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Recent Developments Concerning Preferred Stockholder Rights under Delaware Law

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RECENT DEVELOPMENTS CONCERNING PREFERRED STOCKHOLDER RIGHTS UNDER DELAWARE LAW

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I. INTRODUCTION

IN *Jedwab v. MGM Grand Hotels, Inc.*, the Delaware Chancery Court held that:

> with respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.[1]

Given that preferred stockholder preference rights are contractual in nature, common stockholders' rights and director duties—as stockholders' agents—depend on how the preference rights have been defined in the contract.[2] Preferred stockholders are stockholders, after all, and have residual rights as stockholders in addition to their preference rights.

This Article will examine the preferred stockholder rights by contrasting the long established general rule concerning preferred stockholder rights with the newer approach in the *Jedwab* case. This Article will provide an overview of the Delaware Chancery Court decision in *Jedwab* and selected later decisions by the Delaware courts. Section II will showcase background information that led to the decision in *Jedwab* and later cases. Section III will discuss the characteristics of preferred stock. Section IV will review the *Jedwab* and the *In re Trados Inc. Shareholder Litigation*[3] opinions and will establish how the *Jedwab* rule differs from the general rule of preferred stockholder rights.[4] The latter part of Section IV will discuss several criticisms of *Jedwab* and various suggestions offered to justify the protection of preferred stockholders' rights. Section V will discuss the Delaware courts' effort to

1. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
2. Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984).
3. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).
4. *Compare* Rothschild, 474 A.2d at 136 (stating the general rule that "[p]referential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation"), *with* Jedwab, 509 A.2d at 594 (stating that some preferential rights "may be measured by equitable as well as legal standards").

reconcile the criticisms of the *Jedwab* opinion in the *Trados* opinion.. Section VI will be devoted to the discussion of cases which reflect on the Delaware courts' tendency for strict construction of the preferred rights in contracts. Section VII will discuss the Delaware courts' current stance in terms of the *Jedwab* rule by taking a look at the trend in recent cases. Finally, this Article will discuss lessons from these recent cases that should be learned by lawyers, as well as current and prospective preferred stockholders.

II. BACKGROUND INFORMATION

The distribution of corporate wealth underscores the continual tension between common and preferred stockholders. The interests of the classes in companies with two or more classes of stockholders may differ, potentially pulling the directors in two separate directions.[5] As a result, disputes arise on many levels. But, as far as the decided cases are concerned, conflicts between classes of stockholders typically arise under several scenarios. The following examples demonstrate the most common of those situations.

First, in the event of a merger transaction, if the common is allocated an unfair portion of the merger consideration relative to the preferred, the preferred can bring suits against directors demanding fair distribution of the merger proceeds.[6] These cases raise the issue of how a fair distribution should be determined and the importance of procedural protections to achieve that distribution.[7]

Second, if the preferred receives an unfairly large portion of the merger proceeds, the common may bring a breach of fiduciary duty claim against the directors.[8] Complex transactional situations are typical in a distressed economy—a struggling corporation considering a transaction that would benefit certain preferred stockholders at the expense of the common—and

5. William Savitt, *When Classes of Stockholders Clash*, *in* GOING PRIVATE 2010: DOING THE DEAL RIGHT, at 75, 77 (PLI Corp. Law & Practice Course Handbook Series No. 1796, 2010).
6. *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986); *In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *1 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
7. *See In re FLS Holdings*, 1993 WL 104562, at *4–5.
8. *See In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009).

the job "of balancing duties to different equity classes can become a liability minefield."[9]

Third, disputes also arise with regard to the preferred stockholder's voting rights. The Delaware General Corporation Law (DGCL) requires voting in order for a corporation to amend its certificate of incorporation.[10] Under Section 242(b)(2), if the preferences of any class of stockholders are affected adversely, class voting of such stockholders is required.[11] In order to avoid this separate class voting requirement, a corporation will often incorporate a wholly-owned subsidiary and merge itself into the subsidiary.[12] As a result, the rights and preferences of the preferred stockholders in the certificate of incorporation will be eliminated.[13]

III. CHARACTERISTICS OF PREFERRED STOCKHOLDER RIGHTS

Professor Mitchell presents detailed explanations regarding the characteristics of preferred stockholder rights.[14] Moreover, in light of the question of whether directors owe fiduciary duties to the preferred, he explains conflicting arguments.[15]

A. Preference Aspect

Professor Mitchell states that preferred stockholders have preference to the extent that the rights created in the corporation's charter or certificate of designation give them an advantage over common stockholders.[16] According to him, "[m]ost commonly, this advantage is recognized in the preferred's priority to common stock upon liquidation, and in the right to receive dividends."[17] Since corporate wealth at any given point is limited, the advantages of the preferred receive come at the expense of the common stockholders.[18] No matter how wealthy a corporation is, such wealth cannot

9. Savitt, *supra* note 5.
10. DEL. CODE ANN. tit. 8, § 242(b)(1) (2009).
11. *Id.* § 242(b)(2).
12. Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 844 (Del. 1998).
13. *Id.*
14. Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 443–44 (1996).
15. *Id.*
16. *Id.* at 445.
17. *Id.* at 445–46.
18. *Id.* at 446.

be available to both the common and the preferred at the same time.[19] Therefore, preferred and common stockholders are, to the extent of their preference, in direct conflict with one another.[20] Hence, the preference rights are contractual in nature.[21]

B. Stock Aspect

According to Professor Mitchell, preferred stockholders are traditionally regarded as having an ownership interest in the corporation.[22] Due to this ownership interest, they represent a statutorily accepted corporate constituency, and it is for their benefit that a corporation's officers and directors must accomplish their duties.[23] Under the proper conditions, directors may owe a fiduciary duty to the preferred; therefore, the existence of preference rights and the extent of the correlative duty may be calculated by equitable and legal standards.[24]

C. Peculiar Status of Preferred Stockholders vis-á-vis Common Stockholders

In contrast to the directors' duty to maximize the value of the common,[25] the directors' basic duty to the preferred is to protect its investment.[26] Due to this status of the preferred stockholders, there arises the dispute of whether and how the preferred stockholders' rights should be protected by the directors. Basically, it is the matter of whether a fiduciary duty should be owed in a particular situation to the preferred stockholders, or whether their rights should be limited to their contractual rights. This is an ongoing argument. According to Professor Mitchell, to the extent of the preferences, the preferred have priority over the common to receive their money, which is typically a predetermined amount,[27] but they cannot normally claim the residual interest; as a result, the preferred tend to be more risk averse than the

19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at 445.
23. *Id.*
24. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
25. Mitchell, *supra* note 14, at 454.
26. *Id.*
27. *Id.* at 472.

common stockholders.[28] Therefore, Professor Mitchell states, if a duty to the preferred were imposed, management would become less willing to undertake projects entailing some risk, despite their likelihood to yield higher expected returns.[29] This arguably would result in the ultimate inefficiency of our corporate system[30] because those transactions that might maximize gains for the company would be avoided due to concerns resulting from the fiduciary duties of loyalty and care; therefore, such duties are considered important obstructions to that maximizing goal.[31]

Moreover, some have asserted that since preferred stockholders have the opportunity to specify the terms of their rights relative to the common in advance, the preferred stockholders should be held to the bargain they made in the contract.[32] According to Professor Mitchell, although the preferred stockholders may not have been afforded the option to negotiate the terms of the contract, they are also not obligated to buy preferred stock.[33] Once they choose to buy preferred stock, this argument maintains that they should not seek more than what they bargained for later.[34] Furthermore, Professor Mitchell states that because the preferred have priority over the common to receive their money, they take different financial risks relative to the common.[35] This is said to justify adjustments to the relative fiduciary rights of the common and the preferred.[36]

However, there remains an argument for a fiduciary duty to be owed to the preferred as well. Professor Mitchell notes that the corporation has no obligation to pay the preferred at all, leading to another way in which preferred differs from creditors and other contractual claimants.[37] However, he states that the preferred and common stockholders are similar in that they are both equity participants in a corporation.[38] Thus, although preference rights are contractual in nature, the preferred are closer to the common stock than other contractual claimants, such as bondholders, in terms of the status

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28. *Id.* at 470.
29. *Id.*
30. *Id.*
31. Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 622 (1997).
32. Mitchell, *supra* note 14, at 470.
33. *Id.*
34. *Id.* at 471.
35. *Id.* at 472.
36. *Id.*
37. *Id.*
38. *Id.*

they have in a corporation.[39] Professor Mitchell states that courts obviously recognize this, although never explicitly, as is evidenced by the decisions in *Jedwab* and other cases acknowledging that some fiduciary rights are owed to the preferred.[40]

IV. THE *JEDWAB* & *TRADOS* OPINIONS

In *Jedwab*, the court distinguished between circumstances in which a matter relates to preference and circumstances where a right asserted is not a preference right *per se*, as against the common stock, but rather a right shared equally with the common.[41] Recognizing the former situation as one where the general rule is applicable, the *Jedwab* court thoroughly discussed the situation where the right asserted is not a preference as against the common stock, but rather a right shared equally with the common.[42]

A. The Long Established General Rule

In *Rothschild International Corp. v. Liggett Group Inc.*, the court created a general rule stating, "[p]referential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation."[43] Section 151(a) of the DGCL allows Delaware corporations to issue stock having such "special rights, and qualifications, limitations or restrictions."[44] In such instances where special rights are defined with regard to the stock, "the law recognizes that the existence and extent of rights of preferred stock must be determined by reference to the certificate of incorporation, those rights being essentially contractual in nature."[45] Therefore, the court indicates that preferred rights, being defined in the contract, have a contractual nature. Recognizing this general rule as accepted principle,[46] the *Jedwab* court stated that "with respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the

39. *Id.*
40. *Id.*
41. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
42. *Id.* at 594–600.
43. Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984).
44. DEL. CODE ANN. tit. 8, § 151(a) (2009).
45. *In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 533 (Del. Ch. 2001).
46. *Jedwab*, 509 A.2d at 593.

scope of the duty is appropriately defined by reference to the specific words evidencing that contract."[47] Therefore, the court indicated that, because of the contractual nature of the preferred rights, the scope of the correlative duty on the part of the directors is limited to according the preferred stockholders the rights that are determined by the specific words in the contract. Therefore, the general rule is two-folded; the preferred stockholders' rights are essentially contractual and therefore their rights and the director's correlative duties are limited to the extent the preferred rights are defined in the contract.

1. Rationale Based on the Wealth-Maximizing Norm

The rationale supporting the general rule could be explained by answering the questions of why the conflict arises and whose interest the directors should favor. The first question to be asked is what brings about the conflict between the common and the preferred. Preferred stockholders are preferred because their preference right is created in the corporation's charter and gives them advantages over common stockholders.[48] Given the limited quantity of corporate wealth at any given point, these advantages come at the expense of the common stockholders.[49] Therefore, conflict naturally arises from any given distribution of corporate wealth at any given point in time due to the corporate wealth's limited nature.

The next issue is whose interests the directors should favor. The directors' basic duty to the preferred is to protect their investment.[50] In contrast, directors owe a duty to maximize the value of the common stock.[51] Since the preferred rights are treated as primarily contractual rights that come at the expense of the common stockholders,[52] directors have to minimize the value of the preferred in order to maximize the value of the common.[53] Therefore, it is argued that when there is a conflict between common stockholders and preferred stockholders, directors should act in the interests of the common stockholders.[54] The recent *Trados* opinion shows that

47. *Id.* at 594.
48. Mitchell, *supra* note 14, at 445.
49. *Id.* at 446.
50. *Id.* at 454.
51. *Id.*
52. *Id.* at 446.
53. *Id.* at 454.
54. *Id.* at 450.

directors can be held responsible for breach of the duty of loyalty if they fail to favor the common's interest in a conflict wherein the preferred stockholders' interests diverge from those of the common stockholders.[55]

2. *In re Trados Inc. Shareholder Litigation*

The general rule states that the preferred rights, being contractual in nature, are limited to those rights defined in the contract. Therefore, the directors owe fiduciary duties to the preferred only to the extent the preferred rights are articulated in the contract, and they have no need to further extend preferred rights. Then, the next question arises if the directors opt to extend preferred rights at the expense of the common. In 2009, the Delaware Chancery Court in *Trados* addressed the issue of whether directors' unnecessary favoritism of the interests of the preferred over the common could constitute breach of duty of loyalty to the common.[56]

The *Trados Shareholder Inc. Litigation* suit was brought by a former common stockholder of Trados Incorporated, later a subsidiary of SDL, plc ("SDL"), for breach of fiduciary duty.[57] Of the $60 million contributed by SDL, Trados preferred stockholders received approximately $52 million, with the rest dispersed to the corporation's executive officers, pursuant to an approved bonus plan.[58] Trados common stockholders received nothing.[59] Prior to the merger, Trados received investments from venture capital firms and other entities to better position itself for the possibility of going public.[60] It is typical for venture capital firms to make investments in the form of preferred stock, especially convertible preferred. This gives the venture capital firms the upside potential of common if things go well, and downside protection in the form of liquidation preferences if things do not go well. The preferred stockholders had four persons on Trados' seven-member board of directors.[61] Each member of Trados' board at the time of the approval of the merger was named as a defendant.[62]

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55. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009).
56. *Id.*
57. *Id.* at *1.
58. *Id.*
59. *Id.*
60. *Id.* at *1.
61. *Id.*
62. *Id.*

Trados' board of directors began to discuss a prospective sale of the company and formed a mergers and acquisitions committee to investigate a sale or merger of Trados, consisting of three designees from the venture capital firms and other entities.[63] Despite the company's markedly improved financial condition, the merger was completed.[64] The plaintiff asserted a claim that the defendants breached their fiduciary duty of loyalty to Trados' common stockholders by approving the merger.[65] Purportedly, it was not necessary to sell Trados because it had become profitable.[66] The plaintiff maintained that the merger took place at the request of "certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados."[67] Further, the plaintiff argued, "in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment."[68] It was alleged by the plaintiff that the directors favored the preferred stockholders at the "expense of the common stockholders."[69] It was further alleged that the Trados board did not appropriately consider what impact the merger would have on the common stockholders.[70] Particularly, the plaintiff asserted that, because the directors had been elected on behalf of the preferred stockholders and had other associations with the preferred stockholders, they could not exercise "disinterested and independent business judgment."[71] Also, it was alleged that two Trados directors received material personal benefits due to the merger.[72] Lastly, the plaintiff alleged that SDL and its officers conspired with the directors of Trados to postpone revenues until after the merger.[73]

The defendants argued, on the contrary, that the plaintiff "ignore[d] the 'obvious alignment' of the interest of the preferred and common stockholders

63. *Id.* at *2.
64. *Id.* at *3–4.
65. *Id.* at *6.
66. *Id.*
67. *Id.* at *1.
68. *Id.* at *6.
69. *Id.* at *1.
70. *Id.* at *1.
71. *Id.*
72. *Id.*
73. *Id.*

in obtaining the highest price available."[74] Because the preferred stockholders would not obtain their complete liquidation preference in the merger, they too would benefit if a higher price were obtained.[75] Essentially, the defendants asserted that there was no conflict of interest between the preferred and common stockholders when the defendants were pursuing the highest price available for the corporation; therefore, the interests of the preferred stockholders and the common stockholders did not diverge.[76] Rather, the defendants maintained, the interests of the common and the preferred were aligned with each other.

The issue in *Trados* was whether the directors breached their duty of loyalty by "favoring the interests of the preferred stockholders over those of the common stockholders."[77] The conflict of interest situation arose when the preferred stockholders' interests diverged from the interests of the common stockholders because the directors proceeded with a merger that was supposedly not necessary.[78] The *Trados* court rejected the argument that there was no conflict because the merger transaction was pursued for the common stockholders as well as the preferred stockholders, and therefore the directors' decision to go forward with the merger and allocate consideration were protected under the business judgment rule.[79]

The *Trados* court started its analysis by recognizing the general rule that preferred stockholders' rights are contractual in nature.[80] Then, the court acknowledged the *Jedwab* rule by stating that "[t]his Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred 'is not to a preference as against the common stock but rather a right shared equally with the common.'"[81] However, the court recognized the situation in question was not a *Jedwab* situation and proceeded with the reasoning in *Equity-Linked Investors, L.P. v. Adams* by stating:

> Where this is not the case, however, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to

74. *Id.* at *7.
75. *Id.* at *7.
76. *Id.*
77. *Id.*
78. *See id.* at *6.
79. *See id.* at *7.
80. *Id.*
81. *Id.* (quoting Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986)).

> prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict."[82]

Therefore, the court concluded that "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is possible that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders."[83] The court held that the allegations in the plaintiff's complaint supported a "reasonable inference that the interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger."[84] In light of this reasonable inference, the court asserted that dismissal could be avoided if the well-pleaded facts of the complaint showed that the director defendants were interested or lacked independence in making this decision.[85] The common stockholders claimed the interests of the preferred stockholders diverged from those of the common stockholders: while the preferred received a multi-million dollar liquidation preference as a result of the merger, the common stockholders reaped no such benefit.[86] The common stockholders further alleged it was reasonable to infer the directors were interested in the transaction and thus incapable of exercising independent business judgment since each "had an ownership or employment relationship with an entity that owned Trados preferred stock."[87] Therefore, the court recognized that, since directors owe fiduciary duties to the preferred only to the extent that the preferred's rights were defined in the contract, it is *possible* that directors could be liable for a breach of duty of loyalty to the common if they go further by favoring the preferred over the common.[88]

It is noteworthy that the court did not suggest that this would necessarily mean directors breach fiduciary duty by approving "a transaction that, as a result of liquidation preferences, does not provide any consideration to the

82. *Id.* (quoting Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997)).
83. *Id.* (emphasis omitted).
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.* at *8.
88. *Id.* at *7.

common stockholders."[89] The plaintiff was not entitled to relief simply by "rebutting the presumption of the business judgment rule; rather, even if the plaintiff ultimately rebuts the presumption of the rule, the burden shifts to the director defendants to demonstrate the entire fairness of the transaction."[90] Therefore, by using the word "*possible*," the *Trados* court indicated that the court may not recognize this type of transaction as a breach of duty. That is, if the directors can prove the entire fairness of the transaction favoring the preferred over the common, it will not be considered as "improperly favoring the interests of the preferred" and therefore there will be no breach of duty on the part of directors to the common.[91] Consequently, in order for the directors to prove the entire fairness, the significance of a "careful process" is emphasized.

3. Practical Implications of Trados

Since *Trados* was decided, a lot of attention has been given to this case regarding the duties of the directors to several classes of stockholders.[92] It is not surprising that the *Trados* decision attracted a good deal of attention, especially from those lawyers who should protect the interests of their preferred stockholder clients. According to one commentator, *Trados* offers noteworthy guidance:[93] if directors were designated by a specific stakeholder, they should avoid even the appearance of favoring those who appointed them directors.[94] Rather, they should defend the interests of the corporation as a whole.[95] The *Trados* court acknowledged that even if a transaction that benefits the preferred returns nothing to the common, it is not *per se* improper.[96] But *Trados* demonstrates that the directors must prove such a transaction was entirely fair,[97] resulting in a painstaking scrutiny.[98]

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89. *Id.* at *7 n.36.
90. *Id*, at *9 n.56 (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).
91. *Id.* at *7.
92. *See, e.g.*, Dennis J. White, Another View: To Sell or Not to Sell, N.Y. Times DealBook, Aug. 20, 2009, http://dealbook.blogs.nytimes.com/2009/08/20/another-view-to-sell-or-not-to-sell/.
93. Savitt, *supra* note 5, at 78.
94. *Id.*
95. *Id.*
96. *Id.*
97. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *9 n.56 (Del. Ch. July 24, 2009) (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).
98. Savitt, *supra* note 5, at 78.

Therefore, the commentator asserts that directors who owe duties to both the common and the preferred must take measures such as retention of expert advisers or the establishment of independent committees in order to "demonstrate deliberate decision-making in the best interests of the company as a whole."[99] According to him, after the *Trados* decision was rendered, "[t]he need for [a] careful process" at every stage during the course of a multiple-class transaction was emphasized.[100] It is worth noting that the *Trados* case held that the "[p]laintiff is not entitled to relief merely by rebutting the presumption of the business judgment rule; rather, even if the plaintiff ultimately rebuts the presumption, the burden shifts to the director defendants to demonstrate the entire fairness of the transaction."[101]

Therefore, if there existed such a "careful process" with which the directors can show "deliberate decision-making in the best interests of the company as a whole," then the transaction favoring the preferred stockholders will be considered to be entirely fair and therefore interests of the preferred will be protected.[102] The importance of "careful process" is emphasized especially when private-equity sponsors and venture capital funds, as they often do, place their employees as directors on company boards.[103] In that case, because the preferred placed their employees on company boards, it will be more difficult for the directors to prove the entire fairness of the transaction favoring the preferred.

B. The *Jedwab* Approach

The *Jedwab* case relied on the rule that states, "where . . . the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards."[104] In *Jedwab*, contrary to the circumstances where the general rule is applicable, the right asserted has not been defined as preference.[105] When a right is not defined as preference in the contract, the question becomes whether,

99. *Id.*
100. *Id.*
101. *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958, at *9 n.56 (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).
102. Savitt, *supra* note 5, at 78.
103. *Id.* at 78.
104. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
105. *See id.*

according to the general rule, the preferred stockholders cannot have the same right as common stockholders or whether they should share the right in question equally with the common.[106] After *Jedwab* is briefly overviewed, analysis will continue with regard to the rationale of *Jedwab*, focusing on what right, if any, is to be granted by directors to the preferred in a conflict with the common for the purpose of this article.

1. Abstract of the Jedwab Case

Jedwab was a class action suit brought by the plaintiff who was a preferred stockholder of MGM Grand, a Delaware corporation operating resort hotels.[107] The preferred class was created after the disastrous MGM Grand fire in Las Vegas.[108] The common stock fell in value, and MGM Grand offered to exchange common for a new class of preferred which had preference on dividends and liquidation, as well as certain redemption features.[109] The liquidation right was $20 a share.[110] The redemptions were to be at $20 a share, unless MGM Grand was able to purchase preferred shares privately or on the market for a lower price, which it did.[111] In any event, MGM common stockholders who exchanged their common for the new class of preferred likely did so thinking they would benefit financially from the exchange, given the dividend preference, the liquidation preference, and the redemptions available for the preferred. The defendant Kerkorian—who was the majority common and preferred stockholder of MGM Grand—was contemplating a merger with Bally Manufacturing.[112] Under the terms of the proposed merger, all classes of the MGM stock would be converted into cash and holders of those stocks would be cashed out.[113] The defendant, who was taking an active role in the negotiations, agreed to vote for the merger, which would guarantee the approval because the preferred stockholders had no voting rights on the merger.[114] Ultimately, after the merger of MGM Grand with Bally, the public common stockholders (that is, the common

106. *See generally id.*
107. *Id.* at 586–87.
108. *Id.* at 588.
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* at 587.
113. *Id.*
114. *Id.*

stockholders other than Mr. Kerkorian, who had a different deal), were to receive $18 a share,[115] whereas the preferred were to receive $14 a share.[116] Clearly, the preferred stockholders were angered because their exchange of common for preferred was turning out to be a bad deal under the terms of the proposed merger. During the process, the board did not ask for advice as to the fairness of the offer to the preferred from any legal counsel, financial advisors or from a special committee, which had been created to evaluate the fairness of an offer to the common.[117] Seeking to enjoin the proposed merger, the plaintiff brought the suit on behalf of all preferred stockholders and moved for a preliminary injunction.[118]

The issue in this case was whether the defendant, as a controlling shareholder, breached a fiduciary duty to the preferred by proceeding with a merger transaction whose terms would result in an allegedly unfair apportionment of merger proceeds between the common and the preferred.[119] The argument advanced by plaintiff was that, since the directors of a Delaware corporation owe a duty to approve a merger transaction only if such merger allocates the merger proceeds fairly among the classes of its stock, by not apportioning the merger consideration equally the directors breached their fiduciary duty.[120]

The Court started its analysis by clarifying that plaintiff's theory is premised upon the existence of a fiduciary duty on the part of the directors, which is recognized in equity and if such premise is to be established, it will require directors to treat shareholders fairly.[121] In this case, the method by which the merger consideration should be allocated among the two classes of stockholders was not contractually determined. Therefore, when it came to the merger consideration, there was no preference defined.[122] With respect to this, the court proposed that where the right asserted was not defined as a preference in the contract, it is shared equally between preferred and common stockholders and such right and ensuring duty of directors may be measured by equitable and legal standards.[123] Based on such reasoning, the court held

115. *Id.* at 590.
116. *Id.*
117. *Id.*
118. *Id.* at 587.
119. *Id.*
120. *Id.* at 591.
121. *Id.* at 593.
122. *Id.* at 596.
123. *Id.* at 594.

that the plaintiff's claim to a fair allocation of the merger consideration implicated fiduciary duties and therefore they should not be evaluated wholly from the contractual analysis.[124] The *Jedwab* court went on to explain that determining fiduciary duties were owed to the preferred was only the first step in the analysis.[125] The next step was to determine whether the business judgment rule or intrinsic fairness test should be applied.[126] The court determined that the more rigorous and burden shifting fairness test was appropriate under the circumstances.[127] Notwithstanding, the court concluded that the plaintiffs would not likely succeed on the merits, even under this test, as the allocation made was already a fair one.[128] However, fair allocation does not necessarily mean equal allocation.[129] The court determined such a proposition by holding that equitable right does not lead to mathematically equal consideration.[130] Consequently, although the preferred was allocated $14 per share when the common was apportioned $18 per share, the court held it was nonetheless a fair allocation.[131]

2. *Does the Director Owe a Fiduciary Duty to the Preferred?*

According to the *Jedwab* court, the first issue to be decided was whether the directors owe *any* duty to the preferred stockholders other than the duty with regard to the rights set forth for the preferred in the certificate.[132] The court pointed out that if a fiduciary duty that is recognized in equity on behalf of preferred stockholders exists, this is the premise upon which plaintiff's theory of liability depends.[133] If such equitable duty does exist, then the director and the controlling shareholders are required to treat all shareholders (common and preferred) fairly.[134] On the other hand, if there is no such duty owed to preferred stockholders, plaintiff cannot proceed with its theories of

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124. *Id.*
125. *See id.* at 593.
126. *Id.*
127. *Id.* at 584–85, 599–600.
128. *Id.* at 599–600.
129. *Id.* at 596–97.
130. *Id.* at 596.
131. *Id.* at 597.
132. *Id.* at 593.
133. *Id.*
134. *Id.* (citing Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)).

liability because the premise cannot be established.[135] "[A]nalogizing to the wholly contractual rights of bondholders—as to which no 'fiduciary' duties extend," the defendants argued that, due to the contractual nature of the preferred rights, the only duties directors have to preferred stockholders are those necessary to confer the preferred rights designated in their contract.[136] However, the court held that the preferred stockholder's claim to a fair allocation of the merger consideration implicated fiduciary duties and thereby it recognized, such premise being established, that the fiduciary duty should be owed to the preferred by directors.[137]

Professor Mitchell elaborated on the issue of whether the director owes a fiduciary duty to the preferred in great detail. According to him, fiduciary duty "is imposed in situations of significant power disparity, where one party is given responsibility and power over something that matters to another party and that vulnerable party is at the mercy of the power-holding party."[138] Professor Mitchell states that when the dominated party cedes power to the power-holder, the power-holder undertakes responsibilities as well as power.[139] Therefore, the power-holder accepts a limitation on their power and in so doing the dominated party is entitled to their fidelity.[140] The next question becomes whether the directors owe a fiduciary duty to the preferred and, if they do, what should be provided as a reason for the argument that fiduciary rights should be owed to the preferred.[141] Providing preferred stockholders' vulnerability as a ground for the protection, Professor Mitchell explains the characteristics of the preferred stock in conjunction with such vulnerability.[142] First of all, according to him, unlike bondholders, preferred stockholders have virtually no right to have their capital returned.[143] Corporations typically retain the option to exercise redemptions, liquidations rarely occur.[144] Thus, the capital of the preferred stockholders is put permanently at the sole discretion of the corporation's directors and thus is

135. *Id.*
136. *Id.*
137. *Id.* at 594.
138. Mitchell, *supra* note 14, at 457–58.
139. *Id.*
140. *Id.*
141. Fletcher Int'l., Ltd. v. ION Geophysical Corp., No. 5109-VCP, 2010 WL 2173838, at *7 (Del. Ch. May 28, 2010).
142. *See* Mitchell, *supra* note 14, at 461.
143. *Id.*
144. *Id.*

entirely vulnerable to their decisions.[145] Given the director's maximizing obligations to the common stockholders, it is hard to expect the protections for the preferred from them.[146] According to Professor Mitchell, this vulnerability provides grounds for a strong argument that meaningful fiduciary rights should be owed to the preferred.[147]

Professor Mitchell next examines whether the preferred stockholders' vulnerability could be ameliorated by the contract, concluding that it could not be ameliorated for several reasons.[148] The first reason advanced is that the preferred are not the ones who draft the contract, but the issuer and its underwriter draft it according to their own interests.[149] Second, when the contract is to be interpreted, the board stands in the "first line of interpretation."[150] The court's tendency to interpret the contract narrowly encourages the board to interpret the same way, which brings about the result that the preferred are put in such a vulnerable situation where their legitimate expectations will not be protected.[151] Along with such vulnerability, Professor Mitchell advances the status of the preferred as participants in the enterprise in support of his argument.[152] The preferred and the common stockholders are similar in terms of their status in a corporation because they are both participants in a corporation.[153] Therefore, he concludes that directors owe some meaningful fiduciary duties to the preferred.[154]

To the same effect, in *HB Korenvaes Investments, L.P. v. Marriott Corp.*, Chancellor Allen noted that "it has been recognized that directors may owe duties of loyalty and care to preferred stock" where a lack of contractual rights places "the holder of preferred stock [in an] exposed and vulnerable position *vis a vis* the board of directors . . . ."[155] Further, the holder of preferred stock is not one of the corporation's creditors, so has no recourse to those protections either.[156] The court additionally stated that "[s]uch a

145. *Id.*
146. *See id.*
147. *Id.* at 473.
148. *See id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *See id.* at 472.
153. *Id.*
154. *Id.*
155. HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *5 (Del. Ch. June 9, 1993).
156. *Id.*

holder has no legal right to annual payments of interest, as long term creditors will have, and most importantly [preferred stock] has no maturity date with its prospect of capital repayment or remedies for default."[157]

3. What Are the Rights of the Preferred?

As previously explained, the *Jedwab* court held that, "where . . . the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards."[158] Therefore, the *Jedwab* rule has two aspects; one aspect is that the preferred shares equally with the common when the right asserted is not a preference. The other aspect is that in that case, equitable as well as legal standards should be applied to determine the existence of such right and the scope of the duty. Then, the question would be what rights the preferred stockholder shares equally with the common. The *Jedwab* court held the point that:

> At common law and in the absence of an agreement to the contrary all shares of stock are equal. Thus preferences and limitations associated with preferred stock exist only by virtue of an express provision (contractual in nature) creating such rights or limitations. But absent negotiated provision conferring rights on preference stock, it does not follow that no right exists. The point may be conclusively demonstrated by two examples. If a certificate designating rights, preferences, etc. of special stock contains no provision dealing with voting rights or no provision creating rights upon liquidation, it is not the fact that such stock has no voting rights or no rights upon liquidation. Rather, in such circumstances, the preferred stock has the same voting rights as common stock.[159]

On its face, it looks like the preferred stockholder should have the exact same rights as the common stockholder with respect to rights that were not defined as preference. However, specifically what rights the preferred should

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157. *Id.*
158. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
159. *Id.* at 593–94 (citations and emphasis omitted).

have depends on what type of right is in question; whether the right is an occasional specific right, or whether it is the right to share in corporate wealth.

Where the right is an occasional specific right to be given to the preferred,[160] the preferred has the same right as the common. *Jedwab* depends on the proposition that "[a]t common law and in the absence of an agreement to the contrary all shares of stock are equal."[161] In *Jedwab*, the Chancellor cited voting rights and rights upon liquidation as two examples to support the court's opinion.[162] And, he stated, where the contract is silent, preferred stock get the same voting rights and the same rights to participate in the liquidation of the corporation as common stock.[163] Therefore, the preferred has simply the same rights as the common.[164] In contrast, if the right is one for both preferred and common stockholders to share in the corporate wealth, just because the preferred share the rights equally with the common does not necessarily mean that the preferred are entitled to the equal allocation of such corporate wealth with the common.[165] For example, in the event of allocation of merger consideration, as it was the case with the *Jedwab* case, the preferred are entitled to the fair allocation of the merger consideration, instead of equal allocation.[166] It is because, based on the court's proposition that "the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards,"[167] the court concluded that the plaintiff's claim to a fair allocation of merger consideration implicated fiduciary duties.[168]

Notably, in light of a fiduciary duty being owed to the preferred, Professor Brudney, citing the *Jedwab* decision, states that the argument for the fiduciary duty was based on the theory that, the preferred stock being a stock, preferred stockholders are the same as the common stockholders in a sense

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160. *See* Mitchell, *supra* note 14, at 471.
161. *Jedwab*, 509 A.2d at 593 (citing Shanghai Power Co. v. Del. Trust Co., 316 A.2d 589 (Del. Ch. 1974)). *See also* Stephen Bainbridge, Fiduciary Duties and Preferred Stockholders, http://www.professorbainbridge.com/professorbainbridgecom/2009/08/fiduciary-duties-and-preferred-stockholders.html (Aug. 26, 2009, 12:21 PDT).
162. *See Jedwab*, 509 A.2d at 593.
163. *Id.* at 593–94.
164. *Id.*
165. *See id.* at 596.
166. *See id.* at 596–97.
167. *Id.* at 594.
168. *Id.*

that they are owners of the corporation.[169] Therefore, management or controlling stockholders owe fiduciary obligations to preferred stockholders as well as to common stockholders.[170] At least in matters that were not defined in the contract, fiduciary duty on the part of management must be incurred to the preferred stockholders; therefore, they should allocate at least some of the economic interests to the preferred stockholders.[171] According to Professor Brudney, this leads to the suggestion in *Jedwab* that matters that are not dealt with by the preferred stock contract be treated as matters with regard to which the preferred stockholders enjoy "rights shared equally with the common."[172] Nevertheless, he points out that it is not clear whether the equality guarantees that the preferred stockholders will be entitled to the same consideration by the board which represents the common stockholders' interests when it proceeds with transactions that have redistributive effects between the common and the preferred.[173]

However, he goes on to say that the essence of the arrangements between preferred and common stock is that, while the preferred have priority of the asset entitlements to the common and their rights are limited to such priority, the common are allocated the residual interest and control.[174] Therefore, with the explicit provisions of the typical preferred stock contract allocating returns and voting power, the preferred stockholders will be put in a much closer position to the bondholders than that of owners.[175] Accordingly, he maintains, as it is the case with the bondholders, restricting the common stockholders' opportunistic behavior through provisions based on the traditional fiduciary notion is at odds with the parties' underlying agreement.[176]

C. Criticisms of the *Jedwab* Decision

The issue of whether directors should owe a fiduciary duty and what this duty entails to the preferred is a hot button topic within the legal community. As we have previously stated, the *Jedwab* court held that the directors owe a

169. Brudney, *supra* note 31, at 651.
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.* at 651–52.
175. *Id.* at 652.
176. *Id.*

fiduciary duty to the preferred stockholders and therefore they should be protected by the directors when it comes to the rights about which there was no preference defined in the contract.[177] In contrast, Professor Bainbridge criticizes the *Jedwab* decision, arguing that a fiduciary duty for the preferred should not be imposed upon directors.[178] Professor Bainbridge suggests that the *Jedwab* case should be overturned on several grounds.[179] He starts his argument by characterizing the preferred stock and the documents governing preferred stock. According to him, in contrast to bondholders who are creditors of the corporation, holders of the preferred stock are nominally shareholders.[180] Bainbridge added the fact that, while bond indentures tend to be long with highly detailed provisions, only the very basic affairs tend to be covered by the documents governing preferred stock.[181] It seems that his characterization of the preferred stock as nominal shareholders undermines the rationale of the *Jedwab* case, since preferred stock is stock, preferred stockholders, like common stockholders are owners of the enterprise.[182]

Further, Professor Bainbridge recognizes that *Jedwab* depends on the proposition that "[a]t common law and in the absence of an agreement to the contrary all shares of stock are equal."[183] Therefore, even in the absence of an agreement, preferred stock is conferred certain rights.[184] He points out that the Chancellor in *Jedwab* cited two such examples: where there are no provisions governing voting rights and rights upon liquidation and where preferred stocks get the same voting rights or the same rights to participate in a liquidation as the common.[185] Then, he concludes that neither of these examples represent the proper situation for fiduciary obligation to be invoked for preferred stockholders.[186] Moreover, he raises the objection that, from a policy perspective, fiduciary obligation does not give a solution to potential conflicts of interest between the holders of preferred and common.[187] Specifically, when it comes to the question of whose interests the board must

177. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593–94 (Del. Ch. 1986).
178. *See* Bainbridge, *supra* note 161.
179. *Id.*
180. *Id.*
181. *Id.*
182. *See* Brudney, *supra* note 31, at 651.
183. Jedwab, v. MGM Grand Hotels, Inc., 509 A.2d 584, 593 (Del. Ch. 1986) (citing Shanghai Power Co. v. Del. Trust Co., 316 A.2d 589 (Del. Ch. 1974)).
184. Bainbridge, *supra* note 161.
185. *Jedwab*, 509 A.2d at 593–94.
186. Bainbridge, *supra* note 161.
187. *Id.*

maximize when stockholders' interests diverge, the court holds that the common must be favored over the preferred, but it seems to be only when or with respect to which the preferred stockholders' preferences are defined in the contract.[188] In addition, he brings up the issue of fairness, the concept that is notoriously difficult to specify.[189] According to him, the *Jedwab* decision makes clear that the preferred are entitled only to a fair share in merger consideration, not an equal one.[190] However, there remains the issue of how the board decides what constitutes a fair share.[191] Even if the board makes a good faith effort to set a fair price, given the valuation is indeterminable by its nature, reasonable people could still differ with regard to the fair price.[192] He wraps up his objection by stating that *Jedwab* implies that greater rights may be granted to the preferred regarding nonpreference than with respect to preferences, which may bring about odd results.[193] Even though Professor Bainbridge states no reason as to why he comes to this conclusion, it might be because of the immeasurable nature of fairness that comes into play when dealing with stockholder rights in general. Furthermore, his result does seem odd because the contract did not define nonpreference aspects with regards to the nonpreference, as opposed to the fact that the contract clearly defined what the preference aspects were.

According to Professor Bainbridge, *Jedwab* sounds plausible, but proves unpersuasive if closely examined.[194] He bases his opinion on a number of Delaware Supreme Court cases, alleging that those cases suggest that all of the rights of preferred stockholders are contractual in nature and those rights that have a contractual nature are not related only to preferential rights.[195] He recognizes that in *RGC International Investors, LDC v. Greka Energy Corp.*, Vice Chancellor Strine characterized *Jedwab* as an exception to the general rule

188. *Id.*
189. Mitchell, *supra* note 14, at 475.
190. Bainbridge, *supra* note 161.
191. *See id.*
192. *Id.*
193. *Id.* (citing Gale v. Bershad, No. 15714, 1998 WL 118022 (Del. Ch. Mar. 4, 1998)). In *Gale*, Vice Chancellor Jacobs followed *Jedwab* by asking whether a preferred shareholder's right to a fair valuation is contractual or whether it is "created not by virtue of any preference" and is "shared equally with the Common." *Gale*, 1998 WL 118022 at *5.
194. Bainbridge, *supra* note 161.
195. *See, e.g.*, Judah v. Del. Trust Co., 378 A.2d 624, 628 (Del. 1977) ("Generally, the provisions of the certificate of incorporation govern the rights of preferred shareholders, the certificate . . . being interpreted in accordance with the law of contracts, with only those rights which are embodied in the certificate granted to preferred shareholders.").

"that the rights of preferred stockholders are largely governed by contract law and that corporate directors do not owe preferred stockholders the broad fiduciary duties belonging to common stockholders."[196] However, Professor Bainbridge would consider *Jedwab* as an aberrational violation of the general rule, not simply as a narrow exception to the general rule.[197]

D. Suggestions Concerning a Way to Protect Preferred Stockholders' Rights

First of all, Professor Mitchell suggests that the preferred stockholders should consider their contract as an exclusive source of their rights and that they should not consider themselves stockholders at all.[198] As an ultimate solution, he suggests that a law should be put in place providing that some duty should be imposed on corporate directors for preferred stockholders, which may not happen anytime soon.[199] Therefore, Professor Mitchell suggests, as an interim solution, a covenant that prevents the corporation from defeating the preferred stockholders' legitimate expectations.[200] In the situation where such provisions are used, those provisions would empower the preferred stockholder to block transactions designed to transfer their wealth gratuitously to common stockholders.[201] Due to such a covenant, the resulting effect would be the incorporation of the fiduciary notion into the preferred stock provisions of the certificate of incorporation.[202] However, Professor Mitchell concludes that the interim solution may not be perfect.[203] The reason for his concern is it may not give enough protection for the public preferred stockholders who most need fiduciary protection since they may not be given the opportunity to negotiate for such a provision.[204]

In stark contrast, Professor Bainbridge suggests that in the absence of a contract provision that covers the rights asserted by the preferred, as it is analogous to the bond setting, an implied covenant of good faith should be

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196. RGC Int'l Investors, LDC v. Greka Energy Corp., No. 17674, 2000 WL 1706728, at *16 (Del. Ch. Nov. 8, 2000).
197. *See* Bainbridge, *supra* note 161178.
198. Mitchell, *supra* note 14, at 444.
199. *Id.* at 476.
200. *Id.*
201. *Id.*
202. *Id.*
203. *See id.* at 477.
204. *See id.*

the solution, rather than fiduciary duties.[205] Professor Bainbridge points out that since bond indentures tend to be hundreds pages long, they cover almost all conceivable events.[206] In contrast, certificates of designation governing preferred stock tend to be relatively short only covering a few issues.[207] According to him, it raises the question of "how [to] deal with issues that come up that the contract does not cover[.]"[208] He maintains that using an implied covenant of good faith, instead of fiduciary duties, would be the solution, as it is used in bond setting.[209] With such a covenant, the preferred would be protected from the board who may try to deprive them of the benefit of their bargain.[210] And Bainbridge goes on to say that to the extent that even the covenant cannot provide protections, the preferred stockholders should protect themselves by diversifying portfolios.[211]

However, according to Professor Mitchell, the purpose of the good faith doctrine is limited to protect one party's legitimate expectations from the contract by preventing the other party in the contract from opportunistically taking advantage of the ambiguities of terms.[212] Contractual good faith has been recognized as a very narrow doctrine and its substance should be drawn from the explicit terms of contract itself.[213] Thus, this doctrine is applied only when "implied good faith terms [are] consistent with the explicit terms of the agreement itself and must further the parties' performance of that explicit agreement."[214] According to Professor Mitchell, one court made it clear that the doctrine is applied narrowly and with a very limited function: "'[w]here plaintiffs' contractual rights have not been violated, there can have been no breach of an implied covenant.'"[215] Thus, in order for the implied covenant of good faith doctrine to be applied, there must be an initial breach of contract.[216] Given that contractual good faith has been applied in the

205. Bainbridge, *supra* note 161.
206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*
211. *Id.*
212. Mitchell, *supra* note 14, at 456.
213. *See id.*
214. *Id.*
215. *Id.* (quoting Gardner & Florence Call Cowles Found. v. Empire Inc., 589 F. Supp. 669, 673 (S.D.N.Y. 1984), *vacated on other grounds*, 754 F.2d 478 (2d Cir. 1985)).
216. *Id.*

corporate finance context as a very narrow doctrine, invoking the doctrine of the covenant of good faith may not be helpful.

V. RECONCILIATION OF *TRADOS* WITH *JEDWAB*

In *In re FLS Holdings, Inc. Shareholders Litigation*, the Delaware Chancery Court discussed the issue of fair allocation of merger consideration, which was the same issue that the *Jedwab* case addressed.[217] The question before the court was whether the procedural protection for the preferred during the course of the allocation of the merger consideration existed to make such allocation fair.[218] In *LC Capital Master Fund, Ltd. v. James*, which was decided in 2010, the court addressed the issue of whether directors "owed the preferred a fiduciary duty to accord it more than it was contractually entitled to receive by right in a merger."[219] Further, the court examined whether the directors' distribution of more proceeds than preferred stockholders were guaranteed by the certificate would contradict its decision in *Equity-Linked Investors*, cited in the *Trados* opinion.[220] Also, in an effort to reconcile *Jedwab* and *FLS Holdings* with *Trados*, the court distinguished between the situation where *Jedwab* and *FLS Holdings* apply and the one in which *Trados* is applicable.[221] As a result, this case clarified the current standing of Delaware law with regard to preferred stockholder rights.

A. *In re FLS Holdings, Inc. Shareholders Litigation*

The *FLS Holdings* case discussed what mechanism employed satisfies the procedural protections or safeguards for the preferred stockholders so that the distribution of the merger consideration can be considered fair.[222] An order was sought under Chancery Court Rule 23 to approve the settlement and dismissal of some stockholder class action suits.[223] The class action was

217. *See In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
218. *See id.* at *1.
219. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 438 (Del Ch. 2010) (emphasis omitted).
220. *See id.* at 445–46.
221. *See id.* at 447.
222. *See In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *1 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
223. *Id.*

brought by the preferred stockholders of FLS Holdings.[224] The claim asserted on behalf of the preferred stockholders against the directors of FLS Holdings was that the merger proceeds negotiated with Kyoei was not fairly distributed between the preferred and common stockholders of FLS.[225] Only those directors who either owned large amounts of common stock, or were affiliates of Goldman Sachs and Citicorp, represented FLS Holdings in its negotiations with Kyoei.[226] There were no independent advisers, and no independent directors' committee was appointed to represent the interests of the preferred stockholders, which were in direct conflict with the common stockholders.[227] The preferred stockholders did not hold voting rights in the transaction or in the allocation.[228] Salomon Brothers, Inc.—which was hired by FLS to determine whether the merger agreement was fair—issued an opinion after the merger had been consummated, concluding that the distribution was fair to the preferred.[229]

The court recognized that "[i]n allocating the consideration of this merger, the directors, although they were elected by the common stock, owed fiduciary duties to both the preferred and common stockholders, and were obligated to treat the preferred fairly."[230] The court further stated that this somewhat opaque standard "may require a reviewing agency to make a highly specific inquiry of the company and the transaction," unless procedures are in place that are sufficient to give reasonable guarantees of fairness.[231] Therefore, the issue addressed by the court was whether the procedural protections or safeguards for the preferred stockholders were lacking and the allocation in the merger agreement was not fair.[232] The court recognized that, in order for the fair allocation to be warranted, there must be a mechanism employing a "truly independent agency" on the behalf of the preferred "before" the transaction was completed.[233] However, in this case, the court held that, "[o]nly the relatively weak procedural protection of an investment

224. *Id.*
225. *Id.*
226. *Id.* at *4.
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.* *See also* Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1062 (Del. Ch. 1987); Jedwab v. MGM Grand Hotels, 509 A.2d 584, 593–94 (Del. Ch. 1986).
231. *In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *4 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
232. *Id.*
233. *Id.* at *5.

banker's *ex post* opinion was available to support the position that the final allocation was fair."[234] The court held that anyone who seeks a court order to settle and dismiss claims of class members must abide by the burden to demonstrate that the anticipated settlement is a fair compromise and embodies ample compensation for the claims to be discharged.[235] Even though an opinion was issued by plaintiff's expert after the merger agreement had been signed concluding that the allocation was fair to the preferred, the court held that those opinions "would not substantially assist in satisfying defendants' burden of showing that the allocation was fair."[236] The court concluded that the supporters of the settlement had not reached their burden and there was a substantial issue that was reasonably litigable.[237] Accordingly, the court denied the defendants' motion.[238]

Therefore, in *FLS Holdings*, the court maintained that the early employment of a "truly independent agency" was crucial in determining whether allocation of merger proceeds was fair.[239] Therefore, if a "truly independent agency" is lacking or if the opinion as to the fairness of the distribution is issued "after" a transaction is completed, then the allocation will not be considered fair. Professor Bainbridge has criticized the *Jedwab* decision by stating that, even after the *Jedwab* decision, there remains the question of how the board should decide what is fair ex ante.[240] In this regard, *FLS Holdings* would give the preferred as well as the directors some guidance as to the matter that *Jedwab* did not clarify, which is how to demonstrate fair allocation.

B. *LC Capital Master Fund, Ltd. v. James*

In this 2010 case, the plaintiff was LC Capital Master Fund, Ltd., a preferred holder of QuadraMed which sought to enjoin the acquisition by defendant Francisco Partners of QuadraMed.[241] The plaintiff felt the consideration that was to be given to the preferred holders of QuadraMed did

234. *Id.*
235. *Id.* at *1. *See* Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1285–86 (Del. 1989).
236. *In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *5. (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
237. *Id.*
238. *Id.* at *6.
239. *Id.* at *5.
240. *See* Bainbridge, *supra* note 161.
241. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 438 (Del. Ch. 2010).

not surpass the "'as if converted' value the preferred were contractually entitled to demand in the event of a merger."[242] The "as if converted" value, which was based on a formula in the certificate of designation, gave the preferred stockholders "the bottom line right to convert into common at a specified ratio . . . and then receive the same consideration as the common in the [m]erger."[243] In order to value the preferred stock, the merging parties decided to "cash out the preferred stock at the price the preferred stockholders would receive if they exercise[d] their right to convert to common stock."[244] The QuadraMed board of directors created a special committee of independent directors to assess the various incoming bids.[245] Except for one member, who held over 650,000 shares of QuadraMed common stock, the special committee members owned a nominal amount of QuadraMed shares.[246] The court held that the special committee carefully considered the duties it owed to both the common and preferred stockholders when it made its decision.[247] The preferred stockholders sought to enjoin the merger arguing the directors breached fiduciary duty owed to them.[248]

The preferred stockholders' complaint was based on the theory that the directors owed a duty to distribute more merger proceeds to the preferred than the preferred could demand as an entitlement under the certificate.[249] Therefore, the issue was whether directors owed the preferred "a fiduciary duty to accord it more than it was contractually entitled to receive by right in a merger."[250] Another issue was whether the directors' allocation of more proceeds than preferred stockholders were guaranteed by the certificate would contradict with the *Equity-Linked Investors* rationale that was cited in the *Trados* case.[251]

The preferred stockholders argued that the directors would breach their fiduciary duty to them if more of the merger consideration was not allocated them.[252] This argument was made based on a certain contractual rights that

242. *Id.*
243. *Id.*
244. *Id.* at 439.
245. *Id.* at 442.
246. *Id.*
247. *Id.* at 443.
248. *Id.* at 438.
249. *Id.* at 450–51.
250. *Id.* at 438 (emphasis omitted).
251. *Id.* at 447.
252. *Id.* at 438.

the preferred had if a merger did not happen.[253] Based on this supposed breach of fiduciary duty, the preferred stockholders sought to enjoin the merger.[254] Believing that merger consideration given to them was not enough, the preferred asserted that the distribution of the merger consideration between the preferred and the common was unfair because the directors disbursed the merger consideration to the preferred on an "as if converted" basis.[255] The preferred believed it minimized the value of their stock.

The preferred stockholders, pointing to the decisions of the Delaware Chancery Court in *Jedwab* and in *FLS Holdings* "argue[d] that the QuadraMed board had the duty to make a 'fair' allocation of the Merger consideration between the common and preferred stockholders."[256] In order to warrant fairness in doing this, the preferred stockholders argued that the board was required to set up some type of negotiating agent, which would owe a duty and exercise discretion on behalf of the preferred stockholders during the course of the allocation process.[257] They argued that is more so in this case because, when the directors own common stock and do not own preferred stock, the fair balance between the interests of the preferred and their own interest is more problematic.[258]

By contrast, the defendants argued that the QuadraMed board released themselves from any fiduciary duty because it allocated the percentage of value equivalent to the preferred's "bottom line right, in the event of a merger, to convert and receive the same consideration as the common."[259] On the basis "that the preferred stockholders had no contractual right to impede, vote upon, or receive consideration higher than the common stockholders in the [m]erger," defendants argued "that the Board's decision to accord them the value that the preferred were entitled to contractually demand in the event of a merger cannot be seen as unfair."[260] Therefore, the defendants maintained that "because the QuadraMed Board honored all

253. *Id.*
254. *Id.*
255. *Id.* at 439.
256. *Id.* at 445. *See also* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986); *In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *4 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993).
257. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 445 (Del. Ch. 2010).
258. *Id.*
259. *Id.*
260. *Id.*

contractual rights belonging to the preferred, . . . it was the duty of the Board not to go further and bestow largesse on the preferred stock at the expense of the common stock."[261] In support of their argument, the defendants cited the proposition from *Trados* and *Equity-Linked Investors* that "it was the Board's duty, once it had ensured treatment of the preferred in accord with their contractual rights, to act in the best interests of the common."[262] Further, acknowledging that, because of the simple fact that directors own common stock and no preferred stock, under certain circumstances, directors might be found to be "interested" in a transaction.[263] But, the defendants argued this would not be that type of circumstance.[264] Since four of the "[s]pecial [c]ommittee members own very modest common stock stakes, this would reduce those [s]pecial [c]ommittee members' [m]erger take by, at most, several thousand dollars, an amount the preferred stockholders have done nothing to show is material to these directors."[265]

The court started its analysis by considering two cases cited by the plaintiff: the *FLS Holdings* and the *Jedwab* cases.[266] The court admitted that in *FLS Holdings*, Chancellor Allen stated that without any contractual provision, a mechanism employing a truly independent agency on behalf of the preferred is required in order for a fair allocation to be warranted in a conflict between the common and the preferred.[267] Also, the Court admitted that "in *Jedwab,* Chancellor Allen said that directors owe preferred stockholders a fiduciary duty to 'exercise appropriate care in negotiating [a] proposed merger' in order to ensure that preferred shareholders receive their 'fair allocation of the proceeds of [a] merger.'"[268]

By contrast *Trados*, one of the two cases cited by the defendant (another case being *Equity-Linked Investors*, which was cited in the *Trados* case),[269] stated that the rights and preferences of preferred stock are contractual in nature, and that, "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred

261. *Id.*
262. *Id.* at 445–46.
263. *Id.* at 446.
264. *Id.* at 446.
265. *Id.*
266. *Id.*
267. *Id.*
268. *Id.* (alterations in original) (quoting Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986)).
269. *Id.* at 445.

stockholders over those of the common stockholders."[270] After considering all of these cases, the court made a distinction between a situation where contractual terms were absent and one where contractual provisions existed.[271] Based on this distinction, the court recognized that, in *FLS Holdings* and *Jedwab*, there was no objective contractual basis upon which the board could allocate the merger proceeds between the preferred and the common. However, in this case, there existed one: the conversion mechanism.[272] Therefore, the court recognized that this case was different from *FLS Holdings* and the *Jedwab* because, unlike both cases, here there was an objective contractual basis for treatment of the preferred.

At this point, the court investigated whether the decisions by Chancellor Allen, who authored both *Jedwab* and *Equity-Linked Investors*, were contradictory to *Trados*.[273] Answering the question by stating that they were not inconsistent when Chancellor Allen's opinion in *HB Korenvaes Investments, L.P. v. Marriott Corp* is considered, the court further examined *Korenvaes* case. In that case, "a board took very aggressive action that was, objectively speaking, adverse to the interest of the preferred."[274] The board of Marriott "agreed to a transaction that issued a large special dividend . . . to the common stock and indefinitely suspended dividends on the preferred stock."[275] The preferred stockholders then sought to enjoin the payment of the special dividend, arguing that Marriott's directors "breached their fiduciary duties to the preferred stockholders by agreeing to the transaction."[276] Rejecting that argument, Chancellor Allen held that even if the board had acted in order to benefit the common by taking extremely aggressive action that was adverse to the interests of the preferred, it did not constitute breach of the duty of loyalty.[277]

The court went on to state the analysis of Chancellor Allen in *Korenvaes* decision.[278] Chancellor Allen manifested the contractual nature of the preferred right by stating that "[r]ights of preferred stock are primarily but not

270. *Id.* at 447.
271. *Id.* at 449.
272. *Id.* at 446–47.
273. *Id.* at 447.
274. *Id.*
275. *Id.*
276. *Id.*
277. *Id.*
278. *Id.*

exclusively contractual in nature."[279] Then, he ascertained that "'it has been recognized that directors may owe duties of loyalty and care to preferred stock' where a lack of contractual rights renders 'the holder of preferred stock [in an] exposed and vulnerable position vis-à-vis the board of directors.'"[280] According to him, "the question whether duties of loyalties are implicated by corporate action affecting preferred stock" is a question to which the answer depends on the particularities of context.[281] Chancellor Allen then pointed out that "the fact that the certificate of designation considered the possibility of an in-kind dividend and gave the preferred certain rights in that context was dispositive of whether there was any fiduciary duty claim."[282] Therefore, Chancellor Allen recognized that if the preferred rights were articulated in the contract in a specific context, then the preferred did not have a fiduciary duty claim. And, he went on to state:

> Most important . . . is the fact that the certificate of designation expressly contemplates the payment of a special dividend of the type here involved and supplies a device to protect the preferred stockholders in the event such a dividend is paid . . . . [Therefore,] the legal obligation of the corporation to the Series A Preferred Stock upon the declaration and payment of an in-kind dividend of securities has been expressly treated and rights created.[283]

Consequently, Chancellor Allen acknowledged that when the preferred right was expressly contemplated in the contract, the legal duties on the part of the directors are limited to such extent and therefore the preferred cannot bring a fiduciary duty claim. Therefore, the Chancery court determined the reasoning of Chancellor Allen in *Korenvaes* reconciles the doctrine.[284]

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279. *Id.* (quoting HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *5 (Del. Ch. June 9, 1993)).
280. *Id.* at 448 (alteration in original) (quoting HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *5 (Del. Ch. June 9, 1993)).
281. *Id.* (quoting HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *6 (Del. Ch. June 9, 1993)).
282. *Id.* (citing HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *7 (Del. Ch. June 9, 1993)).
283. *Id.* (alterations in original) (quoting HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *7 (Del. Ch. June 9, 1993)).
284. *Id.*

In support of the conclusion that the Chancellor Allen's *Jedwab* opinion is not inconsistent with *Trados*, the court presented the following proposition and thereby reconciled the situation where *Trados* applies with the one where *Jedwab* and *FLS Holdings* apply.

> When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common. When, however, as in *Jedwab* and *FLS Holdings*, there is no objective contractual basis for treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.[285]

The first half of the proposition ascertained the general rule by stating that, because the rights of the preferred, if articulated by contract, are essentially contractual, the preferred are limited to those rights. Since the directors owe fiduciary duties to the preferred only to the extent that the preferred rights are defined in the contract, the directors do not need to extend preferred rights. Then, the question becomes what result will ensue if directors do go further and extend the preferred rights at the expense of the common anyway. This was the issue the *Trados* court addressed and, in brief, the court recognized that directors should not go further by extending the preferred rights at the expense of the common, unless the directors can prove the entire fairness of the transaction favoring the preferred over the common.[286] Therefore, *Trados* is consistent in this regard with *Korenvaes*, which held that the preferred could not bring a fiduciary duty claim if the preferred right was articulated in the contract. It is because, in both cases, the court did not allow the preferred either to pursue or to be accorded by directors "more than it was contractually entitled to receive by right."[287] Consequently, the court ascertained that both *Trados* and *Korenvaes* are

285. *Id.* at 448–49.
286. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *9 n.56 (Del. Ch. July 24, 2009).
287. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 438 (Del. Ch. 2010).

applicable to the situation where there is a provision governing preferred rights in the contract.

In contrast, as the second half of the proposition, the court acknowledged that, as in the *Jedwab* and *FLS Holdings*, where there is no provision governing the preferred rights, the director, acting as an agent, owes a fiduciary duty to the preferred and should treat the preferred fairly to fill the gap in light of the terms of the contract.

Consequently, by contrasting *Trados* with *Jedwab*, the court differentiated the situation where *Trados* applies from the one where *Jedwab* applies. Essentially, in order for there to be a contradiction, two rationales must be applicable to the same situation. But, here, the court recognized that the rationales of *Trados* and *Jedwab* were not. Rather, those two rationales apply to completely different situations; *Trados* applies when there exist provisions governing the preferred rights, whereas the *Jedwab* applies when such provisions do not exist. Therefore, the court concluded that *Trados* and *Jedwab* do not conflict with each other.

After acknowledging that *Jedwab* and *Trados* are not inconsistent, the court concluded that the situation in question is closer to *Korenvaes*, which falls within the general rule category, than it is to *Jedwab*.[288] That is because, based on the distinction previously made by the court, in this case, unlike in *Jedwab* and *FLS Holdings*, there was an objective contractual basis for treatment of the preferred.[289] And, on such basis, the preferred have right to receive the same consideration they would have received if they had converted their shares according to the formula in the certificate.[290]

Further, the court examined whether the directors' allocation of additional value to the preferred would contradict with reasoning in *Equity-Linked Investors*, which was cited in the *Trados* case.[291] The court recognized that, since the preferred rights were articulated plainly and their rights were limited to them, the directors owed no duty to the preferred to go further and allocate additional value to the preferred. It went on to say that, if directors go further, it would be inconsistent with Chancellor Allen's reasoning in *Equity-Linked Investors*:

288. *Id.* at 449.
289. *Id.*
290. *Id.*
291. *Id.*

> While the board in these circumstances could have made a different business judgment, . . . it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But . . . generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock as the good faith judgment of the board sees them to be to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict.[292]

Therefore, it can be inferred that if directors go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common, under the *Trados* rationale, "it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders."[293]

In conclusion, recognizing that the certificate of designations in question "does provide the preferred with a contractual right to certain treatment in a merger," the court held that "a board of directors that allocates consideration in a manner fully consistent with the bottom-line contractual rights of the preferred need not . . . do more."[294] Therefore, the court held that the directors acted equitably toward the preferred because they treated the preferred entirely consistently with the conversion formula the preferred bargained for in the certificate.[295] Consequently, the court recognized that the directors did not owe the preferred a fiduciary duty to accord it more than it was contractually entitled to receive by right in a merger.[296] Rather, the court determined that the directors have a duty to prefer the interests of the common where there is a conflict.[297] Therefore, the court held that the preferred had not established a reasonable probability of success on the

292. *Id.* at 449 (citing Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch.1997)).
293. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009).
294. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 438 (Del. Ch. 2010).
295. *Id.* at 438–39.
296. *See id.* at 449.
297. *Id.* at 449 (citing Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch.1997)).

merits of their fiduciary duty claim; thus, their preliminary injunction was denied.[298]

Notably, the court delineated a gap-filling duty that is recognized when there is "no objective contractual basis for treatment of the preferred," as in *Jedwab* and *FLS Holdings*.[299] The court acknowledged that, under the DGCL, directors may have gap-filling duties in the event that there is not an objective basis to apportion consideration between the preferred and common in a merger event.[300] Also, the court stated that without an objective contractual basis, the only protection for the preferred is for the directors to find a way to fairly fill the gap left by incomplete terms of the contract, as they are fiduciaries who sold their shares to the preferred.[301] Otherwise, the preferred would be entirely vulnerable and subject to arbitrary treatment in a merger situation.[302] Therefore, the court held that "when, . . . as in *Jedwab* and *FLS Holdings*, there is no objective contractual basis for treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred."[303]

VI. DELAWARE'S STRICT CONSTRUCTION OF PREFERENCE RIGHTS

The general rule manifests that the rights of preferred stock are essentially contractual and the scope of the correlative duty on the part of the directors is determined by the specific words in the contract.[304] Therefore, the general rule implicitly instructs the preferred to have their rights articulated in the contract in order to protect them.

"[P]referred shareholder[] rights are defined in either the corporation's certificate of incorporation or in the certificate of designation, which acts as an amendment to a certificate of incorporation."[305] Since the rights of preferred shareholders are primarily contractual in nature, the "'construction of preferred stock provisions are matters of contract interpretation for the courts.'"[306] In that regard, Professor Mitchell stated that the courts rendered

298. *Id.* at 439.
299. *Id.* at 449.
300. *Id.* at 449.
301. *Id.* at 447.
302. *Id.*
303. *Id.* at 449.
304. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
305. *In re* Appraisal of Metromedia Int'l Group, Inc., 971 A.2d 893, 899 (Del. Ch. 2009).
306. *Id.* (quoting Matulich v. Aegis Commc'ns Group, Inc., 942 A.2d 596, 600 (Del. 2008)).

decisions in a manner where it was indisputably clear that the preferred stock contract is construed literally, or at least rather narrowly.[307] The following cases demonstrate the tendency of Delaware courts toward strict construction when it comes to the interpretation of the preferred stock contract.

A. *In re Sunstates Corp. Shareholder Litigation*

In *In re Sunstates Corp. Shareholder Litigation*, the Delaware Court of Chancery held, in applying principles of contract interpretation, that the rights of a preferred stockholder as set forth in the certificate must be construed strictly.[308] The court recognized that, in certain circumstances, the strict construction of the terms may permit the directors to avoid a restriction through the agency of its subsidiaries.[309] Although such literal interpretation would cause the protective provision of the charter to be rendered "nugatory and illusory," strict construction controls.[310]

In *Sunstates*, one of the corporation's preferred stockholders brought a class action suit based on the claim that Sunstates violated its certificate of incorporation by repurchasing shares when it was in arrears on the preferred stock dividend.[311] The defendants moved for summary judgment on this claim, arguing that the special limitation in the charter should not apply because Sunstates, itself, made no share repurchases.[312] Rather, one or more of Sunstates' subsidiary corporations were responsible for purchasing all reacquired shares.[313] As the Sunstates certificate does not specify that repurchases by subsidiaries are to be prohibited when the parent is in arrears on its preferred stock dividend, Sunstates argued it was entitled to judgment in their favor as a matter of law.[314] Therefore, the issue was whether a subsidiary can properly repurchase shares when the charter merely stipulates that the defendant-parent company cannot purchase shares when it is in arrears on the preferred stock dividend.[315] In response to Sunstates'

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307. Mitchell, *supra* note 14, at 453 (citing HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *5 (Del. Ch. June 9, 1993); Rothschild Int'l Corp. v. Liggett Group Inc., 463 A.2d 642, 646 (Del. Ch. 1983), *aff'd* 474 A.2d 133 (Del. 1984)).
308. *In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 533 (Del. Ch. 2001).
309. *Id.* at 531–32.
310. *Id.* at 531.
311. *Id.*
312. *Id.*
313. *Id.*
314. *Id.*
315. *See id.*

argument, the preferred stockholders argued that because the subsidiary corporations acted as mere agents for the parent company when they purchased the shares, their acts should be treated as those of the parent company.[316] The preferred stockholders also argued that Sunstates violated its implied covenant of good faith and fair dealing.[317]

Relying on principles of corporate law, the court rejected the stockholders' agency theory.[318] Specifically, "the act of one corporation is not regarded as the act of another merely because the first corporation is a subsidiary of the other, or because the two may be treated as part of a single economic enterprise for some other purpose."[319] The court reasoned that the law imposes a higher standard for in order to pierce the corporate veil based on an agency or "alter ego" theory, the only purpose of the corporation, the corporation being a sham, must be to commit a fraud.[320]

Additionally, the court failed to find a breach of the implied covenant of good faith and fair dealing.[321] The court recognized that "the duty [arising from the implied covenant] arises *only* where it is clear from what the parties expressly agreed, that they would have proscribed the challenged conduct as a breach of contract," emphasizing that the duty can only be relied on to find a breach of contract in a narrow range of circumstances.[322] In this case, the court found the parties expressly agreed, as evidenced by the certification of incorporation, to the prohibition against share repurchases only by Sunstates.[323] Therefore, the court concluded there is no "reasonable basis to infer that 'the parties would have proscribed' share purchases by Sunstates's subsidiaries 'had they thought to negotiate with respect to the matter.'"[324]

Further, the court recognized that, under Delaware law, "special rights or preferences of preferred stock must be expressed clearly and that nothing will be presumed in their favor."[325] Accordingly, there was no basis to infer that parties negotiating the terms of the certificate of incorporation could have

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316. *Id.* at 534.
317. *Id.*
318. *Id.*
319. *Id.*
320. *Id.* (citing Wallace v. Wood, 752 A.2d 1175, 1184 (Del. Ch. 1999).
321. *Id.* at 534–35.
322. *Id.* at 535 (alteration in original) (quoting Greytak Enters. , Inc. v. Mazda Motors of America, Inc., 622 A.2d 14, 22–23 (Del. Ch. 1992), *aff'd*, 609 A.2d 668 (Del. 1992)).
323. *Id.*
324. *Id.*
325. *Id.* *See also* Rothschild Int'l Corp. v. Liggett Group, Inc., 474 A.2d 133, 136 (Del. 1984) ("Stock preferences must also be clearly expressed and will not be presumed.").

reasonably believed that the limitation of share repurchases would prohibit the repurchase by any party other than the parent corporation.[326] The *Sunstates* court held that it is more reasonable to infer that negotiating parties to the certificate of incorporation knew and understood the scope of the limitations of the provision.[327] Under Section 151(a) of the DGCL, Delaware corporations can "issue stock having such 'special rights, and qualifications, limitations or restrictions' relating thereto 'as shall be stated and expressed in the certificate of incorporation or of any amendment thereto . . . .'"[328] Therefore, the court recognized that under Delaware law, the special limitations must be expressed clearly in the certificate.[329] Construing the clause at issue strictly and recognizing that "nothing should be presumed in [its] favor," the court concluded that the clause at issue clearly and unambiguously applies the special limitation against share repurchases only to Sunstates and not to its subsidiary entities.[330] The court noted that nothing prevented the certificate from prohibiting share repurchase from one of Sunstates' subsidiary corporations, but "[i]f the special limitation had been meant to apply to the actions of Sunstates' subsidiaries, the certificate of incorporation could easily have said so."[331]

B. *Matulich v. Aegis Communications Group*

In 2008, the Supreme Court of Delaware delineated the process for properly constructing certificates of designation, and the preferred rights set forth therein.[332] This appeal, brought by a former common stockholder of Aegis, Carlo Matulich, arose from the "Court of Chancery's interpretation of a Certificate of Designation, which delineates the rights, preferences, limitations and restrictions of the Series B [p]referred [s]tock."[333]

The relevant facts are as follows: In 2006, World Focus made the decision to take Aegis private by completing a short-form merger.[334] When the merger was taking place, Aegis had two classes of stock that were

326. *In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 535 (Del. Ch. 2001).
327. *Id.*
328. *Id.* at 533. *See also* DEL. CODE ANN. tit. 8, § 151(a) (2009).
329. *See In re Sunstates*, 788 A.2d at 533.
330. *Id.* at 531 (quoting Waggoner v. Laster, 581 A.2d 1127, 1134 (Del. 1990)).
331. *Id.* at 532.
332. Matulich v. Aegis Commc'ns Group, 942 A.2d 596, 600–01 (Del. 2008).
333. *Id.* at 598.
334. *Id.*

outstanding, common stock and Series B preferred stock.[335] World Focus held approximately 94.84% of the Aegis outstanding common stock.[336] All but 29,778 shares of Series B preferred stock were converted into common stock in the mid-1990s.[337] While the outstanding shares were recorded as being in the hands of a single entity, all attempts to find the present holder of the Series B preferred stock were unsuccessful.[338] Because the Series B preferred stock had a right to approve any merger and the identity of the holder of the Series B preferred stock was a mystery, equitable relief would be required to complete the merger.[339] Hence, World Focus filed a petition for equitable relief in the Delaware Chancery Court.[340] The petition sought a declaration that the holder of the Series B preferred stock had approved and consented to the merger, in case the holder of the outstanding Series B preferred stock was not discovered after notice was published.[341] The Chancery Court ordered World Focus to place notices in two European newspapers to attempt to notify the holder.[342] World Focus abided by that order, but the holder of the Series B preferred stock did not surface.[343] The Chancery Court then entered a final order deeming the holder of the Series B preferred stock to have approved of the merger.[344] World Focus then immediately consummated a short-form merger.[345]

After the merger was completed and the time period to seek appraisal had ended, Matulich filed a complaint with the Chancery Court.[346] He owned no Series B stock, but was a former minority holder of common stock who was angry with short-form merger consideration.[347] Matulich argued that the Series B preferred stock, due to its right or approval and consent, had a statutory right to vote on any merger.[348] The Chancery Court nevertheless rejected Matulich's argument, holding instead that any statutory right to vote

335. *Id.*
336. *Id.*
337. *Id.*
338. *Id.*
339. *Id.*
340. *Id.*
341. *Id.*
342. *Id.*
343. *Id.*
344. *Id.*
345. *Id.*
346. *Id.*
347. *Id.* at 598–99.
348. Such a right would foreclose World Focus' ability to perform a short-form merger, as it owed less than the statutorily required proportion of series b shares. *Id.* at 599.

on mergers was unambiguously denied to the holder of the Series B preferred stock by the certificate of designation.[349] The court further held that while the stockholders of the Series B preferred stock did not have the *statutory* right to vote on any sort of merger, they did possess a *contractual* right to approve of and consent to mergers.[350] Consequently, Matulich's complaint was dismissed for failure to state a claim.[351] On appeal, the issue was whether the contract term is ambiguous when the statutory right to vote on the merger was clearly denied in the certificate of designation simply because one party in litigation construes its meaning differently than the other party, alleging "the provisions of the Certificate of Designation providing a contractual right of 'approval and consent' is *legally synonymous* with the statutory right to 'vote' provided for in the DGCL."[352]

The Delaware Supreme Court articulated that the starting point in interpreting any contract is to figure out whether a provision is ambiguous.[353] The court recognized contractual language "is not rendered ambiguous simply because the parties in litigation differ concerning its meaning."[354] A contract provision is ambiguous "only when the provisions in controversy are *reasonably* or fairly susceptible of different interpretations or may have two or more different meanings."[355] If the term is not ambiguous, a court "must give effect to the clear language" of the certificate of designation.[356]

With respect to mergers, the only rights given to the stockholders of the Series B stock were the rights of approval and consent.[357] Matulich argued that the provisions of the certificate governing a contractual right of "approval and consent" were legally synonymous with the statutory right to "vote" provided for in the DGCL.[358] The Delaware Supreme Court held that "[s]ection b in the Certificate of Designation expressly recognizes that the *statutory* right to vote being denied is different and distinct from the *contractual*

349. *Id.*
350. *Id.* at 598.
351. *Id.* at 599.
352. *Id.* at 601 (emphasis added).
353. *Id.* at 600.
354. *Id.* (quoting City Investing Co. Liquidating Trust v. Cont'l Cas. Co., 624 A.2d 1191, 1198 (Del. 1993)).
355. *Id.* (quoting Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co., 616 A.2d 1192, 1196 (Del. 1992)).
356. *Id.* (quoting Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392, 395 (Del. 1996)).
357. *Id.* at 601.
358. *Id.*

consent and approval right that was conferred in section (A)(vi)."[359] Series B holders were not granted a statutory voting right on mergers; however, they were afforded with a contractual "blocking" right to stop mergers if they declined to give their consent and approval.[360] The court reaffirmed its strict construction of the terms by stating that "[a]ny rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated, as provided by statute. Therefore, these rights, preferences and limitations will not be presumed or implied."[361]

Agreeing with the Court of Chancery, the Delaware Supreme Court held that the certificate of designation expressly limits the rights of the stockholders of Series B stock by specifically refusing them any statutory voting right, but conceding those preferred holders a contractual right of consent and approval prior to the completion of any merger.[362] The court recognized that, contrary to the Matulich's argument, the contractual "blocking" right that was conferred and the statutory voting rights that were withheld are different and therefore not "legally synonymous."[363] Even if the preferred holders articulated their contractual right to consent and approve a merger by voting, an exercise of that contractual right in a voting is legally distinctive "from the statutory right to vote on the merger that was denied."[364] Therefore, the court held that the language of certificate of designation was not ambiguous.[365] The preferred shares possessed no statutory right to vote on mergers, but they held a contractual right to approve and consent.[366] However, the court concluded that the contractual right to consent and approve is not equivalent to a statutory voting right on the merger. Therefore, the Chancery Court correctly held that, since the contractual right to consent and approve is not equivalent of a statutory right to vote on the merger, the contractual rights of the Series B preferred holders were immaterial "in calculating whether World Focus had the statutory voting power necessary to execute a short-form merger."[367]

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359. *Id.*
360. *Id.*
361. *Id.* (quoting Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 852–53 (Del. 1998)).
362. *Id.* at 602.
363. *Id.* at 601–02.
364. *Id.* at 602.
365. *Id.*
366. *Id.*
367. *Id.*

C. *In re Appraisal of Metromedia International Group, Inc.*

The 2009 case of *In re Appraisal of Metromedia International Group, Inc.* involves an appraisal of preferred stock in a merger situation where the preferred shares are converted into common shares under the certificate of designation.[368] This suit was brought by the preferred shareholders, who sought "to extract additional value for their shares through the appraisal process even though it exceeded what the certificate defines as their right in the event of a merger or similar transaction."[369] This litigation arose from the merger of CaucusCom Mergerco Corp. a subsidiary of CaucusCom Ventures, L.P. with Metromedia International Group (MIG), in which MIG was the surviving corporation.[370] During the tender offer period, CaucusCom Mergerco Corp. purchased approximately 77.6% of MIG's outstanding common shares, making CaucusCom Ventures, L.P., the controlling shareholder of MIG.[371] As provided in the merger agreement, the preferred stockholders of MIG attained "the right to seek appraisal in accordance with their rights as defined in the certificate of designation."[372]

The dispute arose with regard to the construction of three provisions of the certificate of designation relating to the value to which preferred stockholders are entitled in the event of a merger, Sections 8 (a), (b) and (g).[373] Section 8(a) states that each possessor of preferred stock shall have the right, at its option, at any moment "from the [i]ssue [d]ate to convert, *subject to the terms and provisions of this Section 8,* any or all of such holder's shares of [p]referred [s]tock."[374] The rights granted in Section 8(a) are, however, subject to section 8(g), which establishes the value to be paid to preferred stockholders upon the occurrence of certain events.[375] Section 8(g) is triggered by a merger and provides that the preferred shares, without the consent of their holder, are valued as if they had been converted immediately prior to the merger.[376] Section 8(g) functions "as a non-consensual conversion provision, treating the preferred on a merger event as though they

368. *In re* Appraisal of Metromedia Int'l Group, Inc., 971 A.2d 893, 896 (Del. Ch. 2009).
369. *Id.* at 902 n.25.
370. *Id.* at 895–96.
371. *Id.* at 898.
372. *Id.* at 899.
373. *Id.* at 901.
374. *See id.* at 901–04.
375. *Id.*
376. *Id.*

have converted."[377] If a merger occurs, the preferred stockholders must agree to a conversion into common stock, which is calculated pursuant to the certificate's formula in Section 8(a).[378]

MIG asserted that the maximum value of the preferred stockholder shares is "based on the preferred's being converted into common shares under the certificate of designation."[379] Pursuant to MIG's assertions, the certificate of designation forced limitations on the $18.07 per preferred share consideration that preferred stockholders would obtain upon conversion.[380] Alternatively, petitioners relied on "three different valuation approaches, which yield a range of values from $67.50 per share to $79.76 per share."[381] Therefore, the most significant question in this appraisal action was whether the certificate of designation contractually sets up the metric for valuing the preferred stockholder shares if a merger takes place.[382] The court held that it did, which caused many of the underlying disputes among the testifying experts over the competing valuation models to be effectively rendered irrelevant.[383] Basically, the issue before the court was whether the preferred stockholders can "seek to extract additional value for their shares through the appraisal process even though it exceeds what the certificate defines as their right in the event of a merger or similar transaction."[384]

Chancellor Allen analyzed the rights bestowed upon preferred holders by the certificate of designation because "[t]o the extent it possesses any special rights or powers and to the extent it is restricted or limited in any way, the relation between the holder of the preferred and the corporation is contractual."[385] When determining the fair value of preferred stock, the court must first analyze the contract from which the preferred stock's derives its value.[386] Basically, "the valuation of preferred stock must be viewed through the defining lens of its certificate of designation, unless the certificate is ambiguous or conflicts with positive law."[387] The court first addressed the

377. *Id.* at 903.
378. *Id.*
379. *Id.* at 896.
380. *Id.*
381. *Id.*
382. *Id.* at 900.
383. *Id.*
384. *Id.* at 902 n.25.
385. *Id.* at 900 (alteration in original) (quoting *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 977 (Del. Ch. 1997)).
386. *Id.*
387. *Id.*

validity of the contract, noting that under Delaware law, "a valid contract will be enforced unless the contract violates public policy or positive law, or unless a party's non-performance is excused."[388] The court held that because of the contractual nature of preferred stock, a clear contractual provision that sets forth the value of preferred stock if a cash-out merger occurs does not conflict with section 262 of the DGCL.[389]

Then the court analyzed whether the contract was ambiguous.[390] The court held that "preferred shares are entitled to the value determined under the terms of their constitutive contract—unless ambiguity in the contract compels the Court to employ alternative valuation constructs to determine fair value."[391] No ambiguity existed concerning the value to be paid to the preferred stockholders in the event they are made to have their shares converted when a merger occurs.[392] As a result, the court held that MIG's certificate of designation clearly and unambiguously defined the value preferred stockholders are entitled to when a merger takes place.[393] The rights of preferred stockholders were clearly defined and they were provided with "fair value" to which they were legally entitled.[394] Therefore, the court concluded that since the rights of preferred shareholders in the event of a merger are clearly stated in the certificate of designation, those shareholders cannot bring a suit "seeking additional consideration in the merger through the appraisal process" by insisting that there are alternative value-adding provisions in the certificate of designation.[395]

D. *Elliott Associates, L.P. v. Avatex Corporation*

According to Professor Oesterle, the Delaware Supreme Court performed damage control in *Elliott Associates, L.P. v. Avatex Corp.* in order to reassure those surprised by their strict construction of boilerplate language.[396]

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388. *Id.* (citing *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 977 (Del. Ch. 1997)).
389. *Id. See also* DEL. CODE ANN. tit. 8, § 262 (2009).
390. *See In re* Appraisal of Metromedia Int'l Group, Inc., 971 A.2d 893, 901–02 (Del. Ch. 2009).
391. *Id.* at 902 n.25 (citing *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 975 (Del. Ch. 1997)).
392. *Id.*
393. *Id.* at 901.
394. *Id.* at 902–03 n.25.
395. *Id.* at 907.
396. Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843 (Del. 1998). *See* DALE ARTHUR

Commentators have noted that *Avatex* is different from the court's other cases that demonstrate the court's tendency for strict construction because the *Avatex* court considered the intentions of the drafters, even though it made it apparent that the rights of preferred must be expressly stated and "will not be presumed or implied."[397]

Plaintiffs in this case were preferred holders of defendant Avatex Corporation.[398] Avatex incorporated Xetava Corporation as its wholly owned subsidiary and the following day announced it would merge itself into Xetava, with Xetava becoming the surviving corporation.[399] Immediately after the transaction was completed, Xetava would change its name to Avatex.[400] According to the proposed merger, the preferred stock of Avatex would be converted into common stock of Xetava.[401] Since the conversion would eliminate Avatex's certification of incorporation, which provided rights and preferences for the Avatex preferred stockholders, plaintiffs brought suit in the Chancery Court to enjoin the merger.[402] They argued that in order for the transaction to get started, there must be consent of two-thirds of the holders of the first series preferred stock.[403] Granting the defendant's motion for judgment on the pleadings, the Chancery Court found that the provisions in question did not require any consent.[404] The stockholders then appealed this ruling.[405] The text of the terms governing the voting right of the first series preferred stock was set forth in the certificate of designations and states as follows:

> Except as expressly provided hereinafter in this [s]ection (6) or as otherwise . . . required by law, the First Series Preferred Stock shall have no voting rights. . . . So long as any shares of First Series Preferred Stock remain outstanding, the consent of the holders of at least two-thirds of the shares of the First Series Preferred Stock outstanding at the time (voting separately as a

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OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 89 (Thompson West 3d ed. 2005).

397. *Elliott Assocs., L.P.*, 715 A.2d at 852–53 (citing Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984); Waggoner v. Laster, 581 A.2d 1127, 1134–35 (Del. 1990)).

398. *Id.* at 844.

399. *Id.*

400. *Id.*

401. *Id.*

402. *Id.* at 844–45.

403. *Id.*

404. *Id.*

405. *See id.* at 845.

> class . . .) . . . shall be necessary to permit, effect or validate any one or more of the following:
>
> . . .
>
> (b) The amendment, altercation or repeal, whether by merger, consolidation or otherwise, of any of the provisions of the Restated Certificate of Incorporation or of [the certificate of designations] which would materially and adversely affect any right, preference, privilege or voting power of the First Series Preferred Stock or of the holders thereof . . . .[406]

The court recognized that under Delaware law, corporations are permitted to create and issue stock denying voting rights.[407] The Avatex certificate of incorporation provided that, with the exception of matters set forth in the certificate or required by law, Avatex preferred shares had no right to vote.[408] One such exception applies in the situation where any "amendment, altercation or repeal" of the certificate "whether by merger, consolidation or otherwise . . . [would] materially and adversely" affect the rights of the preferred stockholders.[409] In such event, there must be consent of two-thirds of the preferred holders voting as a class.[410]

Under the certificate, the requirements for the events triggering voting rights would be divided into three parts: (1) whether the events amount to "amendment, alteration or repeal" of the certificate of incorporation, (2) whether the "amendment, alteration or appeal" of the certificate of incorporation was effected "by merger, consolidation or otherwise," and (3) whether such events would "materially and adversely affect the rights of the [preferred] stockholders."[411] In light of the first requirement, the Court ascertained that the terms of the proposed merger showed that Xetava would be the surviving corporation and thus Avatex's disappearance gave rise to the legal nullity of its certificate.[412] Given that the certificate's conversion to legal nullity constitutes "repeal," the Court held that the proposed merger potentially fell within the category of those events that would trigger

406. *Id.* (emphasis omitted).
407. *Id.* at 846.
408. *Id.* at 847.
409. *Id.*
410. *Id.*
411. *See id.* at 845.
412. *Id.* at 851.

preferred voting rights.[413] As for the third requirement, the court held that because the merger rendered the certificate, and so the protection provided to the preferred therein, a legal nullity, it certainly caused an adverse effect.[414] Since the first and the third requirements could be met easily, the dispute revolved around the second requirement of whether "merger, consolidation or otherwise" was the cause of an "amendment, alteration or repeal."

According to Section 251 of the DGCL, there are three ways that a merger or consolidation can affect the certificate:

> (1) *Section 251(b)(3) Amendments.* First, the merger agreement may call for amendments to the pre-existing certificate of the surviving corporation. (2) *Displacement and Substitution by Merger.* Second, the merger can designate the certificate of one of the constituent corporations as the certificate of the surviving entity, and thereby render the certificate of every other constituent corporation a legal nullity. (3) *Displacement and Substitution via Consolidation.* Finally, in the case of a consolidation, the certificate of the resulting corporation displaces and renders a legal nullity the certificate of every disappearing constituent corporation.[415]

Avatex argued that only a Section 251(b)(3) amendment could be the cause of an "amendment, alteration or repeal" under the provisions defining the voting rights of the preferred stockholders.[416] However, according to Avatex, this provision would apply only when Avatex was the surviving company of the merger (and amendment of the certificate was made accordingly), since the provision requires the continued existence of a pre-existing certificate of the surviving corporation.[417] Therefore, Avatex's argument was that since it will disappear along with its certificate after the proposed merger, amendment to that certificate is not contemplated; therefore, Section 251(b)(3) cannot be applied to the proposed merger.[418] However, the court pointed out that the protection in the certificate was provided in a consolidation situation where Section 251(b)(3) will not

413. *Id.*
414. *Id.* at 852.
415. *Id.* at 850 (citing DEL. CODE ANN. tit. 8, § 251(b)(3)–(4), (e) (2009)).
416. *Id.* at 850–51.
417. *Id.* at 851.
418. *See id.* at 854.

apply.[419] Therefore, the court held that if the protections are to be confined to Section 251(b)(3), the word "consolidation" in the certificate becomes meaningless, which violates the established rule that, all terms of the instrument being read as a whole, all provisions of it must be reconciled to the extent possible.[420]

While the court emphasized the fact that Section 6 of the certificate includes the word "consolidation," it acknowledged that the transaction in question was not a consolidation.[421] However, the court seemed to find the fact that Avatex and its certificate in question would simply disappear analogous to a consolidation, where the protection would be provided.[422] For that reason, the preferred should be provided with the analogous protection provided in the context of consolidation.[423] Therefore, considering the drafters' use of the word "consolidation," the court held that contracting parties' intent must have been that, although the certificate would disappear with the Avatex, the preferred holders would still be granted protections in the certificate. The preferred would thereby have the right to vote at least in some transactions, including a merger that would cause Avatex to disappear.[424] In reversing the judgment of the Chancery Court, the Delaware Supreme Court held in favor of the plaintiff—the preferred stockholders.[425] It should be noted that, although the Court looked at the intent of the contracting parties, the Court made it clear that the "rights, preferences and limitations of preferred stock . . . must be expressly and clearly stated . . . . [and] will not be presumed or implied."[426] The Court concluded that the rights of the preferred are expressly and clearly stated in the Avatex certificate.[427]

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419. *Id.*
420. *Id.*
421. *Id.* at 851.
422. *See id.*
423. *See id.* at 851.
424. *Id.*
425. *Id.* at 855.
426. *Id.* at 852–53 (citing Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984); Waggoner v. Laster, 581 A.2d 1127, 1134–35 (Del. 1990)).
427. *Id.* at 853.

VII. CONCLUSION

As previously explained, the *Jedwab* court held, "where however the right asserted is not a preference as against the common stock but rather a right shared equally with the common," fiduciary duties should be owed by directors to the preferred.[428] In 2009, although the *Trados* court explicitly stated the situation before the court was not the *Jedwab* situation, it acknowledged the *Jedwab* rule as a valid law.[429] Also, as recently as 2010, the *LC Capital* court also recognized the *Jedwab* rule as a valid law, but determined that the *Jedwab* rule was not applicable to the situation in question because the preferred right was plainly provided in the certificate.[430] Given that those cases were decided very recently, despite Professor Bainbridge's criticism of the *Jedwab* decision that *Jedwab* rule should be treated as a violation of the general rule,[431] it appears that the *Jedwab* rule still remains good law. Also, it is notable that Professor Mitchell maintained that if the relationship of the preferred stockholders to the directors and the common seems to have been clarified by several decisions, that apparent clarity is an illusion.[432] However, as far as the court is concerned, its position seems to be consistent.

Even though *Jedwab* rule is considered to be still in effect, there remains a question of whether the preferred can be provided with enough protection. In connection with the protection of the rights of the preferred stockholder, Professor Mitchell suggests that the preferred stockholder should consider their contract as the exclusive source of their rights and they should not consider themselves as stockholders at all.[433] Considering his opinion with regard to the *Jedwab* decision that, the preferred and the common being similar as participants in a corporation, the directors should owe some fiduciary duties to the preferred,[434] his statement sounds contradictory to his opinion regarding *Jedwab*. However, as a reason for his seemingly contradictory statement, he advances awareness of the reality that the preferred cannot be protected from being put in a vulnerable position.[435] It is

428. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).
429. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. Jul. 24, 2009).
430. *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 446–47 (Del. Ch. 2010).
431. Bainbridge, *supra* note 161.
432. Mitchell, *supra* note 14, at 444.
433. *Id.*
434. *Id.* at 472.
435. *See id.* at 444.

because most preferred stock is structured in a manner that the corporation is never obligated to redeem it and thus return equity.[436] Thus, the preferred stockholders will be left not being able to realize any value from the enterprise.[437] Therefore, Professor Mitchell seems to emphasize with his statement that the preferred stockholders must protect themselves by defining their rights in the contract carefully. In fact, as an alternative, in order to provide the preferred ultimate protection, a law has been suggested to be put in place to explicitly impose some kind of duty on corporate directors in favor of preferred stockholders.[438] However, since it may not take place soon,[439] it will not be helpful either.

The contract itself being important as a source of preferred rights, the preferred should be encouraged to protect their rights by following what the general rule implicitly instructs, which is to have their rights articulated in the contract. Courts have been recognizing this general rule clearly and consistently.[440] Therefore, when defining preferred rights in the contract, the preferred stockholders must remember that courts strictly construe the terms, looking at whether the rights of the preferred are expressly stated in the contract.[441] This approach has been affirmed by recent decisions, such as *Matulich* in 2008 and *In re Appraisal of Metromedia International Group, Inc* in 2009, respectively. Therefore, the preferred stockholders should be very careful in having their rights carefully designated in the contract.

Given those cases with respect to the preferred rights including recent *Trados* case, the question of what role the lawyers should perform to protect the preferred stockholder clients arises.

First, considering the Delaware Court's tendency for strict construction of contract terms, when negotiating the initial contract the lawyers should remind their prospective preferred shareholder clients to pay more attention as to the way the preferred rights will be defined in the contract—if they have opportunity to negotiate it.

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436. *Id.*
437. *Id.*
438. *Id.* at 476.
439. *Id.*
440. *See, e.g.*, *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. Jul. 24, 2009); LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 445–46 (Del. Ch. 2010).
441. *See* Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984); *In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 536 (Del. Ch. 2001).

Second, as a consequence of the strong impact the *Trados* case has made on lawyers since the decision was rendered, "careful process" has become a matter whose significance cannot be over-emphasized. That is, as *Trados* instructs, lawyers should advise their preferred stockholder clients to check whether there was a careful process, such as the "retention of expert advisers or the formation of independent committees,"[442] and whether it continued to exist "at every stage in the planning of a . . . transaction" favoring the preferred over the common.[443] It would help the directors to prove fairness of the entire transaction favoring the preferred stockholders and thereby the interests of the preferred stockholders can be protected. Therefore, those lawyers who advise preferred clients must make sure there was such "careful process" during the course of the transaction. Especially when private-equity sponsors and venture capital funds, as preferred stockholders, could place their employees on company boards, lawyers should advise the preferred stockholder clients to make such directors arrange for the careful process to be put in place, just in case a suit is brought by the common.[444] Otherwise, because of the fact that the preferred has placed their employees on company boards, it will be more difficult for directors to prove the entire fairness of the transaction favoring the preferred.

442. Savitt, *supra* note 5, at 78.
443. *Id.*
444. *Id.*