THE PERIL AND PROMISE OF PREFERRED STOCK

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ABSTRACT

This Article presents a comprehensive legal analysis of preferred stock in the wake of the doctrinally transformative cases of Trados *(2009),* LC Capital *(2010), and* Thoughtworks *(2011). These cases mark the culmination of a long and gradual decimation of the legal rights of preferred shareholders under Delaware corporate law. Preferred stock has become less secure than ever, as opportunistic issuers have demonstrated the ability and the willingness to divert its investment value to the common equity. As a result, it is disappearing, along with its unique financial properties that help struggling firms avoid insolvency. This Article offers a novel solution to restore preferred stock to viability: a specific division of corporate control between preferred and common that will allow them to harmoniously co-exist. One central advantage of this approach is that it requires no changes in existing law to be implemented; only clever, sophisticated bargaining by each side is required.*

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I. INTRODUCTION

The irony of preferred stock is that courts treat it with disdain.[1] It should be a staple of modern finance, because it offers an unparalleled financial flexibility that helps businesses stay afloat during hard times and thus reduces bankruptcy risk for investors.[2] Yet it has virtually disappeared in most mature industries, largely because preferred shareholders have found it terribly difficult to protect the value of their investment.[3] As a result, they demand a risk premium that few companies are willing to pay, except as a last resort.[4] Today, nearly all public preferred stock is issued by financial

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[1]*See, e.g.*, William W. Bratton, *Venture Capital On The Downside: Preferred Stock And Corporate Control*, 100 MICH. L. REV. 891, 894 (2002) (stating that courts are as hostile as ever toward preferred stockholders).

[2]*See infra* notes 81-83 and accompanying text (discussing the utility of preferred stock in avoiding creditor opportunism).

[3]*See, e.g.*, Bratton, *supra* note 1, at 892 ("The only mature firms that finance with preferred, which once was ubiquitous in American capital structures, tend to be firms in regulated industries having little choice in the matter.").

[4]For instance, Goldman Sachs famously issued $5B in preferred stock to Warren Buffett in September 2008, when it badly needed new capital to ensure that it survived the great financial crisis of that year. *See, e.g.*, Zachery Kouwe, *Buffett's Goldman Stake Pays Richly*, N.Y. TIMES (July 24, 2009), http://dealbook.nytimes.com/2009/07/24/buffetts-goldman-stake-worth-91-billion/?_php

institutions, insurance companies, or other institutions subject to strict capital adequacy regulation,[5] as illustrated by the size and composition of preferred stock exchange-tradable funds.[6] Preferred stock is more commonly used for funding startups, owing to the peculiar risk-return ratio sought by venture capitalists.[7] Even in that context, however, its use may be declining, as some venture capitalists are rethinking their commitment to an investment vehicle that offers few legal protections.[8]

The problem is that corporate law now gives short shrift to the equity aspect of preferred stock. Financially, preferred stock resembles debt, in that it has limited upside and its return comes in the form of periodic coupon payments.[9] Legally, though, it is much more like common equity: preferred

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=true&_type=blogs&_r=0 (discussing the original investment and its appreciation to an estimated $9.1B nine months later). The terms were almost usurious: Buffett was able to extract a 10 percent yield *and* an in-the-money option to buy another $5B worth of common stock. *Id.* At the time, though, Goldman had few better options: the capital markets were frozen and investors were scared to invest in any investment bank. *Id.* Within a year, Buffet's investment almost doubled in value. *Id.*

[5]In the United States and other countries that comply with the Basel Capital Accords, institutions regulated as banks are required to finance a certain amount of their lending (or other asset acquisitions) with instruments junior to senior unsecured debt. *See generally* Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 649-56 (2012) (explaining bank capital requirements). Currently, 4 percent of a bank's risk-weighted assets must be financed with Tier 1 capital (which consists mostly of common equity), and 8 percent must be financed with Tier 1 or Tier 2 capital. *See id.* at 654. Preferred stock counts as Tier 2 capital, whereas ordinary debt does not. *Id.* at 652. Thus, banks interested in maximizing the financial leverage of its common equity have an incentive to issue preferred stock to meet the Tier 2 capital requirements.

[6]To take one example, Blackrock's iShares Preferred Stock ETF—the largest preferred stock ETF, traded under the symbol "PFF"—holds over 83 percent of its non-real estate preferred assets in the "Diversified Financial," "Banks," and "Insurance" sectors. *See* iShares U.S. Preferred Stock ETF Fact Sheet, *available at* http://us.ishares.com/content/stream.jsp?url=/content/en_us /repository/resource/fact_sheet/pff. pdf&mimeType=application/pdf.

[7]The typical venture capital business model involves distributing bits of money to a large number of startups, hoping that a few of them will turn into exponentially-growing companies. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt And The Missing Lever Of Corporate Governance*, 154 U. PA. L. REV. 1209, 1218, 1220 (2006). A handful of early-stage investments in firms like Google, Facebook, or Groupon can more than make up for hundreds of unsuccessful bets on failed startups. The model does not work, though, if the venture capitalist can lose its equity investments in a struggling startup that files for bankruptcy before becoming a hit. *See id.* at 1227-29. Thus, VCs are keenly interested in making sure their portfolio firms do not issue debt, because there can be no bankruptcy without creditors. *See id.* at 1219. Thus, they invest by means of preferred stock. *See id.* at 1229-30. The insecurity of the preferred stock form costs little, since VCs do not expect to recoup their investments in failed startups anyway. *See id.* at 1230-31.

[8]*See, e.g.*, Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control In Startups*, 81 N.Y.U.L. REV. 967, 978 (2006) ("When determining which strategies the firm should pursue, directors elected by common shareholders owe a duty solely to common shareholders and are not required to take into account the interests of preferred shareholders, as long as the firm does not violate specific provisions of the preferred stock agreement.").

[9]*See* 11 WILLIAM M. FLETCHER, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE

shareholders, unlike creditors, cannot sue in contract to recoup either their principal investment or unpaid coupons, and the terms of a preferred stock investment, unlike those of a debt contract, can be altered unilaterally by the firm.[10] As a result, the value of fixed income equity can be opportunistically expropriated by common equity, by such means as dilutive mergers, leveraged recapitalizations, or risk-seeking economic strategies.[11] Not even venture capitalists are safe, despite their deep experience with preferred stock and their business power over the companies.[12] Occasionally, they let down their guard, and then can only watch helplessly as their investments are decimated.[13]

The corporate law once offered at least a modicum of protection against exploitation. For instance, the famous 1986 Court of Chancery case *Jedwab v. MGM Grand Hotels, Inc.* held that boards must respect fiduciary duties when dealing with the preferred.[14] Over the past three decades, however, courts have eroded such duties to the preferred so far that they exist in name only.[15] Indeed, recent opinions have suggested that the board may even have a fiduciary duty to siphon value from the preferred when the opportunity arises.[16] Today, preferred shareholders must protect themselves with contract-like covenants in the certificate of designation[17]—covenants

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CORPORATIONS § 5289 (West 2013) [hereinafter FLETCHER CYC. CORP.]. A coupon payment is a payment made on a financial instrument according to a fixed schedule and for a fixed amount. *See* BLACK'S LAW DICTIONARY (9th ed. 2009). For instance, the holder of a $1,000 bond having a 6 percent coupon will typically receive $30 twice a year. Preferred stock also comes with a coupon, but it takes the form of a dividend. *See* FLETCHER CYC. CORP., *supra*, § 5299. As discussed in Part II., *infra*, dividends are not nearly as secure as interest payments, as they can be effectively discontinued by the board.

[10]The terms of a preferred stock investment are established by its certificate of designation, which becomes part of the company's certificate of incorporation when executed. *See* Matulich v. Aegis Commc'ns Grp., Inc., 942 A.2d 596, 600 (Del. 2008). As such, the designated terms are subject to amendment in the same manner as any other provision of the certificate. *See* DEL. CODE ANN. tit. 8, § 242 (2013).

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

[12]*See* Baird & Rasmussen, *supra* note 7, at 1218-19.

[13]A recent, famous example is documented in *Benchmark Capital Partners IV v. Vague*, 2002 WL 1732423 (Del. Ch. July 1, 2002), *aff'd*, 822 A.2d 396 (Del. 2003). In this case, Benchmark, the venture capitalist, saw its preferred stock subordinated, against its will, to a large subsequent preferred stock investment. *See id.* at *1. The certificate contained a provision to protect Benchmark against this circumstance in the certificate, but the provisions were poorly drafted and were evaded by the issuer. *See id.* at *10. *See generally* D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825 (2004) (describing the transaction involved in *Benchmark*).

[14]509 A.2d 584, 594 (Del. Ch. 1986) (requiring the board to respect fiduciary duties toward preferred shareholders in allocating merger consideration between common and preferred).

[15]*See infra* Part II.E.

[16]See *infra* notes 219-41 and accompanying text (comparing cases that suggest directors may rightfully favor common shareholders over preferred when faced with a conflict).

[17]*See, e.g.*, *In re* Trados Inc. S'holder Litig. (*Trados I*), 2009 WL 2225958, at *7 (Del. Ch.

that are most often interpreted very narrowly, in favor of the common.[18] It is no wonder, then, that investors have lost interest in preferred stock; if one must rely on covenants, better that they be included in an unalterable, legally enforceable debt contract. Preferred stock cannot survive if the board, acting on behalf of the common, can readily expropriate much or all of its value.

This Article argues that preferred stock can regain its prominence if it evolves.[19] Preferred shareholders need not rely on the law if they can obtain voting control over a majority of the seats of the board.[20] This suggestion, in itself, is nothing new; preferred shareholders have long sought board control, only to find that the common won't give it up, and for good reason.[21] What has not been tried—the novel solution offered here—is a division of board control between the two classes of equity in such a way to ensure their harmonious co-existence.[22] The common would retain full power over executive compensation, to ensure that the directors and officers are sufficiently incentivized to pursue profitable, risky investments.[23] The common would also retain its merger veto and continue to be the beneficiaries of the board's fiduciary duties, so as to prevent the preferred from seeking to liquidate the firm or drain its assets at the expense of the common.[24] The preferred would get operational control, and with it, domain over the mechanisms that today can be used by the common to exploit their

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July 24, 2009) (noting that "the rights and preferences of preferred stock are contractual in nature"). *Trados I* (and other cases that recite the same standard) uses the term "contractual" loosely, to refer to bargained-for provisions that specify rights with particularity—as opposed to rights that derive from the fiduciary duty of the board. *Id.*; *see, e.g.*, Matulich v. Aegis Comm'ns Grp, 942 A.2d 596, 600 (Del. 2008) (reciting same standard). Technically, the rights are not fully contractual; preferred shareholders who seek to enforce their bargains must proceed in equity under corporate law. *See* FLETCHER CYC. CORP., *supra* note 9, § 5295. Thus, in Delaware, disputes involving preferred shareholders are heard in the Court of Chancery. DEL. CODE ANN. tit. 10, § 341 (2013).

[18] *See infra* Part II.D.

[19] *See infra* Part II.F.

[20] *See infra* Part III.D.

[21] *See, e.g.*, Rothschild Int'l v. Leggett, 474 A.2d 133, 136 (Del. 1984) ("[M]inority stock interests may be eliminated by merger."). While preferred shareholders are always vulnerable to opportunism by the common, they at least have seniority within the capital structure. *See* FLETCHER CYC. CORP., *supra* note 9, §5299. As a result, the board can expropriate significant value, but it cannot easily strip the preferred entirely *and* retain value for the common. *See, e.g.*, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1041-42 (Del. Ch. 1997) (describing the conflict between the financial interests of holders of preferred and common stock where the company is on the brink of insolvency). Matters would be comparatively worse for the common if control were reversed. *Cf. id.* at 1042 (stating that the board of a nearly insolvent company may impose economic risks on the preferred stock for the benefit of the common without breaching fiduciary duties because the preferred would always rather force a liquidation in such a case). Preferred shareholders with board control could divert most or all of the firm's cash flow into their own coffers.

[22] *See infra* Part III.C.

[23] *See infra* notes 401-06 and accompanying text.

[24] *See infra* Part II.C.1.

senior partners in equity.[25] Divided board control ("DBC") forces the common and the preferred to cooperate in efficiently managing the firm; each side understands that the alternative might lead to mutually assured destruction.[26]

One advantage of DBC over other reform agendas is that it can be implemented under current law, simply by negotiation.[27] Other proposals for reviving preferred stock call for changes to the law. Fried and Ganor, for instance, suggest that common and preferred can co-exist with a change in Delaware law permitting certificate-level restrictions on directors' fiduciary duties.[28] A recent paper by Professors Bratton and Wachter proposes a fiduciary duty of good faith owed by the board to the preferred, which would require (at a minimum) the board to seek to maximize not the common's wealth, but the total enterprise value of the firm.[29] As meritorious as these suggestions might be, there does not seem to be a reform agenda anywhere on the horizon.[30] By contrast, DBC achieves similar results by breaking free of the age-old assumption that voting rights, incentive alignment, and fiduciary expectations need be fused into one type of equity interest.[31] Splitting them up wisely between different classes of equity can be more effective.

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[25] *See infra* notes 42-48 and accompanying text.

[26] *See infra* notes 305-16 and accompanying text.

[27] *See* discussion *infra* pp. 215-16.

[28] *See* Fried & Ganor, *supra* note 8, at 1024 (suggesting that investors may prefer "boards to be governed by some approach to fiduciary duties other than the courts' current . . . approach, and that courts should allow parties, through charter provisions, to opt into more restrictive fiduciary duty rules that those currently offered"). They also suggest that boards be permitted only to favor one class of equity over another if such favoritism passes cost-benefit analysis. *See id.* at 1022-24. It is unclear how such a rule would be implemented. If the board's cost-benefit analysis is subject to the business judgment rule, nothing will have been gained. On the other hand, one doubts that the corporate law courts are institutionally equipped to make such determinations.

[29] William W. Bratton & Michael L. Wachter, *A Theory Of Preferred Stock*, 161 U. PA. L. REV. 1815, 1894 (2013) (arguing that enterprise value maximization presents a stronger case for fiduciary scrutiny than common equity value maximization in the preferred stock context).

[30] *See, e.g.*, William W. Bratton, *Gaming Delaware*, 40 WILLAMETTE L. REV. 853, 863-64 (2004) (recounting the efforts by a prominent legal scholar over two decades to convince the courts of the need for "robust good-faith review of financial contracts" only to find that "nobody paid the slightest attention[,]" and asserting that Delaware is too concerned with pleasing its "customer base" of corporate executives to offer meaningful protections to preferred stock).

[31] This classic economic view has been called into question by recent scholarship. *See, e.g.*, Frank Partnoy, *Financial Innovation In Corporate Law*, 31 J. CORP. L. 799, 807 (2006) (using option theory to argue that the allocation of control and fiduciary rights as between asset classes is arbitrary). This article takes no position on the proper distribution of rights as between the equity and other interests. *See generally id.* The suggestion here is that whatever portion of these protections are allocated to the equity, they should be segregated by type between preferred and common to counter-balance power between the two classes of equity. *See id.*

II. THE PERILS OF PREFERRED STOCK

A. *Preferred Stock Basics*

Preferred stock is a class of stock that is senior to common equity in a firm's capital structure.[32] If the corporation is liquidated, the preferred is paid off in full before the common can claim any assets.[33] The amount of money that constitutes full satisfaction of the preferred's fixed claim is called the liquidation preference.[34] The preferred's seniority also extends to current income, meaning that the common cannot be paid any dividends until the dividends promised to the preferred are paid in full.[35] Both the preference and the dividend—along with other contractual rights and protections, some of which will be discussed later in this Article—are determined by active bargaining between the investors and the issuing firm.[36] They are formally specified in a contract known as the certificate of designation,[37] which becomes incorporated into the corporate charter when executed.[38]

As an illustration, consider a firm called Apoogle Oil capitalized with two classes of stock: one million shares of preferred stock that each carry a $50 liquidation preference and a dividend of $5 per year, and ten million

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[32]*See* FLETCHER CYC. CORP., *supra* note 9, § 5283.

[33]*See id.* § 5303.

[34]*See* BLACK'S LAW DICTIONARY (9th ed. 2009) ("A preferred shareholder's right, once the corporation is liquidated, to receive a specified distribution before common shareholders receive anything.").

[35]*See* FLETCHER CYC. CORP., *supra* note 9, § 5299 ("The holders of preferred shares are entitled to be paid dividends, in accordance with the terms of their contract before any dividends can be paid to the holders of common stock." (footnotes omitted)). In theory, preferred stock dividends can be noncumulative, meaning that the preferred holders have no claim on unpaid (or less than fully paid) dividends from prior time periods. *See id.* § 5446 (distinguishing cumulative from noncumulative preferred dividends). Thus, the board could pay dividends to the common while bypassing the preferred simply by (1) building up cash reserves by not paying any dividend for many time periods and (2) paying out that cash in the form of a special dividend to the common after paying to the preferred its promised dividend for that single time period. *See id.* Absent extraordinary facts, a rational person would never purchase non-cumulative preferred, and hence it will be assumed that all preferred stock is cumulative.

[36]*See, e.g.*, Jedwab v. MGM Grand Hotels Inc., 509 A.2d 584, 593 (Del. Ch. 1986) ("[P]references and limitations associated with preferred stock exist only by virtue of an express provision (contractual in nature) creating such rights or limitations.").

[37]*See, e.g.*, DEL. CODE ANN. tit. 8, § 151(d) (2011) ("The holders of the preferred . . . shall be entitled to such rights upon the dissolution of, or upon any distribution of the assets of, the corporation as shall be stated in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock . . . .").

[38]*See* Elliot Assocs. v. Avatex, 715 A.2d 843, 843 n.3 (Del. 1998) ("When certificates of designations become effective, they constitute amendments to the certificate of incorporation so that the rights of preferred stockholders become part of the certificate of incorporation.").

shares of common stock initially purchased for $10 each. Assume that, three years later, Apoogle's net assets have grown to $200M. If the firm were liquidated at that point, the preferred shareholders collectively would collect $50M, and the common shareholders would receive $150M, or $15 per share. By contrast, if the firm's assets had shrunk to $60M, the preferred would still collect $50M, whereas the common shareholders would divide only the remaining $10M. Each year, the firm would pay $5M per year in dividends to the preferred, meaning that profits earned in excess of that amount could be paid to the common in the form of dividends.

The financial attributes of preferred stock resemble those of debt, because usually preferred stock entitles its owner to a fixed claim on the firm's assets along with a periodic yield. A liquidation preference is analogous to the principal a debtor owes to a creditor;[39] the preferred dividend is analogous to the interest a debtor pays on that principal.[40] Both types of fixed claims have limited upside, meaning that their maximum return on investment is pre-defined, usually as the interest or dividend to be paid.[41] Returning to the Apoogle Oil example, suppose that in ten years, the company's assets and profits have grown so vast that the firm is worth one trillion dollars. The preferred shareholders would still have a liquidation preference of $50M, and they would have been paid $50M in dividends over that time period. Meanwhile, the remaining $999.99B in value would go to the common. If Apoogle had issued debt instead of preferred stock, the finance would be unchanged: the creditors would have received $100M, and the common would be worth very nearly a trillion dollars.

Preferred stock also resembles debt in that both instruments are vulnerable to exploitation by the common. By their nature, fixed claims lose value when subject to increased risk, whereas equity tends to benefit from additional risk.[42] Thus, if the common shareholders can impel the firm to take on additional risk, the value of their investments will appreciate, at the expense of the fixed claimants.[43] A bit of arithmetic and a hypothetical help illustrate the point. Suppose a firm, capitalized with 75 percent fixed

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[39]*See* FLETCHER CYC. CORP., *supra* note 9, § 5303 (describing liquidation rights of preferred shareholders).

[40]*See id.* § 5291 (distinguishing preferred stockholders from creditors).

[41]*See id.* § 5303 ("[H]olders of preferred shares have the same, and no greater right, to share in the assets as the holders of common shares . . . .").

[42]Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good and The Hobson's Choice During a National Crisis*, 17 GEO. MASON L. REV. 661, 721 n.369 (2010) (discussing how increases in firm riskiness benefits equity and harms debt, and how therefore the interests of equity and debt holders are often in conflict).

[43]*See id.*

financing (*i.e.*, debt or preferred) and 25 percent common equity, is presented with an opportunity to bet all of its assets on a coin flip. This bet would be a great deal for the common: while they could be wiped out (along with the debt) if the firm loses the bet, they would make 5 times their money if it wins.[44] Assuming that the coin is fair, the expected gain to equity from merely placing the bet would be 250 percent.[45] In fact, at this leverage ratio, equity would come out ahead even if the coin were loaded so as to give the firm only a 25 percent chance of winning.[46] Thus, equity can profit by causing a company to make knowingly terrible investments, so long as the potential upside is sufficiently high.[47] This opportunistic gain, of course, comes at the expense of the fixed claims, which bear most of the downside risk but have no claim on the winnings; in this example, the fixed claims would lose half their value even assuming a fair coin.[48]

Thus, both debt and preferred seek to protect their claims on the firm's assets against opportunism by the common. Their ability to do so differs greatly.[49] Creditors have access to contractual remedies, which means they can regulate the firm's behavior with bargained-for covenants in the debt contract.[50] In most cases, these contracts are written so that the outstanding principal and interest on the loan becomes immediately due if any covenant is breached.[51] Both common equity and management fear this circumstance,

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[44]The arithmetic works as follows. Suppose the company has $100M in assets, meaning that it has $75M in debt and $25M in equity. If it wins the bet, its assets will increase to $200M—a gain that goes only to the equity, since the debt's claim is fixed. Thus, the equity would now be worth $125M, which is 5 times its original value.

[45]After the coin flip, the equity would be equally likely to be worth nothing or $125M, meaning that its expected value before the flip (but after the bet) would be $62.5M, 2 ½ times its original value of .25X.

[46]In this case, the expected value of the equity would be 0.25*12.5M = 3.125M, which still represents a healthy 25 percent gain.

[47]*See, e.g.*, Credit Lyonnais Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *24-*25 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 (1992) (noting that the decisions of a board representing only shareholders' interests will be inefficient for the firm as a whole).

[48]After the coin flip, the fixed claim would be equally likely to be worth nothing, or retain its original value, meaning that its expected value after the bet but before the flip would fall to $37.5M. To be sure, the market value of the debt might slightly rise if the firm won the bet, because the debt would be secured by more assets and would therefore be somewhat less risky. This magnitude of this effect, though, is insignificant compared to the massive increase in risk occasioned by the bet itself.

[49]*See infra* notes 50-54 and accompanying text.

[50]*See* JEFFREY J. HAAS, CORPORATE FINANCE IN A NUTSHELL 317, 317 (2d ed. 2010) ("[A]n indenture sets forth the issuer's promise to repay debt holders. . . . [which is] fully enforceable . . . as it was given by the issuer in a bargained for exchange in return for the loaned funds.").

[51]*See, e.g.*, REVISED MODEL SIMPLIFIED INDENTURE §§ 6.01(3), 6.02 (defining "Event of

as firms usually lack the liquidity to satisfy the accelerated obligation and thus reorganization becomes likely.[52] As Professors Baird and Rasmussen have observed, the covenants included in revolving lines of credit are often so detailed and firm-specific that they confer upon the creditor bank an effective veto over excessive risk-taking by the debtor firm.[53] While debt covenants cannot render creditors completely invulnerable to opportunism, they are usually at least somewhat effective in protecting the underlying value of debt claims.[54]

Preferred stock, by contrast, must rely on much weaker remedies.[55] To be sure, preferred stock typically issues with covenants similar to those included in bond indentures, but they are not backed by the power of accelerated repayment of principal and interest.[56] Dividends promised to preferred stock can be retracted, and the preferred generally cannot force repayment of the principal in the event that a covenant has been breached.[57] The preferred can roughly approximate accelerated principal repayment by obtaining a promise from the firm to redeem the stock if any covenants are breached,[58] but redemptions cannot be relied upon in a pinch—they are subject to statutory restrictions and are regulated less by contract than by equitable principles of corporate law.[59] Ultimately, the preferred shareholders, as shareholders, must seek legal remedies by means of actions

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Default" as including failure to comply with any agreement "in the Securities or this Indenture," and providing that the indenture trustee or holders of at least 25 percent of the outstanding principal may, upon an event of default, declare the principal and unpaid interest to be immediately due and payable); Baird & Rasmussen, *supra* note 7, at 1227-28 (noting that the basic structure of a loan agreement includes a set of covenants and a provision that defines covenant breaches as default events that permit the creditor to demand repayment).

[52] *See* Baird & Rasmussen, *supra* note 7, at 1230-35.

[53] *Id.*

[54] As Baird and Rasmussen note, private lenders can obtain much greater protection, because they can tailor the covenants much more narrowly to the specific risks presented by the borrower. *See id.* at 1231-32. However, even generic financial covenants, such as maximum leverage ratios, can discipline the behavior of debtor firms. *See, e.g.*, M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1557 & n.74 (describing studies demonstrating that covenants on publicly issued debt can be used by vulture investors to veto unpalatable managerial decisions).

[55] *See supra* notes 56-62 and accompanying text.

[56] *See* HAAS, *supra* note 50, at 416-17.

[57] *See* Bratton & Wachter, *supra* note 29, at 1861 ("Promises to pay dividends on stock or redeem stock for cash cannot be made absolute in the same sense as promises to pay interest and to repay principal on a bond.").

[58] *See* HAAS, *supra* note 50, at 423.

[59] *See, e.g.*, SV Inv. Partners v. Thoughtworks, Inc. (*Thoughtworks I*), 7 A.3d 973, 988 (Del. Ch. 2010), *aff'd* 37 A.3d 205 (Del. 2011) (declining to enforce a mandatory preferred stock redemption provision when the board determined that there were no funds legally available with which to redeem); *infra* Part II.D.

in corporate law.[60] In board-friendly jurisdictions such as Delaware, this operates as a powerful practical disadvantage.[61] While the common shareholders occasionally win when taking action against the board, the preferred nearly always lose.[62]

What preferred stock can obtain, in theory, is control over the board.[63] Indeed, board control is even better than a contract remedy; investors would have no need to go to court if the board were to do its bidding.[64] However, the preferred rarely gets control, as control is generally considered to be more valuable to the common.[65] While the preferred can suffer a loss if the board, favoring the common, causes the firm to increase its risk, the inverse situation—in which the board does the preferred's bidding—can wipe out the common almost in its entirety,[66] leaving the common with barely a cent.[67]

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[60]This is not to say that the court's decisions cannot be grounded on contract principles. *See* Rothschild Int'l Corp. v. Liggett Grp. Inc., 474 A.2d 133, 136 (Del. 1984). In fact, as described below, courts usually look to the terms of the preferred stock contract in deciding cases. *See infra* Part II.D. But the corporate law foundations mean that a court can depart from the terms of a contract (or at least alter the interpretation of the contract) on the basis of equitable principles. *See* discussion *infra* Part II.C.2.

[61]The last significant victory for preferred shareholders in the Court of Chancery was the 1997 case of *Orban v. Field*, 1997 WL 153831, at *9 (Del. Ch. Apr. 1, 1997), *reprinted in* 23 DEL. J. CORP. L. 335, 352 (1998).

[62]*See, e.g.*, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1059 (choosing the wealth maximization of common stock over the liquidation preference of preferred shares).

[63]Corporation law affirmatively permits voting rights to be parceled out among classes of stock according to terms established in the certificate of incorporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(a) (2011) ("[Each class of stock] may have such voting powers, full or limited, or no voting powers . . . as shall be stated and expressed in the certificate of incorporation or of any amendment thereto . . . .").

[64]Assuming, that is, that directors are faithful agents of the majority who elected them. As Air Products discovered in its attempt to acquire Airgas, this is not always the case. *See* Air Prods., Inc. v. Airgas, Inc., 16 A.3d 48, 128 (Del. Ch. 2011) (noting that the three directors nominated by Air Products and elected in a subsequent proxy contest voted with the incumbent board members to reject Air Products' offer to maintain Airgas' poison pill).

[65]*See* Richard A. Booth, *Who Owns a Corporation and Who Cares*, 77 CHI.-KENT L. REV. 147, 166 (2001).

[66]The asymmetry between these situations is the result of the financial seniority of the preferred over the common. *See* FLETCHER CYC. CORP., *supra* note 9, § 5299. For instance, a preferred-controlled board need not concoct risk-exposure schemes to profit at the common's expense. The board can simply sell the firm's assets to fund a buyback or dividend for the preferred. *See, e.g.*, *In re* Primedia Inc. Derivative Litig., 910 A.2d 248, 261 n.45 (Del. Ch. 2006) (not dismissing a derivative suit alleging self-interest by a preferred-controlled board that sold assets—and crippled the future prospects of the company and the common—in order to redeem preferred stock). Alternatively, the preferred could simply bury the common under a mountain of preferences. This ruthlessly direct oppression is unavailable to the common, because the preferred have first claim to the firm's assets. *See* FLETCHER CYC. CORP., *supra* note 9, § 5303.

[67]In Delaware, a preferred-dominated board would likely be in breach of duty if it wiped out the common completely. *See* Trados I, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009) (holding

The board's fiduciary duties—which always run to the common[68]—may offer but a token resistance against gradual, systematic looting.[69]

That venture capitalists often obtain control rights for their preferred is the exception that proves the rule.[70] The venture capitalist ("VC") has an unusual amount of leverage over an entrepreneur (who holds common) desperate for funding that cannot be obtained elsewhere on better terms.[71] The VC may insist on control rights, and the common may be in no position to object. The transfer of control is also facilitated by the unique economics of the VC business.[72] The entrepreneur need not fear that the VC will drain the cash of a successful startup,[73] because it is far more profitable to sell that cash flow to the public in the form of a public offering of common equity[74]—and also profitable in the long term to share the proceeds of that sale with the entrepreneur.[75] When these unique circumstances are not present, control

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that the board arguably breached its duties when approving a merger in which the merger consideration would go entirely to the preferred, leaving the common with "the worst possible outcome for the common stockholders"). *Trados I* gives no indication, though, that the board would have been liable had it reserved a pittance for the common. *Id.*

[68]*Id.* at *7 (reciting Delaware authorities requiring the board to favor the interests of the common over the preferred where they conflict).

[69]Indeed, it is likely that preferred-favoring decisions of disinterested, preferred-elected directors will be protected by the business judgment rule, so long as the directors remain formally independent. *See, e.g.*, Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 65 (Del. 1989) (holding that a director's nomination and election by a powerful shareholder "alone did not make him an interested director"). In *Trados I*, Chancellor Chandler wondered aloud whether the *Fairchild Camera* rule would be softened when the directors represent shareholders with "direct financial interest[s]" in a transaction. 2009 WL 2225958, at *10 n.43. For the affirmative case, he could point only to a little-known Court of Chancery opinion, *Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *3 (Del. Ch. June 14, 2002). The authority of *Pogo.com* does not stand well against the longstanding, authoritative Supreme Court precedent of *Fairchild Camera*. *See generally Fairchild Camera*, 569 A.2d 53.

[70]*See* Fried & Ganor, *supra* note 8, at 987-88.

[71]*See id.* (describing how VCs usually wield effective control over the board in companies they finance).

[72]*See id.* at 972.

[73]In unsuccessful startups, the VC usually walks away with most, if not all, of the residual assets, by virtue of its liquidation preference. *See* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 68 (2002). Entrepreneurs are, by definition, risk-seeking; they accept the possibility of losing their shirts in an unsuccessful venture for the prospect of huge profits if the venture achieves success. *See id.* at 81.

[74]*See* Fried & Ganor, *supra* note 8, at 997 n.88. This assumes that there even is a positive cash flow. In many cases, such as the recent IPO of Groupon, the public is willing to pay richly for the opportunity to invest in a firm with negative cash flow. *See* Alistair Barr & Clare Baldwin, *Groupon's IPO Biggest by U.S. Web Company Since Google*, REUTERS (Nov. 4, 2011), http://www.reuters.com/article/2011/11/04/us-groupon-idUSTRE7A352020111104.

[75]VC firms, are, after all, repeat players. *See generally* Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 870 (1997). A firm that hoarded the IPO proceeds for

rights will not readily transfer.[76] Fixed claim financing in the form of preferred stock is vanishingly rare.[77]

In short, the one feature that could protect preferred stock is the one that is generally out of its reach under current practice. This Article returns to preferred board control in Part II, which develops a system for control transfer that protects all parties.[78] But first, it is useful to consider why we should want to save preferred stock, and examine in more detail the dangers from which it needs to be saved.

B. *The Utility Of Preferred Stock*

In most situations, investors prefer enforceable legal rights over mere promises. However, the inability for fixed-claim financers to force liquidation can be efficient and lead to higher overall returns for firms with highly variable or unpredictable cash flow.[79] Over time, these firms can be highly profitable, but only if they can survive their lean years—periods during which they lose money, exhaust their liquid assets, and are unable to pay the yield on their fixed-claim financing.[80] In such cases, debt financing renders the firm and its investors vulnerable to opportunistic creditors, who can force the company into a bankruptcy and seize its equity during reorganization.[81] This costly and *ex ante* inefficient process can be avoided by financing with preferred stock, since the company cannot be forced into default.[82] It can simply wait out the lean years by suspending its dividend, resuming it (and paying arrears) upon regaining profitability. It is for this reason that venture capitalists rely so heavily on preferred stock financing: they value the ability to prevent the company from filing for Chapter 11.[83]

In this sense, preferred stock acts as a type of firm-level "automatic stabilizer." In macroeconomics, that term refers to fiscal policies with

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itself—which, in theory, it could do with control over the board—would quickly find itself lacking in new investment opportunities from other entrepreneurs.

[76] *See* Fried & Ganor, *supra* note 8, at 987-88.

[77] *See id.* at 981-82.

[78] *See infra* Part II.G.

[79] *See generally* HAAS, *supra* note 50, at 416.

[80] *See* Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1037-46 (2011) (commenting on creditor opportunism with respect to struggling firms).

[81] *See id.*

[82] *See* RICHARD A. BOOTH, FINANCING THE CORPORATION § 6:5 (2013).

[83] *See* Baird & Rasumussen, *supra* note 7, at 1218 ("[A] venture capitalist [who] want[s] to prevent a business from filing for Chapter 11, but otherwise enjoy all the usual attributes of a creditor [does so by] becom[ing] a preferred shareholder and tak[ing] steps to ensure that no other creditors of any consequence come into being."). In the absence of creditors, a business cannot file for bankruptcy. *See id.*

naturally counter-cyclical effects; for instance, when workers are laid off as an economy begins to slide into recession, the payment of unemployment benefits or provision of food stamps immediately provides a fiscal stimulus to slow the recession's progress.[84] Preferred stock works analogously at the level of the firm: as liquidity decreases, financing commitments automatically loosen so as to prevent a liquidity failure.[85] By contrast, debt is pro-cyclical. A faltering debtor firm is likely to breach a maintenance covenant, and trigger creditors' control rights—rights that can be used to push the firm into a bankruptcy event.[86] By reducing expected bankruptcy costs, preferred stock should increase investor yields, as compared to debt, for risky companies.

Sadly, the automatic stabilizing feature has a significant downside: its issuance signals to the market that management believes the firm's expected bankruptcy costs to be high.[87] Otherwise, the firm would simply finance with a lower-yield instrument like debt. An adverse selection feedback loop thus arises: by issuing preferred stock, firms signal that they are uncertain of their future prospects, which in turn causes investors to demand an even higher yield. The result is that preferred stock—though low-cost in theory—ends up being a high-cost financing mechanism for companies with uncertain outlooks. As explained in the next Section, this particular disadvantage of preferred stock is critical to its undoing.[88]

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[84]On the effectiveness of macroeconomic automatic stabilizers, see Xavier Debrun & Radhicka Kapoor, *Fiscal Policy and Macroeconomic Stability: Automatic Stabilizers Work, Always and Everywhere* (Int'l Monetary Fund Working Paper 10/111, 2010), *available at* http://www.elibrary.imf.org/view/IMF001/10922-9781455200702/10922-9781455200702/10922-9781455200702_A001.xml.

[85]*See* Tom Drinkard, *A Primer on Preferred Stocks*, INVESTOPEDIA (Aug. 9, 2012), http://www.investopedia.com/articles/stocks/06/preferredstock.asp.

[86]*See* Lipson, *supra* note 80, at 1040 ("[C]ontrolling creditors may replace management of a distressed firm with professional 'turnaround experts' whose loyalties may not run to the firm . . . .").

[87]It is important to note that expected bankruptcy costs depend heavily on the firm's corporate, non-beta risk. *See, e.g.*, MICHAEL C. EHRHARDT & EUGENE F. BRIGHAM, CORPORATE FINANCE: A FOCUSED APPROACH 219-56 (4th ed. 2011) (discussing risk, return and the capital assert pricing model). Bankruptcy costs can be modeled as the inverse of a deep in the money put option: the value is zero unless the firm performs very poorly. *See id.* Just as volatility increases the value of a put option, so too does riskiness—*i.e.*, volatility of firm performance—increase the expected bankruptcy costs. *See id.* Thus, the CAPM thesis that securities prices depend only on beta depends on an assumption of zero bankruptcy costs. *See id.* at 239-43.

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

C. *Opportunistic Exploitation of Preferred Stock, Continued*

Part A discussed one way that common equity can exploit fixed claimants: increasing the riskiness of the corporation's operations.[89] Betting on a coin flip is a largely hypothetical example,[90] but leveraged recapitalizations[91] and asset substitutions[92] are quite real. As noted above, covenants in debt contracts can offer some protection against over-leveraging, and to a lesser extent, against asset substitution.[93] Preferred stock

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[89]*See supra* Part II.A.

[90]But it is not entirely hypothetical. MF Global, for instance, went bankrupt precisely because it bet the company on a hunch that European sovereign debt—which had been trading at a discount to par value—would rebound in price. *See* Rena S. Miller, *The MF Global Bankruptcy, Missing Customer Funds, and Proposals for Reform*, FED'N OF AM. SCIENTISTS, 1-2 (Aug. 1, 2013), https://www.fas.org/sgp/crs/misc/R42091.pdf. Instead, the bonds continued to lose value, and soon the value of the bond portfolio was dwarfed by the debt the company had incurred to purchase it. *See id.*

[91]In a leveraged recapitalization, the firm replaces most of its equity financing with debt, thus dramatically reducing the debt's equity cushion. *See* Mark G. Metzler, *The Leveraged Recap: A Tool to Achieve Liquidity and Retain Control*, KREISCHER MILLER (Aug. 5, 2013), http://www.kmco.com/articles/looking-forward/the-leveraged-recap-a-tool-to-achieve-liquidity-and-retain-control/. The market value of the existing bonds can drop precipitously, because the recapitalization greatly increases firm's credit risk. *See id.* In the wake of the takeover boom of the 1980s, bondholders insisted on covenants to protect against increases in leverage, but by the 2000s, the lesson had been forgotten: buyers were once again lining up to buy so-called "covenant-lite" debt, which lacked such protections. *See* Tim Cross, *Covenant-Lite Leveraged Loan Volume Soars To New Record*, FORBES (Aug. 14, 2013), http://www.forbes.com/sites/spleverage/2013/08/14/covenant-lite-leveraged-loan-volume-soars-to-new-record/.

[92]In an asset substitution, the firm trades a safe, predictable cash flow for a riskier, more speculative cash flow. *See* WILLIAM W. BRATTON, CORPORATE FINANCE 283 (Foundation Press, 7th ed. 2012). A recent example of an asset substitution was the plan by Hewlett Packard, under the direction of its now-deposed CEO Leo Apotheker, to sell its safe, low-margin personal computing business and purchase a data analytics company called Autonomy, which was growing rapidly but had inconsistent cash flows and competed in a rapidly evolving marketplace against much larger competitors such as Oracle. *See* Michael J. de la Merced, *Hewlett-Packard Weighs Deal Options*, N.Y. TIMES DEALBOOK (Sept. 21, 2011), http://dealbook.nytimes.com/2011/09/21/hewlett-packard-weighs-deal-options/?_r=0 (describing Apotheker's strategy). While shareholders objected to Mr. Apotheker's plans and forced him out as CEO, that was largely due to a perception that he had massively overpaid for Autonomy and had no clear strategic direction for the company. *See id.* HP bondholders were surely even more furious, though they remained silent (most likely because they had no control or influence over the company's strategic decision-making).

[93]*See supra* Part I. Public debt very rarely, if ever, protects against asset substitution. *See* BRATTON, *supra* note 92, at 330-31 (noting that "there does not appear to be such a thing as a meaningful affirmative promise to invest capital competitively at an acceptable risk level"). It is not only difficult to define, but could be positively harmful: constraints on management's ability to refocus the company's strategic direction could invite sclerosis. *Id.* Private debt, on the other hand, can easily confer veto power over asset substitution transactions, because banks are closer to the operation of the business and can make decisions rapidly. *See* Baird & Rasmussen, *supra* note 7, at 1227 (observing that "the complete control the lender has over the debtor's cash flow gives the

agreements also include covenants, but they are less effective because they cannot be as easily enforced.[94] Even for preferred stock, however, risk-seeking behavior by equity is not necessarily fatal. After all, most managers are risk-averse, as they hold much of their personal wealth in their firms' common equity, and can be expected to favor risk enhancement only when the gains are very large.[95]

The common can also exploit fixed claims by forcing them to give up their securities at heavy discounts.[96] The temptation to do so is strongest after a rapid decrease in a firm's cost of capital, as might occur when a firm emerges from a period of financial stress. The newly liquid firm likely wants to eliminate its high yield financing obligations. This, in itself, is unremarkable: firms frequently borrow money at a lower coupon rate and self-tender for their outstanding securities, which trade at a premium to par value because their high yield is no longer accompanied by as much credit risk.[97] But who wants to a pay a premium? The windfall for the firm comes from finding a way to squeeze out the fixed claims at par value or below—and doing so without dissipating its gains in transaction costs.[98]

Preferred stock is a particularly attractive target. Because it issues at a higher yield than debt, as described above,[99] firms can realize especially large profits by squeezing it out. At the same time, case law has rendered it increasingly simple and inexpensive to redeem preferred stock at sub-market prices, as will be discussed shortly.[100] Notice that the preferred cannot easily be compensated for squeeze out risk with a higher yield *ab initio*.[101] To the contrary, the higher yield will simply increase the squeeze out incentive, and when transaction costs are taken into account, it might even prove to be self-defeating.[102]

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lender veto power over every course of action, whether internal to the corporation or outside it").

[94]*See supra* notes 17-18 and accompanying text.

[95]*See id.* Note, however, that the still-increasing prevalence of risk-seeking hedge funds can change this equation. *See* Dan Barufaldi, *Hedge Funds: Risks*, INVESTOPEDIA, http://www.investopedia.com/university/hedge-fund/risks.asp (last visited Feb. 3, 2014).

[96]*See infra* Part II.C.1.

[97]Sometimes issuers include call options on debt or preferred stock so as to cap the premiums that must be paid to retire those obligations, but such options, of course, are not free. *See* JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 595-97 (Prentice Hall, 12th ed. 2001). A firm that wants to redeem its securities must compensate investors for that privilege in the form of higher yield. *Id.*

[98]*See id.*

[99]*See supra* Part II.B.

[100]*See infra* Part II.C.1.

[101]*See Avatex*, 715 A.2d at 846-47.

[102]*See infra* notes 196-97 and accompanying text. Consider the following illustration. Suppose five years ago, a firm issued preferred stock carrying an aggregate par value of $100M at a 10 percent dividend. Since then, the firm's finances have improved and the preferred now trades at

This court's facilitation of this second form of exploitation decouples the risk of preferred stock from its reward,[103] thus jeopardizing its viability as an investment. A preferred shareholder will only assume the risk of losing part or all of her principal investment (in the event of insolvency) if she can expect to reap the benefits of the high yield in the event that the firm survives. If the firm can diminish that yield without adequate compensation, then the investor can lose but never win, and she will not put her money at risk. Worse, preferred investors apparently cannot even rely on the honor and integrity of directors or executives who promise not to act opportunistically, because the case law suggests that the board may actually have a fiduciary duty to exploit the preferred to the benefit of the common whenever possible.[104]

At this point, it will be helpful to lend concreteness to the discussion by describing how the preferred can be redeemed against its will.

1. The White-Out Merger

The most basic technique for eliminating an expensive commitment to preferred stock is by merging the company into another.[105] A merger permits a voting majority to force the minority to exchange their investments for the consideration set forth in the merger agreement.[106] Thus can the common equity force the preferred to redeem their shares for inferior value, so long as the common has the majority of voting power.[107] These might be usefully called white-out mergers, so as to (1) distinguish them from cash-out mergers, in which controlling common shareholders liquidate the equity of minority common shareholders[108] and (2) emphasize that these transactions

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an aggregate market value of $110M. This implies that the firm would realize a net present benefit of $10M by borrowing at its current cost of capital and redeeming the preferred at its par value—a course of action that would be unprofitable if the transaction costs of forcing the redemption were $15M. The preferred shareholders would thus continue to enjoy their supra-market yield. Suppose, however, that the investors had originally demanded an additional 1 percent yield to compensate them for squeeze out risk. In that case, the stock would now carry a yield of 11 percent, and it might trade at an aggregate value of $120M. Now the squeeze out would be worth the firm's trouble, and the preferred would be redeemed at the $100M par value. Having bargained for a higher yield, the investors would perversely have less to show for it.

[103] *See infra* Part II.C.1.

[104] *See infra* Part II.E.

[105] *See, e.g.*, *Avatex*, 715 A.2d at 849 (discussing a merger in this context).

[106] *See, e.g.*, *id.* at 849-50 (discussing the merger and effect on the preferred stock).

[107] *See, e.g.*, *id.* (discussing adverse effects on the First Series Preferred).

[108] A cash-out merger is a "merger in which shareholders of the target company must accept cash for their shares." *See* BLACK'S LAW DICTIONARY, (9th ed. 2009).

are undertaken specifically to erase preference rights (both as to liquidation and dividends) from the company's capital structure.[109]

A well-known white-out merger was attempted by Avatex, a struggling company with a class of preferred stock on top of a layer of ordinary equity that had become essentially worthless.[110] Avatex created a new wholly owned subsidiary, Xetava, into which it planned to merge.[111] The merger agreement between the two companies called for Avatex common and preferred stock both to be converted into Xetava common stock.[112] Then, after the merger, Xetava would change its name back to Avatex.[113] The entire purpose of the transaction was to convert preferred stock into common so that the preferred shareholders would have to share their equity value with the common. In other words, the liquidation preference was to be erased. As an added benefit, Avatex would have been able to write itself a new certificate—the one it drafted for Xetava—since its certificate was eliminated when the original Avatex ceased to exist.[114]

The most notable aspect of the *Avatex* litigation case was that the white-out merger nearly succeeded, even though the preferred was seemingly well protected by contract.[115] Indeed, the preferred had bargained for a certificate provision requiring Avatex to obtain supermajority approval from the preferred before effecting any "*amendment, alteration or repeal, whether by merger, consolidation or otherwise, of any of the provisions of the* Restated Certificate of Incorporation . . . which would *materially and adversely affect any right, preference, privilege or voting power*" of the preferred.[116] At trial, however, Vice Chancellor Lamb disregarded the italicized phrases as irrelevant to the case.[117] In his view, the preferred did not suffer any harm from any sort of "*amendment, alteration, or repeal*" of the certificate.[118] Rather, he viewed the conversion of the preferred into Xetava stock—which was, of course, effected by and inseparable from the merger—as the source of injury.[119] Since the certificate said nothing about conversion, he saw no reason to enjoin the transaction.[120]

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[109]*See Avatex*, 715 A.2d at 849 (stating the purpose of effectuating the merger).

[110]The white-out transaction was described by the Delaware Supreme Court in *Avatex*. *Id.* at 845-47.

[111]*Id.* at 844.

[112]*Id.*

[113]*See Avatex*, 715 A.2d at 844.

[114]*Id.* at 844.

[115]*See id.* at 854.

[116]*See id.* at 845 (emphasis in original).

[117]*Avatex*, 715 A.2d at 847.

[118]*Id.* (emphasis in original).

[119]As Chancellor Allen observed in *Warner Communications Inc. v. Chris-Craft Industries,*

On appeal, the Delaware Supreme Court reversed and remanded,[121] but on grounds so formalistic that the preferred's victory was almost serendipitous. Chief Justice Veasey reasoned that the word "consolidation" in the supermajority voting provision implied that the displacement of Avatex's certificate in the Xetava merger constituted an "amendment, alteration or repeal."[122] Otherwise, the word "consolidation" would have been surplusage, since it is impossible for a consolidation to affect a certificate except by displacement.[123] Such peripatetic reasoning may have helped the court arrive at the right outcome for the facts before it, but it also established a surreal precedent: the preferred were saved from exploitation by a *merger* transaction only because the certificate was drafted also to protect against *consolidations*.[124] The parties probably did not bargain over—or even give any thought to—including the word "consolidation," because there exists no legally consequential distinction between mergers and consolidations.[125] The certificate could easily have been drafted to protect against "amendment, alteration or repeal, whether by merger or otherwise," and the meaning would have been the same.[126] Yet the preferred might have lost the case had it used this slightly more succinct, semantically equivalent formulation. Chalk one up for lawyers' lists.

Inc.—a case on which the Vice Chancellor heavily relied—the certificate modification and the stock conversion are both "necessitated by" and "flows from" the merger itself. 583 A.2d 962, 968 (Del. Ch. 1989), *reprinted in* 15 DEL. J. CORP. L. 1167, 1179 (1990). They are distinct consequences of that merger, not distinct actions having independent existence. *See id.*

[120] *See id.*

[121] *Avatex*, 715 A.2d at 855.

[122] *Id.* at 851.

[123] *See id.* at 854.

[124] *Id.* at 855. The term "consolidation" is a quirk of the Delaware merger statute. DEL. CODE ANN. tit. 8, § 251(a) (2011). Consolidations are functionally identical to mergers, in that both types of transactions involve the combination of two corporations into one. *See id.* In a "merger," one of the merging entities survives in name and absorbs the other; in a consolidation, the surviving corporation is a newly incorporated company. *See id.* No such distinction exists in modern corporation statutes, like the Model Business Corporations Act, because nothing of substance turns on whether a transaction is styled as a "merger" or a "consolidation." *See id.* (defining mergers and consolidations).

[125] *See* DEL. CODE ANN. tit. 8, § 251 (2011); *Avatex*, 715 A.2d at 854-55. The dual terminology of mergers and consolidations is a pure administrative formality, existing only to specify what papers must be filed with the office of the Delaware Secretary of State. *See* DEL. CODE ANN. tit. 8, § 251(c) (2011) (requiring the merging parties to file a certificate that, in the case of a merger, must include "such amendments or changes in the certificate of incorporation of the surviving corporation . . . to be effected by the merger," and in the case of a consolidation, must include "certificate of incorporation of the resulting corporation"). Nowhere else does the DGCL distinguish mergers from consolidations, let alone subject them to different legal rules.

[126] *See Avatex*, 715 A.2d at 845, 851.

The *Avatex* litigation vividly illustrates the fragility of preferred stock contracting.[127] Both opinions interpreted the certificate of designation without even contemplating the parties' intentions, or even whether their interpretations made any real-world sense.[128] The Vice Chancellor rested on a supposed technical distinction between stock conversion and certificate amendment[129] to which the preferred could never possibly have assented. Almost the entire value of preferred stock lies in its preference;[130] it is inconceivable that the preferred bargained for protection against preference-eroding amendments but traded away a protection against preference-destroying conversion. Chief Justice Veasey's interpretation rested on the use of one boilerplate provision over a slightly different formulation—a selection more likely made by chance than by choice.[131] In the end, the white-out merger was enjoined,[132] but the case should not have been close. That the preferred ultimately eked out a narrow win inspires little confidence in adequacy of contract as a protection against senior-to-junior wealth transfers.

2. The Dormant Firm

If the whiting out of a liquidation preference is the worst possible outcome for the preferred, being frozen inside a dormant firm ranks a close second. Freezes often occur when the book value of common equity falls below zero.[133] At that point, the firm will not be sold or liquidated, as neither action would yield anything for the common.[134] Instead, the board will put the comatose firm on life support and try to keep it breathing as long as possible.[135] After all, miracles do happen: its assets could appreciate to a value greater than the liquidation preference, at which point the common would spring back to life. Perhaps another firm will infringe or need to license one of its patents; maybe shifting patterns of land use will bring

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[127] *See* Bratton, *supra* note 1, at 893 (recognizing preferred stock's history of contract failure).

[128] *See Avatex*, 715 A.2d at 852-53; Harbor Fin. Partners Ltd. v. Butler, 1998 WL 294011, at *8 (Del. Ch. June 3, 1998), *reprinted in* 24 DEL. J. CORP. L. 248, 262 (1999), *rev'd sub nom.* Elliot Assocs. v. Avatex Corp., 715 A.2d 843 (Del. 1998).

[129] *Harbor*, 1998 WL 294011, at *9. As *Avatex* illustrates, this distinction does not hold up under scrutiny. *See Avatex*, 715 A.2d at 854.

[130] *See* Bratton, *supra* note 1, at 925.

[131] *See Avatex*, 715 A.2d at 855.

[132] *See id.*

[133] *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 32 (2005).

[134] *See* Bratton & Wachter, *supra* note 29, at 1889.

[135] *See id.* at 1886.

value to its real estate. Improbable? Of course, but life support has no downside for the common.[136] All the costs are borne by the frozen-in preferred.[137] Meanwhile, even as the firm lingers on indefinitely, the common may be concocting a plan to liberate whatever assets remain.[138]

Preferred shareholders are not entirely defenseless against dormant firms, because they can and do bargain for mandatory redemption provisions.[139] Unfortunately, redemption provisions often fail when they are most needed, as illustrated by the recent case of *SV Investment Partners, LLC v. Thoughtworks, Inc.*[140] There, SV Investment Partners (SVIP) made a venture capital investment in Thoughtworks, obtaining convertible preferred stock with a mandatory redemption option.[141] The certificates stated that if Thoughtworks had not gone public after five years, the preferred holders were "entitled to require [Thoughtworks] to redeem for cash out of any funds legally available therefor . . . ."[142] After five years with no IPO, SVIP exercised its redemption option, only to be told by the Thoughtworks board that the company had essentially no cash with which to redeem the preferred.[143] The board would apply whatever spare cash dripped in each quarter to gradual redemption, but this repayment schedule held little value.[144] After all, a primary reason that the company had not gone public is that it was not profitable.[145]

Had SVIP been holding redeemable debt, it would have had less of a problem: it could have obtained a judgment of deficiency forcing

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[136] *See id.* at 1888.

[137] *See id.* at 1889.

[138] *See, e.g.*, Bratton & Wachter, *supra* note 29, at 1890 (stating that common holders may have reasons to negotiate even when they are surviving). A personal anecdote aptly illustrates the point. Many years ago, during the dot-com boom, a distant acquaintance approached me with what seemed like an unusual offer: he would sell me a patent for a pittance, and then fund my efforts to develop the patent into a workable business. At first, I did not understand why he wanted to give me the patent instead of hiring me (perhaps with an incentivizing equity stake) to develop it. I soon learned that the patent was not exactly his: it was the sole remaining asset in a company he controlled, and it was buried under a six-figure liquidation preference. Selling me the asset would liberate it from the preference, at which point he could invest new, unencumbered equity in its development. Since I was on my way to law school, I declined his offer; I later learned that he found a partner for his transaction, although I do not know if anything ever became of their development project.

[139] *See* Thoughtworks I, 7 A.3d 973, 982 (Del. Ch. 2010), *aff'd* 37 A.3d 205 (Del. 2011).

[140] *Id.* at 987.

[141] *Id.* at 976.

[142] *Id.* at 978.

[143] *Thoughtworks I*, 7 A.3d at 979-80.

[144] *Id.* at 980.

[145] *Id.* at 979-80.

Thoughtworks to liquidate assets to repay the loan.[146] Its preferred stock did not give it the right to force liquidation.[147] In denying SVIP's request for a court-ordered redemption, the Court of Chancery invoked the ancient rule that a corporation cannot distribute money to shareholders if doing so "diminishes the ability of the company to pay its debts"—even if the value of the firm's equity is positive.[148] As Vice Chancellor Laster explained:

> [A] corporation can nominally have surplus from which redemptions theoretically could be made and yet be unable to pay its debts as they come due. The common law prohibition on redemptions when a corporation is or would be rendered insolvent restricts a corporation's ability to redeem shares under those circumstances . . . .[149]

This restriction on redemption takes precedence over any clause in the certificate of designation that requires the company to redeem its preferred stock at a given price, or to pay "guaranteed dividends."[150] This is not to say the preferred lack all rights to mandatory distributions when the company has no cash on hand—as the Thoughtworks board recognized, the preferred had a valid claim on whatever drips of cash become available as the company continues its operations.[151] However, as the Delaware Supreme Court held in SVIP's appeal, determination of when funds become legally available is a matter reserved for the business judgment of the board.[152]

Thoughtworks' charter contained an additional restriction on the preferred's redemption right: it could only draw on "legally available" funds that were "not . . . designated by the Board of Directors as necessary to fund the working capital requirements of the Corporation . . . ."[153] In other words, the company was entitled to keep a sufficient amount of cash on hand to pay

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[146] *See* DEL. CODE ANN. tit. 6, § 9-601 (2005). In response, of course, Thoughtworks likely would have declared bankruptcy. Still, SVIP would have had an unsubordinated claim on its assets and a concrete expectation of some near-term recovery.

[147] *See Thoughtworks I*, 7 A.3d at 992.

[148] *See id.* at 987 (quoting *In re* Int'l Radiator Co., 92 A. 255, 256 (Del. Ch. 1914)).

[149] *Id.*

[150] *Id.* at 986.

[151] *See Thoughtworks I*, 7 A.3d at 980.

[152] SV Inv. Partners, LLC v. Thoughtworks, Inc. (*Thoughtworks II*), 37 A.3d 205, 211 (Del. 2011) ("When a board decides on the amount of surplus available to make redemptions, its decision is entitled to deference absent a showing that the board: (1) acted in bad faith, (2) relied on unreliable methods and data, or (3) made determinations so far off the mark as to constitute actual or constructive fraud.").

[153] *Id.* at 207.

employee salaries and claims of trade creditors as they arose.[154] Because the charter contained this express restriction, the court did not have occasion to decide if a working capital exclusion was legally required. It seems likely, based on the court's logic, that the company would have been able to exclude a reasonable measure of working capital from the funds available to the preferred, regardless of the terms of the contract. If the preferred could draw on *all* the company's cash, it could jeopardize the company's solvency. Creditors left waiting for cash to drip in might, at some point, obtain a judgment giving them a right to seize or force liquidation of the company's assets.[155] Any redemption provision that did not allow the board to keep some cash in reserve to prevent such a circumstance would seem to be inconsistent with the "statutory or common law restrictions . . . that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution."[156]

D. *Contract Does Not Adequately Protect Preferred Investors*

In 2002, William Bratton summed up the plight of a preferred shareholder under Delaware law:

> Preferred stockholders face a uniquely hostile interpretive environment. . . . When senior-junior securityholder [sic] interests conflict, the managers' interest usually lies with the juniors. As a result, the Delaware courts have for decades been ratifying senior-to-junior wealth transfers.
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> . . . .
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> [Thus,] a preferred stockholder who does not control the board or possess a majority of the voting shares needs a carefully drafted, triple-riveted set of charter terms. Having gotten that, it will still need the best lawyer in town should any problems arise.[157]

A decade has passed since this assessment, but it is mostly accurate today. Preferred stock remains highly vulnerable to wealth transfers to the common equity, and the charter provisions designed to discourage such opportunism

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[154] *Id.* at 212.
[155] *See id.*
[156] *See Thoughtworks I*, 7 A.3d at 988.
[157] Bratton, *supra* note 1, at 938-39.

fail much more frequently than analogous provisions in corporate debt.[158] Contract may be a theoretically elegant prophylactic, but in practice, it does not seem adequate to the task.[159]

In a 2004 article, Bratton changed his tone slightly, suggesting that maybe the preferred has only itself to blame.[160] Noting that "[t]he end-run merger with a wholly-owned subsidiary has been there in the form file for almost seventy years, and still lawyers do not plug the loophole[,]" he observed that "parties in preferred stock deals just do not get it"—"it" being the folly of foregoing robust protection in favor of a "couple of extra basis points in yield."[161] Without question, there is some truth to this charge. During the credit bubble of the first decade of this century, investors and lenders were so yield-hungry that they bought hundreds of billions of dollars worth of so-called "covenant-lite" debt—*i.e.*, debt issued with few, if any, financial covenants to protect the lender.[162] For instance, KKR was able to draw on $13B of covenant-lite bank financing and $9B in subordinated debt to finance a very heavily leveraged buyout of First Data.[163] While the market for junk debt paused briefly after the financial crisis, it did not lay dormant for long: by 2011, issuance of covenant-lite debt had recovered to its 2006 pace.[164] If investors are eschewing covenants in debt contracts, it is doubtful that they would insist on less-enforceable provisions in preferred transactions.

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[158]*See* Bratton & Wachter, *supra* note 29, at 1874.

[159]*See id.* at 1846 ("Complete contract treatment coupled with appraisal exclusivity is untenable in extreme cases.").

[160]Bratton, *supra* note 30, at 862-63.

[161]*Id.*

[162]*See* Harvey R. Miller, *Chapter 11 In Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 380 (2007) (noting that almost $48B in covenant-lite debt was issued in the first quarter of 2007 alone).

[163]Vipal Monga, *First Data's Banks Start Debt Sale*, THE DEAL, Sept. 18, 2007. The company's debt was over 10 times cash flow. *See* Dana Cimilluca, *Ahead Of The Tape*, WALL ST. J., July 9, 2007, at C1 (citing a Fitch Ratings' characterization of this leverage as "aggressive even by today's freewheeling standards"). The transaction had originally been structured to include over $14B worth of covenant-lite bank debt with essentially no financial covenants at all, but by the summer of 2007, some investors had begun to become wary of credit market volatility. *See* Monga, *supra*. Still, the loan included only a loose maintenance covenant described by one banker as "toothless," and permitted the interest to be repaid in the form of more debt for up to four years. *See id.*

[164]*Compare* Gregory Zuckerman & Matt Wirtz, *There's Plenty Of Money For Junk*, WALL ST. J., May 1, 2012, at C1 (noting that $11.5B worth of covenant-lite debt was issued both in May, 2011 and April, 2012), *with* Miller, *supra* note 162, at 380 (noting that, in calendar year 2006, $23.6B in covenant-lite debt was issued). It may take a long time before the debt markets reach 2007 levels of insanity, but 2006 was plenty crazy: according to Harvey Miller, more covenant-lite debt issued that year than in the previous ten years combined. Miller, *supra* note 162, at 380.

Still, a broader canvas of the case law suggests a different, complimentary hypothesis: a preferred stock contract is simply very hard to write with the precision demanded of it.[165] Consider that one year after the *Avatex* decision, a well-established venture capital firm called Benchmark Capital Partners invested in the preferred stock of Juniper Financial according to terms that left it vulnerable to a white-out merger not unlike the one at issue in *Avatex*.[166] In rejecting Benchmark's motion to enjoin the white-out transaction, Vice Chancellor Noble implied that Benchmark had been unaware of *Avatex*[167] and perhaps even of "a long line of Delaware cases" holding that covenants in a preferred stock certificate do not apply to mergers if "the protective provisions do not expressly afford protection against a merger."[168] How could this have happened? As the Vice Chancellor observed, "Benchmark and its representative . . . had extensive experience in investing in preferred securities . . . ."[169] It seems unlikely that ignorance of the law was at fault.

It is more likely that Benchmark's blunder was caused by the complexity of Juniper's capital structure and the concomitant difficulty that Benchmark might have had in anticipating the transaction that was used to exploit it. Indeed, the capital structure was initially simple, and Benchmark's preferred stock was guarded by a thorough set of covenants that *did* expressly protect against mergers or consolidations.[170] However, the firm soon needed a new and larger round of financing, and the new investor, Canadian Imperial Bank of Commerce (CIBC), understandably did not want to operate in the shadow of Benchmark's unilateral veto powers.[171] To facilitate the new investment, Benchmark gave CIBC the power to operate free of those covenants so long as CIBC did not use this so-called "covenant trump" to diminish or alter Benchmark's rights.[172] It was the covenant trump

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[165] *Cf.* Smith, *supra* note 13, at 848 ("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?").

[166] *See generally* Benchmark Capital Partners IV v. Vague, 2002 WL 1732423 (Del. Ch. July 15, 2002).

[167] *See id.* at *9 ("The corporate charter of Juniper was adopted after our Supreme Court's decision in *Avatex* and the drafters of the Certificate are charged with knowledge of its holding . . . .").

[168] *Id.* at *7.

[169] *Id.* at *11.

[170] *See Benchmark*, 2002 WL 1732423, at *1.

[171] *See id.* at *2. Indeed, it would have been dangerous for CIBC to permit Benchmark—which was now a minority investor—to exercise a firm-wide veto. Benchmark could have held the firm hostage by threatening to use veto at every opportunity unless it was given special concessions not to do so. *See id.* at *1.

[172] *See id.* at *3.

provision that lacked express protection against a merger,[173] probably because Benchmark did not foresee that CIBC, a fellow preferred stock investor, would scheme with the common to implement a white-out merger designed to injure only Benchmark's shares.[174] In retrospect, of course, Benchmark should have considered that possibility, but it is not as if Benchmark fell into trap for the unwary. It fell into a trap for the less-than-hypervigilant.[175]

An even simpler, but still plausible, explanation for Benchmark's folly is that its attorneys made a mistake. It is unrealistic to expect preferred stock investors to be perfect—not when the most experienced and prestigious M&A lawyers consistently made mistakes in negotiating private equity transactions,[176] white-shoe investment bankers conducted due diligence shoddy enough to enable its client to sell itself to a fraudulent enterprise,[177] and sophisticated financial traders can lose billions of dollars in a matter of weeks.[178] The problem for preferred shareholders is that they have almost no

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[173] *See id.* at *10.

[174] It is not worth reciting the complexities of that scheme here. It will suffice to note that its end result was that CIBC's preferred became senior to Benchmark's. *See Benchmark*, 2002 WL 1732423, at *1.

[175] *See, e.g.*, *infra* notes 258-65 and accompanying text (discussing another example of preferred stock being stripped of its preferences by an action taken by another preferred series).

[176] *See* Steven M. Davidoff, *The Failure Of Private Equity*, 82 S. CAL. L. REV. 481, 513-15 (2009) (cataloguing the many negotiating and drafting mistakes in private equity acquisitions during the 2006-2008 time frame).

[177] *See* Loren Feldman, *The $580 Million Black Hole*, N.Y. TIMES (July 14, 2012), http://www.nytimes.com/2012/07/15/business/goldman-sachs-and-a-sale-gone-horribly-awry.html (describing how Dragon Systems, a firm advised by Goldman Sachs, was sold to a fraudulent enterprise in exchange for worthless stock). While it is clear that *someone* dropped the ball in the Dragon Systems sale, it might not have been Goldman Sachs: it convinced a jury that it was not culpable for the shareholders' loss, in part by introducing testimony from its bankers that they had raised concerns with Dragon management only to be brushed aside. *See* Steven M. Davidoff, *Lessons For Entrepreneurs in Rubble of a Collapsed Deal*, N.Y. TIMES DEALBOOK (Jan. 29, 2013, 7:44 PM), http://dealbook.nytimes.com/2013/01/29/lessons-for-entrepreneurs-in-rubble-of-a-collapsed-deal/. Culpability aside, though, it is inconceivable that the transaction would have been so completely botched had Goldman's representation been subpar in at least some respect.

[178] The multi-billion dollar losses suffered by J.P. Morgan in connection to the "London Whale" is but one example of clever trading gone awry. *See* Ben Protess et al., *In JPMorgan Chase Trading Bet, Its Confidence Yields to Loss*, N.Y. TIMES DEALBOOK (May 11, 2012, 9:49 PM), http://dealbook.nytimes.com/2012/05/11/in-jpmorgan-chase-trading-bet-its-confidence-yields-to-loss/ (describing the London Whale trade, and noting other's belief that the mistake was "self-inflicted"). Still, the clearest example of trader fallibility may be Howie Hubler's infamous MBS trade, chronicled in Michael Lewis's *The Big Short*, that lost $9B by itself. *See* MICHAEL LEWIS, THE BIG SHORT INSIDE THE DOOMSDAY MACHINE, 143-53 (2010). This disaster was not the result of recklessness or greed, but of miscalculation. Hubler thought he was making a smart long/short trade, financing a short bet on the junior tranches of mortgage backed securities (which he correctly predicted would fail) by using interest payments generated by much larger long positions in the

margin for error; a single crack in the fortress wall may cause the entire protective edifice to collapse.[179]

Consider, for instance, the redemption obligation at issue in the *Thoughtworks* case.[180] There, the preferred stock issued in 1999 with a certificate provision giving the preferred the right to recoup its original equity investment if the company had not gone public after five years.[181] As the firm and the investor both anticipated going public within two years[182]—recall that 1999 was near the height of the dot com mania[183]—both parties must have expected that, by 2004, a still-private Thoughtworks would likely be an unprofitable and perhaps almost dead company. Hence the redemption provision, which the preferred would use to salvage its initial investment. It would have made no sense for that obligation to have been constrained by the firm's liquidity; to the contrary, the preferred wanted an exit from what it feared would be an illiquid if not wholly insolvent firm.

It probably came as some surprise to the deal lawyers for both sides when the Thoughtworks certificate was found to permit redemption only out of liquid capital, because the stock could be redeemed only out of "funds legally available."[184] In so ruling, the Court of Chancery merely interpreted the certificate's plain language; as it noted, the word funds refers to "cash, cash-equivalents, and other relatively liquid assets that could readily be used as a source of cash."[185] It is unlikely that the contract drafters actually intended to limit recovery to "funds" so narrowly defined; after all, the purpose of the redemption provision was to permit SVIP an exit when the company's cash was running dry.[186] Somewhere along the line, attorneys

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AAA-rated senior tranches of those securities (which he thought were safe). *See id.* at 143-44. The senior tranche paid less interest than the junior position demanded, so Hubler's long positions had to be much larger in principal amount than his short transaction. *See id.* at 140. Apparently he didn't consider the possibility that the AAA tranches could also fail; when they did, his gains on shorting the junior tranches was dwarfed by the losses on his much larger long position. *See id.* at 175-76.

[179]For another example of a contracting mistake by a sophisticated preferred stock investor, see *In re* Sunstates Corp. S'Holder Litig., 788 A.2d 530 (Del. Ch. 2001). There, the preferred certificate prevented the company from repurchasing common shares if a preferred dividend was outstanding, but the preferred had forgotten to prohibit such repurchases by subsidiaries. *Id.* at 532-34. As a result, the company was able to circumvent the provision. The Court of Chancery, citing a fifty-year-old treatise, declined to enjoin the company's opportunism. *Id.* at 531-32 n.2.

[180]*See supra* note 141 and accompanying text.

[181]*See* Thoughtworks I, 7 A.3d 973, 978-79 (Del. Ch. 2010), *aff'd* 37 A.3d 205 (Del. 2011).

[182]*See* Thoughtworks II, 37 A.3d 205, 207 (Del. 2011) ("[The parties] initially expected an . . . [IPO to occur] within one to two years.").

[183]*See* Declan McCullagh, *Nasdaq 5,000: Ten Years After the Dot-com Peak*, CNET (Mar. 10, 2010 4:00 AM), http://news.cnet.com/8301-10784_3-10466637-7.html.

[184]*Thoughtworks II*, 37 A.3d at 207.

[185]*Thoughtworks I*, 7 A.3d at 984.

[186]*See id.* at 978.

made a mistake, although it might not have been the attorneys involved in this particular deal. Professors Bratton and Wachter describe the "funds legally available" language as a drafting convention, which would point to a systemic error in deal lawyers' standard practices.[187] At some stage in the production process, undue attention was given to avoiding statutory prohibitions against impairment of a corporation's capital, reflected in SVIP's focus on legal availability.[188] The word "funds" might have become drafting convention out of mere happenstance—the product of a personal preference of lawyers for the word "funds" over the more sterile "capital legally available." Whatever the cause, SVIP chose the wrong word and lost the case.[189]

Sometimes the lawyers' mistakes are more obviously mistakes. In a pair of recent cases, holders of convertible preferred shares sought to block mergers on the grounds that the compensation granted to them—namely, as-if-converted value—was insufficient.[190] It is hard to criticize the dismissal of these claims, since the certificates of designation expressly stated that the preferred would receive merger consideration no more or less than the as-if-converted value.[191] On the economics of the issue, the investors had the better claim. Convertible preferred is equivalent to ordinary preferred plus a conversion option, which is itself a type of call option.[192] The value of a call option, in turn, depends on expectations of how valuable the underlying asset might become before the option expires.[193] Why, then, would the preferred negotiate for a conversion option if the common could force its exercise (via merger) the minute it came into the money? A call option with

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[187]Bratton & Wachter, *supra* note 29, at 1860-63.

[188]*See, e.g.*, DEL. CODE ANN tit. 8 § 160(a)(1) (2006) (stating that a company may not effect any purchase or redemption that would cause any impairment of the capital of the corporation).

[189]As noted above, SVIP would have lost anyway; the Vice Chancellor ultimately observed that preferred shareholders cannot force the liquidation of assets regardless of the certificate language. *See supra* notes 149-50 and accompanying text. But the drafting error let the court hold against SVIP on narrow grounds, which would have made a difference had the court adopted a default legal rule somewhat more favorable to the preferred.

[190]*See* LC Capital Master Fund, Ltd., v. James, 990 A.2d 435, 438 (Del. Ch. 2010); *In re* Metromedia Int'l Grp., Inc., 971 A.2d 893, 902 (Del. Ch. 2009).

[191]*See LC Capital*, 990 A.2d at 438; *In re Metromedia*, 971 A.2d at 901.

[192]A call option gives its holder a right to buy a certain number of shares at a certain price. *See Option Types: Calls & Puts*, NASDAQ, http://www.nasdaq.com/investing/options-guide/option-types-puts-calls.aspx (last visited Feb. 9, 2014). In a conversion option, investors have a right to convert their preferred shares into a certain number of common shares—which is to say that they can buy those shares for a price equal to the value of the preferred stock. *See* Bratton & Wachter, *supra* note 29, at 1878.

[193]*See* Tobias Hammar, *Valuation of Options*, NASDAQ OMX, http://nordic.nasdaqomxtrader.com/trading/optionsfutures/Education/Valuation_of_Options (last visited Feb. 9, 2014).

little upside is a curious investment indeed,[194] but that was what the contract created. One need not think that these cases were wrongly decided to be concerned that the lawyers drafting preferred stock agreements simply cannot bear the heavy responsibility that the courts are placing on them. As always, transaction costs lurk in the background.[195] There are limits to how much investors will pay lawyers in seven- or low-eight-digit transactions and how much attorney diligence that money will buy.[196]

Even the most sophisticated parties obtain legal advice riddled with mistakes. For instance, Professor Steven Davidoff has catalogued, classified, and dissected the numerous mistakes made by highly experienced, top-rate attorneys in private equity contracts during the bubble of 2006–08.[197] As he explains, the problem includes not only human error, but structural features of legal markets that encourage lawyers to rely on sub-optimal contractual protections for their clients.[198] Indeed, many of the cases described above represent real-world examples where experienced and highly reputable attorneys made mistakes that left their clients open to opportunism.[199] The same will continue to be true in the preferred stock context, except to a greater degree. Stock issuance is a more routine, lower-margin transaction, for which the highest-priced, most diligent legal services are uneconomical. The law should expect mistakes; the question is what to do in response.

E. *Fiduciary Duties: From Protection To Oppression*

If the preferred has little financial protection, and cannot reliably protect itself through contract, then one last non-nuclear option remains: the board's fiduciary duties, which purportedly protect all shareholders, including the preferred, in some capacity.[200] These can only offer limited

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[194] Admittedly, there is a strong efficiency rationale for the existence of *some* mandatory conversion price. Acquirers might be reluctant to engage in serious negotiations so long as the preferred can hold up any deal to extract a better price. Mandatory conversion thus simplifies merger negotiations and deliberations. Still, mandatory conversion need not occur at the same price as optional conversion. The preferred should have demanded at least some premium over as-if-converted value in the event of a merger, to compensate them for losing the option value of their preferred shares.

[195] *See, e.g.*, Thoughtworks I, 7 A.3d 973, 978 (Del. Ch. 2010), *aff'd* 37 A.3d 205 (Del. 2011) (noting that the original value of the preferred investment was $26.6M).

[196] *See id.*

[197] *See* Davidoff, *supra* note 176, at 513-15.

[198] *Id.*

[199] *See supra* Part II.D.

[200] *See supra* Part II.E.

protection, because the board's loyalties will run to the common when the interests of the common and the preferred collide—as they inevitably will on occasion, as described above in Part II.C.[201] Still, fiduciary duties could be interpreted to encourage the board to act in a peacekeeping role, in which it would endeavor to protect each shareholder class from each other, and avoid or at least minimize conflicts where possible.[202]

Not so long ago, Delaware law contained an important peacekeeping component. The famous *Jedwab* formulation required the board to exercise its business judgment for the non-exclusive benefit when the preferred's claimed right "is not to a preference as against the common stock but rather a right shared equally with the common . . . ."[203] Since the board cannot serve two warring masters, the *Jedwab* principle was accompanied by the *Katz* corollary that "it will be the duty of the board . . . to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict."[204] This rhetorical formulation was still reconciliatory; the mention of conflict is set apart by a comma at the end, as if it was an exogenous condition that would necessitate the board to choose sides out of an inability to please all parties at once. This would not be the most favorable rule for preferred shareholders, but it would not be a disaster.

Recent Delaware law, however, has followed a different path. It has embraced a model of fiduciary duties that casts the board as a bully, picking fights with the preferred on behalf of the common. The bully model featured prominently in the famous 1997 case of *Equity-Linked Investors v. Adams*, a case involving what can best be described as an ambush of the preferred shareholders of the struggling biotechnology company Genta Incorporated.[205] Genta's total equity was valued at less than the liquidation value of the preferred, and was consistently losing money.[206] To finance its continued operation, it obtained convertible debt financing from an asset management fund (Aries), conditional on giving Aries the right to appoint the majority of

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[201] *See supra* Part II.C.

[202] This peacekeeping role appears to be what Bratton and Wachter advocate in their recent article. *See* Bratton & Wachter, *supra* note 29, at 1898-1900 (arguing for a good faith standard of review of preferred-initiated mergers, with the burden of proof on the board, so as to put "procedural pressure on the venture capitalist to examine alternatives" to the exploitative merger).

[203] *Id.* at 1848.

[204] *See* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (restating the holding of Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

[205] The irony here is that *Equity-Linked Investors* succinctly formulated the peacekeeping principle that it eviscerated. *See id.* at 1041.

[206] *See id.* at 1044, 1057.

the board.[207] In effect, the transaction vacuumed up most of the preferred's value and distributed it to Aries and the Genta common in the form of option value.[208] If the company's extended lease on life produced a valuable drug, then the common equity could vastly increase in value.[209] If not, the losses would be borne by the preferred, who were now subordinated to debt and likely to receive nothing in bankruptcy.[210] It was a classic option value of equity play,[211] and the preferred sued to enjoin it.[212]

The Chancellor resolved *Equity-Linked Investors* by cheering on the ambush.[213] The preferred contended that the Aries transaction was a *Revlon* change-of-control transaction, and asked the court to order an auction to obtain the best value reasonably available.[214] The preferred's plan was to win the auction, obtain control, and likely sell or liquidate the company.[215] The money spent to buy out the common would be lost, but at least the preferred would salvage some equity.[216] It was not to be. The court held that even if Genta was required to conduct an auction, it was permitted to exclude the preferred from bidding.[217] The preferred thus could not avoid subordination under the convertible debt. To his credit, the Chancellor recognized the implications of his opinion. He saw the ambush, and expressly approved:

> A bidding contest between the [preferred] and a new investor interested in developing Genta's intellectual property would be a poor way to attempt to maximize either the present value or some future value of the common stock in these particular circumstances, I assume, as the facts allow, that the Series A liquidation premium is greater than the liquidation value of the firm—but that the preferred stock has no legal right to force a liquidation. In that event, the preferred would have a bidding

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[207] *See id.* at 1052.

[208] *See Equity-Linked Investors*, 705 A.2d at 1048-52.

[209] *See id.* at 1041.

[210] *See id.* at 1050. Aries, of course, also had capital at risk. *Id.* at 1051. But with control of the board, it could pull the plug on the company's operations after all the preferred equity had been exhausted but before the debt was substantially impaired. *Id.* at 1048.

[211] *See supra* notes 42-62 and accompanying text.

[212] *See Equity-Linked Investors*, 705 A.2d at 1042.

[213] *See id.* at 1059.

[214] The rationale for the *Revlon* claim was that Aries had taken control of the firm. *See id.* at 1055. Its debt was convertible into enough common equity to give it a majority stake in the firm, and it exercised board control even before conversion. *Id.* at 1052.

[215] *Id.* at 1057.

[216] *See Equity-Linked Investors*, 705 A.2d at 1057.

[217] *Id.*

> advantage and would use it to *deprive the common of their power to exploit the preferred that the common currently possesses.* Assume, for example, that . . . . [a third party] bid would permit the common stock some further opportunity to see a payoff in the company labs and in the marketplace. Now assume that a bidding contest occurs in which the preferred takes part. What will probably happen? The preferred's aim might be simply to liquidate the company and take all of the net proceeds and apply it to its preference. This will prevent its exploitation by the common and cut its losses. . . .
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> To generalize, the existence of a "below water" liquidation preference would allow the preferred to . . . defeat an attempt to exploit the company's properties (and not incidentally, an attempt to exploit the preferred in its current situation) for the benefit of the common stock. What the board did, in effect, was to try on behalf of the common to exploit the preferred—by imposing risks on them without proportionate opportunity for rewards. That the preferred is open to this risk legally, is a function of the terms of its security. I think it is perfectly permissible for the board to choose this course in these circumstances.[218]

Thus, the *Jedwab* principle that the board should favor the common over the preferred in the face of a conflict had morphed into permission for the board to instigate a conflict, and favor the common.[219] In fact, this is such a combative stance that seems to abandon the concept of fiduciary duties toward the preferred altogether. Note the repeated use of the word "exploit."[220] Whatever it is that a fiduciary is required to do, surely it cannot gratuitously "impose risks" on the principal without any proportionate opportunity for rewards. Nor can this holding be justified on the grounds of economic efficiency. In essence, it permitted the common to extend the life of a money-losing operation by buying a lottery card paying out cents on the dollar. The deal was profitable for the common only because the preferred absorbed the deadweight loss. On the whole, the arrangement was *ex ante* value-destroying.

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[218] *Id.*
[219] *See id.*
[220] *See supra* text accompanying note 218.

Contrast the board's bullying tactics with a more peaceful option. Following *Rothschild International, Corp. v. Liggett Group, Inc.*, the board could have sold the firm in a deal that cashed the preferred out for less than its preference and allocated positive consideration to the common.[221] This would hardly be the best imaginable outcome for the preferred, but it would have no valid complaint. There was, in fact, some degree of genuine conflict between the common and the preferred, because the going-concern and liquidation values of the firm were both less than the liquidation preference.[222] The common's value was entirely option-based and thus the common wanted the company to extend its life indefinitely;[223] the preferred claimed whatever intrinsic value remained in the assets and wanted the company to shut down.[224] That conflict would have been minimized by a sale in which both sides obtained some consideration. This type of solution is further discussed in Part III.[225]

As written, *Equity-Linked* purported only to approve of the common's bullying tactics in "these circumstances"—that is, to a company in the zone of insolvency.[226] The holding, though, cannot be easily cabined to the context of financial distress. The common's desire to exploit the preferred does not uniquely arise when its equity value is negative.[227] As described above, common equity *usually* has the incentive to try to exploit any fixed claims with higher seniority, because its payoff function resembles a call option, with fixed downside and unlimited upside.[228] This incentive happens be to be maximized when the common lacks equity, since there the option is deep out of the money and volatility is the only source of value.[229] But it is merely a matter of degree.[230] In most circumstances, the common will have

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[221] 474 A.2d. 133, 135 (Del. 1984).

[222] *See Equity-Linked Investors*, 705 A.2d at 1057.

[223] *Id.* at 1041.

[224] *See id.*

[225] *See infra* Part III.

[226] *Equity-Linked Investors*, 705 A.2d at 1057. In fact, the company received its additional equity financing less than a week before it would have run out of cash and been forced into bankruptcy. *Id.* at 1051.

[227] *See id.* at 1042.

[228] *See supra* Part II.A. This incentive shrinks with increasing intrinsic value of equity. *See supra* Part II.A. For a company like Apple, with $100B on its balance sheet, this incentive would be infinitesimal. Apple Inc., Notice of Exempt Solicitation (Form PX14A6G) (Feb. 7, 2013), *available at* http://files.shareholder.com/downloads/AAPL/2906373658x0xS1011438-13-69/320193/filing.pdf. In such circumstances, preferred stock would not fear excessive risk-taking—hence the activism of shareholders seeking to convince Apple to issue preferred. *See id.*

[229] *See, e.g.*, *Equity-Linked Investors*, 705 A.2d at 1057.

[230] *See, e.g.*, *id.*

some incentive act as a bully, simply because the nature of preferred means that it can.[231]

Subsequent case law has, in fact, approved of bullying tactics in a wider variety of situations. Indeed, the 2010 case of *LC Capital Master Fund, Ltd. v. James* suggested that the common would even be permitted to extract value from the preferred that it had expressly granted by contract.[232] The question posed there—albeit only in dicta—was whether the common could seek a merger that cashed out the preferred for the consideration established in the certificate of designation, even if the certificate also conferred a right to a fully guaranteed dividend of higher-net present value.[233] Following *Equity-Linked*, then-Vice Chancellor Strine reasoned that the preferred were entitled to the protections they negotiated by contract, and nothing more.[234] But this begs the question of the parties' intent. Did the preferred mean to bargain for a guaranteed dividend that wasn't actually guaranteed because it could be evaded with a merger? Or did they intend for the merger formula to be applied in good faith transactions, not ones created to buy out the dividend at a discount? One would expect a fiduciary for the preferred to recognize the implied terms of the bargain, and to avoid exploiting an inconsistency or ambiguity in the contract. If, as the then-Vice Chancellor suggested, the board would be within its rights to concoct a transaction simply to deprive the preferred of a guaranteed dividend stream,[235] is there *anything* left of a fiduciary duty to the preferred?

The bullying discussed in *LC Capital*[236] could be proscribed without resort to an expansive concept of preferred shareholder rights. Courts would merely need to examine the nature of the transaction in question, and could do so without looking at its "economic quality."[237] Sales to strategic buyers would probably not be motivated by a desire to strip preferred dividend rights, as strategic buyers rarely acquire companies for such extractive purposes.[238] They usually look for operational synergies or other business-

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[231] *Cf. id.* ("That the preferred is open to this risk legally, is a function of the terms of its security."); *supra* note 219 and accompanying text.

[232] LC Capital Master Fund, Ltd., v. James, 990 A.2d 435, 438-39 (Del. Ch. 2010).

[233] *Id.* at 450-51 n.56 (discussing a hypothetical, not squarely presented in the case, what the then-Vice Chancellor considered "a much harder case" where of guaranteed).

[234] *Id.* at 438-39.

[235] *Id.* at 450-51.

[236] *See LC Capital*, 990 A.2d at 450-51 (holding that the common did not act "wrongly in viewing itself as under no obligation to satisfy" the desires of the preferred above what they are guaranteed by the Certificate).

[237] *Cf.* Elliot Assocs. v. Avatex Corp., 715 A.2d 843, 849 (Del. 1998) (suggesting that courts should evaluate the legality of merger transactions without evaluating their "economic quality").

[238] *See* DELOITTE & TOUCHE LLP, Mergers & Acquisitions Operational Synergies:

related considerations, and often attempt to integrate the acquired assets (at least to a limited degree) with their other operations.[239] In such cases, the courts could limit the preferred to the contractual merger consideration. By contrast, *LC Capital* involved a sale to a private equity buyer[240]—exactly the sort of transaction that the board would choose if it was attempting to exploit the preferred. Financial buyers can afford to pay to the common shareholders a premium (even if the common equity is fully valued by the market) and still profit if the merger strips the preferred's dividends. In these situations, courts should scrutinize more closely, with an eye to perhaps respecting the guaranteed dividend rights.

Nevertheless, the then-Vice Chancellor opted for a bright-line rule, albeit in a discussion of how the case would have been resolved under different facts.[241] It is unfair to criticize him for that choice; the transaction-type approach, whatever its merits, would be a departure from current trends.[242] It is sufficient to note that if *LC Capital* represents the logical conclusion of the preferred stock jurisprudence, then fiduciary duties to the preferred have been emptied of all content. The rule of *Jedwab*, that "the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred" when "no objective contractual basis exists for treatment of the preferred,"[243] is eviscerated. How can the court distinguish a failure of the parties to address a particular issue from the choice of one party not to seek any protection on that issue? When dividends are guaranteed but merger consideration is to be governed by a formula, the contract is ambiguous[244]—perhaps intentionally so. Or perhaps the problem was that the parties did not consider the possibility of the as-if-converted formula yielding a result less than the present value of the dividends.[245] The then-Vice Chancellor implicitly blamed the preferred as a

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Perspectives on the Winning Approach 1 (2013), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_auto_MAOperationalSynergiesPOV_Part%201_110713.pdf.

[239] *See id.*

[240] *LC Capital*, 990 A.2d at 442.

[241] *Id.* at 450-51 n.56. To be clear, the preferred dividends in *LC Capital* were not guaranteed. *See id.* at 449. On the facts of the case, the preferred's argument was a bit of a Hail Mary, in light of the long-standing reluctance of the Delaware courts to criticize a board (let alone find it in breach of duty) for following the certificate of designation to the letter. *See id.* at 450-51 n.56.

[242] *See id.* at 450-51 n.56 ("Our law has not, to date, embraced the notion that Chancery should create economic value for preferred stockholders that they failed to secure at the negotiating table.").

[243] *See id.* at 449 (citing Jedwab v. MGM Grand Hotels, 509 A.2d 584, 593 (Del. Ch. 1986)).

[244] *See LC Capital*, 990 A.2d at 451.

[245] As illustrated later, this situation is only likely to arise if there is a steep drop in the stock

matter of law for the contractual ambiguity,[246] which seems only to confirm Bratton's diagnosis that the preferred face a uniquely hostile interpretive environment.[247]

The consequence of this doctrinal development is stark: preferred stock begins to lose all attractiveness as an investment vehicle. Lacking secure robust contractual provisions and any expectations of fair dealing or good faith by the board, preferred stock seems to have become nothing more than inferior form of debt. It is said that a corporate bond is not secured by any particular corporate asset, but rather by the entire asset base of the firm.[248] Preferred stock does not enjoy even that level of security.[249] It has become super-unsecured.

F. *Conversion Options To The Rescue?*

It has been argued above that preferred stock has no right to recoup its principal or enforce promises to pay even "guaranteed dividends;" it is a likely target for *ex post* opportunism because of its high yield; it cannot easily contractually protect itself from such opportunism, and indeed, exploitation has become well within the scope of the board's fiduciary duties.[250] Preferred stock seems to be a failure as a debt instrument.[251] Can it be more successful if it is more like equity, or more specifically, convertible into equity?

At a bare minimum, convertible preferred must expressly negotiate for contractual provisions that protect it from the abuses described above.[252] First, it must preserve the option value of the option that it purchases. If the common insists, as will sometimes be reasonable, that the preferred can be cashed out in a merger, the preferred should not be satisfied with as-if-converted consideration. Rather, it should demand an option-conversion premium on top of that. Second, the preferred must insist on obtaining the higher of the contractually specified merger consideration and the risk-

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market and interest rates.

[246] *LC Capital*, 990 A.2d at 450 n.56 ("Indeed, the only thing rendering the future dividend stream in the hard case a non-speculative future source of income would be the judicial holding that preferred stockholders who did not bargain for the right to block a merger that would result in the end of the corporation and therefore their future dividend stream, have to be compensated for the very stream that they did not procure a contractual right to force to continue.").

[247] *See* Bratton, *supra* note 1, at 894.

[248] *See About Corporate Bonds*, SEC. INDUS. & FIN. MKTS. ASSOC., http://www.investinginbonds.com/learnmore.asp?catid=10&subcatid=47&id=181 (last visited Feb. 9, 2014).

[249] *See, e.g.*, *LC Capital*, 990 A.2d at 438.

[250] *See supra* Part II.A-E.

[251] *See supra* Part II.A-E.

[252] *See supra* Part II.A-E.

adjusted present value of its dividends. Finally, if the courts are not going to permit it to obtain any compensation above what it specifically contracts for, it should insist on a provision that requires the board to reciprocate, and follow exactly the letter of the contract. Otherwise, it might be subject to the *Korenvaes* gambit, in which the board substituted a new formula for determining the new conversion price after a dividend distribution as an "alternate method" to the formula specifically set forth in the certificate.[253] Surprisingly, the company convinced Chancellor Allen to approve it;[254] unsurprisingly, the new formula was unfavorable to the preferred.[255]

The preferred must also take care to protect against the *Mary's Gone Crackers* exploitation scheme, in which conversion right is used against the preferred to strip it of its liquidation preference.[256] In that case, the plaintiff, Greenmont, was a venture capital fund holding series B convertible preferred stock in MGC, Inc.[257] The certificate provided for an automatic conversion upon the majority vote of all preferred shareholders.[258] Since the Series B was outnumbered by the Series A, the Series A controlled the outcome of the conversion vote.[259] Greenmont, however, had negotiated for a separate series vote on "[a]ny agreement or action that alters or changes the voting or other

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[253]The certificate provided that the Adjusted Conversion Price (ACP) would be equal to the old conversion price (CP) times the difference between the market price of the common stock before the dividend (MP) and the fair market value (FMV) of the dividend, divided by the MP. HB Korenvaes Invs. v. Marriott Corp., 1993 WL 257422, at *771 (Del. Ch. 1993), *reprinted in* 19 DEL. J. CORP. L. 748, 771 (1993). Expressing it as a formula, ACP = CP*(MP-FMV)/MP. *Id.* Since the transaction was a spinoff, the distributed assets were shares in a new publicly traded company, the market value of which was readily ascertainable. *Id.* at *755. The board, however, decided on a different formula. *Id.* at *762. It divided the "intrinsic value" of the spun-off firm by the sum of the intrinsic values of the spun-off firm and the post-spinoff value of the original firm, and multiplied that amount by the pre-spinoff value of the original firm. *Id.* at *776. In other words, its formula was $ACP = CP*(MP - (Int_{new})/(Int_{new} + Int_{orig\text{-}ps}))/MP$, where Int_{new} was the board-determined "intrinsic value" of the spun-off firm and $Int_{orig\text{-}ps}$ the "intrinsic value" of the original firm, post-spinoff. *Id.* These formulas bear little resemblance.

[254]The Chancellor gave two primary justifications for upholding this sleight of hand. *Id.* at *778. First, he noted that the under the contractual formula, the fair market value of the spun-off firm could exceed that of the original firm. *Id.* This is not, as the Chancellor and the company argued, unreasonable. *Id.* Mergers and spin-offs frequently unlock value. Second, the certificate specified the fair market value of the spun-off assets would be "determined by the Board of Directors, whose determination shall be conclusive . . . ." *Id.* at *771. While this cannot possibly permit the board to invent any formula it wants, it would be better if preferred shareholders avoid this language in the future.

[255]*Id.* at *752.

[256]*See generally* Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc., 2012 WL 4479999 (Del. Ch. 2012).

[257]*Id.* at *1.

[258]*Id.*

[259]*Id.* at *2.

powers, preferences, or other special rights" of the Series B.[260] Greenmont likely believed that it was protected, but it apparently forgot that it was a preferred stockholder in Delaware, for whom certificate protections rarely function as intended. Indeed, the court interpreted the class vote provision not to apply to the automatic conversion right because:

> [A]utomatic conversion is one of the "special rights, privileges or restrictions" created by the Charter. . . . Because the Automatic Conversion provision exists on equal footing with the Voting Provision, an action taken under the Automatic Conversion provision cannot be seen to "alter or change" any of the Series B Preferred's "voting or other powers, preferences, or other special rights, privileges or restrictions."[261]

Somehow, an action taken specifically to nullify Greenmont's liquidation preference did not count as a change of its preference.[262] Once again, the court failed to consider whether the contracting parties could possibly have intended this outcome. Why would Greenmont have bargained for a right for a class vote, if that right could simply be extinguished at the will of the Series A—which held inferior rights to the Series B and would gain power in a conversion? The special twist in this case was the court's interpretation of the conversion provision as a "right" of the Series B, even as that "right" was being forced upon the Series B and used to deprive it of its liquidation preference.[263]

Even assuming that the preferred manages to negotiate contractual protections that function as intended, conversion options are limited in what they can accomplish. First, options are very difficult, if not impossible, to value over very long time horizons.[264] Since the duration of a preferred stock investment can be indefinite, practicability would require the conversion option to expire after some reasonably short period of time.[265] After the option expired, the preferred would be unprotected.[266] To be sure, the certificate could require that the parties agree to rollover the conversion

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[260] *Greenmont Capital Partners*, 2012 WL 4479999, at *2.

[261] *Id.* at *5.

[262] *Id.*

[263] *Id.* at *4.

[264] *See Complete Guide To Corporate Finance*, INVESTOPEDIA, ch. 5, http://www.investopedia.com/walkthrough/corporate-finance/5/risk-management/option-valuation.aspx (last visited Feb. 9, 2014).

[265] *See id.*

[266] *See* Bratton & Wachter, *supra* note 29, at 1834.

option when it expires at a new price, but this would create pricing discontinuities that could be taken advantage of by the common.[267]

Second, conversion options merely give the preferred the ability to participate in the upside potential created by the common's excessive risk taking.[268] It does not change the fact that, if the equity cushion is small, the preferred will end up bearing most of the costs of the risky behavior.[269] It is possible for the preferred to ask for a sufficient number of options to compensate, or perhaps a number of options that varies with the equity cushion, but it is unlikely that the common would readily agree to such an arrangement—which in any event would be complex and hard to administer.

G. *The Importance Of Control*

If all else fails, the preferred can try to reduce its exposure to opportunism by bargaining for control of the company—*i.e.*, the ability to appoint or elect a majority of the board.[270] It is easy to see how this could be a panacea: a preferred-elected board would be unlikely to adopt any opportunistic strategies that favor the common over the preferred;[271] moreover, if anything were to go terribly wrong, the board could sell all of the company's assets and permit the liquidation preference to be cashed in.[272] Under stewardship from the preferred, the company would be managed conservatively, with a sufficient cash reserve to keep the preference full.[273]

However, the preferred rarely succeed in obtaining control rights, except in the special case of venture capital.[274] As many scholars have

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[267]For instance, suppose each option term is seven years, and the first conversion option implies a strike price of twenty dollars per share. After six years, the original option has only one year left, after which the new option would take effect. If the new option price is expected to be substantially lower than twenty dollars per share, if for no other reason than the stock's volatility has changed and thus preserving the same option value requires a different strike price, then the common will have an incentive to force exercise before the first option expires, when its value is low.

[268]*See* Bratton & Wachter, *supra* note 29, at 1847.

[269]*See id.* at 1879.

[270]*See id.* at 1874-75.

[271]*See* Fried & Ganor, *supra* note 8, at 986.

[272]*See, e.g.*, Orban v. Field, 1997 WL 153831, at *8-*9 (Del. Ch. Apr. 1, 1997), *reprinted in* 23 DEL. J. CORP. L. 335, 350, 352 (1998) (finding the board did not breach its fiduciary duty to common shareholders when the board allowed the preferred to conduct transactions that resulted in the common's ownership interest to dilute below 10 percent).

[273]*See* Fried & Ganor, *supra* note 8, at 989-90.

[274]*See* Stephen N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Study of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 287 (2003). Even venture capitalists usually cannot obtain full control. *See* Bratton & Wachter, *supra* note 29, at 1874-75. The most common arrangement is for control to be shared between VC and entrepreneur: each side gets to appoint equal numbers of directors to the board, and the directors agree upon a

observed, preferred control creates an economic inefficiency that would tend to disappear in a robust capital market.[275] In particular, investors will not be willing to hold common equity underneath a preference without assurances that the board will take enough risks to offer them upside potential.[276] Venture capital is a special case, because the venture capital business model is highly risk-seeking by nature.[277] The upside potential that VCs obtain with a conversion option on their preferred stock is typically of far greater interest to them than the preservation of their initial capital investment.[278] Of course, VCs seek to protect their capital when the prospects of a portfolio firm sours,[279] but *ab initio*, the common equity need not fear excessive risk aversion. In any event, entrepreneurs desperate for funding might not have choice in the matter, if VCs insist on control as a condition for financing.[280]

Outside the VC context, it is hard to see why the common equity would ever agree to yield control. As vulnerable as the preferred may be to opportunism, matters are appreciably worse for an equity classes junior to a controlling tranche.[281] Indeed, to the common, vulnerability to opportunism would be a luxury compared to the constant oppression of its financial interests to which it would be subject.[282] The common's economic position would resemble that of the second player in a one-stage dictator game: it gets the residual interest, but only according to a division of assets chosen at the discretion of the senior tranches. The common can expect, for instance, the preferred to siphon out as much cash as possible, leaving only enough

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third-party director to fill out the board and in essence arbitrate disputes. *See* Kaplan & Strömberg, *supra*, at 288-90 (finding control to be shared control 61 percent of the time).

[275]*See, e.g.*, Bratton & Wachter, *supra* note 29, at 1839-41 (collecting authorities and arguing that it is more efficient to protect the common residual interest with board control and fiduciary duties than by contract).

[276]*See* Fried & Ganor, *supra* note 8, at 977.

[277]*See* Bratton & Wachter, *supra* note 29, at 1885 ("Venture capital investment is a high-risk, high-return proposition for all participants.").

[278]*See id.* at 1878-79.

[279]*See id.* at 1878.

[280]*See generally* Bratton, *supra* note 1.

[281]Note that in the cases in which the common was able to exploit the preferred, the preferred was not completely wiped out—usually, it ended up taking a steep haircut. *See supra* Part II.E. By contrast, when preferred adds control to its seniority, it can easily leave the common with nothing. For instance, the company might be sold at a price below the liquidation preference, which lets the preferred recoup most or all of its investment and avoid further downside risk. *See, e.g.*, *In re* Trados S'holder Litig. (*Trados II*), 73 A.3d 17, 76 (Del. Ch. 2013) (upholding the decision of a preferred-controlled board to sell the company for net proceeds less than the liquidation preference as entirely fair, even though the board "failed to consider the common stockholders, and sought to exit [the investment] without recognizing the conflicts of interest presented by the Merger . . . ."). The fact pattern of the *Trados* cases is discussed extensively *infra* Part III.

[282]Jesse Fried and Mira Ganor have noted that "common shareholders may be vulnerable to preferred shareholder opportunism when preferred shareholders control the board." Fried & Ganor, *supra* note 8, at 972.

reinvestment funds to keep the asset base from depreciating below the value of the liquidation preference of the company.[283] In theory, the common would retain unlimited upside, but the preferred would rarely permit the company to take sufficient risks for upside to materialize.[284] Only if the common insisted on giving the preferred a conversion option would its interests be taken into consideration by the board.[285] The irony, or perhaps absurdity, is that the common would benefit only by giving something of value away for free.[286]

Thus, preferred shareholders are able to obtain control in situations where they are sufficiently powerful that they probably had little to fear from exploitation by the common.[287] The general power of the preferred to alleviate its vulnerability through control[288] is likely to be limited absent a more creative and grander bargain between common and preferred. This topic is explored in the next Section.[289]

III. RESUSCITATION: THE GRAND BARGAIN OF DIVIDED BOARD CONTROL

Not all is lost for preferred stock. Its exclusion from fiduciary duties is, without more, but a minor tragedy; as it happens, duties aren't particularly valuable to investors in the first place.[290] The bigger problem is that the preferred typically relies on contract rights to protect its interests, rather than what might be called decisional calculus representation.[291] This latter term is shorthand for the intuition that investors can expect better treatment by the corporation's management if it would be costly for management to make decisions that treat them adversely.[292] In most companies, both debt and common have such representation, whereas preferred usually lacks anything stronger than the unreliable contract-lite covenants described above.[293]

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[283] *See* Bratton & Wachter, *supra* note 29, at 1825.

[284] *See* Fried & Ganor, *supra* note 8, at 993.

[285] *See id.* at 970.

[286] *See id.*

[287] *See id.* at 972.

[288] *See infra* notes 296-97 and accompanying text.

[289] *See infra* Part III.

[290] *See* Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, U.C.L.A. SCH. L. L. & ECON. RES. PAPER SERIES 06-19, 11 (arguing that IPO firms tend to opt for charter provisions that minimize the fiduciary duties owed to the investors); Larry E. Ribstein, *The Uncorporation's Domain*, 55 VILL. L. REV. 125, 137 (2010) (observing that LLCs, which have greater latitude to privately order fiduciary duties, typically opt for lower standards than higher ones).

[291] *See* Fried & Ganor, *supra* note 8, at 975-76.

[292] *See* Stout, *supra* note 290, at 12.

[293] *See supra* Part I.

Saving preferred stock is simply a matter of obtaining representation of its interests alongside those of common and debt in the day-to-day decision-making of the company—specifically the right to appoint the majority of directors to the board. The common, of course, must agree to such an arrangement.[294] Such agreement can be secured with a grand bargain of sorts between the preferred and the common, which I call Divided Board Control ("DBC"): the preferred gets to appoint the majority of board and by extension the executives, but the common gets to set their compensation and continues to be the recipients of fiduciary duties. The preferred obtains its goal, which is protection against opportunistic exploitation, while the common uses its compensation power to induce that level of risk-taking that it desires.[295]

A. *The Corporate Decisional Calculus*

Corporate decision-makers (*e.g.*, the officers and/or the board) can be induced to take heed of investors' interests primarily by three familiar mechanisms: the investors' power to replace the decision-makers, the alignment of interests between investors and the decision-makers, and the firm's capital market reputation. In standard governance arrangements, these inducement mechanisms are over-allocated to the common, mildly under-allocated to debt, and allocated hardly at all to the preferred.[296] Alignment of interests almost always redounds to the common's benefit, as directors and managers frequently are paid in part with common equity interests and essentially never with preferred.[297] Thus, common stockholders can confidently anticipate that the board will at least attempt to increase the share price of the common. In most corporations, the common equity also elects the board, and, as noted above, they enjoy the protections of fiduciary duties

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[294] *See id.* at 986-89.

[295] *See supra* Part II.

[296] *See* Fried & Ganor, *supra* note 8, at 975-76.

[297] *See infra* note 314 and accompanying text. To be sure, executive compensation frequently includes some deferred-cash components, such as severance agreements, defined benefit pensions or retirement plans, change-in-control bonuses, and so forth. *See* Fried & Ganor, *supra* note 8, at 989. Since these obligations are rarely bankruptcy-remote to the corporation, they often situate executives as creditors of their employers, and every so often, executives will act in accordance with their interests as creditors. *See, e.g.*, *In re* Lear Corp. S'Holder Litig., 926 A.2d 94, 97 (Del. Ch. 2007) (recounting the eagerness of a CEO holding a large deferred compensation interest in a financially fragile company to sell the company to a private bidder). Nonetheless, equity compensation grants typically have a stronger incentive effect because they are typically larger than deferred cash, and have value that is more responsive to the executives' actions. Deferred compensation in the form of preferred stock is almost unheard-of.

as against the preferred.[298] Creditors have no direct representation on the board, but they hold the greatest leverage in terms of capital market reputation.[299] Firms more frequently need to roll over their debt than raise new equity;[300] if they wish to secure low-cost financing, they need to establish a reputation in the debt markets for good capital stewardship.[301] Preferred stock, by contrast, has little input into or sway over firm policy.[302]

Preferred stock can regain its viability simply by gaining one of these two major protections (*i.e.*, control or compensation) currently allocated to the common.[303] In theory, either will do, but DBC will prove more efficient than a system in which managers are compensated in preferred stock. This follows from the standard economic insight that maximizing the value of the residual claim—absent any opportunistic exploitation of a senior class by the junior—will maximize the overall value of the firm.[304] When managers' personal wealth is tied to the value of that residual interest, they will personally benefit from every iota of value they add to the firm.[305] In other words, incentive alignment is an inherently optimizing mechanism.[306] By contrast, board control is most useful in controlling risk.[307] It confers on investors only the ability to encourage adequate management, because it ultimately relies on the power to replace the existing board with a new set of directors, whose expected performance will be average or worse.[308] Boards

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[298] *See* Fried & Ganor, *supra* note 8, at 975-76.

[299] *See* Baird & Rasmussen, *supra* note 7, at 1215. They can also exert *de facto* control if debt covenants are breached, especially in private loan arrangements. *See id.* at 1211.

[300] *See id.* at 1222-23.

[301] *See* Soku Byoun, William T. Moore & Zhaoxia Xu, *Why Do Some Firms Go Debt Free?*, 42-1 ASIA-PACIFIC J. FIN. STUD. 1, 3 (2012), *available at* http://www.apjfs.org/conference/2012/cafmFile/9-4.pdf.

[302] *See* Fried & Ganor, *supra* note 8, at 1008-10.

[303] *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, ATTORNEY'S GUIDE TO BUSINESS AND FINANCE FUNDAMENTALS §11.16 (2d ed. 2007).

[304] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983).

[305] *See id.*

[306] *See* Sayan Chatterjee, *Does Increased Equity Ownership Lead to More Strategically Involved Boards?*, 87 J. BUS. ETHICS 267, 268 (2009) (noting increased stock ownership by board members has a positive correlation with corporate performance).

[307] *Cf.* Trados I, 2009 WL 2225958, at *1-*4 (Del. Ch. July 24, 2009) (describing a company whose preferred shareholders' liquidation preference was safeguarded when the preferred-controlled board approved a merger despite objections from the common shareholders).

[308] I am assuming that the ability of a director to manage a particular company is *ex ante* unobservable, in which case the investors should expect a new board to be of average talent and below-average experience. *See* Chatterjee, *supra* note 306, at 268. This is likely a generous assumption: given that directors and executives' track records typically consist of a small number of observations, their general managerial talent (if such a thing exists) cannot be reliably inferred from past performance. *See id.* To take but one example, hedge fund manager Eddie Lambert managed

performing above the fiftieth percentile are usually safe, and even boards of moderately underperforming firms are likely to keep their jobs.[309] But this reality is acceptable to preferred shareholders, because they do not benefit from and thus do not require optimal firm performance. They will be happy as long as management maintains a safe cushion of common equity beneath the preferred and refrains from exploiting it.

At the same time, the common should be nervous about handing over operational control to the preferred. As described above in Part I.F., an equity tranche yields control to a senior tranche at considerable peril,[310] and cannot rely solely on equity compensation to protect their interests.[311] To be sure, executives paid in common stock have an incentive to take risks that benefit the common.[312] But executives are also naturally risk-averse, because their stock portfolios are not diversified and also because a risky investment that does not pan out might lead to the executives losing their jobs.[313] Holders of preferred stock are also naturally risk-averse, since they participate in losses but not in gains; they can be expected to be unhappy with the board if it takes risks.[314] The temptation exists, therefore, for the preferred and the board to strike an implicit bargain: in exchange for pursuing the risk-averse strategy that the executives naturally prefer anyway, the preferred will let them keep their jobs. The interests of the common could be ignored.

When companies enter a period of low profitability, the common encounters an even greater risk: that the preferred has an incentive to liquidate the firm as soon as possible, even if the firm has a pipeline of NPV-positive investment opportunities. In such situations, the equity cushion below the preferred has presumably shrunk, perhaps near zero. This means that the preferred would bear most of the losses if the projects do not

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to revitalize a moribund K-Mart franchise upon obtaining control; however, his subsequent attempt to turn around Sears was much less successful. *See* Nathan Vardi, *Sears Shares Crushed on Eddie Lampert's One Year Anniversary as CEO*, FORBES (Jan. 10, 2014, 9:52 AM), http://www.forbes.com/sites/nathanvardi/2014/01/10/sears-shares-crushed-on-eddie-lamperts-one-year-anniversary-as-ceo/.

[309] *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 857-64 (2005) (discussing the uphill battles shareholders face to replace boards).

[310] This doesn't apply only to preferred, but to any senior class with a fixed claim.

[311] *See supra* Part II.F.

[312] *See Knowledge Center—Stock Basics*, SCOTTRADE, http://research.scottrade.com/Public/knowledgecenter/education/article.asp?docid=4192e85b45d148ccbf1f285f03173a5a (last visited April 29, 2014).

[313] *See* Mark J. Loewenstein, *Making America Competitive*, 18 DEL. J. CORP. L. 453, 470 (1993).

[314] *See generally* FLETCHER CYC. L. CORP., *supra* note 9, § 5448 (explaining that preferred shareholders generally do not receive dividends above the predetermined amount).

perform, whereas they will see only a small benefit from a successful project.[315] Moreover, in such a situation, the preferred cannot trust managers who are compensated in common, because the common's reduced equity interest has come to closely resemble an at-the-money option. Thus, the managers will have an incentive to develop high-risk projects and attempt to disguise them as safe investments. Rather than face the prospect of having their good money after bad, the preferred investors will want to close up the shop—for instance, by selling the firm for cash. With control of the board, they will have the leverage to effect such a transaction.

The common needs more than a guarantee that executives will be paid in common stock; it needs exclusive control over the compensation process. It should have the sole power to elect all the directors on the compensation committee, which in turn should be given exclusive authority over compensation—not simply to recommend pay packages, but to implement them as well[316] (subject to sensible equitable principles).[317] Generally, the common would want directors to avoid long exposure, directly or indirectly,[318] to the firm's preferred stock, and to pay executives (and perhaps directors as well) primarily with heavily geared options that are extremely sensitive to the performance of the common stock.[319] Under such a system, the board and the managers would resist liquidating the company without securing gains for the common, because they would have to forfeit a large amount of wealth (*i.e.*, the option value they have been paid) to do so. In

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[315] *See Knowledge Center—Stock Basics*, *supra* note 312.

[316] *See* DEL. CODE ANN. tit. 8, § 141(c) (2011) ("Any such committee [of the board], to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation . . . .").

[317] For instance, the preferred will seek charter provisions providing that all directors get compensated in the same way.

[318] That is, owning preferred, or having substantial equity interest in a firm that owns a substantial interest in preferred.

[319] Heavily geared options can retain substantial value even if they are far underwater. For instance, suppose that a firm has $50M in net assets, is losing money, and its residual claim sits beneath a liquidity preference of $150M. The firm would have to triple in value before the residual claim has any value, and thus the value of the common equity would be close to zero. Suppose, though, that each of five directors was given a security that would be worth $30M if the net asset value of the company were to reach $200M. Even if there is only a 10 percent chance of that happening, the security would be worth $4M—which is a large sum of wealth that would disappear if the firm was sold. Note that the common would essentially be agreeing to pay the board the entire book value gain from $50M to $200M, which is extreme, but not irrational. For the company's value to quadruple, it would have to become highly profitable, in which case the company's asset value would likely continue to rise well past $200M and the common would then gain. Meanwhile, the current value of the equity is 0, so the common would have essentially nothing to lose any way.

essence, the common would be trying to buy off the directors' loyalties to the preferred holders who appointed them to the board.

B. *Divided Board Control in Operation*

This form of power allocation between the preferred and the common is well-modeled by the classic game-theory narrative of the prisoner's dilemma. In this particular instance, there are two players: the preferred and the common, each represented by the directors they appoint to the board. Each side can choose a Conflict strategy, in which they attempt to increase their compensation at the expense of the other player, or a Cooperation strategy, in which they try to pursue strategies that maximize the overall wealth of the firm and minimize opportunism. For the common, Conflict would consist of a risk-incentivizing executive compensation plan, perhaps centered on a large grant of out of the money stock options.[320] Managers would have to pursue risky projects—ones advantageous to the common—in order to actually profit from their equity compensation. For preferred, Conflict would involve stripping the firm of assets and leaving little left over;[321] it would entail policies such as aggressively removing managers who take high levels of risk and distributing free cash to shareholders.

In firms expected to have short life spans, the actions of the equity investors could be modeled as a one-stage version of this game. In this scenario, both the common and the preferred will realize that Conflict strictly dominates Cooperation.[322] If one class of stock pursues Cooperation, the other would obtain large benefits from playing Conflict, essentially appropriating whatever value can be gleaned from unopposed exploitation of the cooperating stockholders. Thus, neither class of stock wants to play Cooperation unless it can be sure that the other class will do so as well. As there is no binding mechanism in a one-stage game, both classes can be expected to play Conflict, with dysfunction resulting.

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[320] *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 227-30 (1999) (noting that executives compensated with stock options are risk-incentivized).

[321] *Cf. Trados I*, 2009 WL 2225958, at *3-*4 (Del. Ch. July 24, 2009) (describing a situation where the preferred-controlled board approved a merger that left nothing for the common shareholders).

[322] That is, both sides will realize that Conflict will always be wealth-maximizing, regardless of what strategy the other side adopts. Here, Conflict both permits each side to opportunistically exploit a Cooperating adversary, and protects against exploitation by a Conflicting adversary.

In most cases, equity investors expect firms to have indefinite life, and thus they will tend to see themselves as playing many-stage game.[323] If so, the two classes of stock can achieve a peaceful coexistence in equilibrium, by committing to a carrot-and-stick strategy for inducing Cooperation from the other class of stock.[324] In particular, each class of stock can promise to play Cooperation until Conflict has been played against them, at which point they will punish the attempted opportunism by playing Conflict for many periods in a row. If each side knows that the other will play this strategy, it will be efficient to adopt the same strategy: the gains from a potentially indefinite period of Cooperation will trump whatever gains can be had by a short period of opportunistic gains. When both classes of stock are playing Cooperation, the value of the firm can be maximized. Projects will be evaluated, for instance, by their risk-adjusted net present value at a cost of capital that reflects a compromise between the common's desire for risky, upside-laden projects and the preferred's desire for low-discount-rate, safe investment strategies.[325]

For Cooperation to be a viable equilibrium, the common must be able to pre-commit to playing Conflict when the preferred does.[326] Absent a pre-commitment, one side could play Conflict for one period (thus expropriating some value) and test the other's resolve.[327] Would the other class of stock really pull the trigger on the punishment strategy, knowing that they will be equally harmed by the devolution into the Conflict-Conflict dysfunctional equilibrium? In other words, the rival equity groups might skirmish and hope to call each other's bluff—an outcome that is itself inefficient, even without considering the non-zero possibility of one side actually deciding to revert to conflict mode. The common can avoid this outcome by means of compensation contracts. For instance, it might provide an executive with an

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[323] *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 64 (8th ed. 2006) (noting the valuation of shares presumes infinite corporate life); MARTIN J. OSBORNE & ARIEL RUBINSTEIN, A COURSE IN GAME THEORY 135 (1994) (describing repeated games).

[324] *See* OSBORNE & RUBINSTEIN, *supra* note 323, at 133-49 (explaining repeated games).

[325] *See* HAMILTON & BOOTH, *supra* note 303, § 16.02 (comparing the risk levels of common and preferred stock and suggesting investing in common stock is for a person willing to take greater risk).

[326] Technically, a pre-commitment by the preferred would also work. Such pre-commitment is more difficult, though, because directors are not permitted to bind their discretion in advance. *Cf.* FLETCHER CYC. L. CORP., *supra* note 9, § 990 ("[D]irectors may not lawfully agree to abrogate the continuing duty to exercise their independent judgment with respect to determinations as to what is in the best interests of the corporation.").

[327] *See* OSBORNE & RUBINSTEIN, *supra* note 323, at 133 (noting that terminating cooperation does have a short-term gain).

extremely generous severance upon removal by less-than-unanimous approval from disinterested directors, or make the executives' equity convertible into a smaller amount of debt. Both would reduce the value to the preferred of liquidating the firm.[328] Since the preferred would be on notice that they would be punished by playing Conflict, they would play Cooperation, and thus the common would have little incentive to deviate from that strategy.

Thus, Cooperation can be a stable equilibrium, if the duration of the game is long. Mergers pose a threat, because they cut short the many-period game and thus nudge the parties into playing Conflict as a dominant strategy.[329] If so, the preferred would likely prevail, by virtue of holding the legal power of the board. One mechanism at its disposal would be to cause the firm to merge on financial terms unfavorable to the common. If no external bidder emerged, a shell subsidiary could be created into which the company would merge.[330] To be sure, the common would not be helpless, as it could avail itself of all the contractual protections historically used by the preferred, such as class votes on mergers.[331] It could even block the board from taking action without its consent by insisting upon a supermajority quorum, thus giving its directors the ability to veto by not showing up.[332] Nonetheless, it is not hard to foresee that the common could have the same

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[328]This assumes, of course, that the common-elected directors would carefully implement an incentivizing compensation system. Admittedly, this is a significant assumption in light of current practice, which has only loosely tied compensation to performance. *See* Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues*, 20 ACAD. MGMT. PERSP. 5, 8 (2006) (noting executive compensation is generally not performance-based). But for reasons explained below in Part II.B, there is reason to believe that compensation practices would significantly change under DBC. *See supra* Part II.B.

[329]*See* OSBORNE & RUBINSTEIN, *supra* note 323, at 135 (describing the difference between finite and infinite games). Clearly, once a merger is proposed, then the corporation would be modeled as a single-period game in which the common and preferred each decide how to respond. *See id.* A merger need not materialize, though, for the many-period game to collapse. If the preferred can, at any point, solicit a merger, then it is immune to punishment for opportunistically deviating from the Cooperation strategy. All the common could do in response would be to play Conflict—at which point the preferred might simply merge the company away, likely to the common's detriment. Thus, the common might not have a credible threat to deploy against preferred opportunism.

[330]*See* HAMILTON & BOOTH, *supra* note 303, § 13.02 (explaining merging into a shell subsidiary).

[331]*Id.* § 13.02 (noting shareholders may vote as a class on mergers).

[332]*See* DEL. CODE ANN. tit. 8, § 141(b) (2011) ("A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number."). This strategy for blocking hostile board action has been upheld in Delaware. *See* Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985).

degree of trouble protecting its interests that preferred shareholders have now.

However, in protecting against opportunistic mergers, the common would have two advantages that preferred shareholders lack today: control over compensation, and the benefit of the fiduciary duties owed to them under the common law.[333] Would this make enough of a difference to prevent (or discourage) the preferred from lapsing into Conflict? It would depend on how the courts would characterize such preferred-initiated mergers. Minority shareholders are robustly protected against being cashed out at an inferior price by the majority.[334] Arguably, the same protections would extend to the common in the case of a preferred-favored merger designed to cash out at least some portion of the common. Indeed, the recent decision of *In re: Trados Inc.* suggests that common shareholders would enjoy meaningful protection against unfair or unfaithful transactions propagated by a preferred-controlled board.[335]

C. Trados *and Divided Board Control*

Trados[336] can be viewed as the mirror image of the fact patterns in *Equity-Linked*[337] *Investors* and *LC Capital*.[338] It also involved a merger that pit common against preferred, but in this case, the preferred had control; each of the four venture capital funds that had financed Trados as a startup appointed one member to a seven-person board.[339] After a few years of middling performance, the preferred started to look for an exit.[340] To this end, the board hired a new management team, hoping that a new business plan and improved financial performance would make it an attractive acquisition target for a strategic buyer.[341] The compensation plan for the new

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[333] *See* Trados I, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009) (noting that boards owe shareholders equal fiduciary duties, but when the interests of the preferred and common conflict, the board is to favor the interests of the common).

[334] *See* William J. Carney & George B. Shephard, *The Mystery Of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 17-28 (2009); Subramanian, *supra* note 133, at 11-17. Generally, minority cash-outs are evaluated under the entire fairness standard unless the terms of the cash-out transaction are negotiated by an independent committee and the transaction receives the support of a majority of the minority investors. *See In re* MFW S'holders Litig., 67 A.3d 496, 504 (Del. Ch. 2013).

[335] *Trados I*, 2009 WL 2225958, at *7.

[336] *See generally id.*

[337] Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997).

[338] LC Capital Master Fund, Ltd. v. James, 990 A.2d 435 (Del. Ch. 2010).

[339] *Trados I*, 2009 WL 2225958, at *1-*2.

[340] *Id.* at *2.

[341] *Id.*