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INTRODUCTION

The typical structure of corporations with multiple classes of stock consist of multiple classes of preferred stock and one or more types of common stock. These structures are most commonly used in venture capital-backed companies.[1] Venture capitalists and other "outside" investors[2] receive preferred stock whereas founders and company employees, by and large, hold common stock.

In general, common stock entitles its holder the right to vote in shareholders' meeting (i.e., voting rights) and the right to receive distributions of a company's surplus upon a distribution event, which can be either a mergers and acquisitions ("M&A") event or a dividend distribution (i.e., economic rights).[3] Preferred stock typically entitles its holder to receive all the rights of the common stock along with additional rights, contractual in nature. Such rights can be either additional voting rights (e.g., veto rights over corporate decisions)[4] or additional economic rights (e.g., the right to receive, upon a distribution event, the investment amount prior to any

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1. *See* Elizabeth Pollman, *Startup Governance*, 1 U. PA. L. REV. 14-18 (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3352203.

2. Such as angel investors. *See id*. Angel investors are wealthy individuals who personally finance the same high-risk, high-growth start-ups as venture capitalists, at an earlier stage. *See infra* note 159 and accompanying text.

3. *See Model Amended and Restated Certificate of Incorporation*, NVCA (Jan. 2018), https://nvca.org/resources/model-legal-documents/.

4. *See id*.

distributions to the common stockholders). The latter right is known as liquidation preference and it is one of the most significant features of preferred stock.[5]

These additional rights are contractual in nature, and, as with any other contract, the parties negotiate the terms of such rights. The common stockholders, typically founders and company's employees, secure the required financing and receive extensive resources to professional services, such as project advisement. Research demonstrates that projects financed through venture capitalists have higher returns, higher growth, higher risk, and will be larger in size.[6] Moreover, research also shows that a legal environment supported by venture capitalists is one that strongly protects intellectual property rights,[7] which is generally considered the most significant asset in a start-up.[8]

The contributions made by the venture capitalists (the preferred stockholders) are not done for free.[9] A venture capitalist will only invest if the deal is logical, which typically means that he will receive an adequate sort of consideration, such as additional voting or economic rights. These additional rights seek to protect the high-risk investment of the preferred stockholders (normally venture capitalists) in start-ups;[10] in its early stages, a start-up success is highly uncertain—it can either become wildly successful or fail entirely.[11]

The cases discussed below suggest that enforcement of the preferred additional rights should be carried out in a different manner from enforcement of the common rights. This "different treatment" has the potential not only to diminish the utility of the preferred,[12] but also to disable

5. A liquidation preference provision entitles a venture capitalist to receive a fixed amount (usually the amount of the original investment, or a multiple thereof) for each share of preferred stock; in certain events, this fixed amount is received before payments are made to other stockholders. *See* Gordon D. Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 347 (2005).

6. *See* Masako Ueda, *Banks Versus Venture Capital: Project Evaluation, Screening, and Expropriation*, 59 J. FIN. 601, 601-02 (2004).

7. *See id*.

8. *See, e.g.*, *Using IP for Development: Success Stories from Around the World*, WORLD INTELLECTUAL PROPERTY ORGANIZATION ("WIPO") (2017), https://www.wipo.int/edocs/pubdocs/en/wipo_pub_using_ip_dev.pdf. WIPO's white paper suggests that intellectual property is the basis for a significant portion of venture capital investments; *see also* David Hsu & Rosemarie Ziedonis, *Patents as Quality Signals for Entrepreneurial Ventures*, 1 ACAD. OF MGMT. PROCEEDINGS (2008).

9. *See* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1874 (2013).

10. *See id*.

11. *See* Leo E. Strine, Jr., *Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025, 2037 (2013); *see also* Pollman, *supra* note 1, at 16.

12. *See* discussion *infra* page 10, Part I.B.

that productive mode of financing,[13] which would not otherwise be received by alternate sources (such as banks).[14] Thus, one who considers whether these additional (preferred) rights should be enforced in the same manner as common rights should ask this: “whether the [common] shareholders would have been better or worse off without the preferred financing.”[15]

The first major case to suggest this ‘different treatment’ was decided in 2013. That year, the venture capital community was rocked by a decision of the Delaware Chancery Court in *In re Trados Shareholder Litigation*.[16] In *Trados*, the corporation faced financial difficulties when a potential buyer emerged and the board saw to sell the corporation at a deal price almost equal to the preferred liquidation preference. In other words, the preferred stockholders received almost all of their liquidation preference, and the common stockholders received nothing. Before finding that the common stock was actually worth nothing, the court held that when a board of directors considers whether to take corporate action, it should consider solely the interests of its common stockholders as “residual claimants,” and the interests of preferred stockholders should be taken into account only to the extent that they do not invoke their special contractual rights and rely on a right shared equally with the common stockholders.[17]

In 2017, the Delaware Chancery Court again ruled in *Fredrick Hsu Living Trust v. ODN Holding Corp. et al*.[18] In *ODN*, the court refused to dismiss claims against the board of *ODN*, stating that it breached its fiduciary duties to common stockholders by selling certain corporation business lines and assets to fund a mandatory redemption of preferred stock that had vested after five years. Although the mandatory redemption was a contractual obligation to the preferred stockholders, the court held that such a contractual right is subject to the board’s fiduciary duty; the board has the right/duty to decide whether it is in the best interests of the common stockholders (i.e., not the enterprise as a whole) to commit an “efficient breach” of the corporation’s obligation to the preferred stockholders.[19]

13. *See* Bratton & Wachter, *supra* note 9, at 1874.
14. *See* Pollman, *supra* note 1, at 15.
15. *See* Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 357-58 (2013).
16. 73 A.3d 17 (Del. Ch. 2013) [hereinafter *Trados* or *Trados II*, as applicable]. I would like to note that there are subsequent decisions by the Delaware Chancery Court affirming *Trados*. *See* In re Nine Sys. Corp. Shareholders Litigation, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014), aff’d sub nom Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015); In re PLX Technology Inc. Stockholders Litigation, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018); Mehta v. Mobile Posse, Inc., 2019 WL 2025231 (Del. Ch. May 8, 2019).
17. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 36-37 (Del. Ch. 2013).
18. 2017 WL 1437308 (Del. Ch. Apr. 14, 2017) [hereinafter *ODN*].
19. *See* ODN Holding Corp., 2017 WL 1437308, at *53-54.

Fiduciary duties serve as one of the most important and fundamental corporate governance mechanisms in monitoring the behavior of directors[20] and, in so doing, reducing agency costs.[21] The court's decisions in the *Trados* and *ODN* cases established that fiduciary duties are owed to the holders of "permanent capital" as residual claimants, and, in most cases, this will be the holders of the common stock, with fiduciary duties owed to the holders of preferred stock only to the extent their interests overlap with the interests of the common stockholders.[22] After those decisions were rendered, many corporate law scholars came forward to praise and support the Delaware Chancery Court's unequivocal stand.[23]

This Article, however, takes a more skeptical view and raises the following questions:

Should preferred stockholders (in all cases) be considered residual claimants? Should conflicts between common and preferred stockholders always be resolved in a way that maximizes value for the common stockholders, or should conflict be resolved in a way that would maximize the value of the enterprise as a whole? Should the court use different legal rules for different types of conflicts? How should interclass preference conflicts be resolved in both privately held and publicly traded corporations?

To answer the above questions, this Article analyzes stockholders' conflicts of interest on two levels:

First, Part I of this Article analyzes the common-preferred conflict in light of the *Trados* and *ODN* cases. The analysis argues that due to:

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20. *See* Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. SUPP. 317, 330 (1998); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

21. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM L. REV. 1416 (1989).

22. *See Trados*, 73 A.3d at 40-42.

23. *See, e.g.*, Juliet P. Kostritsky, O*ne Size Does Not Fit All: A Contextual Approach to Fiduciary Duties Owed to Preferred Stockholders from Venture Capital to Public Preferred to Family Business*, 70 RUTGERS. U. L. REV. 43 (2017) (discussing whether corporations should owe fiduciary duties to its preferred stockholders and suggesting a limited fiduciary obligation to preferred stockholders in two specific contexts. The first is when non-working children are given preferred stock in a family business. The second is when a corporation takes on a new unfamiliar product line, allowing common stockholders to wipe out the value of publicly traded preferred stock); Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE WESTERN RESERVE L. REV. 51 (2015) (discussing the opportunity-cost conflict raised in *Trados* and arguing that courts should invoke the doctrine sparingly to avoid upsetting the law's current balance between policing managerial abuse and litigation abuse); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK L. REV. 1163 (2013) (suggesting that VC holders of preferred stock should never be afforded fiduciary protections and should always be required to rely on the protections of their contract); Strine, *supra* note 11, at 2039 (discussing *Trados* in response to a critique by Bratton & Wachter, *supra* note 9).

1. the equity features of non-redeemable preferred stock;[24]
2. the questionable enforcement of preferred stockholders' rights on the contractual level;[25] and
3. the implications of the court's view in *Trados* and *ODN* with respect to an increase in agency costs,[26] transaction costs,[27] and value-maximization issues,[28] enforcement of preferred stockholders' rights should be undertaken via the board of directors' fiduciary duties to all stockholders, without prejudice.

Second, Part II of this Article analyzes potential interclass preference conflicts between and among different types of preferred and common stockholders, in both privately held and publicly traded corporations. This Article argues that the current approach the Delaware Chancery Court takes lacks a solution with respect to interclass preference conflicts both for privately held and publicly traded corporations.[29]

Third, Part III of this Article concludes with a proposed framework for resolving stockholders' conflicts of interest that were previously discussed. This Article proposes the fiduciary duty of impartiality—an extension of the duty of loyalty—as an analytical framework to resolve conflicts of interest between and among holders of common stock and multiple classes of preferred stock.

I. FIDUCIARY DUTIES AND COMMON-PREFERRED CONFLICT OF INTERESTS

In general, a corporate board of directors has fiduciary duties that require it to make business decisions that are in the best interests of its stockholders.[30] This aspect of fiduciary duty is known as the "shareholder primacy norm,"[31] or "shareholder wealth maximization norm," under which directors have a duty to maximize the value of the corporation for the benefit of its stockholders.[32]

24. *See infra* page 14, Part I.B.i.1.
25. *See id.*; *see also infra* page 18, Part I.B.i.2.
26. *See infra* page 21, Part I.B.2.ii.
27. *See id*.
28. *See infra* page 22, Part I.B.iii.
29. *See infra* page 24, Part II.
30. *See*, *e.g.*, Dodge v. Ford Motor Company, 170 N.W. 668, 684 (Mich. 1919).
31. *See* Gordon, D. Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998).
32. *See Dodge*, 170 N.W. at 684; *see also* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010).

A. *TRADOS* AND *ODN* CASES

In *Trados* and *ODN*, the Delaware Chancery Court faced the dilemma of settling a common-preferred conflict of interest with respect to the allocation of the merger consideration.[33] Citing earlier Delaware case law on the matter,[34] the court embraced the view that where directors can exercise discretion, they should generally prefer the interests of common stockholders to those of preferred stockholders.[35] In other words, fiduciary duties are owed to the holders of "permanent capital" as residual claimants and, in most cases, such holders will be the holders of common stock, with fiduciary duties owed to holders of preferred stock only to the extent that their interests overlap.[36]

The basic stance of the court's decisions is that holders of preferred stock obtain their rights and protections by contract (i.e., by the terms of the preferred). However, in reaching its decisions, the court failed to make an important distinction among different rights tied to stock ownership[37] and to address enforcement of the preferred stockholders' rights at the contractual level.[38]

The Delaware Chancery Court's decisions also failed to address a broad range of complex, but commonly occurring, potential conflicts between and among holders of common stock and multiple classes of preferred stock.[39] Finally, the court's decisions also have a negative impact on agency costs,[40] transaction costs,[41] and value-maximization issues.[42]

i. Trados *Case (2013)*

In *Trados*, the board of directors' decision to sell the corporation was challenged by a stockholder who owned 5% of the corporation's common stock.[43] At and before the time of sale, the corporation faced financial difficulties and its mixed performance during the three years preceding the

33. *See* In re Trados Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013).

34. *See id*. at 37-41; Fredrick Hsu Living Trust v. ODN Holding Corp. et al., 2017 WL 1437308, at *50-51 (Del. Ch. Apr. 14, 2017).

35. *See Trados*, 73 A.3d at 37-41; *ODN Holding Corp*., 2017 WL 1437308, at *50-51.

36. *See Trados*, 73 A.3d at 37-41; *ODN Holding Corp*., 2017 WL 1437308, at *50-51.

37. *See* discussion *infra* page 14, Part I.B.i.1.

38. *See id*.; *see also infra* page 18, Part I.B.i.2.

39. *See infra* page 24, Part II.

40. *See infra* page 21, Part I.B.2.ii.

41. *See id*.

42. *See infra* page 22, Part I.B.iii.

43. *See* In re Trados Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013).

merger led its board of directors to search for exit opportunities.[44] The board of directors considered two major exit opportunities with three different buyers, ultimately accepting the one that would likely to result in higher value and lower risk at that time.[45]

The merger consideration satisfied nearly all the preferred liquidation preference and left no proceeds for the common stock. Although the court found that the common stock was worth nothing, it emphasized that a board of directors does not owe fiduciary duties to preferred stockholders when considering whether to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights.[46] In other words, pursuant to the court's view, rights that are enjoyed solely by the preferred class do not give rise to fiduciary duties, because such rights are purely contractual in nature.[47]

The court's rationale was that preferred stockholders protect their rights via their contractual arrangements (e.g., liquidation preference, veto rights, drag-along provisions), and the fiduciary obligation should generally be saved for holders of common stock.[48] However, as we shall see in the following Part,[49] preferred rights, whether entitled as contractual or equity rights, are, as a practical matter, enforced via corporate actions, and are subject to fiduciary duties obligations. For that reason, the dichotomic separation between contract and equity rights, with respect to holders of preferred stock, creates a situation where the rights of the preferred cannot in fact be enforced in many situations.

In its *Trados II* holding, the Delaware Chancery Court cited numerous Delaware cases to support its decision.[50] Among others, the following citations illustrate the court's dramatic shift toward a dichotomic approach in resolving common-preferred conflicts:

In *Wolfensohn v. Madison Fund, Inc.*,[51] the preferred stockholders received both debentures and a share of common stock. The court held that such preferred stockholders were not owed fiduciary duties in their capacity as debenture holders and only had their contractual rights as creditors.[52] Similarly, in *Simons v. Cogan*,[53] the court held that a "convertible debenture

44. *See id*. at 8-10, 18-20.
45. *See id*. at 23-24.
46. *See id*. at 36-37.
47. *See id*.
48. *See id*. at 40-41.
49. *See infra* page 10, Part I.B.
50. *See Trados*, 73 A.3d at 36-41.
51. 253 A.2d 72 (Del. 1969).
52. *See id*. at 75.
53. 549 A.2d 300 (Del. 1988).

represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."[54]

These cases are significantly different from the situation in *Trados*. In *Trados*, the preferred stockholders were not considered creditors because their preferred stock was considered an equity instrument rather than a debt instrument.[55] Therefore, their contractual rights were different from those of creditors, as preferred rights are generally enforced via corporate action directly affecting all stockholders, and, thus, created a direct conflict between common and preferred stockholders.

By not distinguishing between holders of equity instruments (e.g., preferred stockholders) and holders of debt instruments (e.g., creditors) with respect to the fiduciary duty obligation,[56] the court opened the door to possible situations in which preferred stockholders could be left without adequate protection of their rights. This conclusion is reinforced in cases of redeemable preferred stock, such as in *ODN*[57] and cases in which the board of directors is controlled by common stockholders; it would be difficult, if not impossible, to impugn the board's entitlement to the business judgment rule[58] (i.e., a rebuttable presumption that a court will not second-guess a board of directors' decision).[59] This presumption may be rebutted in cases of fraud, illegality, or conflict of interest transactions.[60]

Another case cited by the *Trados II* court is *LC Capital Master Fund, Ltd. v. James*.[61] In that case, the preferred stockholders claimed that the board of directors' decision to allocate the merger consideration on an as-converted basis, rather than in accordance with the liquidation preference (specified in

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54. *See id*. at 303.

55. *See Trados*, 73 A.3d at 38.

56. *See id*. at 41. ("This principle is not unique to preferred stock; it applies equally to other holders of contract rights against the corporation.").

57. *See infra* page 10, Part I.A.ii; *see also* discussion *in*fra page 18, Part I.B.i.2

58. *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 453 (Del. Ch. 2010). For arguments supporting the proposition that a board elected by common stock owners owes fiduciary duties to the common stockholders, but not the preferred stockholders, *compare* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 990-93 (2006) (interpreting Orban v. Field, 1997 WL 153831 (Del. Ch. Apr. 1, 1997) as supporting a "control-contingent approach," in which a board elected by the common stock owes fiduciary duties to the common stockholders, but not the preferred stockholders; however, a board elected by the preferred stockholders can promote the interests of the preferred stock at the expense of the common stock) *with Trados*, 73 A.3d at 43 ("The control-contingent interpretation does not comport with how I understand the role of fiduciary duties or the ruling in *Orban*, which I read as a case in which the common stock had no economic value such that a transaction in which the common stockholders received nothing was fair to them.").

59. *See* Gimbel v. Signal Cos., 316 A.2d 599, 608 (Del. Ch. 1974).

60. *See* Shlensky v. Wrigley, 237 NE 2d 776 (Ill. App. 1968).

61. 990 A.2d 435 (Del. Ch. 2010) [hereinafter *LC Capital*].

the certificate of incorporation)[62] was not a breach of their fiduciary duties. Citing *Equity-Linked Investors, L.P. v. Adams*,[63] *In re Trados Shareholder Litigation*,[64] *Jedwab v. MGM Grand Hotels, Inc.*,[65] and *In re FLS Holdings, Inc. Shareholder Litigation*,[66] the *LC Capital* court noted that once preferred contractual rights are articulated in corporate documents, the board must first respect such rights and then, to the extent there is no contractual basis as to a specific corporate resolution, must act as a "gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred."[67]

In taking a corporate action pursuant to *LC Capital*,[68] a board should consider both preferred and common stockholders' rights.[69] The *Trados II* court, however, established a more extreme approach: a board of directors should only seek to maximize the value of a corporation for the benefit of the common stockholders.[70] Thus, the *Trados II* decision significantly tipped the balance in favor of common stockholders' interests per se and has led to a series of problems whenever there is a gap-filling situation.[71]

A recent, and more extreme, application of the *Trados* decision can be found in the opinion from Vice Chancellor Katie McCormick in *Mehta v. Mobile Posse, Inc.*[72] Similar to *Trados*, in *Mobile Posse*, a preferred-controlled board of directors approved the sale of a corporation at a price that would leave the common stockholders with nothing.[73]

During the three years preceding the merger, the corporation worked with two investment bankers who contacted more than 100 potential buyers and entered into two negotiation processes that ultimately failed due to

62. Note that in LC Capital Master Fund, Ltd. v. James, the liquidation preference specified in the certificate of incorporation was not, by its terms, triggered by the merger.

63. 705 A.2d 1040, 1042 (Del. Ch. 1997).

64. In re Trados Shareholder Litigation, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009) [hereinafter *Trados I*].

65. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584 (Del. Ch. 1986).

66. In re FLS Holdings, Inc. Shareholder Litigation, 1993 WL 104562, at *5 (Del. Ch. Apr. 2, 1993).

67. *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 438-39, 449 (Del. Ch. 2010).

68. This will further be addressed in the discussion regarding the *ODN* case, as it is not clear whether the board of directors would honor the contractual rights of the preferred stock class in all cases.

69. *See supra* note 62; *see also LC Capital Master Fund, Ltd*., 990 A.2d at 446.

70. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 40-43 (Del. Ch. 2013).

71. *See infra* page 10, Part I.B.

72. 2019 WL 2025231 (Del. Ch. May 8, 2019) [hereinafter *Mobile Posse*].

73. The ultimate deal price was $33,800,000 in cash and $1,000,000 in rollover equity, which was lower than the total obligation to the preferred (i.e., $44,678,801 in liquidation preference and $17,003,591 in accrued, but unpaid dividends). The ultimate deal negotiated involved senior preferred stockholders forgoing a portion of their liquidation preference to enable lower classes of preferred stock (but not common stockholders) to receive some consideration. *See id*. at *5-7.

concerns that the corporation depended on just a single customer.[74] Despite that fact, the court held that although the defendants had argued that the common stock was worth nothing[75] (as was the case in *Trados*), the merger was not altogether fair due to an unfair sale process.[76]

Assuming the sale process was flawed, the fact that two previous potential buyers walked away from the deal due to exactly the same business risk (i.e., the corporation depended on a single customer) makes it difficult to see how even an unflawed sale process could have resulted in a deal price that would have been high enough for common stockholders to have received payment.[77]

ii. ODN *Case (2017)*

Continuing with the line of *Trados* and prior case law on mandatory redemption,[78] the *ODN* court held that the board of directors breached its fiduciary duties to the common stockholders by selling certain business lines and assets to fund a mandatory redemption of preferred stock that vested after five years.[79] The mandatory redemption resulted in an asset sales that shrunk the corporation significantly and impaired its ability to generate long-term value to the remaining stockholders.[80]

Notwithstanding the fact that the court recognized the mandatory redemption provision as a contractual obligation toward the preferred, it emphasized that the preferred right to redeem their stock once the mandatory redemption right vested was subject to the board's fiduciary duty to decide whether it was in the best interests of the common stockholders (i.e., not the enterprise as a whole) to commit an "efficient breach" of the corporation's obligation toward the preferred. In *ODN*, the best interest of the common

74. *See id*. Both the first negotiation, for a sale at a deal price of $45,000,000, with another $17,000,000 as part of a potential earn-out (common stockholders could have potentially received only part of the earn-out consideration; $0.38 per share), and the second negotiation, for a sale at a deal price between $31,000,000 and $37,000,000 (i.e., the offer would not have satisfied the corporation's preferred stock), ultimately failed due to concerns that the corporation's business depended on a single customer.

75. Defendants claimed that the price at which common stockholders would receive consideration was $53,189,000, as compared with the $33,800,000 merger price alleged by plaintiff. *See id*. at *28.

76. *See id*. at *26-29.

77. *See id*. at *28-29.

78. *See generally* Carsanaro v. Bloodhound Tech., Inc., 65 A.3d 618 (Del. Ch. 2013); SV Inv. Partners, LLC v. ThoughtWorks, Inc., 37 A3d 205 (Del. 2011); SV Inv. Partners, LLC v. Thoughtworks, Inc., 7 A.3d 973 (Del. Ch. 2010), aff'd, 37 A.3d 205 (Del. 2011); Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp., 906 A.2d 218 (Del. Ch. 2006).

79. *See* Fredrick Hsu Living Trust v. ODN Holding Corp. et al., 2017 WL 1437308 (Del. Ch. Apr. 14, 2017).

80. *Id*.

stockholders was not to take actions to fund the redemption, because doing so diminished the long-term upside potential of the business.[81]

B. Issues Post-*Trados* and *ODN*

Following the Delaware Chancery Court's holdings in *Trados* and *ODN*, scholars took different views with respect to these decisions. Some praised or otherwise supported the court's view,[82] whereas others criticized it to a large extent.[83] Additionally, law firms have focused on the practical implications of these cases to provide guidelines for their clients.[84]

The current criticism of conflicts among stockholders has yet to result in a comprehensive and unified resolution. This Article takes a closer look at the legal reasoning and foundations of the court's rationale in *Trados* and *ODN*, and critiques the court's underlying assumptions in these cases.[85] It also discusses potential interclass preference conflicts and argues that the court's approach lacks a solution with respect to interclass preference conflicts, for both privately held and publicly traded corporations.[86]

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81. *See id*. at *53-54. For prior case law recognizing the "efficient breach" doctrine, see, e.g., Bhole, Inc. v. Shore Invs., Inc., 67 A.3d 444, 453 n.39 (Del. 2013); E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 445–46 (Del. 1996); NAMA Hldgs., LLC v. Related WMC LLC, 2014 WL 6436647, at *30 (Del. Ch. Nov. 17, 2014).

82. *See supra* note 23.

83. *See* Bratton & Wachter, *supra* note 9 (arguing that enterprise value maximization works better as the default when the interests of two classes of equity are in conflict); Pollman, *supra* note 1, at 54 (arguing that the *Trados* court took a formalistic approach to applying fiduciary duties without sensitivity to startup dynamics); Michal Barzuza & Eric Talley, *Long-Term Bias*, (ECGI Law, Working Paper No. 449, 2019) (discussing long-term bias in light of recent Delaware case law and suggesting that long-termism can impose substantial costs on investors that are every bit as damaging as short-termism); Robert P. Bartlett, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255, 295 (2015) (suggesting that *Trados* "undermin[ed] the utility of the corporate form as a vehicle for maximizing firm value, [and] potentially induc[ed] investors and entrepreneurs to turn to noncorporate entities to finance new business enterprises or deter[ed] investment altogether"); Sepe, *supra* note 15, at 351-59 (suggesting that the *Trados* decision could violate investor's participation constraints). Some scholars criticized the *Trados* court for concluding that the common stockholders were unharmed by the unfair dealing of the controlling preferred boards. *See* Adam M. Katz, Comment, *Addressing the Harm to Common Stockholders in Trados and Nine Systems*, 118 COLUM. L. REV. ONLINE 234 (2018); Ethan J. Leib & Stephen R. Galoob, *Fiduciary Political Theory: A Critique*, 125 YALE L.J. 1820 (2016); Ben Walther, *The Peril and Promise of Preferred Stock,* 39 DEL. J. CORP. L. 161 (2014).

84. *See, e.g.*, M&A Update, *Just How Preferred is Your Preferred?*, KIRKLAND & ELLIS (May 9, 2017), https://www.kirkland.com/publications/kirkland-manda-update/2017/05/just-how-preferred-is-your-preferred; Steven E. Boschner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1 (2016); *Delaware Court of Chancery Upholds Trados Transaction as Entirely Fair*, WILSON SONSINI GOODRICH & ROSATI (Aug. 20, 2013), https://www.wsgr.com/publications/PDFSearch/wsgralert-trados.pdf.

85. *See infra* page 10, Part I.B.

86. *See infra* page 24, Part II.

This Article concludes with an alternative analytic consistent framework to resolve conflicts of interest between and among common-preferred and interclass preferences.[87]

i. Preferred Stockholders as Residual Claimants

To initiate the critiques about the Delaware Chancery Court's decisions, one of the first questions is: are the rights of the preferred contractual rights debt-like or equity rights? This question asks whether preferred stock is a debt or an equity instrument. Said more elaborately, do the preferred stockholders gain liquidity via their contractual rights (i.e., similar to creditors), or are they locked into their investment like other equity holders (i.e., common shareholders)?[88]

The court's position is that preferred stock, whether redeemable or not, is an equity rather than a debt instrument.[89] However, the court has missed an important distinction: when analyzing equity and debt features of preferred stock, one should differentiate between redeemable preferred stock and non-redeemable preferred stock. This distinction is important for two principal reasons: First, it explains why, in the case of non-redeemable preferred stock, holders of preferred shares should be considered 'residual claimants.' Second, it sheds light on the expectations and goals of an investor when making an investment decision. Such expectations driving investor's investments are important for analyzing the potential conflicts of interest between common and preferred stockholders.

This Article will first lay out the core differences between redeemable and non-redeemable preferred stock from an accounting perspective and will then analyze the legal characteristics of each.

Figure 1 below describes the main differences between non-redeemable and redeemable preferred stock:

87. *See infra* page 33, Part III.

88. For an interesting discussion regarding the paradox of preferred stock and its dual function as a debt and equity instrument, see, e.g., Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 445 (1996).

89. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 38 (Del. Ch. 2013); Fredrick Hsu Living Trust v. ODN Holding Corp. et al., 2017 WL 1437308, at *33-34 (Del. Ch. Apr. 14, 2017).

Figure 1

Characteristic	Non-Redeemable Preferred (Equity)	Redeemable Preferred (Debt)	Redeemable Preferred (Equity/Debt) (?)
Redeemable by investor	No	Yes	Conditional redemption – instrument becomes debt once event occurs/condition is resolved/the event becomes certain to occur
Mandatory Redemption by corporation	No	Yes	No

Under Generally Accepted Accounting Principles ("GAAP"),[90] an investment in preferred stock that must be redeemed by the issuing entity, or is redeemable at the investor's option, is considered a debt security, despite its legal form. This is the case regardless of how the issuer classified the instrument.[91]

If the preferred stock is not mandatorily redeemable (i.e., there is no stated redemption date), and the investor does not have the unilateral right to ultimately redeem it, it is considered an equity security subject to the provisions of ASC 321, Investments—Equity Securities.[92]

90. *See Investments-Debt and Equity Securities*, ASC 320, https://asc.fasb.org/subtopic&trid=75115025; *Financial Reporting Developments, A Comprehensive Guide: Certain Investments in Debt and Equity Securities*, EY (June 2018), https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_03623-181us_debtandequitysecurities_14june2018-v2/$file/financialreportingdevelopments_03623-181us_debtandequitysecurities_14june2018-v2.pdf. For simplicity of the discussion, I will focus on US GAAP, although there are some similarities to IFRS in this context. For differences in classification between debt and equity instruments between IFRS and U.S. GAPP, see *A Comparison of IFRS Standards and U.S. GAAP: Bridging the Differences*, DELOITTE (Feb. 4, 2019), https://www.iasplus.com/en/publications/us/ifrs-gaap-comparison; *US GAAP Versus IFRS: The Basics*, EY (Feb. 2018), https://www.ey.com/Publication/vwLUAssets/IFRSBasics_00901-181US_23February218/$FILE/IFRSBasics_00901-181US_23February2018.pdf; *IFRS and US GAAP: Similarities and Differences*, PWC (Oct. 2019), https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-ifrs-us-gaap-similarities-and-differences.pdf; *IFRS Compared to US GAAP*, KPMG (Dec. 2017), https://frv.kpmg.us/content/dam/frv/en/pdfs/2017/ifrs-us-gaap-2017.pdf.

91. *See* EY, *supra* note 90, at 6-7.

92. *Accounting Standards Codification*, FINANCIAL ACCOUNTING STANDARDS BOARD, https://asc.fasb.org/subtopic&trid=2196929; *see also id*.

In complex situations in which the terms of a redeemable preferred stock allow the investor the option to redeem it only in certain circumstances (e.g., when an event occurs that is not certain to occur or when a certain percentage (e.g., majority, two-third) of investors elect to redeem their preferred shares), this conditional redemption becomes a liability (for the corporation) if that event occurs, the condition is resolved, or the event becomes certain to occur.[93]

To simplify the following legal discussion, we focus on the pure non-redeemable/redeemable preferred stock.

From Figure 1, we can see that in the pure case of redeemable preferred stock (the second column), such an instrument is classified for, accounting purposes, as a debt rather than as an equity instrument. Under Delaware law, however, there is no distinction between redeemable preferred stock and non-redeemable preferred stock; both are considered equity instruments.[94] The rationale behind the court's view is that each redemption right is subject to statutory, common law, and contractual limitations, including § 160 of the Delaware General Corporation Law ("DGCL") which requires that a repurchase be made in an amount not to exceed the corporation's "surplus."[95] Therefore, the redemption right will always be conditioned upon the fulfilment of § 160 of the DGCL,[96] and will be subordinated to the rights of the corporation's creditors.[97]

In the following subsections, this Article first discuss the legal characteristics of the nonredeemable preferred stock and will then continue with a separate discussion of the legal characteristics of the redeemable preferred stock. The analysis will show that, with respect to nonredeemable

93. For useful illustrations and additional information as to whether the preferred stock is classified as debt or equity security in complex situations, see *Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, KPMG, 26-27 (Nov. 2017), https://frv.kpmg.us/content/dam/frv/en/pdfs/2017/handbook-distinguishing-liabilities-asc480.pdf; EY, *supra* note 83, at 6-7.

94. *See* Fredrick Hsu Living Trust v. ODN Holding Corp. et al., 2017 WL 1437308, at *33-34 (Del. Ch. Apr. 14, 2017) (rejecting the idea that a preferred stockholder who holds a redemption right should be considered a "creditor").

95. *Id*.

96. *Id*.; *see* Carsanaro v. Bloodhound Tech., Inc., 65 A.3d 618, 645 (Del. Ch. 2013).

97. *See ODN Holding Corp.*, 2017 WL 1437308, at *33-34; *accord* 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5297 (perm. ed., rev. vol. 2019) ("As against creditors of the corporation, preferred shareholders have no greater rights than common shareholders. They have no preference over them, either in respect to dividends or capital, and have no lien upon the property of the corporation, except if a statute provides otherwise. On the contrary, their rights, both in respect to dividends and capital are subordinate to the rights of such creditors, and consequently they are not entitled to any part of the corporate assets until the corporate debts are fully paid.") (citations omitted); 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5310 (perm. ed. rev. vol. 2019) ("As a general rule, the shareholder's right to compel a redemption is subordinate to the rights of creditors.").

preferred stock, the preferred stockholders should be considered "residual claimants," thus, fiduciary duties are also owed to them. With respect to redeemable preferred stock, the "efficient breach" doctrine leaves the preferred stockholders without adequate protection of their rights and, therefore, even if they are not purely considered as "residual claimants," the fiduciary duties should also be owed to them to protect their rights as stockholders.

The conclusion that, both in the case of nonredeemable preferred stock and redeemable preferred stock, fiduciary duties are also owed to preferred stockholders raises the need for an alternative mechanism to resolve stockholders' conflict of interest. This alternative mechanism will be discussed in Part III.

1. Nonredeemable Preferred Stock

Nonredeemable preferred stock typically contains liquidation preference, dividend rights, special voting rights, and anti-dilution rights.[98]

As discussed above, the Delaware Chancery Court does recognize these rights as equity rights,[99] but, due to their contractual nature, the court's view is that such rights should be protected by their specific contractual terms and their holders should not be considered "residual claimants."[100] Therefore, fiduciary duties are not owed to preferred stockholders. However, by taking a closer look at the legal characteristics of the non-redeemable stock, this Article argues that the nonredeemable preferred stockholders should be considered "residual claimants" and should too be entitled to fiduciary protection.

First, to initiate our discussion about nonredeemable preferred stock, the questions to be asked are as follows: what are preferred rights and what do they entail?

The rights of preferred stock are typically listed in a corporation's certificate of incorporation ("COI").[101] The COI is a binding contract between corporation stockholders and the corporation, governing the rights of each type of corporation's stock. A COI is limited only to stockholders of the corporation; no other stakeholders' rights are listed therein. This limitation draws the boundary between stockholders and other stakeholders

98. *See* NVCA, *supra* note 3.

99. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 38 (Del. Ch. 2013); *ODN Holding Corp.*, 2017 WL 1437308, at *33-34.

100. *See Trados*, 73 A.3d at 41; *ODN Holding Corp.*, 2017 WL 1437308, at *50-51.

101. There are additional rights of the preferred stock that are listed in other contracts, such as voting agreements and investor rights agreements.

of the corporation, which, pursuant to the Delaware court's point-of-view, the latter are not per se entitled to fiduciary duties.[102] This puts the preferred stockholders in a similar position as common stockholders and different from other corporation's stakeholders. Therefore, the rights and interests of the preferred listed in the COI, and agreed upon by the parties, should be considered and enforced, similar to common stockholders, at the equity level via the board of directors' fiduciary duties.

It bears noting that preferred stockholders receive additional rights, favorable to common stockholders' rights. First, as explained above, the COI reflects an agreement between the corporation's stockholders and the corporation. Just like common rights, preferred rights should be honored and the interests of the preferred should be considered at the equity level. Second, these additional rights aim to protect preferred stockholders' (typically venture capitalists') high-risk investment in start-ups and enable a productive mode of financing,[103] which would otherwise not be received by alternate sources, such as banks.[104]

Further, the additional rights do not convert the preferred rights into debt-like rights.[105] These non-mandatory financial preferences are pure equity rights. Although their existence may create a misalignment with the common preferences and interests, this does not mean that they are debt-like rights or that, consequently, preferred stockholders should be considered creditors. Rather, it means that anytime the board of directors is considering taking a corporate action that is likely to result in a conflict of interest between the common and preferred, the board of directors should resolve the conflict at the equity level via its fiduciary duties to both common and preferred stockholders. The way in which the board of directors could resolve such conflict is through the fiduciary duty of impartiality, which this Article will discuss further in Part III.

Second, just like any corporate decision, most of the preferred rights[106] are enforced de facto through a board of director's fiduciary duty to take corporate action. For example, liquidation rights are primarily triggered after

102. *See* Dodge v. Ford Motor Company, 170 N.W. 668, 683 (Mich. 1919); MELVIN A. EISENBERG, AM. LAW. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994).

103. *See* Bratton & Wachter, *supra* note 9, at 1874; Sepe, *supra* note 15, at 357-58 ("Thus, the question in *Trados* should not have been whether the common shareholders would have been better or worse off had the merger not occurred, as the court assumed. Instead, it should have been whether the shareholders would have been better or worse off without the preferred financing…") (citations omitted).

104. *See* Pollman, *supra* note 1, at 15.

105. By debt-like, I mean mandatory redemption or dividend rights. *See* Fletcher, *supra* note 97.

106. Some rights are not subject to corporate action, such as drag-along rights that empower the controlling stockholder to sell the company and force other stockholders to join in that sale.

a board of directors has approved the sale of the corporation. The same goes for dividend rights—the board of directors must declare a dividend distribution. This means that (almost) every time preferred stockholders enforce their rights, doing so will likely trigger a direct conflict with the common stockholders.

This trigger is different from a situation in which a third party (e.g., a creditor) enforces its contractual rights because presumably the interests of the common and preferred in such a case will align; meaning that the board of directors would not have to address a conflict among the stockholders and will take corporate action that serves the best interests of all stockholders. Therefore, recognizing that preferred rights should be enforced only at the contractual level and not at the equity level, as a practical matter, means that preferred stockholders de facto do not enjoy the same contractual protection as third parties do. Whenever preferred stockholder interests do not align with the interests of the common stockholders, preferred will be at risk that their interests might not be considered because, per *Trados*, the directors will have the duty to maximize the value of the common stock.

Third, the rights of preferred stockholders, although likely superior to the rights of common stockholders pursuant to the provisions of the COI, are subordinated to the rights of other stakeholders of the corporation (e.g., creditors).[107] Furthermore, unlike other stakeholders of the corporation, the preferred stockholders are not entitled to enforce their rights as creditors,[108] including cashing out their investment.[109]

For the aforementioned reasons stated in this sub-section, ". . . the duty to maximize enterprise value should encompass certain contract rights (those of preferred) but not others (those of creditors, employees, pensioners, customers, etc.)."[110]

Finally, the Delaware Chancery Court's current view does not enable consideration of different types of preferred stockholders.[111] For example, the interests of preferred stockholders with a non-capped, 1X participating liquidation preference are more likely to align with those of the common stockholders. On the other extreme, if preferred liquidation preference is 3X nonparticipating, then it is more likely that the interests of the preferred stockholders will not be aligned with those of the common stockholders. There can be very different common-preferred conflicts of interest, each of

107. *See ODN Holding Corp.*, 2017 WL 1437308, at *33-34; *supra* note 90.

108. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 38 (Del. Ch. 2013); *see* Fredrick Hsu Living Trust v. ODN Holding Corp. et al., 2017 WL 1437308, at *33-34 (Del. Ch. Apr. 14, 2017).

109. *See ODN*, 2017 WL 1437308, at *33-34.

110. *See Trados*, 73 A.3d at 43.

111. *See id*. at 53.

which may result in different incentives as to the exit strategy of the preferred stockholders versus that of the common stockholders.[112]

Another example of an impediment caused by the Delaware Chancery Court's current view is an investment by a strategic investor or a corporate venture capital ("CVC") investor.[113] These types of investors have goals that may differ from traditional venture capitalists.[114] Unlike the pure venture capitalist, in some cases, strategic/CVC investors are interested in investing in start-ups that fit their business models.[115] In these cases, they will likely finance start-ups that have technologies that are complementary,[116] in hopes of partnering for the long haul.[117] Strategic/CVC investors' involvement in a corporation's business can be significant. They often provide channels to media, public relations, packages for customers, accelerate programs, product development, and so on.[118] Lastly, they also maintain a tight investor-founder relationship.[119]

Thus, due to their high involvement in a corporation's business and long-term financial and business objectives, strategic/CVC investors may be less conflicted vis-à-vis the interests of the common stockholders (e.g., founders) than other preferred stockholders (e.g., venture capitalists). That said, some CVC investors, such as Google Ventures or Capital G, look far afield at interesting markets that do not necessarily relate at the time to their core business. Therefore, these types of CVC investors could have short investment horizons that diverge from those of the founders. In this context, the *Trados* dichotomic approach seems to make less sense, as it does not encompass the interests of the strategic investors/CVCs that may be more aligned with the interests of the common stockholders, or at the very least, differ from the interests of the traditional venture capitalists.

112. *See* Smith, *supra* note 5, at 348.

113. *See* Thomas Hellmann, *A Theory of Strategic Venture Investing*, 64(2) J. FINANC. ECON. 285, 287, 304 (2002).

114. *See id.*; *see also* Song Ma, *The Life Cycle of Corporate Venture Capital*, REV. OF FIN. STUD. (forthcoming), (manuscript at 1) (https://ssrn.com/abstract=2691210).

115. Symposium Notes, *Case Studies: Creative Ways CVCs Move the Needle for Portfolio Companies*, STANFORD & NVCA VENTURE CAPITAL (Mar. 27, 2019).

116. *See* Hellmann, *supra* note 113, at 304; *see also* Chemmanur, Thomas J., Elena Loutskina, & Xuan Tian, *Corporate Venture Capital, Value Creation, and Innovation*, 27(8) THE REV. OF FIN. STUD. 2434, 2440 (2014).

117. *See supra* note 115.

118. *See supra* note 108; *see* also Cassie Ann Hodges, *Building Better: Qualcomm Ventures & Brain Corp*, NVCA BLOG (Apr. 19, 2019), https://nvca.org/blog/building-better-qualcomm-ventures-brain-corp/.

119. *See supra* note 108.

2. Redeemable Preferred Stock

Redeemable preferred stock typically contains all of the features of nonredeemable preferred stock and, in addition, includes a redemption right.[120] Such a redemption right can be limited in time and may also be conditioned upon an event not certain to occur.[121] For simplicity's sake, this Article will assume that the redemption right is either mandatory or redeemable by the investor.

As discussed in Part I above, under Delaware law, redeemable preferred stock is considered an equity instrument and is subject to statutory, common law, and contractual limitations.[122] Under statutory law, § 160 of the DGCL requires that a repurchase be made in an amount not to exceed the corporation's "surplus."[123]

Under common law requirements, a corporation cannot be forced to redeem preferred shares when it does not have "funds legally available" to make the redemption.[124] As a general rule, the preferred rights to compel a redemption are subordinate to the rights of a corporation's creditors.[125]

An analysis of *ODN* and prior case law[126] on redeemable preferred shares seems to put the preferred in a position where their redemption rights could be meaningless. Recall that in *ODN*, the Delaware Chancery Court held that preferred shareholders' right to redeem their stock, once the mandatory redemption right had vested, is subject to the board's fiduciary duty to decide whether it is in the best interests of the common stockholders (i.e., not the enterprise as a whole) to commit an "efficient breach" of the corporation's obligation to the preferred.[127]

Combining the "efficient breach" doctrine with preferred stockholders not being entitled to the protection of their contractual rights as creditors,[128] leads this Article to conclude that, with respect to their redemption right, the

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120. *See* NVCA, *supra* note 3.

121. *See id*.

122. *See* Frederick Hsu Living Trust v. ODN Holding Corp., 2017 WL 1437308, at *33-34 (Del. Ch. Apr. 14, 2017).

123. *See id*.

124. *See id*.

125. *See ODN Holding Corp.*, 2017 WL 1437308, at *33-34; *supra* note 97.

126. *See* Carsanaro v. Bloodhound Tech., Inc., 65 A.3d 618 (Del. Ch. 2013); SV Inv. Partners, LLC v. ThoughtWorks, Inc., 37 A3d 205 (Del. 2011); SV Inv. Partners, LLC v. Thoughtworks, Inc., 7 A.3d 973 (Del. Ch. 2010), aff'd, 37 A.3d 205 (Del. 2011); Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp., 906 A.2d 218 (Del. Ch. 2006).

127. *See ODN Holding Corp.*, 2017 WL 1437308, at *53-54 (Del. Ch. Apr. 14, 2017). For prior case law recognizing the "efficient breach" doctrine, see, e.g., Bhole, Inc. v. Shore Invs., Inc., 67 A.3d 444, 453 n.39 (Del. 2013); E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 445–46 (Del. 1996); NAMA Hldgs., LLC v. Related WMC LLC, 2014 WL 6436647, at *30 (Del. Ch. Nov. 17, 2014).

128. *See supra* note 101.

interests and rights of the preferred stockholders are likely not to be taken into account by the board of directors when taking a corporate action.

There is a significant concern that due to its lack of a fiduciary duty to preferred stockholders, the board of directors will likely justify its refusal to commence the redemption as a perfectly reasonable business decision because it is only required to consider the common stockholders' interests.[129] This conclusion is reinforced in light of the Delaware Chancery Court's approach that the board of directors should favor an investment that generates higher net returns for the common stockholders in lieu of complying with the corporation's obligation to preferred stockholders.[130]

Unlike contracts with third parties, each time the board of directors considers whether to commence an "efficient breach," the only interests it will take into account in its decision-making process are those of the common stockholders.

In light of the above, it is not surprising that there has been a significant decline in the use of redemption rights in financing rounds between 2018 and 2017,[131] which might suggest that venture capitalists are reluctant to invest in this instrument due to the uncertainty of enforcing such rights.

Moreover, in *ODN*, because the amount of the redemption right was fixed due to a lack of a cumulative dividend, the Delaware Chancery Court argued that the directors should have used this fact as leverage for the benefit of the corporation and its common stockholders. In other words, the working premise should have been to commence an "efficient breach" instead of complying with the obligation to the preferred.[132]

The National Venture Capital Association ("NVCA") added an interest provision to its Model Amended and Restated Certificate of Incorporation for investors wanting to address the *ODN* court's ruling and prior case law.[133] The interest provision was designed as an economic inducement for a corporation to affect redemption, or, at least, to provide compensation to preferred stockholders for a corporation's failure to redeem.[134]

129. For a similar argument, *see* Robert P. Bartlett & Eric L. Talley, *Law and Corporate Governance*, 39, n. 106 (suggesting that the preferred stock redemption cannot be in the best interests of the residual claimants "since, by definition, liquidating will extinguish the common stockholder's option value in favor of distributing the company's remaining value to preferred stockholders").

130. *See* Frederick Hsu Living Trust v. ODN Holding Corp., 2017 WL 1437308, at *55-56 (Del. Ch. Apr. 14, 2017).

131. The use of redemption rights decreased from 19% of all financing rounds in 2017 to 9% of all financing rounds in 2018; *see The Entrepreneurs Report: Private Company Financing Trend*, WILSON SONSINI GOODRICH & ROSATI (2019), https://www.wsgr.com/publications/PDFSearch/entreport/Q42018/EntrepreneursReport-Q4-2018.pdf.

132. *See ODN Holding Corp.*, 2017 WL 1437308, at *89.

133. *See* NVCA, *supra* note 3.

134. *See id*.

However, the inclusion of an interest provision does not guarantee that the redemption right will be enforce because presumably it could be relatively easy for a board of directors to justify its long-term plan (for the benefit of the common stockholders) such that a delay of the redemption fee would be more efficient under the "efficient breach" doctrine. This leaves preferred stockholders without adequate protection of their rights. Such a decision by the board of directors would be protected by the business judgment rule.[135]

Additionally, due the uncertainty in the enforcement of the redemption right, preferred stockholders could include specific terms of the preferred stock to protect their rights (such as the terms of the interest provision described above), resulting in an increase in transaction costs.[136] That said, one may argue that in the case of redeemable stock, stockholders cannot be considered "residual claimants" as, by definition, they have not locked in their investment.[137] Unlike nonredeemable preferred stockholders, after exercising their redemption right, preferred will cease to be stockholders.

Indeed, the similarity of the redemption right to a debt instrument—including that after the redemption, the stockholders would cease being stockholders of the corporation and, therefore, would not pursue any long-term business goals that would generate long-term income—should be given a certain weight. But this weight should be considered and balanced in light of the specific set of circumstances.

The analytical framework proposed in Part III below considers the interests of preferred stockholders in addition to the interests of common stockholders, without automatically favoring common stockholders' interests. Pursuant to this proposed approach, the board of directors would consider the interests of all stockholders without prejudice. No benefit of one stockholder should be per se favored over the other, and the board of directors would resolve a conflict of interest via the duty of impartiality. The benefit of this test is that it does not restrict the board of directors to the "efficient breach" doctrine and allows it to take other considerations into account when reaching its decision—one that would best maximize the value of the corporation as a whole.

135. *See ODN Holding Corp.*, 2017 WL 1437308, at *55.
136. *See infra*, page 21, Part I.B.2.ii.
137. *See* In re Trados Shareholder Litigation, 73 A.3d 17, 34 (Del. Ch. 2013); *ODN Holding Corp.*, 2017 WL 1437308, at *47.

ii. Agency and Transaction Costs

Recall that in both *Trados* and *ODN*, the Delaware Chancery Court held that the fiduciary duties of a corporation's board of directors are owed to the common stockholders as residual claimants, with fiduciary duties owed to the holders of preferred stockholders only to the extent that both their interests overlap.[138]

In the Introduction Part, this Article argued that by analyzing equity features from a legal perspective of nonredeemable preferred stock, holders of nonredeemable preferred stock should be considered "residual claimants." Additionally, this Article argued that both in the case of nonredeemable and redeemable preferred stock, the enforcement of their rights, in many cases, is questionable and leaves preferred stockholders without adequate protection of their rights.

In Part I.B.ii., this Article pointed out another problematic aspect of the dichotomic approach that the Delaware Chancery Court has taken: due to the uncertainty with respect to the enforcement of the preferred rights, a preferred stockholder who wishes to protect his or her rights would need to include specific terms of the preferred stock that would otherwise be protected through fiduciary duties.[139] A lack of specific terms would be interpreted by the court as a waiver of the preferred right.[140] The inclusion of such terms would likely increase transaction costs. An example of such a protection of preferred rights via inclusion of specific terms of the preferred stock was discussed in *Trados II*. There, the court pointed out the lack of a drag-along right that empowers venture capital funds to sell a corporation and force the other stockholders to sell their shares.[141]

As a response to such a requirement, the NVCA revised its Model Voting Agreement to provide a put option for the benefit of the investor to redeem its investment, particularly in a case where board approval is needed and later refused.[142] However, in this situation, if such put option was exercised by the preferred stockholder, it would be identical to *ODN*. The repurchase of preferred stock by the corporation (i.e., redemption right) requires a corporate action and would again result in an uncertainty for preferred stockholders as to the enforcement of their rights.[143] This situation, indeed, requires preferred stockholders to devise creative contractual

138. *See Trados*, 73 A.3d at 40-42; *ODN Holding Corp.*, 2017 WL 1437308, at *44.

139. *See Trados*, 73 A.3d at 71.

140. *Id*.

141. *Id*.

142. *See Model Voting Agreement*, NVCA (Jan. 2018), https://nvca.org/resources/model-legal-documents/.

143. *See* Bratton & Wachter, *supra* note 9, at 1890-93.

solutions to mitigate the likelihood that their rights or interests will be reserved and, consequently, will increases transaction costs.[144]

Additionally, as a response to the Delaware Chancery Court's view, preferred stockholders will also likely invest additional funds to monitor the directors' activities, resulting in an increase in agency costs. Monitoring the directors' activities could be accomplished up to a certain degree for two reasons. First, express contracts may be too costly because the agent's decision-making will depend on information not available at the time of the engagement.[145] Second, the contractual arrangements could mitigate the agency problem only to a limited extent.[146] Therefore, the fiduciary obligation to the preferred stockholders serves to fill a gap in situations where there are no express contractual rights.

iii. Value-Maximizing Issues

One of the primary questions in *Trados* was whether a board of directors' duty is to maximize the value of the common stock or the value of the enterprise as a whole whenever a conflict arises between the common and the preferred stockholders. The Delaware Chancery Court's view in *Trados I* (and affirmed in *Trados II*) is that the duty to maximize the value of the corporation is to its common stockholders, as residual claimants.[147]

The Bratton and Wachter article, published immediately prior to the court's decision in *Trados II*, provided an example of a scenario in which *Trados* can lead to decisions that are not value maximizing. The example given in the Bratton and Wachter article is as follows:

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144. For additional examples of such protection of rights via inclusion of specific terms of the preferred stock, see Frederick Hsu Living Trust v. ODN Holding Corp., 2017 WL 1437308, at *88-89 (Del. Ch. Apr. 14, 2017). The *ODN* court noted that absent an increasing redemption obligation, the holders of redeemable stock are in a relatively weak contractual position to force the corporation to redeem its shares. This concern was addressed by the NVCA by adding an interest provision to the Model Amended and Restated Certificate of Incorporation designed as an economic inducement for the corporation to effect the redemption, or, at least, to provide compensation to the preferred stockholder for the company's failure to redeem; *see* NVCA, *supra* note 3; *see also* Kirkland & Ellis, *supra* note 84 ("[I]nvestors may want to consider including in the specific terms of the preferred stock automatic disincentives to fail to satisfy those obligations …").

145. *See* Kostritsky, *supra* note 23, at 57.

146. *See id*. at 55 ("So while, theoretically, the parties could control agency costs through contract, financial economics suggests that '[c]ontracts can be designed to enable a principal to mitigate agency problems, but agency problems can never be fully eliminated.'") (quoting DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 44 (2d ed. 2014)).

147. *See* In re Trados Shareholder Litigation, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009); In re Trados Inc. Shareholder Litigation, 73 A.3d 17, 40 (Del. Ch. 2013).

> [A]ssume that the $60 million offer is on the table and that there are two possible outcomes if the offer is not accepted. There is a 25% chance that a $70 million offer can be realized in the intermediate term and a 75% chance that the markets will turn down and $50 million will be the best offer available. The expected value of delay is $55 million ($70 million x .25 + $50 million x .75). Delay thus sacrifices $5 million of enterprise value in exchange for a chance to realize an expected $750,000 ($3 million × .25) for the common.[148]

In the above scenario, maximizing value for the common stock sacrifices maximizing enterprise value.[149] The court in *Trados II* criticized the enterprise value maximization approach and noted that scholars' support of the enterprise value maximization approach "does not explain why the duty to maximize enterprise value should encompass certain contract rights (those of preferred) but not others (those of creditors, employees, pensioners, customers, etc.)."[150]

As discussed in Part I, the rights of the preferred stockholders, although superior to the rights of the common stockholders, are not superior to the rights of other stakeholders of the corporation. Unlike other stakeholders of the corporation, preferred stockholders are not entitled to enforce their rights as creditors, including cashing out their investment. Therefore, the duty to maximize enterprise value should also encompass preferred stockholders' rights and interests.

II. FIDUCIARY DUTIES AND INTERCLASS PREFERENCE CONFLICT OF INTERESTS

Trados and *ODN*, discussed in Part I, focused on horizontal conflict of interests between preferred and common stockholders. In addition to the common-preferred conflict of interest, there are also interclass preference conflicts between and among different types of preferred and common stockholders.[151] The current approach taken by the Delaware Chancery Court

148. *See* Bratton & Wachter, *supra* note 9, at 1886 (citations omitted).

149. For an additional scenario in which maximizing value for the common sacrifices maximizing enterprise value, see, e.g., Bartlett, *supra* note 83, at 255-256; *see also* Pollman, *supra* note 1, at 8 (suggesting that a better approach to value maximization "recognizes the corporation itself as the beneficiary of the fiduciary duties, representing the firm value and the interests of all startup participants").

150. *See Trados*, 73 A.3d at 43.

151. *See, e.g.*, Pollman, *supra* note 1, at 22, 30-37 (analyzing the different horizontal conflicts that arise in privately held startups: preferred versus. common, preferred versus preferred, and common versus

lacks a solution with respect to interclass preference conflicts both for privately held and publicly traded corporations.

In Part II, this Article will discuss potential interclass preference conflicts between and among different types of preferred and common stockholders. The discussion will show that such conflicts do exist and, thus, creates a need for a consistent analytical framework to resolve such conflicts. This framework will be discussed in Part III.

A. Potential Conflicts in Private Corporations

In recent years, in the context of privately held corporations, there has been an entrance into late-stage start-ups of different types of investors, such as mutual funds, pension funds, hedge funds, and sovereign wealth funds.[152] Each investor could have different dividend, liquidation, control, voting rights, and other various protective terms.[153] Adding to this complex capital structure, a recent trend has arisen of using proceeds from financing rounds to do share buybacks or to facilitate third party buyers. Examples include large institutional investors making secondary tender offers and allowing stockholders to sell some of their holdings and bring new investors into the corporation, but not necessarily under the same contractual terms of the previous investor.[154]

Among others, one of the issues with a secondary transaction is that, unlike the initial investor (presumably the venture capitalist), the subsequent purchaser who typically buys the preferred stock in a mutual fund does not have an opportunity to bargain for contractual protection against the loss of certain contractual protections that were available to the initial purchaser.[155]

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common); Bartlett & Talley, *supra* note 129, at 42-43 (suggesting that interclass preference conflicts have "long characterized private companies" and "now inform debates about public company governance, requiring close attention to the legal tools used to wage and resolve these conflicts;" such interclass preference conflicts "may force a reconsideration of whether the legal governance 'tools' … are effective in resolving them" and "rais[e] profound questions about whether fiduciary duties should rescale themselves"); Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 40, 63, 108-09 (2006) (suggesting that horizontal conflict exists among venture capitalists themselves and expending its model to both private and public corporations).

152. *See* Pollman, *supra* note 1, at 18; Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns* 2 (Harvard Business School, Working Paper No. 18-037, 2017); Bartlett & Talley, *supra* note 129, at 37.

153. *See* Pollman, *supra* note 1, at 18-19; Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality* (NBER Working Paper No. 23895, 2017); Bartlett & Talley, *supra* note 129, at 37.

154. *See* Pollman, *supra* note 1, at 19; *see also* Lizanne Thomas, Robert A. Profusek & Lyle G. Ganske, *Share Buybacks Under Fire*, HARV. L. SCH. F. ON CORP. GOV'T AND FIN. REG. (May 21, 2019), https://corpgov.law.harvard.edu/2019/05/21/share-buybacks-under-fire/.

155. Some rights, such as those included in shareholders agreements, will not transfer to the

In addition to the entrance of new types of investors, 'existing' investors, both preferred (e.g., venture capitalists, angels, and CVCs) and common (e.g., founders and employees) may have conflicting interests in taking certain actions due to the different types of equity interest they hold that vary in their terms and preferences. For example, different venture capitalists, depending on the time they invest in a corporation, have varying financial interests.[156]

Figures 2 and 3 below demonstrate a potential conflict of interest that can arise among different types of venture capitalist with respect to an IPO and selling a corporation.

Figure 2

Stock	Pre-Money Valuation	Investment	Number of Shares	Participation
Common	—	$400K	4M (PPS: $0.1)	—
Series A	$400K	$100K	1M (PPS: $0.1)	Max: 3X Cap
Series B	$4M	$1M	1.25M (PPS: $0.8)	Max: 5X Cap
Series C	$40M	$15M	2.34M (PPS: $6.4)	Max: 5X Cap
Series D	$60M	$70M	5M (PPS $14.0)	Full
Total	—	$86.5M	13.59M	—

Figure 3

Stockholders Proceeds	IPO – $120M	M&A – $120M
Common	$35.32M	$10.26M
Series A	$8.83M	$2.56M
Series B	$11.03M	$4.08M
Series C	$20.66M	$20.76M
Series D	$44.15M	$82.32M

subsequent purchaser of the preferred. Further, the subsequent purchaser will likely not pay a lower price for the lack of such contractual protection due to difficulty with pricing the fall-off, or absence of such protections, that make the absence of fiduciary protection more critical. *See* Kostritsky, *supra* note 23, at 102-09.

156. *See* Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 100 (2006).

If a corporation is considering an exit event and begins a dual-track process (i.e., IPO and M&A search), what potential conflicts between the different series of preferred listed in Figure 2 might arise?

Assuming that upon an IPO all stocks are converted into common stock, the common stockholders and early stage investors (Series A and Series B) are far better off with an IPO than a sale at $120M (see Figure 3 above). This creates a conflict between the common stockholders and Series A and Series B investors versus the Series C and Series D investors.

The stockholders are likely to anticipate these potential conflicts and include contractual protections in their investment documents, such as special veto rights, special liquidation preference, and automatic conversion provisions.[157] However, the ability to predict such conflicts is not always easy to discern and incomplete contracts are inevitable. Thus, the misalignment cannot be entirely eliminated.[158]

Conflicts can also arise among common stockholders, such as among angel investors, founders, and management. Angel investors are wealthy individuals who personally finance the same high-risk, high-growth start-ups as venture capitalists, but at an earlier stage.[159] They typically receive common stock[160] but their interests can diverge from those of founders and management with respect to everyday corporate decision-making.[161] Further, there could also be a misalignment among the angel investors themselves.[162]

Indeed, the start-up complex capital structure involves serving different types of stockholders with different contractual terms, rights, and interests. It is likely to create conflicts not only between the preferred and common stockholders, but also between and among these diverse types of stockholders.

Under the current Delaware Chancery Court's view in *Trados* and *ODN*, the board of directors would resolve common-preferred conflicts under the common maximization value doctrine and would, thus, lack the required framework to resolve interclass preference conflicts of interest, such as those described above.

Although scholars have articulated interclass preference conflicts between and among preferred and common stockholders,[163] they have yet to

157. *See* Bartlett, *supra* note 156, at 74-77.

158. *See* Pollman, *supra* note 1, at 16, 34; Bartlett, *supra* note 156, at 75-76.

159. *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406 (2008).

160. *See id*. at 1422.

161. *See* Pollman, *supra* note 1, at 35.

162. *See* Ibrahim, *supra* note 159, at 1425.

163. *See supra* note 151.

provide a comprehensive framework to resolve such conflicts. These scholars provide an enormous contribution to the understanding of the various conflicts. Scholars have argued that due to the complexity of the start-up capital structure, stockholders are heterogeneous in their preferences.[164] They have also suggested that with the increase of the number and types of investors, with diverging interests over time, it is even more important to reach a suboptimal outcome that would encompass the interests of the corporation as a whole.[165]

This Article builds on these findings and aims to fill the gap of conflict resolution by providing a comprehensive framework to resolve stockholders' conflict of interest. This framework will be discussed in Part III.

Before discussing the proposed framework and completing the discussion regarding potential stockholders' conflicts, this Article will discuss the potential implications of horizontal conflicts of interest in the public corporation context.

B. Potential Conflicts in Public Corporations

In general, once a corporation goes public, all shares of preferred stock are automatically converted into shares of common stock, immediately prior to complementing the IPO.[166]

Recall that the Delaware Chancery Court's holdings in *Trados* and *ODN* applies only where there is a conflict of interest between the preferred and the common stockholders.[167] Once the corporation is public, *Trados* and *ODN* would not apply because there are no longer preferred shares and common stock has the same cash-flow rights (though not necessarily the same voting rights, as discussed below).

Yet, as mentioned above, potential horizontal conflicts among interclasses preferences exist in the private corporation context. In recent years, such conflicts have also arisen in the public corporation context. For example, "horizontal governance disputes have also begun to permeate public corporation governance disputes as well,"[168] raising profound questions about whether fiduciary duties should rescale themselves.[169]

In a public corporation context, potential horizontal conflict of interest can take place primarily in two forms: shareholders activism or dual-class

164. *See id*.
165. *See* Pollman, *supra* note 1, at 56.
166. *See* Bartlett, *supra* note 156, at 75.
167. *See supra* page 5, Part I.
168. *See* Bartlett & Talley, *supra* note 129, at 39.
169. *Id*. at 42-43.

capital structure. Both of these forms have recently arisen in the context of public corporations' disputes and "may force a reconsideration of whether the legal governance 'tools' . . . are effective in resolving them" and "raising profound questions about whether fiduciary duties should rescale themselves."[170]

i. Shareholder Activism

Shareholder activism is a way in which shareholders influence a corporation's behavior by exercising their rights as shareholders. Two types of activism primarily exist. First, economic activism focuses primarily on steps seeking to increase stock price (e.g., demanding a sale of the company, spin-off, strategic and governance changes, share repurchases/dividends, and M&A related demands). Second, governance activism focuses primarily on issues and principles and augmenting economic activism (e.g., takeover defenses, board structural issues, director election issues, compensation, and risk management).[171]

Shareholder activism is one of the most predominant governance disputes in public corporations today. In its extreme form, activism is claimed to weaken corporations by imposing a short-term perspective on managers[172] over more durable, but less liquid, investments in long-term value.[173] In that sense, activists take on a functional role analogous to that of preferred stockholders.[174] For example, according to the Lazard's 1Q 2019 Activism Review, 46% of activist campaigns launched in Q1 2019 were M&A-driven, with 'pushing for a sale' being the most common M&A objective.[175]

Similar to preferred stockholders, it has been argued that activists pursue short-term gain, running in sharp contrast with long-term investors' interests, such as index funds, pension funds, insurance corporations, and many individual investors who often hold their stock for years.[176] Critics argue that shareholder activism has "very serious adverse effects on the

170. *Id*. at 43.

171. *See generally* CLAIRE HILL, BRIAN JM QUINN & STEVEN DAVIDOFF SOLOMON, MERGERS AND ACQUISITIONS LAW, THEORY, AND PRACTICE 707-28, 735-51, 761-68 (2016).

172. *See* Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions* 1 (ECGI Finance, Working Paper No. 577, 2018).

173. *See* Bartlett & Talley, *supra* note 129, at 40.

174. *See id*.

175. *See Review of Shareholder Activism - Q1 2019*, Lazard's Shareholder Advisory Group (Apr. 2019), https://www.lazard.com/media/450943/lazards-q1-2019-review-of-shareholder-activism.pdf.

176. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1290-1291 (2010); *see* also J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 50 (2014-15).

corporations, their long-term shareholders, and the American economy."[177] In contrast, proponents argue that shareholder activism improves operating performance and long-term returns.[178]

Leo Strine, the former Chief Justice of the Delaware Supreme Court, laid out a few suggestions to address this concern, but his suggestions focused on the duty of the asset managers to pursue the interests of the long-term investor. His suggestions do not include the horizontal conflict between short-term and long-term investors, and the way in which corporations' boards of directors should resolve such conflict.[179]

Recent studies show that management, incentivized by short-horizon investors through short-term pay, takes actions that increase the short-term speculative component in stock prices, at the expense of long-term firm value.[180] Further stating that there is no evidence that activist attacks result in long-term improvements in accounting performance measures.[181] In contrast, a recent study shows that long-term projects are systematically susceptible to overestimation by managers, creating a long-term bias that can impose substantial costs on investors that are just as damaging as short-termism.[182]

As scholars, courts, and regulators continue to debate the implications and economic consequences of shareholder activism, such debates reflect horizontal conflict between stockholders with different investment horizons. Indeed, public corporations' stockholders have heterogeneous preferences, and often find themselves at economic odds with each other, with the sources of conflict increasing.[183]

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177. *See* Martin Lipton, *Empiricism and Experience; Activism and Short-Termism; the Real World of Business*, HARV. L. SCH. F. ON CORP. GOV'T & FIN. REG. (Oct. 28, 2013), https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/.

178. *See* Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Lucian Bebchuk, *The Myth of Hedge Funds as 'Myopic Activists'*, WALL ST. J. (Aug. 6, 2013).

179. *See* Leo E. Strine, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449 (2014).

180. *See* Martijn Cremers, Ankur Pareek & Zacharias Sautner, *Short-Term Investors, Long-Term Investments, and Firm Value: Evidence from Russell 2000 Index Inclusions*, MGMT. SCI. (forthcoming 2019) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2720248).

181. *See* deHaan, Larcker & McClure, *supra* note 172.

182. *See* Barzuza & Talley, *supra* note 83.

183. *See* Anabtawi & Stout, *supra* note 176, at 1284. *See also* Caleb Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, MD. L. REV. (forthcoming 2019) (manuscript at 13-14) (https://ssrn.com/abstract=3365222) (discussing the diversity of individual index fund investors and suggesting that, if given the option, some of them would assuredly sacrifice financial gains for environmental or social benefits, while others would not choose to do so); Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 174 (2008) (noting that shareholders have differing interests).

Consequently, perhaps one of the most obvious questions is: what are the implications of this long-short termism debate on directors' fiduciary duties?

In *Trados*, Vice Chancellor Laster took the view that directors should maximize the long-term value of the common stockholders as residual claimants.[184] Laster's "long-term rule" was further extended to other situations in which directors represented activist stockholders having a short-term horizon.[185] This approach, however, seems far-reaching because the predominate view gives directors discretion to determine the time horizon over which they seek to maximize stockholder value.[186] Further, it is in contrast to the prior Delaware Supreme Court decision in *Paramount Communications Inc. v. Time Inc.*[187] that explicitly held that directors have discretion in managing the affairs of the corporation, including time horizon. The court stated that ". . .the question of 'long-term' versus 'short-term' value is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon."[188]

Among the suggestions of Leo Strine,[189] there was no suggestion with respect to the way in which corporations' boards of directors should resolve conflicts of interest between long-term versus short-term investors.[190] Additionally, the refusal of Chancellor Strine in *In re Synthes, Inc. Shareholder Litigation* to recognize that there is an inherent conflict of interest whenever there is a controlling stockholder with a short-term horizon[191] suggests that the "long-term rule" has yet been accepted by the Supreme Court of Delaware. Instead, it suggests that the predominate view today is that, according to DGCL § 141, directors have discretion in taking corporate action, including setting a time horizon that would maximize the value of the corporation as a whole.[192]

The above line of cases and literature leaves us at a point where there is no clear framework for corporations' boards of directors to apply in their decision-making process when weighing different corporate opportunities

184. *See* In re Trados Inc. Shareholder Litigation, 73 A.3d 17, 34 (Del. Ch. 2013); *see also* In re Rural/Metro Corporation Shareholders Litigation, 102 A.3D 205, 253 (Del. Ch. 2014).

185. *See* Laster & Zeberkiewicz, *supra* note 176, at 50.

186. *See* Jack Bodne, Leonard Chazen & Donald Ross, *VC Laster, Fiduciary Duties and the Long-Term Rule*, LAW 360 (Mar. 11, 2015), https://www.cov.com/-/media/files/corporate/publications/2015/03/vc_laster_fiduciary_duties_and_the_long_term_rule.pdf.

187. 571 A.2d 1140 (Del. 1989).

188. *See id*. at 1150.

189. *See* Strine, *supra* note 179 and accompanying text.

190. *See id*.

191. 50A.3d 1022, 1039 fn. 81 (Del. Ch. 2012).

192. *See Paramount*, 571 A.2d at 1150; *see also* Bodne, Chazen & Ross, *supra* note 186.

with short- and/or long-term implications for a corporation's stockholders as a whole. This conclusion calls for a legal framework that could encompass these different preferences and conflicting interests that public stockholders have and balance them to reach an outcome that maximizes the value of the enterprise as a whole.

The proposed framework in Part III will, among other things, address situations where a board of directors faces a corporate decision that could result in different consequences for a certain group of stockholders, but nonetheless would be in the best interests of the stockholders as a whole.

The additional effects of the above line of cases and literature concerning the standard of review and the vertical conflicts of interest that directors appointed by venture capitalists or activists face, will be discussed in Part III in conjunction with the discussion on the standard of review.[193]

ii. Dual/Multi-Class Stock

Horizontal conflicts among stockholders may arise also in corporations with dual-class capital structure, wherein the voting rights are not equal among all stockholders.[194] Founders and early investors will typically reserve a significant amount of voting power to maintain control over the board of directors and strategic decisions.[195]

Take Dropbox, Inc. ("Dropbox") for example. Dropbox has three types of common stock, all with the same cash-flow rights[196] but different voting rights. Class A common stock has one vote per share, Class B common stock has ten votes per share, and Class C common stock has no voting rights.[197] Class C common stock is to be issued to Dropbox employees under an equity-based plan.[198] Class B common stock is held by the two co-founders, two officers, one independent director, and the venture capital Sequoia Capital (including its affiliates).[199]

The two co-founders jointly hold approximately 55.3% of the total voting power[200] and, therefore, are able to control all corporate matters submitted to stockholders for approval, including a sale of the corporation.[201]

193. *See infra* page 40, Part III.C.
194. *See* Pollman, *supra* note 1, at 25.
195. *See id*.
196. IPO price was $21 per share. *See* Dropbox, Inc., Prospectus (Form 424B4) (Mar. 23, 2018).
197. *See* Dropbox, Inc., Annual Report (Form 10-K) 33 (Feb. 25, 2019).
198. As of February 19, 2019, no Class C common stock have been issued. *See id.*
199. *See* Dropbox, Inc., Proxy Statement (Form DEF 14A), 51-2, (Apr. 9, 2019).
200. The co-founders' voting power as with respect to all shares of Class A common stock and Class B common stock, as a single class. *See id*.
201. *See* Dropbox, Inc., Annual Report (Form 10-K), 33, (Feb. 25, 2019).

Class A common stock is held by the public, the co-founders, and the executive officers and directors. Due to the relatively small number of outstanding shares of Class A common stock after the Dropbox IPO and the number of shares of Class A common stock held by the co-founders as a result of their RSAs (having full voting rights), the co-founders maintain significant influence over any vote of the Class A common stock when voting as a separate class.[202]

One can see that there is a potential conflict of interest between the co-founders and the other holders of Class A common stock, in addition to a potential conflict of interest between Sequoia Capital and the two co-founders. Each of these groups largely have their own investment agendas. For example, Sequoia Capital, as a venture capitalist, may or may not share the same investment horizon as the co-founders. Likewise, the co-founders may or may not share the same investment horizon as the other holders of Class A common stock—specifically when comparing the co-founders' interests and preferences, which are typically long-term as compared to those of the venture capitalists, who typically have a short-term investment horizon.[203]

Interestingly, out of the major three investors who received the IPO Class B common stock,[204] two (T. Rowe Price and Accel) chose to convert all their Class B common stock to Class A common stock,[205] which suggests that they prefer short-term liquidity over long-term investment horizon because they can sell the Class A common stock on the market.

In light of the fact that horizontal conflicts of interest exist, what should the board of directors of a public corporation consider when taking a corporate action? Presumably it should consider the best interests of the stockholders as a whole, but what happens when the board of directors faces a significant conflict of interest? How should the board of directors resolve it? Should it surrender to the whims of the founder who presumably plays by the "long-term rule," or is there a risk that the founder might actually behave in an opportunistic way that harms other stockholders?

Next, take Facebook, Inc. ("Facebook") as an example. Last year, a major pension fund sued the directors of Facebook for being too accommodating to co-founder and controlling stockholder Mark Zuckerberg's proposal to issue non-voting stock so that he could continue to pursue his personal philanthropic agenda without having to sell the vast majority of his Facebook stock and,

202. *See id*.

203. *See* Korsmo, *supra* note 23, at 1169 ("[A] time horizon ranging from a year or two to as long as ten years, followed by 'exit' through an initial public offering ("IPO") or sale of the entire enterprise.").

204. Sequoia Capital, T. Rowe Price and Accel.

205. *Compare* Dropbox, Inc., Prospectus (Form 424B4), 166, (Mar. 23, 2018) *with supra* note 199.

consequently, lose control over Facebook.[206]

Similar to Dropbox, Facebook has a dual-class capital structure wherein Class B stock carries ten votes per share and Class A stock carries only one vote per share. Zuckerberg's proposal was to issue a new class of publicly listed non-voting Class C stock.[207] According to Zuckerberg's reclassification plan, Facebook would issue two Class C stocks as a one-time dividend to each outstanding Class A and Class B stock, thereby tripling the total number of Facebook outstanding stock.[208] The effect would further tilt control in Zuckerberg's favor, reflating the voting weight of his Class B stock holdings and allowing Zuckerberg to liquidate stock for his personal goals without surrendering his hold on Facebook voting power.[209]

Unlike Dropbox, the plan to issue the non-voting shares came after the IPO and was clearly not part of Facebook registration statement back in 2012.[210] Thus, such reclassification would, at the very least, require a legitimate business purpose and to bring some value to Facebook public stockholders. No such value or legitimate business purpose was found in this case.[211] The members of the special committee who approved the reclassification plan were found in breach of their fiduciary duties. The Delaware Chancery Court found that they were "hopelessly biased, or otherwise woefully disregarded their Facebook fiduciary duties" to Facebook's Class A stockholders and the corporation[212] "by favoring Zuckerberg's interests at the expense of the public Class A stockholders' economic and voting rights."[213]

Indeed, this is an extreme case in which it is obvious that the opportunistic behavior of Zuckerberg harmed Facebook's public stockholders. Nevertheless, it is clear that due to heterogeneous time horizons and agendas of investors,[214] a horizontal conflict of interest does exist[215] and is likely to

206. *See* United Food and Commercial Workers Union and Participating Employers Tri-State Pension Fund v. Zuckerberg, 2018-0671, 2 (Del. Ch. Sept. 12, 2018).

207. *See id*. at 4.

208. *See id*.

209. *See id*. at 3.

210. *See* Facebook, Inc., Registration Statement (Form S-1) (Feb. 1, 2012).

211. *See Zuckerberg*, 2018-0671, at 2.

212. *See id*. at 2-3.

213. *See id*. at 39.

214. *See* Barzuza & Talley, *supra* note 83, at 52 ("[T]he founder might simply place idiosyncratic value on maintaining control, and is willing to incur the costs of doing so in the form of the price discount that outside investors will no doubt impose on the sale (particularly if they are short-term oriented."). The argument with respect to the founder's potential "long-term bias" was made in connection with the adoption of the dual class structure but can also be made in regard to decisions made by the founder following the IPO.

215. This is in spite of the equality in cash-flow rights.

increase in the future with the sophistication of capital markets.[216]

The exercise outlined above is not to critique the multi-/dual-class capital structure of corporations, as scholars and regulators currently continue to debate.[217] It is merely to recognize that such potential horizontal conflicts of interest exists and to further suggest in Part III a framework to resolve such interclass preferences conflicts.[218]

III. THE FIDUCIARY DUTY OF IMPARTIALITY

In Part I above, this Article analyzed the Delaware Chancery Court's view in *Trados* and *ODN* regarding the resolution of common-preferred conflict of interest and laid out arguments as to why the enforcement of preferred stockholders' rights should be undertaken through the board of directors' fiduciary duties to all stockholders without prejudice.

In Part II above, this Article discussed the interclass preference conflicts between and among different types of preferred and common stock. It argued that the current approach taken by the court fails to provide a solution with respect to interclass preference conflicts, both for privately held and publicly traded corporations. This Part will propose the duty of impartiality as an alternative analytic-consistent framework for the analysis and resolution of common-preferred and interclass preference conflicts of interest.

A. OVERVIEW AND RATIONALE

The fiduciary duty of impartiality, along with the duty of loyalty and duty of prudence, is one of the three fundamental fiduciary duties of a trustee.[219] It is the trustee's duty to administer the trust in an impartial manner

216. *See* Bartlett & Talley, *supra* note 129, at 39, 42; *see also* Thomas Franck, *SEC Approves New Silicon Valley Stock Exchange Backed by Marc Andreessen, Other Tech Heavyweights*, CNBC (May 10, 2019), https://www.cnbc.com/2019/05/10/sec-approves-new-silicon-valley-stock-exchange-backed-by-marc-andreessen-other-tech-heavyweights.html. Listing standards have not been set yet, but presumably may contain a "scaled voting" mechanism, in which the voting power of shares grows the longer the shares are held.

217. *See, e.g.*, Commissioner Robert J. Jackson, Jr., *Perpetual Dual-Class Stock: The Case Against Corporate Royalty*, SEC (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty; Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 101 VA. L. REV. 585 (2017); Zohar Goshen & Assaf Hamdani, *Idiosyncratic Vision and Corporate Control*, 125 YALE L.J. 560 (2016); Letter from the Council of Institutional Investors to Edward S. Knight, Executive Vice President and General Counsel, NASDAQ OMX GROUP (Mar. 27, 2014), https://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_nasdaq_one_share_one_vote.pdf; Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 137–38 (1987).

218. *See* proposed framework *infra* page 34, Part III.

219. *See* RESTATEMENT (THIRD) OF TRUSTS, Ch. 15, Intro (AM. LAW INST. 2007).

with respect to the various beneficiaries of the trust.[220]

In the United States, the fiduciary duty of impartiality is anchored in § 79 of the Restatement (Third) of Trusts,[221] reflected in § 103 of the Uniform Principle and Income Act,[222] § 803 of the Uniform Trust Code,[223] and § 6 of the Uniform Prudent Investor Act[224] that were enacted in most of the states.[225]

Corporate law has long recognized the principal-agent relationship between directors (agents) and stockholders (principals), where directors must maximize stockholders' wealth via their fiduciary duties to the corporate entity.[226] Conversely, trustees owe their fiduciary duties directly to the trust beneficiaries[227] and, consequently, will be personally liable to the trust beneficiaries in case of a breach of trust.[228]

Because corporate law is primarily derived from agency law,[229] the duty of impartiality of directors to a corporation's stockholders, which is not an explicit part of the agent fiduciary duties,[230] has been rarely analyzed or applied by courts in an intra-corporate context.[231] Although this Article is not suggesting that directors should be viewed as occupying a trustee-like

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220. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 (AM. LAW INST. 2007).

221. *See id*. Although there is no explicit fiduciary duty of impartiality under the Employees' Retirement Income Security Act, 29 USC §18.1104, the United States Supreme Court in Tibble v. Edison Int'l clarified that "[i]n determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts." 135 U.S. 1823, 1828 (2015). And, consequently, applied the Restatement (Third) of Trusts.

222. *See* UNIFORM PRINCIPLE AND INCOME ACT (UNIF. LAW COMM'N 2000).

223. *See* UNIFORM TRUST CODE (UNIF. LAW COMM'N 2000).

224. *See* UNIFORM PRUDENT INVESTOR ACT (UNIF. LAW COMM'N 1994).

225. *See* Uniform Law Commission, https://www.uniformlaws.org/home (last visited May 16, 2019).

226. *See, e.g*., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); *see also* Dodge v. Ford Motor Company, 170 N.W. 668, 683 (Mich. 1919); MELVIN A. EISENBERG, AM. LAW. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994).

227. *See* RESTATEMENT (THIRD) OF TRUSTS, Ch. 15, Intro (AM. LAW INST. 2007).

228. *See* RESTATEMENT (THIRD) OF TRUSTS, Ch. 18, Intro (AM. LAW INST. 2007).

229. *See supra* note 226 and accompanying text.

230. *See* RESTATEMENT (THIRD) OF AGENCY § 1 (AM. LAW INST. 2006). *See also id*. at § 8.

231. Citations of impartiality by Delaware courts in an intracorporate context typically address the impartiality of a board of directors (or a special litigation committee) facing a plaintiff's demand to initiate, or refrain from entering, litigation on behalf of the corporation. *See, e.g*., Sandys v. Pincus, 152 A.3d 124, 126 (Del. 2016); In re Oracle Corp. Derivative Litigation, 824 A.2d 917, 939-40 (Del. Ch. 2003). For proposals to implement impartiality analysis with regard to various beneficiaries, *see* AMIR LICHT, FIDUCIARY LAW: THE DUTY OF LOYALTY IN THE CORPORATION AND IN THE GENERAL LAW 225 (2013).

position,[232] it proposes the duty of impartiality as an analytic framework that allows a board of directors to analyze and resolve conflicts of interest between and among the corporation's stockholders to best fulfill its fiduciary duties.

As discussed in Part I, the fiduciary duties of a board of directors requires it to make business decisions that are in the best interest of corporation's stockholders (i.e., the "shareholder primacy norm" or the "shareholder wealth maximization norm").[233] However, the way in which the board of directors should fulfill this duty is quite ambiguous, and its decisions will enjoy deference under the business judgment rule unless there is a credible allegation of a breach of duty of care, loyalty (including conflict of interest), or waste.[234]

Thus, whenever facing a horizontal conflict of interest between and among the corporation's stockholders,[235] the board of directors has no clear and consistent framework to apply in its decision-making process when resolving such conflicts.

Although some of this ambiguity was presumably mitigated by the Delaware Chancery Court in *Trados* and *ODN* by favoring the "common stockholder maximization value"[236] (and by doing so resolved the common-preferred conflict), for the reasons outlined in Part I above, this Article argues that the duty to maximize enterprise value should also encompass the preferred stockholders' rights.

Consequently, when facing a corporate decision that triggers a horizontal conflict of interest, whether such conflict arises among the common-preferred stockholders[237] or the common-common stockholders[238] or any other potential inter-class preference conflict, the board of directors should resolve these conflicts in a way that would best reflect the interests of the corporation's stockholders as a whole.[239]

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232. *See, e.g.*, Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 DUKE L.J. 879, 880 (1988) (suggesting that a corporation's directors occupy a trustee-*like* position); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85(2) VA. L. REV., 248, 291 (1999) (suggesting that corporate directors resemble trustees). *See also* the decision of the Supreme Court of Texas in Yeaman v. Galveston City Co., 167 S.W. 710, 723 (Tex. 1914) (holding that the relationship between a corporation and its stockholders are akin to one of trust).

233. *See* Dodge v. Ford Motor Company, 170 N.W. 668, 684 (Mich. 1919); Smith, *supra* note 31; *see also* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del Ch. 2010).

234. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (explaining justifications for the business judgment rule).

235. *See* discussion *supra* page 5, Part I and page 24, II.

236. *See* discussion *supra* page 5, Part I.

237. *Id*.

238. *See* discussion *supra* page 24, Part II.

239. *See* Dodge v. Ford Motor Company, 170 N.W. 668, 684 (Mich. 1919); Smith, *supra* note 31; *see also* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del Ch. 2010).

B. Resolving Stockholders' Conflicts via the Fiduciary Duty of Impartiality

The proposed framework for resolving conflicts of interest between and among holders of common stock and multiple classes of preferred stock is through the fiduciary duty of impartiality.

The duty of impartiality is the duty to administer the corporation's affairs in a manner that is impartial with respect to the various beneficiaries (stockholders) of the corporation.[240] It is an extension of the duty of loyalty.[241] The duty of impartiality requires a fiduciary to act in the best interests of the beneficiaries, but recognizes that beneficiaries have competing economic interests[242] and, therefore, it allows a fiduciary to exercise discretion while having a duty to act bona fide in the best interests of the beneficiaries as a whole.[243]

Due to the duty's recognition that beneficiaries may have competing economic interests, it provides a few guidelines to the fiduciary that can be applied by her or him in its decision-making process:

First, impartiality does not mean that a fiduciary must treat each beneficiary equally. The fiduciary may give priority to the interests of certain beneficiaries or decide to give different weight to the interests of certain beneficiaries when balancing those interests, as long as the fiduciary treatment of the beneficiaries' interests or conduct in administrating a trust (corporation) is not influenced by the fiduciary's own personal agenda or favoritism toward individual beneficiaries.[244]

Moreover, it is within the fiduciary duty to balance the beneficiaries' competing interests in a reasonable way to "reflect any preferences and priorities that are discernible from the terms, purposes and circumstances of the trust and from the nature and terms of the beneficial interests."[245] In other words, the fiduciary must take into account any special terms, agreements and understandings that reflect the beneficiaries' priorities, rights, and interests arising from the trust's terms and circumstances.

For example, applying the duty of impartiality on the classic common-preferred stock conflict would require a board of directors to take into

240. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 (AM. LAW INST. 2007).

241. *See id*. at cmt. b.

242. *See id*.; *see also* Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. OF COLO. L. REV. 731, 794 (2019).

243. *See*, *e.g*., Forbes Trustee Services Ltd v. Jackson [2004] EWHC 2448 (Ch) [36]; Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CALIF. L. REV. 1877, 1913 (2000).

244. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b. (AM. LAW INST. 2007); *see also* Forbes Trustee Services Ltd v. Jackson [2004] EWHC 2448 (Ch)[36].

245. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b. (AM. LAW INST. 2007).

account the preferred rights and interests as contracted under the corporation's certificate of incorporation and give such rights and interests the applicable weight in its decision-making process. Depending on the specific set of circumstances surrounding a specific business decision and the specific contractual rights of the preferred, the board of directors would give different weight to the preferred rights.

Under another example, a board of directors considering a sale of the corporation to a third party may give more weight to the rights of the preferred stockholders, with full participation liquidation preference, than it would give to preferred stockholders, with 3X non-participating liquidation preference, because presumably the interests of the preferred stockholders in the first case would be more aligned with those of the common stockholders. Thus, the board of directors is likely to better represent the interest of the stockholders as a whole. Of course, there are additional considerations to be considered in this case, such as whether the corporation was highly successful or facing financial difficulties. Each fact should be given a certain weight in the board of directors' decision-making process.

Second, the duty of impartiality does not require an equal balance of diverse interests, but rather a balance of those interests in a manner that is consistent with the beneficial interests and the terms and purposes of the trust (corporation).[246] The fiduciary should take into account the various needs, objectives, and tax positions that lead to different preferences of beneficiaries.[247] This also includes taking into account different time horizons of different beneficiaries.[248] As a practical matter, a board of directors should consider the interests of both short-term investors (e.g., activist investors) and long-term investors (e.g., founders, pension funds) when balancing these competing interests to reach a suboptimal business decision.[249]

For example, if an activist stockholder proposes a business strategy that is likely to produce short-term returns (but the likelihood for long-term returns is low) and the founder (also the CEO and corporation's stockholder) proposes a long-term strategy that will likely to result in a long-term return, a board of directors would be required to consider each of these investment strategies in an impartial way. That means that the board of directors may give significant weight to the founder's proposal if it believes that such proposal would reflect

246. *See id*. at cmt. c.

247. *See id*.

248. *See* Gary, supra note 242, at 794-96.

249. *See* James Hawley, Keith Johnson & Ed Waitze, *Reclaiming Fiduciary Duty Balance*, 4(2) ROTMAN INT'L J. OF PENSION MGMT. 4, 8 (2011); *see also* the decision of the United States Supreme Court in Varity Corp. v. Howe, 516 U.S. 489, 514 (1996) ("The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries.").

the best interests of the corporation's stockholders as a whole. On the other hand, the board of directors may also adopt the activist's proposal if it believes that the founder's proposal is too optimistic[250] or driven by her or his own personal agenda[251] or that the activist proposal is likely to result in a higher return (even if the likelihood for long-term return is low). Of course, for such suboptimal outcome to be practically feasible, the board of directors would need to communicate with the stockholders in order to fully understand the effects of each of these investment strategies.

Third, whenever necessary, the fiduciary duty of impartiality requires a fiduciary to obtain information from the beneficiaries concerning their financial needs, circumstances and preferences.[252] The fiduciary typically does need not to consult with all existing beneficiaries, but should select beneficiaries who would reasonably be expected to reflect the diverse beneficial interests that are likely to be affected.[253] The fiduciary should avoid arbitrary discrimination among persons similarly situated with respect to the matter involved.[254] Additionally, in matters that can be expected to affect the trust beneficiaries generally, such as a change of business, the fiduciary might need to consult with all types of beneficiaries.[255]

As a practical matter, such communication is done through stockholders' resolutions, allowing stockholders to express their preferences for certain corporate actions.[256] Although this process has been shown to successfully influence corporate actions,[257] it is important to note that under both the Restatement (Third) of Trusts [258] and Delaware case law,[259] the board of directors may take discretionary corporate actions that it believes are in the best interests of the stockholders, even if it believes that the stockholders would disagree with such decisions.[260]

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250. *See* Barzuza & Talley, *supra* note 83, at 7 ("Optimism bias—the proclivity of corporate managers to overestimate the success probability of their own projects—has already been documented extensively in the economics and finance literature.").

251. *See* discussion regarding the Facebook case *supra* page 31, Part II.B.ii.

252. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. d. (AM. LAW INST. 2007).

253. *See id*.

254. *See id*.

255. *See id*.

256. *See* Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 218-19 (2018).

257. *Id*.

258. *See* RESTATEMENT (THIRD) OF TRUSTS § 80 cmt. b. (AM. LAW INST. 2007) (referring to § 79 cmt. D which stated that "[a]fter obtaining advice or consultation, the trustee can properly take the information or suggestions into account but then, unlike delegation, must exercise independent, prudent, and impartial fiduciary judgment on the matters involved").

259. *See, e.g.*, the decision of then-Vice Chancellor Strine in In re Lear Corp. Shareholder Litigation, 967 A.2d 640, 655 (Del. Ch. 2008) ("[D]irectors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them.").

260. *See id*. For an interesting discussion on whether directors should act in what they think are the

In conclusion, the fiduciary duty of impartiality provides an analytic framework for the consistent resolution of stockholders' conflicts of interest. It is a balancing test that provides a corporation's board of directors a flexible tool with which to weigh various, and often conflicting, interests of stockholders to reach a resolution that maximizes the value of the enterprise as a whole. This framework is a proposed way of resolving stockholders' conflicts of interest and, because it is mostly derived from the U.S. common law of trusts, it should be further shaped and developed by courts to be adequately applied in an intra-corporate context.

C. Standard of Review

The proposed framework outlined above is with respect to the standard of conduct, i.e., the considerations a board of directors should consider when considering taking a corporate action.[261] In the context of common-preferred conflict,[262] and in the context of interclass preference conflicts,[263] this Article argues that the board of directors should consider both the interests of the common stockholders and the preferred stockholders, and balance their competing interests through the fiduciary duty of impartiality to reach a decision that would reflect the best interests of the corporation's stockholders as a whole.[264]

One may wonder how a director who, for example, was appointed by a venture capital firm could be impartial? Indeed, such a director may be conflicted if the interests of the preferred stockholders diverge from those of the common stockholders.[265] Such a situation is not a given one[266] and, therefore, is generally considered on a case-by-case basis.[267] In case the majority of directors are found to be conflicted, the decision of the board of directors would generally not enjoy deference under the business judgment rule, and the Delaware court would review the directors' decision under the

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best interests of stockholders, or what stockholders think are in the best interests of stockholders, *see* Hirst, *supra* note 256, at 232-34.

261. *See supra* page 34, Part III.

262. *See supra* page 5, Part I.

263. *See supra* page 24, Part II.

264. *See supra* page 37, Part III.B.

265. *See* In re Trados Inc. Shareholder Litigation, 73 A.3d 17, 52 (Del. Ch. 2013).

266. *See* Boschner & Simmerman, *supra* note 84, at 7. On that note, there is an emerging jurisprudence in Delaware case law that directors who represent venture capital investors and activists with short-term investment horizons face an inherent conflict of interest. *See* Bodne, Chazen & Ross, *supra* note 186. However, it seems that the predominant view today remains that, absent special circumstances, directors "have discretion to determine the time horizon over which they seek to maximize stockholder value." *See id*.; *see also* In re Synthes Shareholder Litigation, 50A.3d 1022 (Del. Ch. 2012); *supra* page 28, Part II.B.i.

267. *See* Boschner & Simmerman, *supra* note 84, at 8-9.

strict "entire fairness" standard of review.[268]

Recall that the fiduciary duty of impartiality is an extension of the duty of loyalty.[269] As such, a director who would be found conflicted by the Delaware court could not be considered impartial. Alternatively, a director not found to be conflicted by the Delaware court should enjoy the deference under the business judgment rule, including the presumption that her or his decisions were made in an impartial way, because there would presumably be no concern that the director would favor per se the preferred stockholders' interests over those of the common stockholders.[270]

CONCLUSION

Horizontal conflicts of interest have been increasing in the past few years, both in privately held and publicly traded corporations. As a result, they have raised profound questions about whether fiduciary duties should rescale themselves.[271]

This Article analyzed stockholders' conflicts of interest on two levels. First, this Article analyzed the common-preferred conflict in light of *Trados* and *ODN* and pointed out the problematic issues that arose vis-à-vis the Delaware Chancery Court's decisions.[272] The conclusion of this analysis was that the enforcement of preferred stockholders' rights should be undertaken through the board of directors' fiduciary duties to all stockholders, without prejudice. Second, this Article analyzed the potential interclass preference conflict between and among different types of preferred and common stockholders and argued that the current approach the court takes lacks a solution both for privately held and publicly traded corporations.[273]

The Article concluded with a proposed framework for resolving these conflicts of interest. The Article proposed the fiduciary duty of impartiality as an analytic framework to resolve conflicts of interest between and among holders of common stock and multiple classes of preferred shares.[274]

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268. The business judgment rule presumption may be reinstated in case a board majority composed of disinterested and independent directors, who can also be a special committee, approved the transaction. *See Trados*, 73 A.3d at 1.

269. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b. (AM. LAW INST. 2007).

270. *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 453 (Del. Ch. 2010) (holding that the impartiality of directors holding common stock should not be impugned solely because of their ownership of common stock, and not preferred stock, without presenting facts that the directors were materially self-interested).

271. *See* Bartlett & Talley, *supra* note 129, at 42-43.

272. *See supra* page 5, Part I.

273. *See supra* page 24, Part II.

274. *See supra* page 34, Part III.