Poor Pitiful or Potently Powerful Preferred?

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Whenever a policy solution is proposed, two questions are raised. The first is whether there is a problem that requires a solution. The second is whether, if there is a problem, the solution has more benefits than costs.

Because I am a judge, not a professor, my comments on Professors Bratton and Wachter's thoughtful article will be questioning rather than conclusory.[1] Bratton and Wachter claim that the law lacks an adequate theory about preferred stockholders and that this is problematic for society because preferred stockholders are being deprived of the benefit of their bargain, a result that may imperil society as a whole because it undermines the ability of corporations to raised needed capital for long-term investment.[2] The solution to this problem is for corporate law to impose on directors the duty to protect the bargained-for expectations of preferred stockholders by somehow identifying the extra value—the lagniappe in more savory terms—that preferred stockholders should receive over common stockholders.[3] These bargained-for expectations are, interestingly, not in the written contract. Rather, they constitute some noncontractual expectation that

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[1] William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. (forthcoming 2012), at 4. All pincites are to the November 9 draft.

[2] *Id*. at 1-4.

[3] *Id*. at 66, 68.

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

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

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[4] *See, e.g., id.* at 18-20, 41-42, 62-68.
[5] *See, e.g., id.* at 15, 18-19, 23.
[6] *See, e.g., id*. at 66.
[7] *Id.* at 49-51.

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

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

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[8] *Id.*
[9] *Id.* at 63.
[10] Chancellor Allen articulated this in *Jedwab v. MGM Grand Hotels, Inc.*:

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

preferences, they are entitled to no better treatment than other stockholders.[11] As preference holders, preferred stockholders are owed the duty the corporation owes to other contractual claimants, which is to honor their *legal* rights. Only insofar as they are stockholders like other stockholders, are preferred stockholders owed fiduciary duties by the board. Thus, because preferred stockholders desire value from the company's performance, they may bring derivative suits if they suspect directors are self-dealing. If the corporation is being sold, the preferred can sue under *Revlon* if they believe the board is not honoring its duty to maximize the sale value of the corporation.[12] But the board owes no fiduciary duty to maximize the value of the preferred or in any way to *prefer* the preferred over the common, except when contractually required. In fact, the law suggests

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> and the scope of the correlative duty may be measured by equitable as well as legal standards.
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> 509 A.2d 584, 594 (Del. Ch. 1986).

Jedwab restates a long-held view of preferred stockholder rights. *See, e.g.*, Gaskill v. Gladys Belle Oil Co., 146 A. 337, 339 (Del. Ch. 1929) ("The holder of preferred stock must therefore refer to the appropriate language of the corporate contract for the ascertainment of his rights . . . . The statute, by providing that the preferred stock which corporations created under it may issue shall possess such preferences as are stated in the certificate of incorporation, by obvious inference must be taken to mean that unless the preferences are stated in the certificate of incorporation, they shall not exist."). This principle was confirmed by Richard Buxbaum in his article *Preferred Stock—Law and Draftsmanship*, which—as the title suggests—showed how the drafters of company charters could grant preferred stockholders rights that they would not have by statute. 42 CALIF. L. REV. 243 (1954); *see, e.g., id.* at 243-57 (discussing how corporate drafters may, by contract, confer dividend rights upon preferred stockholders). The same view still holds true. *See, e.g.*, Matulich v. Aegis Commc'n Grp., Inc., 942 A.2d 596, 599 (Del. 2008).

[11] *See, e.g.*, Penington v. Commonwealth Hotel Constr. Co., 151 A. 228, 233 (Del. Ch. 1930) ("The general rule is that preferred stock enjoys only those preferences which are specifically defined and that as to all matters lying outside the field of defined preferences, preferred stock has no rights which are not shared equally with the common stock."); Rice & Hutchins, Inc. v. Triplex Shoe Co., 147 A. 317, 320 (Del. Ch. 1929), *aff'd sub nom.* Triplex Shoe Co. v. Rice & Hutchins, 152 A. 342 (1930) ("The preferred was simply called such; any description of preferences, however, was omitted. The word 'preferred' therefore meant nothing.").

[12] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

that when push comes to shove, the board has a duty to prefer the common's interests, as pure equity holders, over any desire of the preferred for better treatment based on some generalized expectancy that they will receive special treatment beyond their contractual rights.[13] Indeed, if the preferred stockholders actually secure control of the board, they are then expected to fulfill this fiduciary responsibility and to refrain from using their power selfishly to extract a return of their own investment, unless they do so on terms that are shown to be fair to the common.[14]

Second, there are reasons to doubt that preferred stockholders lack sufficient market clout to protect their interests at the negotiating table. Preferred stockholders are not obviously the poor pitiful preferred that Bratton and Wachter describe. That proposition makes little intuitive sense. No one has to buy preferred stock. Those who do are quite sophisticated. Preferred stock issuances often involve provisions such as: (1) a requirement for a class vote on any issues affecting the preferred, including any merger, asset sale, charter change, issuance of more preferred shares, and (2) a liquidation preference in the event of merger.[15] In fact, Bratton and Wachter's own research reveals

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[13] *See* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997).

[14] *See, e.g.*, Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 658 (Del. Ch. 1975) ("Although one purpose of allowing the preferred to elect a majority of the board may be to bring about a payment of the dividend delinquencies as soon as possible, that should not be the sole justification for the existence of a board of directors so elected. During the time that such a preference board is in control of the policies and business decisions of the corporation, it serves the corporation itself and the common shareholders as well as those by whom it was put in office."); *accord In re* Trados Inc. S'holder Litig., 2009 WL 2225958, at *6-7 (Del. Ch. July 24, 2009).

[15] Professor Gordon Smith has found that venture capitalists frequently negotiate for and receive negative covenants to protect their investments. The following table summarizes his results of 367 IPOs of venture capital-backed firms between 1997 and 2002:

that half of new issuances of preferred since 2009 give the preferred effective approval rights over mergers.[16] Although I am not sure what the authors consider "effective" protection, an earlier study of preferred contractual rights concluded that about 81% of preferred shareholders had negative covenants relating to business combinations.[17] And the common feature of a class vote is one that solves most of the problems Bratton and Wachter raise in their paper. Rather than viewing the absence of such a common provision as an indication that a particular preferred stock issue has simply not gotten any extra holdup value and is subject to no better treatment than the common, Bratton and Wachter fill a gap that they have little evidence to claim is a gap, rather than an intentional contract omission. Although the authors in fact fear that common contractual provisions giving preferred stockholders the ability to protect themselves in a merger, default, or other event endangering their investment will result in "holdups," (i.e., where preferred stockholders use their ability to vote as a class to impede valuable corporate

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Restriction on . . .	Frequency
Business combinations	81%
Adverse charter amendments	91%
Redeeming common stock/ paying common stock dividends	71%
Issuing more preferred stock	80%

D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 346 (2005). *See also* Steven Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003) (finding that venture capitalists negotiate, for example, optional redemption and put provisions in 84% of cases; provisions granting them additional voting rights if the target does not meet financial milestones in 20% of cases; and anti-dilution provisions in 95% of cases).

[16] Bratton & Wachter, *supra* note 1, at 19.

[17] Gordon, *supra* note 15, at 346.

transactions),[18] they ignore the fact that such provisions are common and are bargained for by issuers. Therefore, the common stockholders have no just reason to complain about them (assuming the preferred was issued for proper corporate purposes), and such provisions give the real parties an incentive to reach a mutually acceptable compromise.

The proposition that instead of extracting these specific contract rights and risking holdup by the real parties in interest, the preferred should be able to look to judges to give them noncontractual contractual rights as a matter of equity, rests on the idea that litigation about a nebulous proposition is more efficient than a contract that forces agreement among the contracting parties with economic interests. By way of example, in their discussion of *SV Investment Partners v. Thoughtworks*, Bratton and Wachter arguably overstate the extent to which courts, rather than the statutory corporate law itself, should affect the ability of preferred stockholders to get full redemption when the issuer does not have the funds statutorily required for it to do so.[19] To them, the court "strip[ped] away the promise's contractual vitality by remitting the decision to perform the promise to pay to the discretion of the issuer board and thereby subordinating the preferred stockholders' payment rights not only to the interest of the issuer's creditors but to those of its common stockholders."[20] The court was biased against the preferred by

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[18] Bratton & Wachter, *supra* note 1, at 19.
[19] SV Inv. Partners, LLC v. Thoughtworks, Inc., 7 A.3d 973 (Del. Ch. 2010), *aff'd*, 37 A.3d 205 (Del. 2011); Bratton & Wachter, *supra* note 1, at 36-41.
[20] Bratton & Wachter, *supra* note 1, at 33.

stating that it would accept the issuer's position that there were not funds legally available unless the issuer has cash on hand (or the equivalent).[21]

This reading is strained for a couple of reasons. First, the preferred stockholders' right to mandatory redemption in the defendant's charter was governed by language saying that the preferred "shall be entitled . . . to redeem [their stock] *for cash* out of any funds legally available therefor."[22] This language presupposes that the corporation must have cash on hand before making any redemption. But, as the trial court in *Thoughtworks* found, the plaintiffs' own expert had "no thoughts" on how the corporation might obtain the cash to finance a redemption, even though the size of the proposed redemption was approximately equal to the expert's low-case estimate of the corporation's equity.[23] The corporation in *Thoughtworks* had volatile cash flows, and management took care to "keep some funds on hand so that checks don't bounce during a dry spell."[24] Because the plaintiffs introduced no evidence to show that the corporation could raise the funds for the redemption, and it was undisputed that the corporation needed to keep a cash cushion to operate as a going concern, Bratton and Wachter seem to be overstating the leeway *Thoughtworks* leaves to the board by claiming that the court left the promise to redeem the preferred "in the promisor's discretion."[25]

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[21] *Id*. at 37.
[22] *Thoughtworks*, 7 A.3d at 978 (emphasis added).
[23] *Id.* at 989. The Supreme Court affirmed the case on these grounds. SV. Inv. Partners, LLC v. Thoughtworks, Inc., 37 A.3d 205, 211-23 (Del. 2011).
[24] *Thoughtworks*, 7 A.3d at 977.
[25] Bratton & Wachter, *supra* note 1, at 39.

More importantly, Bratton and Wachter slight as ironic the fact that *Thoughtworks* was citing a standard that had been articulated in cases in which the Delaware courts had upheld the payment of a redemption to the preferred against challenges by the common.[26] In these cases, the plaintiffs claimed that the board acted outside its authority in determining that that the corporation had the required legal funds to pay the preferred.[27] In rejecting those challenges and ruling for the preferred stockholders, the Delaware courts afforded reasonable deference to boards in determining whether funds were available, and held that a board's determination of what was available would not be set aside unless "the board acted in bad faith, relied on methods and data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud."[28] There is nothing ironic about using that same standard to uphold a board's decision *not* to make a payment to the preferred; it is simply evenhanded. *Thoughtworks* was thus not, in the authors' words, "tak[ing] a giant step away from contract into corporate territory."[29]

Relatedly, even if redemption of preferred stock is made difficult if there is a bona fide question whether the company's creditors, who are senior in priority, will get paid, Bratton and Wachter do little to show why this is a problem. The preferred stockholders have many options to be treated as a pure creditor without having to straddle the

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[26] *Thoughtworks*, 7 A.3d at 988 (citing Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150 (Del. 1997); Morris v. Standard Gas & Elec. Co., 63 A.2d 577 (Del. Ch. 1949)); *see* Bratton & Wachter, *supra* note 1, at 38.
[27] *Klang*, 702 A.2d at 152; *Morris*, 63 A.2d at 578.
[28] *Thoughtworks*, 7 A.3d at 988 (citing *Klang*, 702 A.2d at 156, and *Morris*, 63 A.2d at 584-85).
[29] Bratton & Wachter, *supra* note 1, at 39.

equity/debt line. Instead of investing in stock with contractual rights, they could invest with secured debt, subordinated debt, unsecured high-yield debt, mezzanine debt, and convertible debt, among other financial products. The provision of the Delaware General Corporation Law that prevents a corporation from redeeming its stock when such a redemption would impair the capital of the corporation is designed to protect the superior interests of creditors from injury at the hands of equity investors, just as the liquidation preferences preferred get protect them over the common.[30] It is therefore odd that preferred shareholders might champion risking *creditors'* ability to be repaid to effect a redemption of their class of *equity*. The reality is that the only thing Bratton and Wachter have shown is that the law is careful to make sure that a preferred shareholder does not get paid its mandatory redemption unless the corporation has the funds to pay more senior claimants. This is not a problem of contracting. It is the bargain the preferred make.

Finally, Bratton and Wachter seem troubled that preferred stockholders win very few litigated cases.[31] I do not have the training or resources to conduct a historical study of whether that is true, but even if it is, it may also not prove their point. Even if the win-loss record were tallied by Bratton & Wachter—and it is not—that record may be affected by an overwhelming tendency of issuers to honor, not violate, the contractual rights of the preferred. The cases Bratton and Wachter cite are largely ones where the preferred are asking courts to give them extra value, which they could have rooted in

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[30] 8 DEL. CODE ANN. tit. 8, § 160(a) (2012).
[31] *Id.* at 64.

written contract, but did not.[32] The refusal of courts to make up noncontractual contractual rights is not a reality that immediately suggests a problem: indeed, it tends to suggest a rightful application of judicial discipline. The authors seem to acknowledge this, claiming that "the preferred always loses *and for a good reason: . . . it could have been protected at the drafting stage*."[33] But in any case, they admit that courts have in fact ruled for the preferred many times,[34] and in the brief period allotted to prepare this Comment it was not hard to find examples they fail to cite.[35]

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And what of Bratton and Wachter's solution? In the context of mergers, the authors suggest that the preferred stockholders should have the protections of at least one director, who will be charged with vindicating their noncontractual contractual interests. Bratton and Wachter do not explain how, as a practical matter, directors are to fulfill this duty.[36] Why is the omission important to the workability of their policy proposal? Well,

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[32] For example, in *LC Capital Master Fund Ltd. v. James*, the court, in refusing to enjoin a transaction on the basis that the board did not allocate more than they would have received if they had converted to common (i.e., the merger agreement treated them equally with the common based on the conversion ratio), noted that the preferred did not negotiate for veto rights over a merger and the board did not violate any of the preferred shareholders' other extensive contractual rights. 990 A.2d 435, 448 (Del. Ch. 2010). Under such circumstances, the court concluded that the board "need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common." *Id*. at 449.

[33] Bratton & Wachter, *supra* note 1, at 1 n.1

[34] *Id.* at 65 n. 271 (citing cases where the preferred prevailed on their claims in Delaware).

[35] *See, e.g.*, *Klang*, 702 A.2d at 150; Hokanson v. Petty, 2008 WL 5169633 (Del. Ch. Dec. 10, 2008); Orban v. Field, 1997 WL 153831 (Del. Ch. Apr. 1, 1997); Cannon v. Denver Tramway Corp., 373 A.2d 580 (Del. Ch. 1977); Morris v. Standard Gas & Elec. Co., 63 A.2d 577 (Del. Ch. 1949).

[36] The authors suggest that one way a board can satisfy this duty to defend the extra noncontractual contractual value due to the preferred is to guarantee that the preferred get at least

if the preferred stockholders had a contractual right to a certain degree of extra value, there would be no need for a special director, and the corporation would just be obliged to honor those contractual rights. To send a director out to bargain for the preferred stockholders on the basis that they deserve some value, different from the common stock into which their shares could convert, is to have them bargain for something indeterminate. Once a focus on the specific terms of the preferred stock is rejected, how to quantify the extra non-contractual expectancy value the authors believe exist is not

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the price available for the preferred shares in the market before a merger. Bratton & Wachter, *supra* note 1, at 31. This has an attractive facial tangibility. But if the preexisting market price of the preferred is in fact related to actual contractual guarantees—such as a higher entitlement to share in cash flows or to better treatment in a merger such a right to receive a liquidation preference—then reference to the price will not be necessary to address any problem because the contract will solve the problem itself. If, by contrast, there is no rational reason why the preferred is trading at a premium to the common other than the market's own perception of the lagniappe that will be given by courts for the noncontractual contractual value that supposedly comes with the name "preferred," the board is not aided in any real way by the market price. Although it is difficult to gauge, it is likely that most preferred stock does not trade on a recognized market. In that respect, it is also uncertain how often there will be a reliable trading value for the preferred; in the cases upon which the authors seem to focus, the preferred shares seem to be privately held and not widely traded. For example, the preferred stock in *James*, a decision the authors criticize, was not publicly traded. As a result, the market price tether that should limit the board's duty would have been of little use. *James*, 990 A.2d 435; *see* Schedule 14A (Proxy Statement), Quadramed Corporation (Jan. 4, 2010), at 3. Even so, it would be surprising if the authors found the market's price for preferred shares as reliable, given their doubts about the reliability of share prices for widely held and liquid common shares of corporations. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 723 (2009) (stating that, before the financial crisis, "[a]t least in retrospect we know that the market underestimated the risk being taken and thus failed to provide an objective, critical reference point for monitoring purposes"); *see also* Robert W. Holthausen & Mark E. Zmijewski, *Pitfalls in Levering and Unlevering Beta and Cost of Capital Estimates in DCF Valuations*, J. APPLIED CORP. FIN. 60 (2012) (discussing substantial valuation errors that result from the common practice of assuming that the betas of securities like preferred stock are equal to zero).

explained in detail, and no obvious methodology comes to my mind.[37] To this point, I note the absence of any clear way for a special committee to value a control premium in a merger where a controlling stockholder with actual voting control seeks extra compensation for that control, as the law putatively permits.[38] Thus, the noncontractual contractual value that the special committee should look to protect thus becomes a matter largely influenced by judicial decisionmaking about the lagniappe the preferred deserve in particular contests—decisionmaking untethered to any clear interpretive or valuation techniques.

Even with this gap in their proposal, I think it is fair to say that Bratton and Wachter advocate a litigious, fact-intensive solution to the problems they perceive. The authors propose various new standards of review, some involving the defendant having

[37] Because the value of the cash flows realizable from preferred shares will depend on the occurrence or non-occurrence of various scenarios in which the preferred may have different rights and special entitlements over the common, distinguished scholars have pointed out the difficulty of valuing preferred shares. *See* Paul Glasserman & Zheny Wang, *Valuing the Treasury's Capital Assistance Program*, 7 MGMT. SCI. 1195 (2011) (noting the complexity in valuing TARP preferred shares that have cash flow outcomes based on decisions the issuer and holder may take); David Emanuel, *A Theoretical Model for Valuing Preferred Stock*, 38 J. FIN. 1113 (1983) (observing the difficulties of developing a valuation technique for preferred stock that pays dividends based on available funds).

[38] In *In re Tele-Communications, Inc.*, the controlling stockholder demanded and received a premium of 10% more for his shares from a third-party acquirer than would be received by the minority stockholders. The Court of Chancery suggested that in such a case, an investment bank should deliver an opinion that the lower amount per share received by the minority was fair. 2005 WL 3642727, at *12-14 (Del. Ch. Jan. 10, 2006). Commentators reacted with concern, noting that there was no recognized corporate finance theory an investment bank could apply to give such an opinion. *See, e.g.*, Kevin Miller, *Delaware Court's Criticism of Special Committee in TCI Merger Provides Important Guidance But May Not Be Entirely Fair*, 10 M&A LAW. no. 2, at 4 (Feb. 2006).

the burden of persuasion, making all motions to dismiss almost impossible.[39] Thus, cases will require discovery and have holdup value simply for that reason and most will be expensive to resolve if tried. As a judge, I suppose I should feel complimented that Bratton and Wachter regard the after-the-fact resolution of disputes by the judiciary as more efficient than honoring the before-the-fact specific written bargain of the sophisticated parties who entered preferred stock contracts. But I am perhaps more aware than most of how different an adjudication is from a creator's determination of ultimate truth. Judges do the best we can, trying in good faith to determine what happened and why from a record based on after-the-fact testimony about past events by witnesses who often have a bias. Many of us struggle to recall what we had for dinner last Thursday, much less what was said during that dinner, and two people without a reason to misremember will often recount a recent conversation in materially different ways. Adding to this inherent potential for error is the same factor that would afflict special committee members charged with bargaining for preferred stockholders, and which would make the judicial task an adventure in indeterminacy: once the inquiry is not whether the preferred's *contractual* rights have been honored, but whether the preferred's extra *noncontractual* expectancy has been honored, no reliable frame of analysis exists to guide judicial analysis. When we are beyond the contractually enforceable and into valuing the subjectively expected, but not contractually protected, we are on a speculative journey. Imposing liability on the basis of such a space mission seems to have the

[39] Bratton & Wachter, *supra* note 1, at 14, 31, 42, 63.

potential to create more fundamental unfairness than it would prevent. And, of course, in many states, juries decide these questions, not judges.

To me, the point that Bratton and Wachter make that has the most policy force, if it is true, is that the law is discouraging innovation and therefore wealth creation by being too begrudging toward preferred stockholders.[40] Because preferred stock is often the favorite vehicle of venture capital, Bratton and Wachter contend that venture capitalists will be inhibited from investing the optimal amount unless they can be assured that whenever they secure board control, they can cash out whenever they want to, so long as they sell the company for its fair market value.[41] Rather than bargaining for a right to mandatory redemption at a particular time or using high-yield debt as their method of investing, venture capitalists should be able to secure board control rights and use that to determine, in their sole economic interest, when they want liquidity. Bratton and Wachter argue that this is good for wealth creation because venture capitalists will be encouraged to invest, knowing that they can, in essence, act like a creditor when they are in control, subject only to the duty to market the company so as to secure a fair price.

Bratton and Wachter have a high degree of confidence, apparently, in markets and courts to determine the value of early stage companies.[42] Their article is replete with

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[40] Bratton & Wachter, *supra* note 1, at 48-57.
[41] *Id*. at 51-55.
[42] I note that this contrasts with their greater realism about the market's wisdom in assessing the value of established companies. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 723 (2009) (stating that, before the financial crisis, "[a]t least in retrospect we know that the market underestimated the risk being taken and thus failed to provide an objective, critical reference point for monitoring purposes").

probability scenarios to highlight "problems" in order to offer solutions, mainly judicial in nature.[43] But as a judge who must conduct appraisal proceedings, and often sees two "experts" of "valuation science" with tenure at top universities come in to court and swear under oath that their views of the DCF value under the CAPM model of the same established corporation with a sustained period of earnings vary widely, I have far less certainty than the authors that their confidence in market-testing early-stage companies is well-placed.

Venture-backed companies are often the kind of companies that can become wildly successful or fail entirely. Venture capitalists have often claimed that they require strong contractual protections precisely because only a small percentage of the companies that they fund will pan out.[44] But, of course, they are not the only ones who take risks. Many early-stage companies have common stockholders who have made company-specific investments just as real as the preferred, although not always in purely monetary ways. Employees work "on the come" and even some suppliers do. And some investors buy common stock. Many of these equity holders accept risk on the promise that the company is going to do what it says and try to take a risky technology or service idea and turn it into a viable profit generator.

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[43] Bratton & Wachter, *supra* note 1, at 8-10, 14-15, 20-22, 23-24, 26-27, 31-32, 35-36, 39-40, 52, 53-55, 60.
[44] *See id*. at 47 n.202.

Thus, it is not obvious that the authors' proposal is the one most consistent with promoting innovation.[45] Perseverance has been critical to the success of many American companies. Bratton and Wachter would give venture capitalists the right to act as lenders, to end a company's pursuit of good faith risk-taking, and leave others who took critical risks with nothing. Although they cite no decisions in which any court has ever required preferred stockholders in control to engage in casino-like gambling and to pursue strategies without a bona fide potential for success that would leave creditors at unfair risk, Bratton and Wachter slight the fact that many early-stage companies cannot credibly project their future earnings because they are at a stage of their existence when developing their technology and products is a critical part of their business plan. The venture capitalists who buy stock in such companies know that the common stockholders in those companies are taking a big risk on whether that innovative design process will pan out, and those venture capitalists have specific tools of contracting that can protect them if they want a firm date on which they can liquidate their investment.[46] So when

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[45] Commentators have suggested that venture capitalists may be too narrowly focused on an IPO or bust strategy, a strategy Bratton and Wachter seem to encourage with their revision of the law. *See, e.g.*, Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 2 (2012) (arguing that venture capitalists' main exit strategy should be to sell their investments to other investors in secondary markets because this exit strategy will avert "premature, traditional exits to satisfy an individual investor's liquidity needs").

[46] *See, e.g.*, Hokanson v. Petty, 2008 WL 5169633 (Del. Ch. Dec. 10, 2008) (permitting the preferred stockholders to cash out the common stockholders based on an amount determined by a buyout option, an option secured by the preferred stockholders in contract and exercised during the time period negotiated by the preferred stockholders and the board of directors). More common instruments preferred stockholders use to protect their investment include mandatory redemption provisions or automatic redemption dates, which are akin to put options on their preferred shares, subject to the statutory requirement that a corporation may not redeem its shares when the redemption "would cause any impairment of the capital of the corporation." 8

venture capitalists fail to get such contractual guarantees, the notion that their interests as noncontractual contractual expectancy holders are paramount, and supersede any duty that the board of directors would otherwise owe to the common, seems to have as much potential to *dis*courage innovation and wealth creation as it does to *en*courage it. The need for equity to protect the preferred's noncontractual company-specific investments over those of the entrepreneurs, employees, and investors who buy common stock remains questionable to me, given the abundant evidence of preferred stockholders' ability to get specific contractual protections.

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

DEL. CODE ANN. tit. 8, § 160(a) (2012); *see supra* note 15. And courts recognize that there is real value in these contract rights. *See, e.g.*, Shiftan v. Morgan Josephs Holdings, 2012 WL 120196, at *2-3 (Del. Ch. Jan. 13, 2012) (holding that in an appraisal action for preferred shares the court must consider all nonspeculative contractual rights, and in the context of that case, the preferred stockholders' "automatic redemption" must be included as part of their shares' fair value). The authors cite the sophisticated tools promoted by the National Venture Capital Association, but because they misconstrue the holding of *Thoughtworks* as "implying a *duty* on the board's part to drag its feet about paying the redemption price," and because they overlook the cases discussed in this footnote, I question if they also underestimate the effectiveness of these tools. Bratton & Wachter, *supra* note 1, at 57.

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The world is messy. When an early-stage company has two years of cash at hand, there is no danger that its legal creditors will not be paid, can continue to develop the technology or product that inspired its creation, and when that development has a bona fide chance to pan out in a way that will generate substantial value, Bratton and Wachter say that a preferred stockholder in control can simply call in its investment as if it were a creditor, regardless of the adverse effect that has on the common stockholders, subject to the limited duty to market the company for sale in a competent way. They say this in criticism of *Trados*, which suggests a traditional duty of loyalty toward the interest of the common must be observed and that a preferred controller cannot disregard the best interests of the common in its effort to exit its investment.[47] Thus, the common stockholders' expectations can be dashed, and an obligation of fairness toward them satisfied, if preferred stockholders market the company to fifteen buyers, and no one can credibly say for sure that the idea at the heart of the company will in fact pan out. The probabilities of the market protect the controller, it collects its liquidation preference, and the common stockholders can have the satisfaction of knowing that the market is always right. That is so even if the preferred stockholder bought its position at a discount from a prior preferred holder. This, for Bratton and Wachter, is simply the hard cheese of capitalism.

[47] *See* Bratton & Wachter, *supra* note 1, at 51.

A more conservative mind might question whether the simpler solution is for preferred stockholders to be reminded of the long-standing principles applicable to them. To the extent the preferred get a contract right, they are preferred. To the extent they do not, they are subject to the same risks as other stockholders and entitled to no extra value or rights. To the extent the preferred exercise contract rights, they have no duties to other stockholders and are entitled to those rights. To the extent the preferred stockholders assume control as fiduciaries, they owe the duties traditionally owed by the fiduciaries of corporations, including the duty to consider the best interests of the common stockholders in making decisions, and so long as the legal rights of other constituencies are not hazarded improvidently, to pursue business strategies benefiting the common stockholders.

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