—move. Because § 242(b)(2) does not provide a right to a separate class vote in the event of a merger, a contract provision whose language resembles § 242(b)(2) also does not provide such a right. This is, of course, exactly the reasoning embraced in *Benchmark.* Chancellor Allen attempted to connect this reasoning to the drafter's intent. Chancellor Allen concluded that it was unlikely that the drafters of the charter, being familiar with corporation law, would have chosen language similar to § 242(b)(2) if they meant for a merger to trigger a class vote.[95]

Underlying this conclusion are two behavioral assumptions about the predilections of corporate lawyers: (1) that the lawyers who drafted the terms of Warner's preferred stock would attempt to replicate by contract the protections already provided in the Delaware statute; and (2) that they would do this by including language that was only similar—not identical—to the statute. With respect to the first assumption, I believe that all corporate lawyers would agree that the practice of replicating statutory provisions in charters and bylaws is not uncommon. The second behavioral assumption is more controversial. Admittedly, the language at issue in *Warner* is close to the language of § 242(b)(2), but why would the drafters not make the language identical? Corporate lawyers who want to obtain exactly the protections of the statute know how to accomplish this task—copy the statute exactly. One needs only read the director exculpatory provisions of a few Delaware corporate charters, which parrot DGCL § 102(b)(7), to realize that corporate law practitioners are fully capable of copying the statute. Plagiarism is not a concern. They are not interested in paraphrasing. To assume that a drafter who writes something other than the exact words of the statute, all the while intending only to incorporate the statute, requires a large leap of faith.

The most important feature of *Warner* for present purposes is the influence of the doctrine of independent legal significance on contract interpretation. By attributing to the drafters of Warner's charter an intention to emulate § 242(b)(2), Chancellor Allen imposed on the charter the same limitations that adhere to the statute. In his words:

> Our bedrock doctrine of independent legal significance . . . compels the conclusion that satisfaction of the requirements of Section 251 is all that is required legally to effectuate a merger. It follows,

as a class upon a proposed amendment . . . if the amendment would . . . *alter or change the powers, preferences or special rights of the shares of such class so as to affect them adversely. Id.* (citing DEL. CODE ANN. tit. 8, § 242(b)(2)) (emphasis added)).

95. 583 A.2d at 970.

> therefore, from rudimentary principles of corporation law, that the language of 242(b)(2), which so closely parallels the language of 3.3(i), does not entitle the holders of a class of preferred stock to a class vote in a merger, even if (as we assume here) the interests of the class will be adversely affected by the merger . . . .
>
> Since I take this legal conclusion to be the general understanding among corporation law specialists . . . I can only conclude that it is extraordinarily unlikely that the drafters of Section 3.3(i), who obviously were familiar with and probably expert in our corporation law, would have chosen language so closely similar to that of Section 242(b)(2) had they intended a merger to trigger the class vote mechanism of that section.96

Although Chancellor Allen kept his eye firmly focused on the drafters' intentions, he took a large step toward importing the doctrine of independent legal significance from its domain as a rule of statutory interpretation to the realm of contract interpretation. The next part of this Article explores the means by which the Delaware courts completed the transformation of that doctrine. The result was that by the time *Benchmark* was decided, the Delaware courts had replaced the emphasis on the drafters' intention with a formal inquiry into "magic words." Viewed another way, the formalism that lies at the heart the doctrine of independent legal significance had infected the interpretation of contracts.

III. THE INTERPRETATION OF PREFERRED STOCK CONTRACTS

The terms regulating preferred stock of Delaware corporations usually are to be found in a document called the "Certificate of Designations." Although this document has a physical existence separate from the Certificate of Incorporation, the two certificates are joined at the hip, so to speak; together, they comprise the corporation's charter.

When the Delaware courts are asked to interpret corporate charters, the judges approach the documents as contracts.[97] Chancellor Allen's interpretation of Warner's preferred stock provisions is typical in that he focused on the drafter's intent. Preferred stock provisions, however, may be burdened by a special interpretive rule that Chancellor Allen mentioned only in passing: "While the effort is to arrive at the intended meaning of the words employed, it is generally

96. *Id.*

97. *See, e.g.*, Gentile v. SinglePoint Fin., Inc., 788 A.2d 111, 113 (Del. 2001) ("It is a fundamental principle that the rules used to interpret statutes, contracts, and other written instruments are applicable when construing corporate charters and bylaws.").

said that rights or preferences over common stock should be clearly expressed and not presumed."[98]

The impetus for creating this interpretive rule for preferred stock is clear. As observed by the Delaware Court of Chancery in an early preferred stock case, "If you say that the preferred's preferences are enlarged, as a corollary you must say that the common's burdens are increased and its rights curtailed."[99] The court conjures an image of preferred stock investors forcing their will upon the common stockholders. This image appears again in another frequent articulation of the rule: "Because at common law, in the absence of agreement to the contrary, all shares of stock, by whatever name they may be known, stand upon an equal footing, preferences, being in derogation of the common law rule, must be strictly construed."[100] As is apparent in the subsequent discussion, the image of opportunistic preferred stockholders continues to exert a tremendous influence on the Delaware courts.

The rule of strict construction can be criticized on a number of grounds. One might argue, as does Professor Bratton in his comments on this Article, that the rule is grounded on a misguided understanding of preferred stock investing and that preferred stockholders tend to be weak bargaining foes.[101] While this is a strong argument in the context of traditional preferred stock investment, it does not resonate in the venture capital context.

To the extent that the rule emanates from the old legal canon that statutes in derogation of the common law are to be interpreted strictly, one might argue that legislatures have roundly rejected this approach.[102] In addition, legal scholars since Roscoe Pound have at-

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98. 583 A.2d at 967. Chancellor Allen did not rely on this rule for his holding in *Warner*, presumably because he felt that the interpretation was clear.

99. Gaskill v. Gladys Bell Oil Co., 146 A. 337, 340 (Del. Ch. 1929).

100. Goldman v. Postal Tel., 52 F. Supp. 763, 767 (D. Del. 1943).

101. *See* William W. Bratton, *Gaming Delaware*, 40 WILLAMETTE L. REV. 853, 858 (2004).

102. *See* Einer Elhauge, *Preference Eliciting Statutory Default Rules*, 102 COLUM. L. REV. 2162, 2268 (2002):

> Given that courts have long interpreted ambiguous statutes to further the perceived legislative intent or purpose, one might have thought that a legislature that preferred that judges instead interpret all statutory ambiguity narrowly would have enacted an interpretive statute saying so. In fact, none of the codes of construction enacted by legislatures within the United States directs a narrow construction of statutory ambiguities. To the contrary, the state legislatures that have addressed the issue have expressly rejected the canon providing for narrow construction of statutes in derogation of the common law.

tacked that principle of statutory construction as anachronistic and unnecessary.[103] Use of the principle in the context of preferred stock seems particularly out of place, because the terms being strictly construed are drafted by private parties, not by a legislature.

While any of these arguments might carry the day, I take a different tack—one more narrowly tailored to the task at hand. In my view, the interpretive rule of strict construction, when combined with the doctrine of independent legal significance, unduly impairs the purported goal of contract interpretation. Two cases illustrate the combined effect.

The first is *Sullivan Money Management, Inc. v. FLS Holdings, Inc.*,[104] where then Vice-Chancellor Jacobs considered a charter provision that read as follows:

> So long as any shares of the Cumulative Exchangeable Preferred Stock are outstanding, the Corporation will not, without the affirmative vote of the holders of at least two-thirds of the outstanding shares of Cumulative Exchangeable Preferred Stock, voting as a class, change, by amendment to the Certificate of Incorporation of the Corporation or otherwise, the terms and provisions of the Cumulative Exchangeable Preferred Stock so as to affect adversely the rights and preferences of the holders thereof or authorize the issuance of any Senior Securities or Parity Securities or any securities exchangeable or convertible into any Senior Securities or Parity Securities.105

Unlike the provision at issue in *Warner*, this provision resembles § 242(b)(2) only to the extent that both deal with charter amendments. The structure of the provision, however, is completely unlike § 242(b)(2). Moreover, this provision includes the pregnant words "or otherwise," which could be interpreted as an inclusion of changes other than amendment of the Certificate of Incorporation that require a vote of at least two-thirds of the outstanding shares before a change

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103. *See* John Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 120 n.478 (2001) (quoting Roscoe Pound, *Spurious Interpretation*, 7 COLUM. L. REV. 379, 387 (1907)).

> [T]he rule that statutes in derogation of common right are to be construed strictly has some excuse in England where there are no constitutional restrictions. There it is really another form of stating Blackstone's tenth rule, that interpretations which produce collaterally absurd or mischievous consequences are to be avoided. In the United States it means that interpretations which would make an act unconstitutional are to be avoided, or else it is equivalent to Blackstone's tenth rule.

Id.

104. 1992 WL 345453 (Del. Ch. 1992).

105. *Id.* at *2 (emphasis added).

can be made. Nevertheless, Vice-Chancellor (now Justice) Jacobs refused to extend this provision to mergers. Instead of using *Warner*'s close textual analysis,[106] Vice-Chancellor Jacobs leaned heavily on the strict interpretive rule to find that the provision did not cover mergers.[107]

In Delaware's most recent expression on this subject, *Elliott Associates, L.P. v. Avatex Corp.*,[108] the Supreme Court ruled that the holders of preferred stock were entitled by the terms in the charter to vote as a separate class.[109] The relevant provisions read as follows:

> So long as any shares of First Series Preferred Stock remain outstanding, the *consent* of the holders of at least two-thirds of the shares of the *First Series Preferred Stock* outstanding at the time (voting separately as a class . . .) . . . *shall be necessary to permit, effect or validate* any one or more of the following:
>
> . . .
>
> (b) *The amendment, alteration or repeal, whether by merger, consolidation or otherwise, of any of the provisions of the Restated Certificate* of Incorporation or of [the certificate of designations] which would materially and adversely affect any right, preference, privilege or voting power of the First Series Preferred Stock or of the holders thereof . . . .[110]

Although the Supreme Court was required to wind its way through some rather technical arguments, it ultimately concluded that even under an interpretive rule of strict construction, this provision allowed

106. Of course, Vice-Chancellor Jacobs was not blind to the differences between the provisions. He noted that the provision in *Sullivan* was "arguably distinguishable" from *Warner* because of the words "or otherwise." *Id.* at *3. Moreover, Vice-Chancellor Jacobs examined other provisions in the Certificate of Designations for evidence regarding the meaning of "or otherwise," but he found that "[r]eading the Certificate in its entirety [did] not aid the plaintiffs' construction." *Id.* at *5-*6.

107. Vice Chancellor Jacobs wrote:

> Although "or otherwise" could conceivably (a) mean a merger or (b) have no substantive meaning, an interpretation of the Certificate cannot rest upon such speculative possibilities. For this and the other reasons already discussed, the analysis must end where it began: by resort to the exacting burden that the plaintiffs must satisfy for their position to prevail. "Under the rule of strict construction, any ambiguity must be resolved against granting the challenged preferences, rights or powers." In other words, "nothing should be presumed" in favor of preferences. "They ought to be clearly expressed, if not by words of explicit import, then by necessary implication."

1992 WL 345453, at *7 (citations omitted).

108. 715 A.2d 843 (Del. 1998).

109. *Id.* at 851-52.

110. *Id.* at 845 (emphasis added by the court).

for a class vote of the preferred stockholders.[111] The use of the word "merger" clinched the deal:

> The path for future drafters to follow in articulating class vote provisions is clear. When a certificate (like the *Warner* certificate . . .) grants only the right to vote on an amendment, alteration or repeal, the preferred have no class vote in a merger. When a certificate (like the First Series Preferred certificate here) adds the terms "whether by merger, consolidation or otherwise" and a merger results in an amendment, alteration or repeal that causes an adverse effect on the preferred, there would be a class vote.[112]

The Delaware courts are noted for instructing practicing lawyers.[113] In this instance, they provided detailed guidance for creating a class vote in a merger. It is worth noting, however, that the charter at issue in *Benchmark* was drafted in September 2001—over three years after the *Avatex* decision. This is not anomalous. The Delaware courts have been warning preferred stockholders about rights stripping transactions for generations, but the contract drafters continue to make mistakes.

Although problems inevitably accompany the sort of formalism employed by the Delaware courts, strict interpretation of contracts has some substantial potential benefits, including the conservation of judicial resources[114] and the encouragement of *ex ante* bargaining. Whether these benefits justify the costs is considered in Part V below.

IV. THE CONTRACT DOCTRINE OF GOOD FAITH

The contract doctrine of good faith rests on a simple empirical observation: "Contracts are always more than the contract docu-

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111. *Id.* at 853.

112. *Id.* at 855.

113. *See, e.g.*, Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997)

> Taken as a whole, the Delaware opinions can be understood as providing a set of parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players. My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.

Id.

114. This is similar to the classic argument in favor of strict liability in tort cases. *See* J.C. Ver Steeg, *Strict Liability and Judicial Resources*, 3 J. LEGAL STUD. 217 (1974).

ment."[115] Despite widespread recognition that the express terms of most bargains are incomplete, courts strive to anchor the duty of good faith to those express terms.[116] This means at least two things: (1) courts generally will not change the express terms of the bargain to conform to the court's notion of good faith[117] and (2) courts apply the duty of good faith to extend the express terms of the bargain only when those terms somehow justify action.[118] The scope of this latter claim is the primary focus of attention for the voluminous commen-

115. Stewart Macaulay, *The Real Deal and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, 66 MOD. L. REV. 44, 45 (2003). Macaulay proceeds with inimitable clarity to explain why this is so:

> Words do not have a fixed meaning that every speaker of the language will translate in the same way . . . . Also, it is very hard to bring the future to the present and provide that X will happen if event Y takes place. Our ability to predict the future is limited, and even careful business people often leave gaps in written contracts . . . . Even when we can foresee that it is possible that something might happen, there are limits on the time that we can or should spend on trying to provide for all contingencies in our contracts.
>
> Furthermore, we must remember that business corporations are collections of people and their activities are tightly coordinated. Those who negotiate the deal often are not the people who draft the written document recording it. Still others must perform the contract. This opens the possibility that, for example, a firm's lawyers may have different assumptions and expectations than its purchasing agents, sales people, and engineers.
>
> Strategy may be involved too. If I want a clause that says if event X takes place, the consequence Y will follow, you may demand something in exchange that I do not want to give you. When I anticipate this, it may be better to avoid raising the issue in negotiations and hope that the matter can be resolved if event X ever takes place.

Id. at 45-46.

116. Daniel A. Farber & Brett H. McDonnell, *Why (and How) Fairness Matters at the IP/Antitrust Interface*, 87 MINN. L. REV. 1817, 1848 (2003) (describing the duty of good faith as a "backstop to explicit contractual terms").

117. *See, e.g.*, Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992) ("[W]here the subject at issue is expressly covered by the contract, or where the contract is intentionally silent as to that subject, the implied duty to perform in good faith does not come into play."). The Delaware courts sometimes capture this idea by asserting that they will not "rewrite" the contract. *See, e.g.*, Cincinnati SMSA L.P. v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) ("[I]t is not the proper role of a court to rewrite or supply omitted provisions to a written agreement.").

118. While the challenged actions need not violate the express terms of the contract (*see* PAMI-LEMB I Inc. v. EMB-NHC L.L.C., 857 A.2d 998, 1016 (Del. Ch. 2004) ("A party may breach the implied covenant of good faith and fair dealing without violating an express term of the contract")), they must violate the "spirit of the agreement" as extrapolated from the express terms. Chamison v. HealthTrust, Inc., 735 A.2d 912, 920 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000).

Even when one of the parties is granted discretion under the contract, the duty of good faith limits the exercise of that discretion. Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990); Wilmington Leasing, Inc. v. Parrish Leasing Co., L.P., No. Civ.A.15202, 1996 WL 560190, at *2 (Del. Ch. Sept. 25, 1996).

tary on the duty of good faith,[119] and it is the main issue that occupies our attention here. We know from the discussion in Parts II and III above that the Delaware courts use a strict interpretation of preferred stock terms to demand complete contracts, and that in regard to class votes for mergers, a complete contract exists only when the word "merger" is specifically mentioned. In a nutshell, the Delaware courts do not have room for the duty of good faith in cases like *Benchmark*. This Part of this Article examines the duty of good faith and suggests that it might have relevance to these cases.

The Delaware courts have embraced the conception of good faith expressed in the *Restatement (Second) of Contracts*, which "emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party . . . ."[120] That formulation provides courts with ample discretion, while simultaneously attempting to link the duty of good faith to the actual bargain (note the necessity of an "agreed common purpose" and "justified expectations"[121]). The *Restatement* further qualifies this expansive obligation by "exclud[ing] a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."[122] This language embraces Robert Summers' well-known conception of good faith as an "excluder," which holds that good faith is best understood as the absence of bad faith.[123]

Deciphering the content of any obligations that flow from the

119. *See* Emily M.S. Houh, *Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law*, 88 CORNELL L. REV. 1025, 1034 n.25 (2003) ("[M]ore than one hundred law review and bar journal articles have been written about the implied duty of good faith in the past twenty years alone."). *See also* E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 201 (1968) [hereinafter Summers, *"Good Faith"*]; Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980).

120. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1979).

121. *Id.* (emphasis added).

122. *Id.*

123. Summers, *"Good Faith," supra* note 119, at 201. This view has been rightly criticized as indeterminate. *See, e.g.*, Larry T. Garvin, *Adequate Assurance of Performance: Of Risk, Duress, and Cognition*, 69 U. COLO. L. REV. 71, 120 (1998) ("Professor Summers sees no real meaning in good faith as such. Rather, he sees the concept as something of a safety-valve, allowing the courts to police agreements and performance for fairness.").

duty of good faith is tricky.[124] The Delaware courts often use the familiar thought experiment known as the "hypothetical bargain."[125] In the well-known case of *Katz v. Oak Industries Inc.*,[126] Chancellor Allen described the inquiry as follows:

> Because it is an implied contractual obligation that is asserted as the basis for the relief sought, the appropriate legal test is not difficult to deduce. It is this: is it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[127]

For present purposes, the most interesting feature of the hypothetical bargain, so expressed, is the implied assumption that contractual gaps are caused by a failure of imagination (had they thought to negotiate with respect to that matter).[128] Even a moment's reflection reveals that this is not the only source of incomplete contracts,[129] but

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124. *See* Houh, *supra* note 119, at 1033 ("[A]lthough the concept of good faith is relatively easy to grasp, the actual standard by which good faith or its absence is discerned can be frustratingly elusive.").

125. *See* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991) (giving detailed analysis and criticism of the hypothetical bargain technique of contract interpretation).

126 508 A.2d 873 (Del. Ch. 1986).

127. *Id.* at 880; *see also* Mkt. St. Assoc. Ltd. P'ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (The implied duty of good faith "is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute.").

128. *Mkt. St. Assocs.*, 941 F.2d at 595.

129. Contracts may be incomplete in one of two ways: (1) the express terms of the contract are ambiguous, or (2) the express terms of the contract do not cover the matter in question. Charny, *supra* note 125, at 1816. Ambiguity might be addressed in various ways, and the duty of good faith is sometimes employed to prevent a perverse interpretation of the express provisions of a contract. *See, e.g.*, Chamison v. HealthTrust, Inc., 735 A.2d 912 (Del. Ch. 1999) ("[A] party to a contract has made an implied covenant to interpret and to act reasonably upon contractual language that is on its face reasonable.") (citing Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984) ("[I]f one party is given discretion in determining whether [a] condition in fact has occurred[,] that party must use good faith in making that determination."), *aff'd*, 575 A.2d 1131 (Del. 1990).

The second malady—commonly referred to as the problem of contractual "gaps"—may have several causes: contracting parties may write contracts that are purposely incomplete, contracting parties inevitably suffer from "bounded rationality" (they cannot foresee all potential problems), certain aspects of the relationship might be observable by the parties but not verifiable by a court (e.g., the effort exerted by the parties), or transaction costs may make bargaining prohibitively expensive. *See* Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83, 84-85 (1999) (arguing that transaction

it seems to be the main focus in many Delaware cases,[130] and it will suffice to illustrate the rationale for the duty of good faith in Delaware jurisprudence.

Some insight into the rationale for the duty of good faith may lie in the answer to this question: Why does the limited imagination of contracting parties justify judicial intervention? The answer is far from obvious. At the end of this Article's discussion of the strict interpretation of preferred stock contracts, it was observed that there are salutary effects of that approach, namely, the conservation of judicial resources and the encouragement of ex ante bargaining. When courts employ the duty of good faith to imply terms in incomplete contracts, they forfeit those benefits.

On the other hand, judicial intervention might be useful in getting the right answer. While one can safely assume that contract drafters respond, in some degree, to the incentives imposed by a commitment to judicial abstention, if contract drafters suffer from bounded rationality, then limited imagination becomes a persistent source of contractual incompleteness. Perhaps the application of the duty of good faith is merely the recognition that contractual gaps are an inevitable result of limited imagination.

This possibility creates something of a problem for the interpretation of venture capital contracts. If the Delaware courts employ the duty of good faith to most contracts because they are inherently incomplete, why do the Delaware courts demand complete contracts for preferred stockholders? The task of the next portion of this Article is to explore whether this interpretive structure is a sensible way to approach venture capital contracts.

V. THE PROPER ROLE OF COURTS

The doctrine of independent legal significance is a rule of judicial abstention, while the doctrine of good faith is a rule of judicial intervention. In the face of contractual incompleteness, these two doctrines imply different roles for markets, legislatures, courts, and norms. The doctrine of independent legal significance honors market solutions—shaped in accord with legislative templates—while the

costs do not prevent complete contracting); *but see* Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115, 116 (1999).

130. *See* Cincinnati SMSA Ltd. P'Ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998); DuPont v. Pressman, 679 A.2d 436, 443 (Del. 1996); Schwartzberg v. CRITEF Assocs. L.P., 685 A.2d 365, 375-76 (Del. Ch. 1996).

doctrine of good faith relies on judicial review of market activities and judicial interpretation of the scope of legislation. Under both doctrines, business norms are assumed to have some influence over outcomes. Whether this allocation of judicial resources makes sense depends not only on whether one institution or another has the capacity for getting the answer right, but rather on a comparative institutional analysis of all relevant institutions.

A framework and vocabulary for comparative institutional analysis have been developed by Neil Komesar, who concentrates on four institutions: courts, political processes, markets, and norms.[131] These institutions are society's mediators. Simply stated, their task is to resolve conflicts.[132]

The goal of comparative institutional analysis is to define a role for law, by which Komesar means "the adjudicative process."[133] In comparing markets and courts, many policymakers and commentators employ a single institutional framework that skews the analysis. For example, by focusing on the characteristics of courts, commentators have proposed judicial intervention where market solutions are superior or judicial abstention where the market is dysfunctional.[134] Alternatively, by focusing on the shortcomings of the market, commentators often argue for judicial intervention in areas where the courts have little to offer.

Comparative institutional analysis is complicated by the fact that institutional competencies are not static. Komesar identifies two attributes of transactions that seem to influence the quality of institutional performance most: the number of parties connected to the transaction and the complexity of the transaction.[135] Importantly, "*[i]nstitutions tend to move together*,"[136] and as numbers and complexity increase, institutional competence declines across the board.[137] As a result, "analysis of law and rights will usually involve a series of

131. *See, e.g.*, KOMESAR, LAW'S LIMITS, *supra* note 27, at 31. Komesar uses the term "informal communities" where I use "norms." Admittedly, communities are more than the norms that they embrace, but those norms are the operative feature of communities in Komesar's analysis. *Id.* at 27.

132. *Id.* at 31 ("Institutions for me are large-scale social decision-making processes—markets, communities, political processes, and courts").

133. KOMESAR, LAW'S LIMITS, *supra* note 27, at 3.

134. As will become clear below, I place the doctrine of independent legal significance in this latter category.

135. KOMESAR, LAW'S LIMITS, *supra* note 27, at 23.

136. *Id.*

137. *Id.*

close institutional choices."[138]

When faced with a conflict like *Benchmark*, the Delaware courts have chosen the path of abstention through the doctrine of independent legal significance, rather than the path of intervention through the doctrine of good faith. In doing so, they express a preference for the outcome of *ex ante* bargaining over *ex post* judicial intervention. The elephant in this room is the fact that all contracts are incomplete. If the Delaware courts expect their "tough love" to induce complete contracting, they are simply delusional. *Benchmark* is a case in point: After decades of experience with rights stripping of preferred stock, the courts still regularly hear cases in which "sophisticated" parties leave themselves open to opportunistic behavior. The decision by the Delaware courts to do nothing, therefore, is a decision to ignore the reality of incomplete contracts.

Would a more realistic view of the contracting process necessarily dictate judicial intervention through the doctrine of good faith? Consider the following stylized hypothetical parties to a relational contract bargain at a point in time. At some future point in time, the parties discover a gap in their original agreement. One of the parties—by virtue of having physical control over relationship assets or some other real-world advantage—decides to act opportunistically vis-à-vis the other party, who turns to the courts for assistance. Should courts intervene in this dispute?

A single institutional analysis considers the costs of judicial intervention and the likelihood that courts would generate the "right" outcome in this case. A comparative institutional analysis, by contrast, considers not only the likely outcome of judicial intervention *in this case*, but also the relative merits of judicial intervention as compared to legislative action, *ex ante* or *ex post* bargaining, and the effect of "community" forces, such as norms and reputation. Moreover, comparative institutional analysis must contemplate the implications for other institutions of entrusting the decision to courts. For example, one must consider whether judicial intervention would improve bargaining.

In the context of the stylized facts discussed above, judicial intervention at the future point in time (when the parties discover the defect in the contract) has the salutary effect of moving the decision point to a time when information about potential conflicts is more readily available. Indeed, the relevant conflict has been exposed, thus

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138. *Id.* at 24.

creating an opportunity for judicial intervention. On the other hand, we might have concerns that such intervention would override bargaining. The concern is persistent in debates about the duty of good faith, as it should be.[139] Nevertheless, the stylized facts assume an inadvertent gap in the contract, suggesting that judicial intervention would not do harm to a pre-existing bargain.[140]

Judicial application of the duty of good faith also might benefit *ex post* bargaining. In the absence of judicial intervention, the party with the stronger position vis-à-vis the real-world assets at the center of the dispute is likely to pursue its preferred path over the objections of the weaker party. Meanwhile, the weaker party will look for exit options, realizing the futility of appealing to the courts. In short, judicial abstention enables opportunism. Judicial intervention, on the other hand, disrupts the stronger party. The ensuing uncertainty forces the stronger party to the bargaining table.[141] This result arises regardless of judicial competence.

VI. CONCLUSION

The problem described above is part of a larger debate about the proper role of good faith in contract law. In simplest terms, courts could deal with the expectations of parties formally (*i.e.*, inquiring only about the plain meaning of the contract) or qualitatively (*i.e.*, enforcing the presumed expectations of the parties, regardless of whether those expectations are expressed in the contract).[142] While no one seriously advocates a strict application of the "plain meaning" approach to contract interpretation in all cases, the Delaware courts have adhered fairly consistently to such a standard in cases involving

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139. *See, e.g.*, Robert M. Phillips, *Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 1179, 1199 (1993) (discussing the duty of good faith in employment termination cases); Kevin M. Teeven, *Decline of Freedom of Contract Since the Emergence of the Modern Business Corporation*, 37 ST. LOUIS U. L.J. 117, 143 (1992) (referring to the duty of good faith as "a judicial doctrine . . . where fairness overrides freedom of contract").

140. The stylized facts raise a new concern, however, about the legitimacy of judicial intervention: If the parties have not bargained over the matter at issue, what standards will guide the court in making determinations about the proper range of good faith behavior? As noted above, the Delaware courts often attempt to ground their inquiry in a hypothetical bargain, but this approach has been criticized on multiple fronts.

141. *Cf.* Jason S. Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON. & ORG. 256 (1995) ("When parties bargain over [an] entitlement when there is private information about value and harm, bargaining may be more efficient under a blurry balancing test than under a certain rule.").

142. *See* Macaulay, *supra* note 115, at 44-45.

the interpretation of preferred stock terms. This decision by the Delaware courts prompts us to reconsider the proper role of courts in interpreting venture capital contracts.

By imposing strict standards of contract interpretation, the Delaware courts seem to be engaged in an effort to force contracting parties toward completeness. As noted above, however, contracts are inevitably incomplete. While the duty of good faith appears to respond to this truism by filling gaps in contracts, the courts largely ignore this duty in preferred stock cases. This omission, coupled with the doctrine of independent legal significance—which treats charter amendments via merger separately from charter amendments via board and stockholder approval—virtually ensures that preferred stockholders will be the subjects of opportunistic behavior by common stockholders.

Whether courts should respond to claims of injustice in this context depends on comparative institutional analysis. Just because market contracting produces incomplete contracts does not mean that courts should be obligated to fill such contracts. On the other hand, this Article suggests that the application of the duty of good faith in this context might provide valuable incentives to renegotiate when unexpected circumstances arise.