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THE PERIL AND PROMISE OF PREFERRED STOCK

BY BEN WALThER

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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The irony of preferred stock is that courts treat it with disdain. 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. 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. As a result, they demand a risk premium that few companies are willing to pay, except as a last resort. Today, nearly all public preferred stock is issued by financial institutions.
institutions, insurance companies, or other institutions subject to strict capital
adequacy regulation, as illustrated by the size and composition of preferred
stock exchange-tradable funds. Preferred stock is more commonly used for
funding startups, owing to the peculiar risk-return ratio sought by venture
capitalists. 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.

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. Legally, though, it is much more like common equity: preferred

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&emimeType=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
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.\textsuperscript{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.\textsuperscript{11} Not even venture capitalists are safe, despite their deep experience with preferred stock and their business power over the companies.\textsuperscript{12} Occasionally, they let down their guard, and then can only watch helplessly as their investments are decimated.\textsuperscript{13}

The corporate law once offered at least a modicum of protection against exploitation. For instance, the famous 1986 Court of Chancery case \textit{Jedwab v. MGM Grand Hotels, Inc.} held that boards must respect fiduciary duties when dealing with the preferred.\textsuperscript{14} Over the past three decades, however, courts have eroded such duties to the preferred so far that they exist in name only.\textsuperscript{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.\textsuperscript{16} Today, preferred shareholders must protect themselves with contract-like covenants in the certificate of designation\textsuperscript{17}---covenants

\begin{itemize}
\item \textsuperscript{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 \textit{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 \textit{DEL. CODE ANN. tit. 8, § 242} (2013).
\item \textsuperscript{11}See infra Part II.C.
\item \textsuperscript{12}See Baird & Rasmussen, supra note 7, at 1218-19.
\item \textsuperscript{13}A recent, famous example is documented in \textit{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 \textit{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 \textit{id.} at *10. See generally D. Gordon Smith, \textit{Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts}, 40 \textit{WILLAMETTE L. REV.} 825 (2004) (describing the transaction involved in \textit{Benchmark}).
\item \textsuperscript{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).
\item \textsuperscript{15}See infra Part II.E.
\item \textsuperscript{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).
\item \textsuperscript{17}See, e.g., \textit{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

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'n's 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.

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.
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

\(^{32}\) 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; the preferred dividend is analogous to the interest a debtor pays on that principal. 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. 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. 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. 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.\textsuperscript{44} Assuming that the coin is fair, the expected gain to equity from merely placing the bet would be 250 percent.\textsuperscript{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.\textsuperscript{46} Thus, equity can profit by causing a company to make knowingly terrible investments, so long as the potential upside is sufficiently high.\textsuperscript{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.\textsuperscript{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.\textsuperscript{49} Creditors have access to contractual remedies, which means they can regulate the firm's behavior with bargained-for covenants in the debt contract.\textsuperscript{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.\textsuperscript{51} Both common equity and management fear this circumstance,

\textsuperscript{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.

\textsuperscript{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 $25M.

\textsuperscript{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.


\textsuperscript{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.

\textsuperscript{49}See infra notes 50-54 and accompanying text.

\textsuperscript{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.")

\textsuperscript{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. 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. 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.

Preferred stock, by contrast, must rely on much weaker remedies. 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. 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. The preferred can roughly approximate accelerated principal repayment by obtaining a promise from the firm to redeem the stock if any covenants are breached, 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. Ultimately, the preferred shareholders, as shareholders, must seek legal remedies by means of actions...
in corporate law. In board-friendly jurisdictions such as Delaware, this operates as a powerful practical disadvantage. While the common shareholders occasionally win when taking action against the board, the preferred nearly always lose.

What preferred stock can obtain, in theory, is control over the board. 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. However, the preferred rarely gets control, as control is generally considered to be more valuable to the common. 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, leaving the common with barely a cent.

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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.


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).


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—may offer but a token resistance against gradual, systematic looting. That venture capitalists often obtain control rights for their preferred is the exception that proves the rule. 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. 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. The entrepreneur need not fear that the VC will drain the cash of a successful startup, because it is far more profitable to sell that cash flow to the public in the form of a public offering of common equity—and also profitable in the long term to share the proceeds of that sale with the entrepreneur.

When these unique circumstances are not present, control
rights will not readily transfer.\textsuperscript{76} Fixed claim financing in the form of preferred stock is vanishingly rare.\textsuperscript{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.\textsuperscript{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.

\textbf{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{81} This costly and \textit{ex ante} inefficient process can be avoided by financing with preferred stock, since the company cannot be forced into default.\textsuperscript{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.\textsuperscript{83}

In this sense, preferred stock acts as a type of firm-level "automatic stabilizer." In macroeconomics, that term refers to fiscal policies with itself—which, in theory, it could do with control over the board—would quickly find itself lacking in new investment opportunities from other entrepreneurs.

\textsuperscript{76}See Fried & Ganor, \textit{supra} note 8, at 987-88.
\textsuperscript{77}See \textit{id.} at 981-82.
\textsuperscript{78}See \textit{infra} Part II.G.
\textsuperscript{79}See \textit{generally} HAAS, \textit{supra} note 50, at 416.
\textsuperscript{81}See \textit{id.}
\textsuperscript{82}See \textit{Richard A. Booth, Financing the Corporation} \textsection 6:5 (2013).
\textsuperscript{83}See Baird & Rasmusussen, \textit{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. \textit{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{88}


\textsuperscript{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 . . . ").

\textsuperscript{87}It is important to note that expected bankruptcy costs depend heavily on the firm's corporate, non-beta risk. \textit{See}, e.g., Michael C. Ehrhardt \& Eugene F. Brigham, \textit{Corporate Finance: A Focused Approach} 219-56 (4th ed. 2011) (discussing risk, return and the capital asset 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. \textit{See id.} Just as volatility increases the value of a put option, so too does riskiness—\textit{i.e.}, volatility of firm performance—increase the expected bankruptcy costs. \textit{See id.} Thus, the CAPM thesis that securities prices depend only on beta depends on an assumption of zero bankruptcy costs. \textit{See id.} at 239-43.

\textsuperscript{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

\(^{89}\)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/ers/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/spl

\(^{92}\)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. 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.

The common can also exploit fixed claims by forcing them to give up their securities at heavy discounts. 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. But who wants to 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.

Preferred stock is a particularly attractive target. Because it issues at a higher yield than debt, as described above, 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. Notice that the preferred cannot easily be compensated for squeeze out risk with a higher yield ab initio. 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.

94 See supra notes 17-18 and accompanying text.
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, 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.  

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. A merger permits a voting majority to force the minority to exchange their investments for the consideration set forth in the merger agreement. 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. 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 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.

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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.\footnote{See Avatex, 715 A.2d at 849 (stating the purpose of effectuating the merger).}

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.\footnote{The white-out transaction was described by the Delaware Supreme Court in Avatex. Id. at 845-47.} Avatex created a new wholly owned subsidiary, Xetava, into which it planned to merge.\footnote{Id. at 844.} The merger agreement between the two companies called for Avatex common and preferred stock both to be converted into Xetava common stock.\footnote{See Avatex, 715 A.2d at 844.} Then, after the merger, Xetava would change its name back to Avatex.\footnote{Id. at 844.} 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.\footnote{See id. at 854.}

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.\footnote{See id. at 854 (emphasis in original).} 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.\footnote{Id. (emphasis in original).} At trial, however, Vice Chancellor Lamb disregarded the italicized phrases as irrelevant to the case.\footnote{Avatex, 715 A.2d at 847.} In his view, the preferred did not suffer any harm from any sort of "amendment, alteration, or repeal" of the certificate.\footnote{Id. (emphasis in original).} 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.\footnote{As Chancellor Allen observed in Warner Communications Inc. v. Chris-Craft Industries,}
On appeal, the Delaware Supreme Court reversed and remanded,\textsuperscript{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."\textsuperscript{122} Otherwise, the word "consolidation" would have been surplusage, since it is impossible for a consolidation to affect a certificate except by displacement.\textsuperscript{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 \textit{merger} transaction only because the certificate was drafted also to protect against \textit{consolidations}.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.

\textit{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), \textit{reprinted in} 15 Del. J. Corp. L. 1167, 1179 (1990). They are distinct consequences of that merger, not distinct actions having independent existence. \textit{See id.}\textsuperscript{120} \textit{See id.}\textsuperscript{121} \textit{Avatex}, 715 A.2d at 855. \textit{Id.} at 851. \textit{See id.} at 854. \textit{Id.} at 855. The term "consolidation" is a quirk of the Delaware merger statute. \textit{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. \textit{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. \textit{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." \textit{See id.} (defining mergers and consolidations).\textsuperscript{122} \textit{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. \textit{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.\textsuperscript{123} \textit{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 amendment129 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).
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*.
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.\textsuperscript{136} All the costs are borne by the frozen-in preferred.\textsuperscript{137} Meanwhile, even as the firm lingers on indefinitely, the common may be concocting a plan to liberate whatever assets remain.\textsuperscript{138}

Preferred shareholders are not entirely defenseless against dormant firms, because they can and do bargain for mandatory redemption provisions.\textsuperscript{139} Unfortunately, redemption provisions often fail when they are most needed, as illustrated by the recent case of \textit{SV Investment Partners, LLC v. Thoughtworks, Inc.}\textsuperscript{140} There, SV Investment Partners (SVIP) made a venture capital investment in Thoughtworks, obtaining convertible preferred stock with a mandatory redemption option.\textsuperscript{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 . . . ."\textsuperscript{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.\textsuperscript{143} The board would apply whatever spare cash dripped in each quarter to gradual redemption, but this repayment schedule held little value.\textsuperscript{144} After all, a primary reason that the company had not gone public is that it was not profitable.\textsuperscript{145}

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

\textsuperscript{136}See \textit{id.} at 1888.
\textsuperscript{137}See \textit{id.} at 1889.
\textsuperscript{138}See, e.g., Bratton & Wachter, \textit{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.
\textsuperscript{139}See \textit{Thoughtworks I, 7 A.3d} 973, 982 (Del. Ch. 2010), \textit{aff'd} 37 A.3d 205 (Del. 2011).
\textsuperscript{140}\textit{id.} at 987.
\textsuperscript{141}\textit{id.} at 976.
\textsuperscript{142}\textit{id.} at 978.
\textsuperscript{143}\textit{Thoughtworks I, 7 A.3d} at 979-80.
\textsuperscript{144}\textit{id.} at 980.
\textsuperscript{145}\textit{id.} at 979-80.
Thoughtworks to liquidate assets to repay the loan. 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. 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 . . . .

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." 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. 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.

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 . . . ." 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. 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. 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."

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.

. . . .

[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.

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

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.\textsuperscript{158} Contract may be a theoretically elegant prophylactic, but in practice, it does not seem adequate to the task.\textsuperscript{159}

In a 2004 article, Bratton changed his tone slightly, suggesting that maybe the preferred has only itself to blame.\textsuperscript{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."\textsuperscript{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—\textit{i.e.}, debt issued with few, if any, financial covenants to protect the lender.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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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\textsuperscript{158}See Bratton & Wachter, \textit{supra} note 29, at 1874.
\textsuperscript{159}See \textit{id.} at 1846 ("Complete contract treatment coupled with appraisal exclusivity is untenable in extreme cases.").
\textsuperscript{160}Bratton, \textit{supra} note 30, at 862-63.
\textsuperscript{161}\textit{Id.}
\textsuperscript{162}See Harvey R. Miller, \textit{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).
\textsuperscript{163}Vipal Monga, \textit{First Data's Banks Start Debt Sale}, \textit{THE DEAL}, Sept. 18, 2007. The company's debt was over 10 times cash flow. \textit{See} Dana Cimilluca, \textit{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 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. \textit{See} Monga, \textit{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. \textit{See} \textit{id}.
\textsuperscript{164}Compare Gregory Zuckerman & Matt Wirtz, \textit{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), \textit{with} Miller, \textit{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. \textit{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. 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*. In rejecting Benchmark's motion to enjoin the white-out transaction, Vice Chancellor Noble implied that Benchmark had been unaware of *Avatex* 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." How could this have happened? As the Vice Chancellor observed, "Benchmark and its representative . . . had extensive experience in investing in preferred securities . . . ." 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. 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. 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. It was the covenant trump.

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?").


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,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{176} white-shoe investment bankers conducted due diligence shoddy enough to enable its client to sell itself to a fraudulent enterprise,\textsuperscript{177} and sophisticated financial traders can lose billions of dollars in a matter of weeks.\textsuperscript{178} The problem for preferred shareholders is that they have almost no

\textsuperscript{173}See id. at *10.
\textsuperscript{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.
\textsuperscript{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).
\textsuperscript{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.
\textsuperscript{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

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'd37 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.\(^{184}\) See *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 Intl' 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.
little upside is a curious investment indeed, 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. 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.

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. 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. 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. 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. 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

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.
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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

207See id. at 1052.
208See Equity-Linked Investors, 705 A.2d at 1048-52.
209See id. at 1041.
210See 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.
211See supra notes 42-62 and accompanying text.
212See Equity-Linked Investors, 705 A.2d at 1042.
213See id. at 1059.
214The 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.
215Id. at 1057.
216See Equity-Linked Investors, 705 A.2d at 1057.
217Id.
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.

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. 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. The common's value was entirely option-based and thus the common wanted the company to extend its life indefinitely, the preferred claimed whatever intrinsic value remained in the assets and wanted the company to shut down. 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.

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. 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. 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. 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. But it is merely a matter of degree. In most circumstances, the common will have
some incentive act as a bully, simply because the nature of preferred means that it can.\textsuperscript{231}

Subsequent case law has, in fact, approved of bullying tactics in a wider variety of situations. Indeed, the 2010 case of \textit{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.\textsuperscript{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.\textsuperscript{233} Following \textit{Equity-Linked}, then-Vice Chancellor Strine reasoned that the preferred were entitled to the protections they negotiated by contract, and nothing more.\textsuperscript{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,\textsuperscript{235} is there \textit{anything} left of a fiduciary duty to the preferred?

The bullying discussed in \textit{LC Capital}\textsuperscript{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."\textsuperscript{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.\textsuperscript{238} They usually look for operational synergies or other business-

\textsuperscript{231}Cf. \textit{id.} ("That the preferred is open to this risk legally, is a function of the terms of its security."); \textit{supra} note 219 and accompanying text.


\textsuperscript{233}\textit{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).

\textsuperscript{234}\textit{Id.} at 438-39.

\textsuperscript{235}\textit{Id.} at 450-51.

\textsuperscript{236}See \textit{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).

\textsuperscript{237}Cf. \textit{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").

\textsuperscript{238}See \textit{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. 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—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. It is unfair to criticize him for that choice; the transaction-type approach, whatever its merits, would be a departure from current trends. 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," 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—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. The then-Vice Chancellor implicitly blamed the preferred as a

dom-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, which seems only to confirm Bratton's diagnosis that the preferred face a uniquely hostile interpretive environment.

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. Preferred stock does not enjoy even that level of security. 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. Preferred stock seems to be a failure as a debt instrument. 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. 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-market and interest rates.

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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.


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. Surprisingly, the company convinced Chancellor Allen to approve it; unsurprisingly, the new formula was unfavorable to the preferred.

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. In that case, the plaintiff, Greenmont, was a venture capital fund holding series B convertible preferred stock in MGC, Inc. The certificate provided for an automatic conversion upon the majority vote of all preferred shareholders. Since the Series B was outnumbered by the Series A, the Series A controlled the outcome of the conversion vote. 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 - (Intron)/(Intnew + Intorig-post))/MP, where Intnew was the board-determined "intrinsic value" of the spun-off firm and Intorig-post 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 spin-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 spin-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.


257 Id. at *1.

258 Id.

259 Id. at *2.
powers, preferences, or other special rights" of the Series B. 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."  

Somehow, an action taken specifically to nullify Greenmont's liquidation preference did not count as a change of its preference. 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.

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. 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. After the option expired, the preferred would be unprotected. To be sure, the certificate could require that the parties agree to rollover the conversion

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261 Id. at *5.
262 Id.
263 Id. at *4.
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.\textsuperscript{267}

Second, conversion options merely give the preferred the ability to participate in the upside potential created by the common's excessive risk taking.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{272} Under stewardship from the preferred, the company would be managed conservatively, with a sufficient cash reserve to keep the preference full.\textsuperscript{273}

However, the preferred rarely succeed in obtaining control rights, except in the special case of venture capital.\textsuperscript{274} As many scholars have

\begin{itemize}
\item \textsuperscript{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.\textsuperscript{268} See Bratton & Wachter, supra note 29, at 1847.
\item \textsuperscript{269} See id. at 1879.
\item \textsuperscript{270} See id. at 1874-75.
\item \textsuperscript{271} See Fried & Ganor, supra note 8, at 986.
\item \textsuperscript{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).
\item \textsuperscript{273} See Fried & Ganor, supra note 8, at 989-90.
\item \textsuperscript{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
\end{itemize}
observed, preferred control creates an economic inefficiency that would tend to disappear in a robust capital market. 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. Venture capital is a special case, because the venture capital business model is highly risk-seeking by nature. 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. Of course, VCs seek to protect their capital when the prospects of a portfolio firm sours, 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.

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. 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. 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.\footnote{See Bratton & Wachter, supra note 29, at 1825.} In theory, the common would retain unlimited upside, but the preferred would rarely permit the company to take sufficient risks for upside to materialize.\footnote{See Fried & Ganor, supra note 8, at 993.} Only if the common insisted on giving the preferred a conversion option would its interests be taken into consideration by the board.\footnote{See id. at 970.} The irony, or perhaps absurdity, is that the common would benefit only by giving something of value away for free.\footnote{See id.}

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.\footnote{See id. at 972.} The general power of the preferred to alleviate its vulnerability through control\footnote{See infra notes 296-97 and accompanying text.} is likely to be limited absent a more creative and grander bargain between common and preferred. This topic is explored in the next Section.\footnote{See infra Part III.}

## 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.\footnote{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).} 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.\footnote{See Fried & Ganor, supra note 8, at 975-76.} 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.\footnote{See Stout, supra note 290, at 12.} In most companies, both debt and common have such representation, whereas preferred usually lacks anything stronger than the unreliable contract-lite covenants described above.\footnote{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

\(^{294}\) 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. Creditors have no direct representation on the board, but they hold the greatest leverage in terms of capital market reputation. Firms more frequently need to roll over their debt than raise new equity; if they wish to secure low-cost financing, they need to establish a reputation in the debt markets for good capital stewardship. Preferred stock, by contrast, has little input into or sway over firm policy. 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. 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. 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. In other words, incentive alignment is an inherently optimizing mechanism. By contrast, board control is most useful in controlling risk. 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. Boards

See Fried & Ganor, supra note 8, at 975-76.
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.
See id. at 1222-23.
See Fried & Ganor, supra note 8, at 1008-10.
See ROBERT W. HAMILTON & RICHARD A. BOOTH, ATTORNEY'S GUIDE TO BUSINESS AND FINANCE FUNDAMENTALS §11.16 (2d ed. 2007).
See id.
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).
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).
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.\textsuperscript{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,\textsuperscript{310} and cannot rely solely on equity compensation to protect their interests.\textsuperscript{311} To be sure, executives paid in common stock have an incentive to take risks that benefit the common.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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...
perform, whereas they will see only a small benefit from a successful project. 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 (subject to sensible equitable principles). Generally, the common would want directors to avoid long exposure, directly or indirectly, 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. 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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\(^{321}\) *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. 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. 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.

For Cooperation to be a viable equilibrium, the common must be able to pre-commit to playing Conflict when the preferred does. Absent a pre-commitment, one side could play Conflict for one period (thus expropriating some value) and test the other's resolve. 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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324 See Osborne & Rubinstein, supra note 323, at 133-49 (explaining repeated games).

325 See Osborne & Rubinstein, supra note 323, § 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.  

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. 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. 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. 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. 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 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. 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. 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.

C. Trados and Divided Board Control

*Trados* can be viewed as the mirror image of the fact patterns in *Equity-Linked Investors* and *LC Capital*. 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. After a few years of middling performance, the preferred started to look for an exit. 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. 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).
336 *See generally id.*
340 *Id.* at *2.
341 *Id.*
executives included sizeable bonuses for arranging and closing a successful sale of the company.\(^{342}\) This strategy proved successful: the company's performance improved, and Trados sold itself to a company called SDL for $60M—a sum that, net of the $7.8M needed to pay the management bonuses, almost satisfied the preferred's liquidation preference and left the common with nothing.\(^{343}\) In a sense, the turnaround strategy was too successful, as the improved business performance gave the common shareholders some hope that their equity—which had long been zero—might soon have some value.\(^{344}\) The merger, of course, extinguished that hope, and the common shareholders sued the board for a breach of fiduciary duty.\(^{345}\) Each of the preferred-appointed board members was employed by, and held equity in, the venture capital funds that owned the preferred stock.\(^{346}\)

In denying the defendants' motion to dismiss, Chancellor Chandler held that the board had acted self-interestedly in cashing out the common for no consideration when the company's financial fortunes seemed to be improving.\(^{347}\) In essence, the merger had negative value to the common, because their equity was extinguished when it still retained some significant option value.\(^{348}\) In this respect, Trados can be usefully compared with the hypothetical "bad faith" scenario discussed in LC Capital, in which the merger had negative value to the preferred because it cashed out a guaranteed stream of dividends for consideration of lower present value.\(^{349}\)

Whereas LC Capital left the preferred to its own (non-existent) devices, Trados intervened on behalf of the common.\(^{350}\) By finding the board to have

\(^{342}\) Id. at *3.

\(^{343}\) Trados I, 2009 WL 2225958, at *3-*4.

\(^{344}\) Id. at *3.

\(^{345}\) Id. at *1.

\(^{346}\) Id. at *1-2.

\(^{347}\) Id. at *9. The alternatives would have been sharing merger consideration with the common, or waiting to sell until the improved business performance led to a valuation in which the common would have obtained some consideration. See id. at *4. It is easy to understand why the preferred shareholders disliked both options. The latter was far from certain, and would have exposed the preferred to the risk that the company's value would actually decline; the former would further reduce their already lowered liquidation preference. Id.

\(^{348}\) Id. at *7. Strictly speaking, of course, common equity always retains some option value, so long as it is possible for the company's business to turn around and become profitable. See id. The key fact in Trados I was that it appeared, from the complaint at least, that the company's business had already turned around. Id. It was not certain that the common equity would ever regain value, but that prospect seemed to be more than a distant and remote possibility. Id.

\(^{349}\) Compare id., with LC Capital v. James, 990 A.2d 435, 438 (Del. Ch. 2010). For a discussion of LC Capital, see supra Part II.E.

\(^{350}\) Compare LC Capital, 990 A.2d at 438, with Trados I, 2009 WL 2225958, at *4.
been acting in breach of duty by favoring the interests of the preferred, the court forced the board to prove that the deal was entirely fair.\textsuperscript{351}

Proving entire fairness turned out not to be a fool's errand for the Trados directors. In an opinion issued after trial (\textit{Trados II}), Vice Chancellor Laster determined that the common stock had no value at the time of the merger.\textsuperscript{352} He thus characterized the transaction as entirely fair, even though he found that the directors had in fact acted in a self-interested fashion \textit{and} had engaged in unfair dealing.\textsuperscript{353} This resolution of the case was simultaneously justified on the facts and implausible in its outcome. The court engaged defendants' contentions in detail and without credulity;\textsuperscript{354} indeed, it is difficult to pinpoint any significant flaw in its evaluation of the record. At the same time, the idea that the common equity lacked any option value makes little sense in a financial market in which deep-out-the-money, soon-to-expire stock options trade with positive value. Ultimately, the common's case was doomed from the start, because the record before the court was shaped entirely by the actions and testimony of directors and officers with a strong financial interest in an immediate sale.\textsuperscript{355} Pointing out inconsistencies and flaws in the defendants' account was no substitute for affirmative evidence that, at the time of sale, the firm realistically could have appreciated to a value \textit{in excess} of the liquidation preference.\textsuperscript{356} What the common needed was a decision-maker inside the company seeking to identify value for them or pushing back on the managers' convenient determinations that the future was all downhill.

Taken together, the \textit{Trados} opinions demonstrate both the viability of and the need for DBC. In this case, the preferred stockholders used their board control to avoid the sad fate of their counterparts in \textit{Equity-Linked}\textsuperscript{351} Technically, \textit{Trados I} decided a motion to dismiss, and so the court did not find the directors to actually have breached their duties. \textit{Trados I}, 2009 WL 2225958, at *10. Nonetheless, the clear thrust of the opinion's logic is that the board will not be protected by the business judgment rule when they sell out the common stock for absolutely nothing. \textit{Id.} As the court noted, "[i]t would not stretch reason to say that this is the worst possible outcome for the common stockholders." \textit{Id.} at *7. Of course, the board will not be liable in a self-interested transaction if it can show entire fairness. See \textsc{Del. Code Ann. tit.} 8, § 144(a)(3) (2011).

\textsuperscript{352}Trados II, 73 A.3d 17, 20 (Del. Ch. 2013). The Vice Chancellor inherited the case when Chancellor Chandler left the Delaware Court of Chancery.

\textsuperscript{353}\textit{Id.} at 56-65.

\textsuperscript{354}\textit{Id.}

\textsuperscript{355}\textit{Id.} at 49.

\textsuperscript{356}The opinion scatters several references to inconsistencies in the directors' testimony throughout its discussion of entire fairness, culminating in the Vice Chancellor's final assessment of that testimony as "often problematic." \textit{Trados II}, 73 A.3d at 76. Still, the plaintiff was unable to demonstrate that the firm could make sufficient profits to keep up with the accumulating preferred dividends. \textit{Id.}
**Investors and Thoughtworks.** The common, meanwhile, used the board's fiduciary duties to form a first line of defense against a zero-value cash-out. But fiduciary duties proved inadequate to the task, as commonly is the case in corporate law.

The transaction might have looked different, and fairer to both parties, if the executives had been compensated differently. Directors who answered to the common shareholders might have designed the merger bonus package to incentivize the executives to obtain at least some value for the common. For instance, they might have granted a large tranche of common equity options with a strike price close to zero. Instead, the preferred-controlled board gave the executives a sizeable bonus simply for completing a deal for less than the liquidation preference.

Taken together, the two *Trados* opinions have the potential to subtly but significantly reshape the law, encouraging the preferred and common shareholders to cooperate. It does not restore the peacekeeping paradigm, but it does at least give each side enough weaponry to deter bullying on the part of the other. As noted above, DBC levies some risks on the common that cannot be neutralized by the common's compensation power—the merger in *Trados* being just such a risk. When preferred-appointed directors want to cash out their investment at the common's expense, there may not exist any realistic compensation scheme powerful enough to change those incentives. In *Trados*, for instance, the directors' equity in (and career prospects with) the venture capital funds likely dwarfed in value whatever directors' fees they might have possibly earned from Trados. Entire fairness review helps protect the common against transactional exploitation, and makes it possible for them to willingly cede board control to the preferred. That willingness is necessary for DBC to gain a foothold, and

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357 See supra Part II.
359 See id. at *10.
360 See supra Part III.
361 *Trados* I, 2009 WL 2225958, at *4 (noting that the executives were paid $7.8M in merger-related bonuses).
362 As noted above, the compensation power is most useful to push back against a preferred-controlled board's tendency to manage too conservatively. See supra note 66 and accompanying text. It is of less use in a transactional context. See supra note 66 and accompanying text.
364 Id. The company's CEO does not appear to have had exposure to Trados preferred. Id. But the board gave him an incentive to support the transaction by means of a large bonus to be paid out of the merger proceeds. Id. Under DBC, only common-elected directors would be able to authorize such bonuses, and presumably they would not have done so unless the merger carried some benefit for the common. See id.
365 See id.
for preferred to regain its viability as a generally available financing mechanism.

For these reasons, *Trados* is better viewed as a victory for the harmonious co-existence of common and preferred than as yet more evidence of Delaware's hostility to preferred stock. Venture capitalists likely view it far less favorably. As Professors Bratton and Wachter have observed, the case empowers entrepreneurs or other common shareholders to potentially block, or at least delay, the sale of a VC portfolio company with negative common equity value. That delay can serve the cause of efficiency—for instance, if the VC's financial incentives lead it to sell the firm below its true enterprise value—but also the cause of opportunism: the common can extract concessions from the VC simply by bringing and then settling derivative litigation. On this view, *Trados II* is at best a mild palliative. While the VCs were able to prevail ultimately on the issue of fair price, it can only be described as a close case. The Vice Chancellor found that the board had engaged in unfair dealing, and even on the issue of price, he characterized the board's evidence at trial as "strained," "overly strident" and "exaggerated to the point of caricature." These wounds may have been self-inflicted, and it might be supposed that a different board of directors would have produced a cleaner evidentiary record. Still, proof of entire fairness typically requires a trial, and trials cost money. *Trados II* might have reassured a nervous VC community, but it is hard to imagine that it caused much rejoicing.

VCs, however, constitute a special class of preferred shareholders. They have little to gain from *Trados* because they already enjoy what *Trados*
makes possible: the prospect of obtaining some board control.\textsuperscript{376} Divided Board Control, as described in this Article, is aimed at more established companies that currently have limited ability to raise preferred stock financing.\textsuperscript{377} As discussed in Part I above, preferred stock can be an elegant financing solution for firms with cyclical business models—one that permits the common to obtain significant upside through financial leverage, with less risk of total or near-total loss in bankruptcy.\textsuperscript{378} To the extent that \textit{Trados} makes it possible for DBC to function, it can be seen as a favorable remedy for preferred shareholders in general, if not for venture capitalists in particular.\textsuperscript{379}

It is also possible that DBC arrangements could help venture capitalists, by restoring the disinterestedness of the company's executives. In \textit{Trados} itself, the executives were interested in the merger because the board had granted them sizeable bonuses payable upon the company's sale.\textsuperscript{380} These bonuses incentivized both a quick sale and a good price, but not in equal measure: the executives had more to lose from delay than they had to gain from waiting for a price favorable to the common.\textsuperscript{381} Even though the bonuses increased non-linearly with increasing sale price, they were still significant at low sale prices and scaled up more rapidly at the low end of the valuation scale.\textsuperscript{382} For instance, the Trados CEO took home $2.34M at the sale price of $60M.\textsuperscript{383} An $11M increase in the sale price (which would have netted a grand total of $3M for the common) would have gained him an additional $430K, but an $11M decrease would have cost him $723K. More importantly, delay risked of losing the transaction—and the multi-million dollar bonus—entirely. Was the difference between the potential $2.77M bonus and the actual $2.34M worth the risk of a much smaller bonus or even none at all? Apparently the Vice Chancellor did not think so: he found that

\textsuperscript{376} See supra note 366.

\textsuperscript{377} See supra Part III.

\textsuperscript{378} See supra Part I.

\textsuperscript{379} See supra Part I.

\textsuperscript{380} See \textit{Trados II}, 73 A.3d 17, 20 (Del. Ch. 2013) (noting that the executives were awarded a total of $7.8M in bonuses upon merger completion).

\textsuperscript{381} Id.

\textsuperscript{382} That is, the incentive plan paid out to the executives a percentage of the total merger consideration, and that percentage itself increased as the merger consideration increased. \textit{Id} at 59. Had the sale price been between $30M-$40M, the executives would have received only 6 percent of the proceeds. \textit{Id}. Had the management team been able to obtain more than $120M, they would have kept 15 percent. \textit{Id}.

\textsuperscript{383} Id.
the bonus plan "skewed the negotiation and structure of the Merger in a manner adverse to the common stockholders." 384 

Suppose, by contrast, that Trados had a divided board in which the common held ultimate power over compensation. If so, this exact same bonus plan might have been interpreted quite differently, as evidence that the managers were incentivized to seek higher sale prices but did not believe that a better price could be obtained. To the extent that the incentives were improperly designed, the common shareholders would have had only themselves to blame. Indeed, a common-approved compensation plan might even have handed the board a victory on the motion to dismiss. Of course, the compensation plan would probably have looked quite a bit different had it been designed by the common. It would have been the product of negotiation between the two classes of stock, and could easily have yielded a more equitable result.

It is harder to assess whether Trados is sufficient to protect the common from preferred board control. Technically, the holding of the case rests on the fact that the directors owned equity in the funds that held the preferred stock; thus, they were financially self-interested in the decision to sell the company and pay off the liquidation preference. 385 What if the preferred shareholders had appointed directors loyal to their interests, but who did not own any equity? This is a critical question: if the court will not prevent preferred-loyal directors from pursuing transactions to exploit the common, then the DBC grand bargain would collapse. Perhaps sensing its importance, the Chancellor avoided the issue:

Each of these four directors was designated to the Trados board by a holder of a significant number of preferred shares. While this, alone, may not be enough to rebut the presumption of the business judgment rule, plaintiff has alleged more. 386

The second sentence was supported by citations to two conflicting authorities: Citron v. Fairchild Camera & Instrument Corp., which held that a director's representation of one of the corporation's largest shareholders "alone did not make him an interested director," 387 and a contrary holding from the Court of Chancery in Goldman v. Pogo.com, that directors who "were the representatives of shareholders which . . . are both alleged to have

384 Trados II, 73 A.3d at 61.
386 Id. at *8 (emphasis added) (internal citations omitted).
had a direct financial interest in this transaction . . . ." were possibly interested.388 This is not remotely a fair fight. *Fairchild Camera* is a Delaware Supreme Court opinion that has been cited dozens of times, often for its statements of foundational corporate law principles.389 *Pogo.com*, by contrast, is a minor Court of Chancery opinion that has been cited primarily for its boilerplate recitation that "[a] claim of tortious interference with a contractual right requires . . . a contract, a breach of that contract, and an injury."390 It is not hard to predict how a future court would resolve this particular split of authority if forced to make a choice.

However, DBC may be viable without a position on director independence as strong as that articulated in *Pogo.com*. As Airgas recently discovered during its hostile bid for Air Products, directors are not necessarily loyal to those who merely nominated or appointed them.391 A preferred shareholder bloc seeking to exploit the common would likely appoint directors with deeper bonds of loyalty.392 Under existing precedent, courts could easily find such directors to be interested. For instance, *In re Primedia Derivative Litigation* held that, when directors have "substantial past or current relationships, both of a business and of a personal nature," it can be inferred (depending on the facts, of course) that the directors felt "a sense of owingness to their mutual patron" that would sterilize their discretion.393 Whether the common can rely on the court sniffing out the directors' loyalties is another question. Presumably, the preferred will seek to appoint directors with whom they are not visibly associated but whom they can trust to do their bidding.

Ultimately, the issue likely reduces to one of risk versus reward. Obviously, the common would be unlikely to take any chances with board control if it has little to gain by doing so. In most situations, perhaps, the

389 See, e.g., Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1114 (Del. 1994) ("For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder though actual control of corporation conduct." (quoting *Fairchild Camera*, 569 A.2d at 70)).
390 See, e.g., Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1036 n.32 (Del. Ch. 2006) (quoting *Pogo.com*, 2002 WL 1358760, at *8). Its assertion that directors lack disinterest with regards to powerful shareholders who appointed them has not been seconded.
391 See Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 103-04 (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 and to maintain Airgas' poison pill).
392 See supra notes 63-66 and accompanying text.
393 In re Primedia Inc. Derivative Litig., 910 A.2d 248, 261 n.45 (Del. Ch. 2006) (internal citations and quotations omitted).
common will be perfectly happy to issue debt, preferring the bankruptcy risk thereby created to the risk of exploitation in a system of DBC. In some circumstances, however, the common might sufficiently value the financial flexibility afforded by preferred stock—in particular, the ability to defer dividends in periods of financial stress—enough to acquiesce to DBC. What seems clear is that DBC opens at least a possibility of the continued viability of preferred stock as a financing vehicle outside of highly specialized contexts. The Delaware courts should continue to expand its protection of common shareholders from exploitation by the preferred, in order to make DBC a viable option.

D. An Extra Benefit: Pay For Performance

The central purpose of DBC is to render preferred stock more investment-worthy, and thus would-be preferred shareholders stand to gain the most by its adoption. However, DBC holds important ancillary benefits for the common. One of them, as discussed above, is the utility that might flow from the greater availability of preferred stock financing. Less obviously, but more importantly, DBC offers a mechanism by which investors can reduce the agency costs associated with inefficient executive compensation.

Executive compensation of large public companies attracts a wide range of criticism, but one of the more persuasive arguments has focused on the dissociation between executives' pay and their performance. As Professors Fried and Bebchuk have long argued, currently dominant compensation practices do not effectively motivate executives to manage in the shareholders' best interests, nor reliably reward (or punish) them for successfully (or not) doing so. While these observations have been presented as part of a more comprehensive and highly controversial "managerial power" theory, one does not have to endorse their entire argument in order to think highly of performance-sensitive compensation.

\[394\] See Partnoy, supra note 31, at 804.
\[395\] See infra Part IV.
\[396\] See supra Part II.B.
\[397\] See supra notes 22-26 and accompanying text.
\[398\] See supra Part II.B.
\[399\] See supra Part III.D.
\[401\] See id. at 6-8.
\[402\] See id. at 61-79.
Perhaps the market price of a firm's common stock should not be the ultimate benchmark of managerial performance, but surely strong market performance is at least a goal and an indicator of managerial prowess. One does not have to accept the idea that managers should focus solely on the welfare of shareholders—to the exclusion of other stakeholders or other members of the firm's production team—to be concerned that managers focus too much on their own welfare. One need not be an advocate of "shareholder power" to be concerned that vast quantities of corporate resources are being inefficiently deployed, doing more to enrich executives than to create economic value.

There are several reasons why boards approve executive compensation plans that under-incent. Perhaps most important is the board's own lack of incentive to achieve optimality. Neither their wealth nor their job security is likely to be meaningfully impacted by the amount of effort they devote to compensation issues. Thus, they tend to delegate compensation matters to consultants, human resources managers, or the firm's legal department—each of whom have incentives to recommend "safe" pay packages in lieu of innovations that would actually increase performance-sensitivity. Shareholders, in turn, lack a meaningful ability to hold the directors accountable for their compensation decisions, by virtue of the "bundling problem." The shareholder franchise permits only a choice between

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403 Some commentators have argued that the obsessive focus by executives and investors on short-term stock price fluctuations has decreased overall corporate efficiency by promoting (or fostering a culture of) myopic management. See David I. Walker, The Challenge Of Improving The Long-Term Focus Of Executive Pay, 51 B.C. L. REV 435, 440 (2010) (collecting arguments linking equity compensation to short-termism among managers). It is true that executives increasingly massage earnings the more equity they hold, and that massaging earnings frequently sacrifices long-term performance—such as when a firm cuts research and development expenditures in order to reduce present period costs. Id. at 441-42. Moreover, the financial crisis of 2008 has made it more difficult to view stock market prices as informationally efficient. Nonetheless, it seems unlikely that stock market prices are either uninformative or dis-informative, or that the costs of myopia usually outweigh the benefits of incentivized management. The burden of demonstrating either proposition has not been met. Equity-based compensation is surely no panacea for the ills of corporate governance, but it can contribute to agency-cost reduction if structured wisely in conjunction with other mechanisms.

404 See BEBCUK & FRIED, supra note 400, at 1.


406 Id.

407 Id. at 140-41.

408 Id.

409 See Bebchuk, supra note 309, at 857 (describing how shareholders cannot punish directors for individual decisions because their only means of discipline is to vote the directors out of office, which they will not do if the directors' performance has been otherwise acceptable).
candidates based on overall performance.\textsuperscript{410} Thus, shareholders are unlikely to vote against a decently-performing board even if they are unhappy with many of its particular decisions—such as compensation—if the alternative is the risky decision to elect a slate of directors who lack experience with the company and an established track record.\textsuperscript{411} In addition, psychological factors likely play a role. Directors may feel beholden to executives for helping them obtain (and retain) their seats; they may value friendship with the executives; and they may simply be risk-averse, willing to over-pay an incumbent CEO to avoid even a minimal risk that the CEO may leave for greener pastures.\textsuperscript{412}

DBC, by contrast, provides a structural remedy for most of these shortcomings of the current process.\textsuperscript{413} It operates by means of the logic of necessity. Investors have to demand performance-sensitivity for executive pay, because that is the primary lever by which to protect their interest in risk-taking.\textsuperscript{414} As described above in Part III.A., executives and directors, like preferred holders, naturally avoid risk: whereas they enjoy the generous compensation, perks, and prestige that comes with their positions so long as the company stays stable, they likely will lose their job and perhaps their whole career if the firm enters distress.\textsuperscript{415} If the board and thus the managers answer to the preferred, risk-aversion will result, and the upside potential of the firm—the most important economic interest of the common stock—will be diminished.\textsuperscript{416} But this implicit collusion can be broken if the right incentives are built into the compensation scheme. If managers' base compensation is set fairly low, but the rewards for common stock appreciation are very high, then the managers will gain an appetite for risk.\textsuperscript{417}

\textsuperscript{410}See id. at 836-38.
\textsuperscript{411}See id. at 857-58.
\textsuperscript{412}See \textsc{Bebchuk & Fried}, supra note 400, at 4 (discussing these factors and other causes of under-incentivizing compensation). In the last decade, an extensive literature on executive compensation has developed, much of which criticizes the Bebchuk/Fried "managerial power" argument that executive compensation reflects the power of executives in setting their own pay. \textsl{See, e.g.,} Marcel Kahan and Edward Rock, \textit{Embattled CEOs}, 88 \textit{Tex. L. Rev.} 987, 1033-37 (2010) (describing the recent diminishment of CEO influence over the board, including over matters of compensation); \textit{cf.} Kevin J. Murphy and Michael C. Jensen, \textit{CEO Bonus Plans And How to Fix Them} 5-6 (Harvard Bus. Sch., Working Paper No. 1935654), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1935654 (recognizing that even critics of the managerial power view, including Murphy and Jensen themselves, acknowledge that executive compensation generally under-incents executives to maximize the corporation's economic profits).
\textsuperscript{413}See infra notes 416-19 and accompanying text.
\textsuperscript{414}See \textsc{supra} Part III.B.
\textsuperscript{415}See \textsc{supra} Part III.A.
\textsuperscript{416}See \textsc{supra} Part III.A.
\textsuperscript{417}See \textsc{supra} Part III.A.
Many people would not risk losing a job that paid them two million a year for a chance at ten, but they might risk a salary of half a million a year for a chance at fifty.

Moreover, DBC provides mechanisms by which the common's demands can be easily translated into action by the board's compensation committee.418 First, it establishes clear accountability and expectations for the directors elected to the compensation committee.419 They would be elected specifically to optimize compensation, and the shareholders would have fewer qualms about replacing those directors if their performance is inadequate.420 The bundling problem would be solved because shareholders would not have to (or be able to) to elect an entirely new, untested board in order to address their unhappiness with the performance of the compensation committee.421 Second, the common-appointed directors' own risk-aversion would be redirected toward optimizing compensation.422 Their constituents will fear the departure of a good executive less than collusion between executives and the preferred, and so directors who want to keep their jobs will err on the side of hard bargaining.423 Finally, the expectation of collegiality on the board would be reduced.424 While the common, the preferred, and the directors themselves would all prefer for the board to function as a team, it would be understood by all parties that the directors represented different constituencies with interests that occasionally conflicted. If disputes are inevitable, the directors won't seek to avoid them at all costs.

To be sure, DBC is no panacea for the many problems that plague the executive compensation process, even if it were the case that all companies adopted a DBC governance regime. It is easy, after all, to talk of optimal compensation for executives; it is much harder, in practice, to determine what that might be in real world situations. That practical reality does not disappear just because directors have better incentives to strive for optimality. Still, compensation is likely to improve if the directors' incentives improve. That DBC can help in this regard is surely a feather in its cap.

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418 See infra notes 419-24 and accompanying text.
419 See supra Part III.A.
420 See supra Part III.A.
421 See supra note 411 and accompanying text.
422 See supra Part III.
423 See supra Part III.A.
424 See supra note 414 and accompanying text.
IV. CONCLUSION

Preferred stock has been placed in a difficult spot by the case law of the past two decades. Its current plight recalls the warnings of the famed investor (and mentor to Warren Buffett) Benjamin Graham, that the yield of preferred stock is almost never sufficient to justify the risk of maltreatment by the board.425 In large measure, the decline in its investment worthiness has been a product of the increasing financial and legal sophistication of directors and their advisors; the economics of and legal strategies for exploitation have been widely disseminated. However, what innovation produced, innovation can reduce. Preferred and common stockholders can use those very same tools—such as distribution of voting rights and equity compensation—to craft an equity structure characterized by harmony between the different classes.

425See BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR 50 (1949) (arguing that preferred stock should be "bought on a bargain basis or not at all" and that even the rare "good" preferred stock is "good in spite of their investment form, which is inherently a bad one").