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ADDRESSING THE HARM TO COMMON STOCKHOLDERS IN *TRADOS* AND *NINE SYSTEMS*

*Adam M. Katz**

INTRODUCTION

According to the opinions in *In re Trados* (*Trados*)[1] and *In re Nine Systems* (*Nine Systems*),[2] both cases involved the peculiar corporate law equivalent of a burglary in which nothing was stolen. In *Trados*, the board of directors—composed mostly of representatives from venture capital (VC) firms holding preferred stock—voted in favor of a $60 million merger in which preferred stockholders received $52.2 million, management (pursuant to an incentive plan designed to encourage a near-term sale) received $7.8 million, and common stockholders received exactly "nothing."[3] In *Nine Systems*, a similarly conflicted and VC-dominated board effected a largely covert recapitalization whereby common stockholder equity was diluted from around 26% to around 2%.[4] The *Nine Systems* recapitalization ultimately entitled preferred VC stockholders to receive around $150 million in connection with a sale of the company while common stockholders received in total around $3 million.[5] In both *Trados* and *Nine Systems*, the courts determined that the boards of directors faced clear conflicts that manifested in grossly unfair processes favoring the VC preferred stockholders.[6] And yet, both courts *also* found that the common stockholders *failed to demonstrate any damage* resulting from the challenged transactions and were thus not entitled to recovery beyond possible shifting of attorneys' fees.[7]

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1. In re Trados Inc. S'holder Litig., 73 A.3d 17, 20 (Del. Ch. 2013).

2. In re Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014), aff'd sub nom. Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015).

3. *Trados*, 73 A.3d at 20.

4. *Nine Systems*, 2014 WL 4383127, at *17.

5. Id. at *20. While this $3 million allocation allowed many common stockholders to profit to some degree, "some did not: one lost nearly 43% of his investment." Id.

6. See infra sections II.A–.B.

7. See *Nine Systems*, 2014 WL 4383127, at *47 (holding that the "grossly inadequate process employed by the Defendants" warranted finding that they breached their duty of loyalty and yet refusing damages because the transaction was "effected at a fair price"); *Trados*, 73 A.3d at 66 (noting that evidence on fair dealing "decidedly favored the plaintiff," but concluding that "the directors breached no duty . . . by agreeing to a Merger in which the common stock received nothing").

Some have defended, or at least accepted, the reasoning in *Trados* and *Nine Systems*;[8] others have focused on the practical implications of these cases for counsel advising preferred-appointed directors;[9] still others have ambitiously argued that the doctrinal framework governing VC-held preferred stock is conceptually unstable and in need of reimagining.[10] This Comment opts for a more modest approach. Rather than posit a procedural strategy to satisfy the Delaware courts or question the underlying doctrine, this Comment argues that *Trados* and *Nine Systems* overlooked the damage imposed upon common stockholders. In other words, *Trados* and *Nine Systems* were *not* victimless breaches: Something *was* taken from common stockholders.

Specifically, this Comment asserts that the Delaware courts in *Trados* and *Nine Systems* failed to acknowledge that the controlling preferred VC stockholders deprived common stockholders of the value of the *option* to continue operating the firm in the hopes of performance improving.[11]

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8. See, e.g., Leo E. Strine, Jr., Response, Poor Pitiful or Potently Powerful Preferred?, 161 U. Pa. L. Rev. 2025, 2040 (2013) [hereinafter Strine, Poor Pitiful].

9. See, e.g., William Savitt, When Classes of Stockholders Clash, Nat'l L.J. (Dec. 7, 2009), http://www.law.com/almID/1202436032445/ (on file with the *Columbia Law Review*) ("[*Trados*] provides practical guidance for directors with duties to multiple classes of stockholders."); Jeffrey R. Wolters, Delaware Insider: Private Company Financings: Delaware Court Provides Guidance for Boards and Venture Funds, Bus. L. Today, Oct. 2014, at 1 (on file with the *Columbia Law Review*); Douglas N. Cogen et al., Corporate and Securities Alert: *In re Trados*: Important Lessons for Directors on Fiduciary Duties to Common Stockholders, Fenwick & West LLP (Sept. 16, 2013), https://www.fenwick.com/publications/pages/corporate-and-securities-alert-in-re-trados-important-lessons-for-directors-on-fiduciary-duties-to-common-stockholders.aspx [https://perma.cc/NU2W-QECB].

10. See William W. Bratton & Michael L. Wachter, A Theory of Preferred Stock, 161 U. Pa. L. Rev. 1815, 1881–85, 1900 (2013); Charles R. Korsmo, Venture Capital and Preferred Stock, 78 Brook. L. Rev. 1163, 1163 (2013) ("The time is ripe for reconsidering the jurisprudence of preferred stock."). As the Delaware courts have made no discernible shift from a corporate to a contractual approach in evaluating venture capital exit, this Comment focuses on the current fiduciary paradigm.

11. In failing to recognize that this option to continue operating the firm itself entails value, the courts effectively decided—this Comment makes no claims as to the *intent* of the courts in doing so—that VC firms would have the right to capture this option value absent an agreement expressly to the contrary.

As of this writing, there appears to be limited discussion of the idea that the Delaware courts erroneously overlooked or ignored the value of the effective option held by common stockholders. See, e.g., Ben Walther, The Peril and Promise of Preferred Stock, 39 Del. J. Corp. L. 161, 211 (2014) ("[T]he idea that the common equity [in *Trados*] lacked any option value makes little sense in a financial market in which deep-out-the-money, soon-to-expire stock options trade with positive value."). Professor Ben Walther focuses on the hostility of Delaware's legal regime *to* preferred shareholders and responds with a proposal for using executive-compensation arrangements to incentivize preferred and common directors to maximize firm value. Id. at 201–02. Walther's approach seems entirely reasonable, but this Comment takes the position that forcing preferred and common stockholders to negotiate ex ante for the value of this option is a less roundabout solution than, as Walther proposes, attempting to design compensation schemes to encourage a more harmonious coexistence of preferred and common stockholders.

Far from a nebulous species of damage, this Comment observes that "underwater" options akin to those seized from common stockholders in *Trados* and *Nine Systems* can be, and routinely are, valued by financiers and economists. The question of which group—the VC preferred or common stockholders—has the right to capture the value of this option is a policy question and has been obscured by *Trados* and *Nine Systems*.[12] This Comment fills a gap by drawing the policy tension into the light and squarely asking which party should have the contractual burden of specifying the right to capture the value of the option.

The remainder of this Comment proceeds as follows: Part I reviews the Delaware doctrine governing controlled preferred stock and VC-held preferred stock, before summarizing the facts and outcomes of *Trados* and *Nine Systems*. Part II turns to critique, explaining why *Trados* and *Nine Systems* were incorrect to conclude that common stockholders were unharmed and, moreover, how this conclusion is inconsistent with other Delaware decisions. Part III then outlines a path forward, framing the decision as to who captures the "option value" in *Trados* and *Nine Systems* as a matter of assigning a default rule.

I. CONTROLLING PREFERRED STOCK IN THEORY AND APPLICATION

This Part begins with a short overview of the Delaware doctrine on preferred and controlling preferred stock, as well as the intersection of this doctrine with the VC business model (section I.A). From there, this Part summarizes the facts and opinions in *Trados* (section I.B) and *Nine Systems* (section I.C), teeing up Part II's critique.

A. *Controlling Preferred Stock and Venture Capital Under Delaware Law*

Preferred stock is, broadly stated, stock issued pursuant to the same corporate charter as common stock but that has been supplemented with certain preferential rights—for example, the right to be paid out dividends before common shareholders or the right to a liquidation preference.[13] As such, preferred stock has a dual nature—it is a creature of

12. See infra Part III (discussing the policy issues implicated by assigning the right to capture the value of this option to either preferred or common stockholders). This question is neither small nor obscure. VC firms and their use of preferred stock are highly significant features of the modern U.S. economy, injecting billions of dollars of capital into startups each year. See Bratton & Wachter, supra note 10, at 1817–18 ("[P]referred stock's economic salience has increased notably in recent decades."); Jesse M. Fried & Mira Ganor, Agency Costs of Venture Capitalist Control in Startups, 81 N.Y.U. L. Rev. 967, 968 (2006) ("Venture capitalists (VCs) play a significant role in the financing of high-risk, technology-based startup companies, investing billions of dollars annually in these businesses."); Korsmo, supra note 10, at 1164 ("[P]referred stock, far from being an outmoded relic, is the investment vehicle of choice for venture capitalists.").

13. See Lawrence E. Mitchell, The Puzzling Paradox of Preferred Stock (and Why We Should Care About It), 51 Bus. Law. 443, 445–46 (1996); see also Del. Code tit. 8, § 151(c) (2018) (providing for the existence of preferred stock and describing its operation under

corporate law insofar as it is stock issued under a charter and a creature of contract law insofar as preferred stockholders bargain for and receive contractually specified rights.[14] Delaware doctrine reflects this amalgam, applying the general rule that boards must "preference" preferred stock to the extent required in the relevant contract, but otherwise boards must attempt to maximize firm value for the benefit of common stockholders as residual claimants.[15]

When the interests of preferred and common stockholders diverge, as they are bound at times to do,[16] courts must determine whether rights claimed on behalf of the preferred stock are entitled to enforcement as a matter of contract law or subordinate to the rights of common stockholders as a matter of fiduciary doctrine.[17] This sorting exercise faces an additional complication when preferred stockholders *themselves* secure board control, as this presents the following question: Should preferred stockholders in control be compelled by fiduciary law to take action for the benefit of common stockholders even when inimical to their own interests as preferred stockholders?

The basic VC model illustrates this controlling preferred stock tension nicely for three primary reasons: First, as a threshold matter, VC investors in startups "almost exclusively" invest using preferred stock;[18] second, VC firms often seek to exit and liquidate a venture before

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Delaware law). Preferred stock exists between common stock and debt on the spectrum of fiduciary to contractual obligation: Common stock receives purely fiduciary protection, debt receives purely contractual protection, and preferred stock receives some of each. See Mitchell, supra, at 447–48.

14. Bratton & Wachter, supra note 10, at 1820 ("Preferred stock sits on a fault line between two great private law paradigms, corporate law and contract law.").

15. See In re Trados Inc. S'holder Litig., 73 A.3d 17, 42 n.16 (Del. Ch. 2013) ("As long as a board complies with its legal obligations, the standard of fiduciary conduct calls for the board to maximize the value of the corporation for the benefit of the common stock."); LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 452 (Del. Ch. 2010) ("[I]t is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred . . . .").

16. See Marilyn B. Cane et al., Recent Developments Concerning Preferred Stockholder Rights Under Delaware Law, 5 Va. L. & Bus. Rev. 377, 385–86 (2011) ("Given the limited quantity of corporate wealth at any given point, [advantages of preferred stockholders] come at the expense of the common stockholders."); Mitchell, supra note 13, at 446 ("[T]he distribution of corporate wealth at any given point in time is zero sum.").

17. See, e.g., Fletcher Int'l, Ltd. v. ION Geophysical Corp., No. 5109-VCP, 2010 WL 2173838, at *7 (Del. Ch. May 28, 2010) ("[R]ights arising from documents governing a preferred class of stock . . . do not give rise to fiduciary duties because such rights are purely contractual in nature.").

18. Fried & Ganor, supra note 12, at 981; see also Bratton & Wachter, supra note 10, at 1875 ("Venture capital is about both finance and governance and preferred stock is the investment vehicle of choice.").

common stockholders would prefer them to do so;[19] and third, VC firms frequently, if not uniformly, obtain board control over their target investments.[20]

In general, VC-backed startups issue common stock, held by the founders and employees, and preferred stock, held by VC firms.[21] The VC model revolves around speedy exit,[22] either by the "gold standard and most lucrative" initial public offering (IPO) route or by the less enticing sale or write-off avenues.[23] Accordingly, VC firms typically negotiate for a fixed preferred claim on firm value (a "liquidation preference") and a right to convert the preferred shares into common shares—the liquidation preference limits downside risk for the VCs while the conversion right allows VCs to capitalize on upside eventualities like an IPO.[24] On top of these cash-flow rights, VC firms often secure *control rights*, sometimes in the form of board control.[25] Outright board control allows VCs not only to impede managerial blunders but also to "*initiate* fundamental transactions such as mergers, IPOs, and liquidations," which can be critical for VC firms hoping to exit and redirect their limited resources elsewhere.[26]

As many have observed, the interests of controlling preferred VCs and common shareholders face acute risk of divergence in a so-called "moderate downside," a scenario in which the startup is neither a major

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19. See D. Gordon Smith, The Exit Structure of Venture Capital, 53 UCLA L. Rev. 315, 316 (2005) ("Before venture capitalists invest, they plan for exit.").

20. Bratton & Wachter, supra note 10, at 1875 ("[VCs] holding preferred sometimes take voting control and can dominate the boards of directors even when holding a minority of the votes."); Manuel A. Utset, Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 Wis. L. Rev. 45, 61 ("Venture capitalists in most instances negotiate to get outright control of the board."). For a variety of reasons, several commentators have expressed skepticism as to whether preferred stockholders, under current doctrine, can viably obtain control outside the VC context. See, e.g., Melissa M. McEllin, Note, Rethinking *Jedwab*: A Revised Approach to Preferred Shareholder Rights, 2010 Colum. Bus. L. Rev. 895, 916–18.

21. Fried & Ganor, supra note 12, at 981.

22. Douglas G. Baird & M. Todd Henderson, Other People's Money, 60 Stan. L. Rev. 1309, 1331 (2008) ("In venture capital deals, everyone begins knowing that things may not work out and the time to shut down or sell out may come.").

23. In re Trados Inc. S'holder Litig., 73 A.3d 17, 50–51 (Del. Ch. 2013).

24. See Cane et al., supra note 16, at 386 ("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."); Fried & Ganor, supra note 12, at 982 ("VCs' preferred shares carry a liquidation preference and are convertible into common. Thus, to the extent that VCs retain their preferred stock, their cash flow rights are debt-like; to the extent that they convert, their preferred stock offers the same cash flow rights as common stock.").

25. For helpful background on the distinction between cash-flow and control rights, see Zohar Goshen & Richard Squire, Principal Costs: A New Theory for Corporate Law and Governance, 117 Colum. L. Rev. 767, 784–85 (2017).

26. Fried & Ganor, supra note 12, at 987.

success nor a complete failure.[27] While success may lead to IPO-generated riches or sales attracting enough value to go around, and failure protects preferred holders via their liquidation preference, the moderate downside—known by an array of colorful epithets, such as a "sideways situation," "zombie company," or "living dead"—is not profitable enough to warrant the VC firm's continued attention but also not dismal enough to dissuade entrepreneurs from wanting to continue to pursue growth.[28]

This enables circling back to the question posed above, this time with more specificity: When a VC firm holds preferred stock, secures control of a startup's board, and is faced with a moderate downside in which the VC would prefer to sell but common stockholders would prefer to continue running the firm, does the preferred-stockholder-dominated board, assuming the VC firm has not specifically contracted for a conflicted exit, have to prioritize the interests of the common stockholders?

The answer, in short, is yes. Under Delaware law, preferred stockholders are entitled to preferential treatment *only* to the extent specified in the contract.[29] This principle has been understood to require that preferred-stockholder-appointed directors "owe the duties traditionally owed by the fiduciaries of corporations, including the duty to consider the best interests of the common stockholders," even if at the expense of VC preferred holders.[30]

This application of fiduciary principles imports Delaware's familiar standards of review governing judicial treatment of fundamental transactions. Therefore, if VC-appointed controlling preferred directors approve a transaction with the potential to favor preferred over common shareholders, and a complainant adequately pleads that these directors were neither independent nor disinterested, the directors will have the burden of proving the transaction was entirely fair.[31] Under Delaware's

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27. See, e.g., Bratton & Wachter, supra note 10, at 1834; Walther, supra note 11, at 204 ("When companies enter a period of low profitability, . . . the preferred has an incentive to liquidate . . . even if the firm has . . . [net present value]-positive . . . opportunities.").

28. *Trados*, 73 A.3d at 51.

29. See Strine, Poor Pitiful, supra note 8, at 2027 ("[P]referred stockholders are *preferred* to the extent that they secure *preferences* (that is, additional rights that may have economic value) in their contract.").

30. Id. at 2040; see also Equity-Linked Inv'rs, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) ("[G]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock."); Strine, Poor Pitiful, supra note 8, at 2028 ("[I]f the preferred stockholders actually secure control of the board, they are then expected to fulfill this fiduciary responsibility and to refrain from using their power selfishly.").

31. Bratton & Wachter, supra note 10, at 1884 ("[W]hen controlling preferred cause the corporation to enter into a transaction that realizes their contractual preferences on the moderate downside, approval by controlled board members will be treated . . . as engaging in a self-dealing transaction.").

entire fairness scrutiny, fairness requires that the board demonstrate it followed a fair process in approving a transaction ("fair dealing") and arrived at an outcome that fairly compensated common shareholders ("fair price"). Both *Trados* and *Nine Systems* ultimately involved applying this framework to moderate-downside scenarios, wherein the interests of preferred and common stockholders sharply diverged.[32]

B. In re Trados

1. *Background.* — In 2000, Trados Inc. (Trados), a translation-software startup, received VC funding from several firms with the goal of eventually pushing Trados toward an IPO.[33] The investing VC firms negotiated for preferred stock carrying a liquidation preference and various control rights, as well as the right to designate representatives to the Trados board.[34] All told, the VC firms secured an aggregate liquidation preference of $57.9 million and placed three directors on Trados's seven-member board.[35]

By 2002, it became apparent to at least some of the VC investors that Trados was growing less rapidly than necessary to generate meaningful returns to the VC firms.[36] By 2004, Trados's board began seriously considering a sale, engaging in talks with potential buyers but receiving only lukewarm reception.[37] After receiving an underwhelming offer from one possible buyer, the board postponed the sale process and instead tried its luck with a newly recruited "hard-nosed CEO" grooming Trados into a more attractive target.[38]

The board's bet proved wise. Within his first year on the job, the new CEO obtained $4 million of venture debt and led Trados to generate "record" revenue.[39] In late 2004, with Trados's attractiveness improving, the board approved a management incentive plan (MIP) designed to encourage a sale of Trados by providing "senior management with an escalating percentage of sale proceeds."[40] In contemporaneous talks with potential buyers, Trados's CEO—at the behest of the board—made clear that Trados sought a price of $60 million, the amount sought by the VC

32. See infra sections I.B.2, I.C.2.

33. In re Trados Inc. S'holder Litig., 73 A.3d 17, 20–21 (Del. Ch. 2013).

34. See id. at 22.

35. See id. at 33.

36. See id. at 24 (noting that one VC board representative reported back to his colleagues: "Investment outlook: return capital at best").

37. Id. at 26–27.

38. Id. at 27–29 (noting that one director described the new CEO's mission as follows: "to architect an M & A exit as soon as practicable").

39. Id. at 28.

40. Id.

firms to recover (after payment of the MIP) most of the collective liquidation preference and to minimize loss on the investment.[41]

In early 2005, the Trados board approved the basic terms of a deal to sell Trados for $60 million.[42] Meanwhile, during the first two quarters of 2005, Trados's performance continued to improve.[43] Finally, at a June 2005 meeting, the board approved the sale, allocating $7.8 million to payment of the MIP while the remaining $52.2 million was soaked up by the $57.9 million VC liquidation preference. As a result of the merger, the VC preferred stockholders each received "less than their full liquidation preference but more than their initial investment."[44] Common stockholders received "nothing."[45]

Thereafter, the plaintiff sued on behalf of common stockholders, alleging that the directors breached their duty of loyalty in approving the merger.[46] Plaintiff argued that the board was neither disinterested nor independent with respect to the merger, given the VC firms' clear desire to exit, and that the directors "had a duty to continue operating Trados on a stand-alone basis" to "maximize the value of the corporation for the ultimate benefit of the common stock."[47]

2. *Analysis.* — Vice Chancellor Laster began his analysis by affirming the principle that board directors—regardless of who appoints them—owe fiduciary duties to common stockholders as residual claimants.[48] Laster contrasted these fiduciary protections with the "contractual rights against the corporation" held by preferred stockholders.[49] Thus, Laster explained, directors must "strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants."[50]

Laster then concluded that six of the seven directors—three VC directors, two management directors who received compensation under the MIP, and one outside director with close ties to the VC funds—were conflicted, making entire fairness the applicable standard.[51] Laster noted

41. Id. at 30–31.

42. Id. at 31–32.

43. Id. at 32.

44. Id. at 33.

45. Id.

46. Id. at 34.

47. Id. at 42.

48. Id. at 36–37.

49. Id. at 38.

50. Id. at 41–42.

51. Id. at 43–45. Among other key details, Laster noted that (1) Trados's CEO (who served on the board during the sale process) "personally received $2.34 million from the MIP" in addition to becoming a member of the buyer's board for $60,000 per year; and (2) the VC directors "received disparate consideration in the Merger in the form of a liquidation preference." Id. at 45–46.

that while there is "nothing inherently pernicious" about VC preferred stockholders negotiating for special contractual rights, controlled VC boards may tend to favor short-term "liquidity events" even when "operating the firm as a stand-alone going concern would generate more value for shareholders."[52]

Laster then applied entire fairness, asking whether defendants had (1) followed a fair process in approving the merger; and (2) approved a fair price for the sale. Regarding fair process, Laster found decisively for the plaintiffs: "[T]here was no contemporaneous evidence suggesting that the directors set out to deal with the common stockholders in a procedurally fair manner. Nor were the defendants able to recharacterize their actions retrospectively to show that they somehow blundered unconsciously into procedural fairness . . . ."[53]

Laster concluded that the VC directors pursued and approved the merger purely because Trados was not growing quickly enough to warrant the VC firms' continued involvement and, as such, the merger offered an exit opportunity.[54] This decision, Laster held, improperly prioritized the contractual interests of the preferred stockholders without attending whatsoever to the perspective of the common stockholders.[55]

Laster also took issue with the MIP, which effectively prevented common stockholders from receiving any of the $2.1 million difference between the $57.9 million VC liquidation preference and the $60 million sale price. Laster concluded the MIP was adopted without any consideration as to how to fairly allocate these "incremental dollars above the liquidation preference."[56] Moreover, the MIP appeared designed to

52. Id. at 48–49 (internal quotation marks omitted) (quoting Fried & Ganor, supra note 12, at 995). Interestingly, discussing the structural conflict faced by VC board members in an exit opportunity that would harm common stockholders, Laster quoted from a piece that characterizes the harm to common stockholders in the event of an "early" sale as lost "'option value' (upside potential) of the common stock." Id. at 50 (internal quotation marks omitted) (quoting Brian Broughman & Jessie M. Fried, Carrots & Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups, 98 Cornell L. Rev. 1319, 1333 n.53 (2013)). Laster later appears to ignore the "upside potential" eliminated for Trados's common stockholders. See infra sections II.A–.B.

53. *Trados*, 73 A.3d at 56. At least some portion of Laster's skepticism seemed to reflect comments made by the defendant directors during the course of pre-trial testimony indicating that common stockholders barely, if at all, entered the calculus in deciding to pursue a sale. Id. at 62–63 (noting one director's disclosure during a deposition that "[t]o tell you the truth, between common and preferred was only a topic which really popped up through this court case" and "I didn't even remember this thing as being a debate or discussion on the board").

54. Id. at 56–58.

55. Id. ("[T]he VC directors wanted to exit. They were not interested in continuing to manage the Company to increase its value to the common.").

56. Id. at 60. Given the MIP's proportional design—that is, management was entitled to larger payments depending on the sale price—Laster observed that the MIP would negatively impact common stockholders even in the case of higher sale prices. Id. ("[A]t $70 million, the MIP receives $9.1 million, the preferred receive $57.9 million, and the

encourage several large Trados stakeholders to vote with the preferred rather than the common stockholders—for example, increasing the MIP payment to one stakeholder from 12% to 14% when that stakeholder "seemed to be having second thoughts just before the Merger."[57] In all, the board's failure to consider the interests of the common stockholders and adoption of an incentive plan that exacerbated the conflict led Laster to conclude that defendants failed to demonstrate fair dealing.

Laster found the fair-price evidence more mixed.[58] Defendants argued that Trados common stock had no value prior to the merger and thus it was fair for common shareholders to receive nothing in the sale. To support this position, defendants claimed Trados faced imminent bankruptcy and lacked a viable business plan.[59] Despite defendants "adopt[ing] aggressive positions that were contrary to the contemporaneous documents and their earlier testimony," Laster was persuaded that the common stock "had no value."[60] Laster noted that while he regarded "Trados's prospects as more bullish than the gloomy picture painted by defendants, particularly with a savvy [CEO] at the helm," it seemed unlikely that Trados could grow at a rate that would allow it to outrun the liquidation preference with profits remaining for the common stockholders.[61]

Having concluded the price received by the common stockholders ($0) was equal to the value of the common stock prior to the merger ($0), Laster held that defendants had demonstrated a "fair price."[62] While Laster recognized that certain instances of unfair dealing can "infect the price" and "result in a finding of breach," under the facts presented Laster found the lack of fair process not to "constitute a separate breach."[63] As such, Laster refused to award damages under the fiduciary claim and instead invited the plaintiff to apply to shift attorneys' fees.[64]

C. In re Nine Systems

1. *Background.* — Nine Systems Corporation (Nine Systems) was founded in 1999 as a media startup looking to capitalize on then-new

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common receive $3.0 million. Without the MIP, the preferred would receive $57.9 million, and the common would receive $12.1 million.").

57. Id. at 65.

58. Id. at 66.

59. Id. at 68.

60. Id. at 66.

61. Id. at 77 ("I do not believe Trados faced mortal crises, but it did face risks.").

62. Id. at 76 ("Although the defendant directors did not adopt any protective provisions, failed to consider the common stockholders, and sought to exit without recognizing the conflicts of interest presented by the Merger, they nevertheless proved that the transaction was fair.").

63. Id. at 78.

64. Laster strongly indicated that such an application would be successful in light of defendants' recalcitrant discovery behavior and "less-than-credible trial testimony." Id. at 79.

technology: broadband streaming.[65] The Nine Systems board was comprised of three directors representing VC investors holding preferred stock; one director representing management; and one director, Abrahim Biderman (a prominent character in the *Nine Systems* litigation), representing a group of minority common shareholders.[66] By late 2001, the three VC firms held a controlling stake in Nine Systems, with 54% of the total vote.[67]

Around this same time in 2001, the board faced a "panic": Nine Systems was "running out of money."[68] The board scheduled a meeting on Friday, December 21, 2001, to discuss possible revenue-generating acquisitions.[69] In choosing the December 21 date, it appears that all directors except Biderman were consulted regarding their availability.[70] December 21 was the "shortest day of sunlight of the year," presenting scheduling issues for Biderman, an Orthodox Jew, who needed to be home by sundown Friday evening to celebrate the Sabbath. While the board was "aware of these restrictions on his availability, . . . they rejected his request to reschedule."[71] At the December 21 meeting, the remaining directors began to discuss plans for a recapitalization whereby new preferred stock would be issued to finance the proposed acquisitions.[72] Biderman learned of the details of the December 21 meeting only after the fact through a phone call with a shareholder of one of the investing companies.[73]

Upon learning of the then-nascent plans to recapitalize, Biderman wrote a strongly worded letter in opposition, expressing his view that the resultant dilution of the minority common shareholders' stake in Nine Systems would be unfair.[74] The board never responded to the letter.[75] Quite the opposite: Over the next several months, the non-Biderman directors held several informal meetings and phone calls in which Biderman was not invited to participate.[76]

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65. In re Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 WL 4383127, at *5 (Del. Ch. Sept. 4, 2014), aff'd sub nom. Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015).

66. Id. at *1.

67. Id. at *7.

68. Id. Running short on funds is common for startups. Wolters, supra note 9, at 1.

69. *Nine Systems*, 2014 WL 4383127, at *7.

70. Id.

71. Id. at *8.

72. Id.

73. Id.

74. Id. ("I would expect that the Board, in the exercise of its fiduciary duty to *all* of the Company's shareholders, will give this extraordinary corporate event the proper attention . . . . I find the possible dilution . . . to be of great concern." (quoting Biderman's letter to the board)).

75. Id.

76. Id. at *10–11.

In 2002, the board approved the recapitalization whereby two of the three VC funds increased their ownership of Nine Systems from around 54% to around 80%, while the minority common shareholders experienced a dilution from 26% to 2%.[77] In investing in the preferred shares as part of the recapitalization, the VC firms relied on a valuation in the form of "handwritten scribbles" prepared by the controlling owner of one of the VC firms.[78] Because the three VC firms held a majority of the Nine Systems equity, the board acted entirely by written consent to issue the new preferred shares—minority common shareholders were not contacted or offered the chance to participate in the recapitalization.[79] Between 2002 and 2005, the board only sporadically and sparsely mentioned the recapitalization to minority shareholders, failing to "disclose who participated . . . or on what terms."[80]

By 2006, the Nine Systems board began seriously considering a sale.[81] On September 29, 2006, the board—at a meeting to which Biderman was not invited—authorized Nine Systems to enter a letter of intent for a merger valuing Nine Systems at around $175 million.[82] After later voting over Biderman's dissent to approve the merger, the board "intentionally scheduled [a] meeting late on a Friday in the fall so that Biderman could not attend" to approve minor changes to the agreement.[83] In connection with the merger, the board issued proxy materials, which for the first time revealed the details of the recapitalization—after seeing the dilution, one plaintiff later testified he "felt that [he] was had."[84]

The merger closed in late 2006, whereby the VC firms and their affiliates received approximately $150 million and the minority shareholders received approximately $3 million in total, causing some minority shareholders to lose considerable portions of their investment.[85] Plaintiff minority common shareholders sued, alleging the board was conflicted and had violated its duty of loyalty by effecting the recapitalization.[86]

2. *Analysis.* — Vice Chancellor Noble began the fiduciary analysis by quickly concluding the Nine Systems board was majority conflicted; the three VC representative directors not only owed competing fiduciary

77. Id. at *17.

78. Id. at *9.

79. Id. at *17 ("Many of the [minority shareholders] testified that, had they been contacted by the [board], they were ready, willing, and able to provide additional capital . . . .").

80. Id. at *18 ("Based on the weight of the trial evidence and testimony, the [board] sought to avoid full and fair communications with the Company's stockholders.").

81. Id. at *19.

82. Id. at *20.

83. Id.

84. Id.

85. Id.

86. Id.

duties to their respective VC firms but also had incentives to take action favoring these firms over minority common shareholders.[87] Noble therefore found entire fairness scrutiny appropriate, requiring defendants to prove both fair dealing and fair price.[88]

Regarding fair dealing, Noble found the process followed by the board to fall far short of fairness. Among other details, Noble cited as evidence of an unfair process: (1) the knowing exclusion of Biderman from meetings and calls;[89] (2) the reliance on a dubious valuation prepared by an interested party;[90] (3) the board's favoritism toward the VC firms reflected in the opportunity to invest as part of the recapitalization;[91] and (4) the board's failure to disclose material information regarding the details of the recapitalization.[92]

As in *Trados*, the *Nine Systems* fair-price analysis turned on whether the equity of the company had value at the time of the disputed transaction—that is, the recapitalization.[93] The defendants argued that the recapitalization-generated dilution was fair because the equity was worth nothing at that time, whereas the plaintiffs contended that the company was in fact worth $30.89 million at that time.[94] After reviewing the conflicting evidence and expert testimony, Noble found that the equity value of Nine Systems at the time of the recapitalization was in fact $0. Thus, as in *Trados*, Noble held that the price was fair, "[r]egardless of how much the Plaintiffs['] [equity] may have been diluted."[95]

Here, however, Noble reached a slightly different outcome from that in *Trados*. Whereas *Trados* held that the finding of a fair price precluded in that instance finding a breach of the fiduciary duty of loyalty, Noble in *Nine Systems* reasoned that an unfair process may "infect" an otherwise fair price.[96] Noble therefore concluded, in light of a "grossly inadequate process," that the board failed to demonstrate the transaction was entirely fair.[97] This departure from *Trados* proved only momentary; Noble found that, despite the fiduciary breach, it would be inappropriate to award damages beyond the shifting of attorneys' fees in light of the fact that the stock was worthless at the time of the recapitalization.[98]

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87. Id. at *34.
88. Id.
89. Id. at *35–36.
90. Id. at *36.
91. Id. at *37.
92. Id. at *37–38.
93. Id. at *38.
94. Id.
95. Id. at *46.
96. Id. at *46–47.
97. Id. at *47.
98. Id. at *51–52.

II. EXPLAINING THE HARM IN *TRADOS* AND *NINE SYSTEMS*

This Part attempts to persuade the reader of a single argument: Both *Trados* and *Nine Systems* erred in concluding that common stockholders were unharmed by the unfair dealing of the controlling preferred boards. These cases were not, as many have assumed, victimless crimes[99] but rather instances in which concrete damage was imposed on common stockholders in the form of the lost option to continue operating the firms.

This Part discusses two reasons to conclude that *Trados* and *Nine Systems* erred: First, *Trados* and *Nine Systems* are *internally* inconsistent insofar as there is nonzero value associated with underwater options akin to the common stock in *Trados* and *Nine Systems* and fiduciary actions permit parties to claim damage based on unfair dealing (section II.A); second, *Trados* and *Nine Systems* are *externally* inconsistent with other Delaware law (section II.B).

A. *Internal Inconsistency*

1. *Option Value.* — *Trados* and *Nine Systems* each held that, despite widespread unfair dealing by conflicted directors, common stockholders were unharmed because the common stock at issue was worth nothing.[100] This Comment argues that this conclusion, in both *Trados* and *Nine Systems*, is untenable because it overlooks the "option value" of the common stock. Specifically, in executing the challenged transactions without any semblance of fair dealing on the part of the conflicted directors, the Trados and Nine Systems boards deprived common stockholders of the option to continue running the firms in the hopes of generating future value, such that *even if the stock was worth nothing at the time of the challenged transactions*, the unfair dealing deprived the stock of potential future value.

In order to make this argument by analogy, it is important first to briefly provide some background on stock options and the valuation thereof. Stock options are securities "giving the right [but not the obligation] to buy or sell an asset . . . within a specified period of time."[101] For example, a stock option with an exercise price of $100 would allow the holder of the option to buy the underlying stock for $100 for some specified duration of time, making the option more valuable as the price of the stock rises. As long as the stock price remains below the exercise price, exercising the option will generate a loss; but once the stock price

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99. See Ethan J. Leib & Stephen R. Galoob, Fiduciary Political Theory: A Critique, 125 Yale L.J. 1820, 1832 n.49 (2016) (describing *Nine Systems* as "a real-world example of fiduciary norms being violated by conduct that does not harm the beneficiary").

100. *Nine Systems*, 2014 WL 4383127, at *51; In re Trados Inc. S'holder Litig., 73 A.3d 17, 76 (Del. Ch. 2013).

101. Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 637 (1973).

rises *above* the exercise price, the right to buy the stock at the exercise price will generate value to the option holder.

Options have been traded on public exchanges since 1973, and the theory of pricing options has an "illustrious history."[102] In 2014, 1.275 billion option contracts valued in the aggregate at just under $580 trillion traded on the Chicago Board Option Exchange.[103] In other words, options and affixing value thereto are nothing out of the ordinary for financial economics.[104] Indeed, the general dynamics of option pricing are fairly straightforward, with the price of an option depending largely on the distance between the stock price and exercise price (the closer together, the more valuable the option) and the length of the option term (the longer one has before the option expires, the more valuable it is), among other factors.[105] An option's value thus reflects the *probability* that the stock price rises above the exercise price (and by how much).

These principles apply equally to options whose stock price is *beneath* the exercise price, so-called "underwater options."[106] Indeed, these principles help to explain why underwater options, even "deep" underwater,[107] trade at positive value. For example, a stock option with an underlying market price of $99, an exercise price of $100, and 15 months before expiration surely is not worth nothing, even though the stock option cannot be exercised for value at the moment the stock price is $99.[108]

The common stock held by the Trados and Nine Systems shareholders at the time of the contested transactions was very much like an underwater option. How? Because, at the time of the challenged transactions, the market value of the stock was lower than the liquidation preferences of the preferred shareholders. As such, a sale of the firm

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102. John C. Cox et al., Option Pricing: A Simplified Approach, 7 J. Fin. Econ. 229, 229 (1979).

103. CBOE, CBOE Market Statistics 1 (2014), https://www.cboe.com/data/marketstats-2014.pdf [https://perma.cc/G8TU-HTYP].

104. John Hull & Alan White, How to Value Employee Stock Options 3 (Sept. 2002) (unpublished manuscript) (on file with the *Columbia Law Review*) ("Standard methods have been developed for valuing the options that trade on an exchange and in the over-the-counter market.").

105. Graef S. Crystal, Handling Underwater Stock Option Grants, Personnel, Feb. 1988, reprinted in Compensation & Benefits Rev., Apr. 1988, at 59, 62–63. For more in-depth background on option valuation, see Zvi Bodie et al., Investments 700–02 (11th ed. 2018) ("[L]onger time to expiration increases the value of a call option."); John C. Hull, Options, Futures, and Other Derivatives 214–18 (8th ed. 2012).

106. Options with a stock price beneath the exercise price are also referred to as "out of the money." See Bodie et al., supra note 105, at 659.

107. See Walther, supra note 11, at 211.

108. See Bodie et al., supra note 105, at 699 ("Consider a call option that is out of the money at the moment, with the stock price below the exercise price. This does not mean the option is valueless. . . . [T]he call still has value because there is always a chance the stock price will rise above the exercise price . . . .").

would go entirely toward satisfying the VC liquidation preferences, as if the market price was beneath the exercise price of the stock. As should be apparent by now, however, the fact that a stock's market price is beneath the exercise price (or in this case, that the market value is beneath the liquidation preference) does not render the stock worthless[109]—it simply means one must look to the prospects of the market value exceeding the exercise price before the expiration of the option.

Here is where *Trados* and *Nine Systems* went astray. Take *Trados* first. In *Trados*, Laster concluded that the common stock did not have a "realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference."[110] First, this overlooks the fact that underwater stock need not have a greater than 50% chance of exceeding the exercise price in order to be worth more than zero. If, hypothetically, the *Trados* common shareholders had a 10% chance of growing the firm such that the firm was worth more than the liquidation preference, surely well-motivated directors protecting the common stockholders (as is their duty under Delaware law) would deem this 10% chance valuable enough to warrant consideration. Second, the *Trados* opinion indicates Laster's skepticism toward the "gloomy picture painted by the defendants" of Trados's business prospects *and* suggests throughout that Trados's business was largely on the upswing.[111] These observations are not consistent with the implicit conclusion that the option held by common stockholders was so deep underwater as to be worthless.

The reasoning in *Nine Systems* suffered similar pathologies. In *Nine Systems*, Noble's conclusion that the common stock had no option value at the time of the recapitalization simply does not comport with the sale of the company for $175 million just a few short years later.[112] Even if, as Noble suggested, Nine Systems would have been unable to attract a $175 million offer without the recapitalization, this sidesteps the fact that common shareholders were excluded from the opportunity to take part (despite later claims that they would have joined in the recapitalization) and that this recapitalization was clearly attractive enough in terms of the firm's future value to persuade the VC firms to participate.[113] Indeed, if

109. Walther, supra note 11, at 210 n.348 ("Strictly speaking, of course, common equity always retains some option value, so long as it is possible for the company's business to turn around and become profitable.").

110. In re Trados Inc. S'holder Litig., 73 A.3d 17, 77 (Del. Ch. 2013).

111. Id. (noting that the court regarded "Trados's prospects as more bullish . . . particularly with a savvy operator"); id. at 66 ("Thanks to [the new CEO's] managerial acumen, [Trados's] cash position improved substantially . . . ."); id. at 67 ("Contrary to the defendant's exaggerated trial testimony, the Company was not headed for a cliff, and there was a realistic possibility that it could self-fund its business plan.").

112. See In re Nine Sys. Corp. S'holders Litig., No. 3940-CVN, 2014 WL 4383127, at *45–46 (Del. Ch. Sept. 4, 2014), aff'd sub nom. Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015).

113. Id. at *10–11, *51.

the VC firms in *Nine Systems* were truly convinced that the deal was fair, why go to the trouble of repeatedly evading the independent director and shrouding behind lack of disclosure the nature of the recapitalization?[114] And if the option was truly worthless, how could the directors breach their fiduciary duty of loyalty by taking it for themselves?

The foregoing analysis of both *Trados* and *Nine Systems* is bolstered by another significant point: The "option" held by the *Trados* and *Nine Systems* common stockholders to continue operating the firms *did not have an expiration date*—common stockholders in both cases had a claim to the value of the corporation into perpetuity.[115] While the liquidation preferences in the preferred contracts entitled the VC firms in *Trados* and *Nine Systems* to preferential treatment in the event of a sale or bankruptcy, these preferred contracts did not attempt to exempt the VC firms from their fiduciary duty to common shareholders, whether in an exit scenario or otherwise.[116] Because common shareholders are free to pursue value for as long as the firm exists, the common stockholders in *Trados* and *Nine Systems* had a rightful claim to the value of a corporation with a "perpetual existence."[117] The VC preferred directors, in turn, had a corresponding obligation to pursue a strategy that accounted for the option value embedded in this right.[118]

A simple example may help to crystallize the practical effect of ignoring this option's value. Imagine a firm worth $60 million, held 50% by common stockholders and 50% by VC preferred stockholders. Imagine further that the firm is subject to a $60 million VC liquidation preference. Suppose that, if the firm continues operating, the firm has a 10% chance of generating $100 million in additional value and a 90% chance of losing $20 million. Because the expected value of the loss ($18

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114. Id. at *15, *20, *37.

115. This is not a controversial claim under Delaware law, which has repeatedly held that directors owe a duty to maximize the long-term value of the firm for the benefit of residual claimants. See, e.g., Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009); TW Servs. v. SWT Acquisition Corp., Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) ("Thus, broadly, directors may be said to owe a duty to shareholders as a class to manage the corporation . . . in a way intended to maximize the long run interests of the shareholders."); Andrew A. Schwartz, The Perpetual Corporation, 80 Geo. Wash. L. Rev. 764, 777–83 (2012).

116. In re Trados Inc. S'holder Litig., 73 A.3d 17, 56 n.32 (Del. Ch. 2013) (noting that the VC firms failed to "attempt at explicit contracting over exit-related conflicts").

117. Id. at 37; see also Schwartz, supra note 115, at 777–83.

118. It is worth emphasizing the connection between the value of the option to the common stockholders of continuing to operate the firm and the *right* of the common stockholders as residual claimants to continued operation. Laster himself seemed to appreciate the *value* tied to continued operation of a firm but failed in *Trados* to recognize that preferred stockholders may not simply take this right from the common stockholders. *Trados*, 73 A.3d at 50 n.25. Untethering Delaware's commitment to shareholder primacy from the value of the option effectively reduces the option's value to zero because an option that can be captured without any compensation is, by definition, worth nothing.

million)[119] will be borne entirely by the preferred stockholders and 50% of the expected value of the gain ($5 million) will accrue to the common stockholders, the option to continue operating the firm has positive value to the common stockholders despite the fact that (1) the firm's current value is swallowed by the liquidation preference and (2) the overall expected value of continued operation is negative (an $8 million loss).[120]

Now imagine that a buyer offers to buy the firm for $60 million. Because common stockholders are entitled as residual claimants to pursue value into perpetuity, recognizing the option value in this example suggests that a nonconflicted board would preserve the option value for the common stockholders while trying to minimize loss to the preferred stockholders. In this example, a fair deal might involve having the preferred pay $5 million of the merger consideration to the common stockholders in exchange for accepting the sale, thereby helping the preferred stockholders to avoid $18 million in expected loss. If one disregards the value of the option, however, a conflicted board might allow the VC preferred stockholders to capture this option value without compensating common stockholders—this Comment argues that this is precisely what occurred in *Trados* and *Nine Systems*.

2. *Damages in Appraisal and Fiduciary-Breach Actions.* — In order to fully understand the damages that the *Trados* and *Nine Systems* shareholders were entitled to, it is important to differentiate Delaware's approaches to damage calculation in *appraisal* versus *fiduciary-breach* actions. Under Delaware law, appraisal is a statutory remedy whereby aggrieved shareholders may seek an independent judicial determination of the "fair value" of the stock held immediately prior to a transaction, without consideration of postmerger synergies or the ability to craft situation-specific equitable remedies.[121] Thus, even when available, Delaware's appraisal remedy is limited insofar as it seeks to evaluate price

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119. This and all other expected value calculations are made by taking the product of an outcome's probability (in this case, 90%) and that outcome's value (in this case, $20 million).

120. In this example, continued operation has *negative* expected value because the sum of expected upside value (10% x ($100 million additional value + $60 million current value)) and expected downside value (90% x ($60 million current value – $20 million lost value)) is $52 million, which is $8 million less than the offered sale price ($60 million).

121. Andra v. Blount, 772 A.2d 183, 192 n.22 (Del. Ch. 2000) (quoting Jack B. Jacobs, Reappraising Appraisal: Some Judicial Reflections, Speech at 15th Annual Ray Garrett, Jr. Corporate and Securities Law Institute, Northwestern University School of Law, at 3 (Apr. 27, 1995)); see also Barry M. Wertheimer, The Shareholders' Appraisal Remedy and How Courts Determine Fair Value, 47 Duke L.J. 613, 685 (1998) ("Although it appears that courts consider unfair conduct or breaches of fiduciary duty to reach equitable appraisal results, they are restricted in their ability to do so under existing Delaware case law.").

Because appraisal is a statutory remedy—that is, available as a cause of action only in certain statutorily defined circumstances—there are by definition certain scenarios in which an appraisal action is not available to an aggrieved party *at all*. See, e.g., City of N. Miami Beach Gen. Emps.' Ret. Plan v. Dr Pepper Snapple Grp., Inc., No. 2018-0227-AGB, 2018 WL 2473150, at *5 (Del. Ch. June 1, 2018).

without delving into "an inquiry into claims of wrongdoing in the merger."[122]

Claims for *fiduciary breach* are evaluated very differently. When shareholders bring a fiduciary-breach action under Delaware law, they are entitled as a matter of equity to seek damages beyond the pre-merger value of the stock and may claim "post-merger values."[123] Fiduciary claims reviewed under entire fairness scrutiny—as both *Trados* and *Nine Systems* were[124]—also permit the court "flexibility to shape a remedy," such that "a plaintiff who can state a claim for breach of fiduciary duty ordinarily should not be relegated to the (implicitly less adequate) remedy of appraisal."[125]

How might a damage award be fair under appraisal but inadequate under a fiduciary claim? To borrow then-Vice Chancellor Strine's illustration: Imagine a controlling shareholder who purchases the shares of minority stockholders in a "squeeze-out" merger for $25 per share, which (we can stipulate) is clearly within the range of fairness in terms of price. Imagine further, however, that the controller failed to disclose that another buyer had offered to buy the stock for $28 per share. Here, appraisal is insufficient because "[w]hile $25 is a fair price, [shareholders] had arguably been wrongfully denied the opportunity for $28."[126] This hypothetical captures, at a high level of generality, the nature of the issue in *Trados* and *Nine Systems*, as both sets of shareholders essentially argued that while $0 may have been within the range of fair prices for the stock immediately prior to the challenged transactions (and therefore implicitly nonactionable through an appraisal action), the directors' self-dealing deprived plaintiffs of the opportunity to receive significantly more (a breach warranting an equitable remedy in a fiduciary-breach action).

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122. Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1189 (Del. 1988).

123. See id. ("If the merger was properly consummated, then 8 Del. C. §262 affords Cinerama a claim for the fair value of its Technicolor shares. If the merger was not lawfully effected, Cinerama should be entitled to recover rescissory damages . . . ." (citation omitted)).

124. In re Nine Sys. Corp. S'Holders Litig., No. 3940-VCN, 2014 WL 4383127, at *34 (Del. Ch. Sept. 4, 2014) ("The Defendants who were members of the Board during the Recapitalization . . . must establish its entire fairness."), aff'd sub nom. Fuchs v. Wren Holdings, LLC, 129 A.3d 882 (Del. 2015); In re Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013) ("In this case, the Board lacked a majority of disinterested and independent directors, making entire fairness the applicable standard.").

125. *Andra*, 772 A.2d at 193; see also Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) ("The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved." (quoting Cole v. Nat'l Cash Credit Ass'n, 156 A. 183, 187 (Del. Ch. 1931))); Wertheimer, supra note 121, at 685 ("[C]laims of unfair dealing may not be litigated within the context of a statutory appraisal proceeding.").

126. *Andra*, 772 A.2d at 193.

While the *Trados* opinion purported to divide its damage discussion into separate appraisal and fiduciary-breach sections, it appears that Vice Chancellor Laster allowed appraisal considerations to seep into the fiduciary analysis. Most noticeably, in the section of the opinion that concludes that the transaction was fairly priced despite unfair dealing, Laster stated the following: "If Trados's common stock had no economic value before the Merger, then the common stockholders received the substantial equivalent in value of what they had before, and the Merger satisfies the test of fairness."[127]

This statement is unusual because it implies that the court was taking a comparative snapshot of Trados's value immediately pre- and postmerger exclusive of postmerger synergies and other harm based in opportunity deprivation—an approach that sounds more in appraisal than fiduciary analysis.[128] It may well have been true that $0 was within the range of fair prices for Trados, but this does not prevent plaintiffs in a fiduciary action from claiming they were "wrongfully denied the opportunity" to continue operating the firm due to director self-dealing or arguing that nonconflicted directors would not have approved a management-compensation plan that soaked up the difference between the $60 million deal value and $57.9 million liquidation preference.

This is not to say that *Trados* exclusively applied appraisal principles. To be sure, as the prior subsection discusses, the larger problem in *Trados* and *Nine Systems* appears to have been the failure to recognize, as part of a fiduciary analysis, the value of the stockholders' option to continue running the firm. Still, comments such as the one highlighted above suggest that appraisal principles may have improperly informed the calculus.

B. *External Inconsistency*

The failure of *Trados* and *Nine Systems* to recognize the damage to common stockholders is also inconsistent with other areas of Delaware law that have considered similar, if not identical, problems. In a series of cases examining the obligations of corporate directors to *creditor* shareholders, the Delaware courts considered,[129] and then expressly

127. *Trados*, 73 A.3d at 76. Laster made substantively analogous statements elsewhere in the fair-price analysis. See, e.g., id. at 78 ("The common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value . . . .").

128. Finkelstein v. Liberty Dig., Inc., No. Civ. A. 19598, 2005 WL 1074364, at *12 (Del. Ch. Apr. 25, 2005) (framing the task of appraisals as "determining the fair value of the petitioners' shares on the date of the merger").

129. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.").

rejected,[130] the possibility that directors should attend to the interests of creditor shareholders when the firm is in the "zone of insolvency,"[131] a situation in which the interests of creditors and common shareholders diverge. This section argues that this rejection is not just an affirmation of the principle that directors owe unflinching fiduciary duties to common stockholders but *also* confirmation that (1) common stockholders retain a right to continue operating the firm in pursuit of value even when the odds of success are slim and (2) this right carries *value*.

In the context of preferred stock, the moderate-downside scenario raises the question as to whether directors owe fiduciary attention to the preferred shareholders; in the creditor context, a similar question arises when the corporation is teetering on the edge of bankruptcy. When a corporation risks insolvency, the main conflict is the difference in *risk preference* between creditors and common stockholders: Because creditors have preferential liquidation rights in the event of bankruptcy, common stockholders have far less to lose by the firm engaging in high-risk–high-reward behavior that could either create significant value (in which case the common stockholders reap the benefits) or destroy considerable value (in which case the creditors bear the brunt of the harm). Therefore, a question arises: When a firm is *nearly* but not *actually* insolvent, may directors direct fiduciary attention to creditors, contrary to the preferences of common stockholders?

In a now-famous footnote, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* in dicta took up this question and suggested that when a company is "in the vicinity of insolvency," the "right . . . course [for the board] to follow for the corporation may diverge from the choice that the stockholders . . . would make."[132] In reaching this conclusion, Chancellor Allen provided the following example: Suppose that a corporation has a single asset, a judgment for $51 million against a debtor, and suppose further that this judgment has a 25% chance of being affirmed on appeal, a 70% chance of being reduced on appeal to $4 million, and a 5% chance of reversal.[133] Suppose also that the corporation has $12 million in liabilities to creditors. This scenario is depicted in Table 1.

130. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("[N]o direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency."); Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.75 (Del. Ch. 2006) ("[C]reditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of the firm.").

131. *Gheewalla*, 930 A.2d at 101 ("When a solvent corporation is navigating in the zone of insolvency, . . . directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.").

132. 1991 WL 277613 at *34 n.55.

133. Id.

TABLE 1: *CREDIT LYONNAIS* "VICINITY OF INSOLVENCY" HYPOTHETICAL

	Value of Outcome	Expected Value
25% chance of being affirmed	$51 million	$12.75 million
70% chance of modification	$4 million	$2.8 million
5% chance of reversal	$0	$0
Expected Value of Appeal		$15.55 million

Based on the expected outcomes shown in Table 1, the total value of the firm's equity is $3.55 million (the result of adding the expected values of the various outcomes on appeal and subtracting the $12 million liability to creditors).[134]

If the debtor to the corporation offers to settle for $17.5 million, a conflict between creditors and common stockholders emerges: Creditors will wish to settle (guaranteeing recovery of their $12 million) whereas common stockholders may wish to take their chances on appeal despite the fact that their $5.5 million recovery would be *greater* than the $3.55 million equity value. Why might common stockholders prefer to do this? Because the expected value of the affirmation on appeal is $9.75 million ((25%) x ($51 million – $12 million)), which is greater than the $5.5 million gained via settlement; assuming that common stockholders are diversified and risk neutral, they will prefer to appeal, even though this choice inflicts damage on creditors. Here, Allen observed, any settlement above $15.55 million ($12 million to creditors and $3.55 million to the common stockholders) is fair, but exclusively adhering to the preference of common stockholders could prevent this result.[135] As such, Allen suggested directors ought to be empowered to consider the full "community" of corporate interests.[136]

Several years later, the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* squarely addressed the *Credit Lyonnais* dicta and firmly rejected the idea that directors owe fiduciary duties to creditors when a corporation is in the

134. Id.

135. Id.

136. Id. It seems possible that the specific, and extreme, facts of *Credit Lyonnais* further encouraged Chancellor Allen to sympathize with the plight of creditors in the zone of insolvency. Among other questionable behavior, one Paretti (a major shareholder whom creditors alleged had violated a key agreement) quite literally threatened one Meeker, a lawyer working on behalf of the creditors: "I want you to understand, Meeker, that I am crazy. I want you to understand that I am really crazy . . . . I am really dangerous." Id. at *17.

"zone of insolvency."[137] Noting that creditors are protected by "contractual agreements, fraud and fraudulent conveyance law, and implied covenants of good faith and fair dealing, bankruptcy law, [and] general commercial law," the *Gheewalla* court explicitly refused—citing directly to the *Credit Lyonnais* footnote—to superimpose fiduciary rights to creditors, even in the zone of insolvency.[138]

In one sense, *Gheewalla* is simply to creditors what *Trados* and *Nine Systems* are to preferred stockholders: a case affirming the obligation of directors to prioritize common stockholders even when other corporate constituencies have conflicting preferences.[139] In another sense, however, *Gheewalla* supports the view that directors must protect the right of common stockholders to pursue high-risk options, such as continuing to operate the firm in the zone of insolvency or moderate downside, even when doing so may *inflict harm* upon other corporate constituencies.

In order to illustrate this point, it is helpful to consider again Allen's *Credit Lyonnais* hypothetical, depicted in Table 1 above, but this time modulated into the moderate downside: Imagine a VC-controlled startup in the moderate downside—somewhere between failure warranting liquidation and IPO-quality growth—currently worth $50 million. Suppose the common and preferred stockholders each own 50% of the outstanding shares. Suppose also that the VC backers have a total liquidation preference of $50 million. Assume that if the startup continues to operate, challenges in the industry are so severe that the startup has a 90% chance of "failure," which will result in the value of the startup falling to $20 million. Assume further that the startup has a 10% chance of "success," which will result in the value of the startup rising to $100 million. These facts are shown in Table 2, below.

TABLE 2: MODERATE-DOWNSIDE HYPOTHETICAL A

	Value of Outcome	Expected Value
90% chance of failure	$20 million	$18 million
10% chance of success	$100 million	$10 million
Expected Value of Continuing to Operate the Firm		$28 million

137. 930 A.2d 92, 101 (Del. 2007) ("[N]o direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.").

138. Id. at 99–100.

139. Id. at 101 ("When a solvent corporation is navigating in the zone of insolvency, the focus of Delaware directors does not change: directors must continue to discharge their fiduciary duties . . . in the best interests of the corporation for the benefit of its shareholder owners.").

Imagine that a buyer offers to pay $50 million to purchase the startup. The VC firms will prefer to take the offer, as they will recover their liquidation preference and avoid the challenges facing the company; this allows them to move on to other projects. Moreover, the VC firms absorb the *full effect* of the risk of failure (see Table 2.1). Compared with the certainty of receiving $50 million, VC preferred stockholders will receive only $23 million in expected value if the firm continues to operate. The shareholders, on the other hand, will clearly prefer to reject the offer because the full $50 million will go toward the VC liquidation preference whereas continuing to operate the startup provides shareholders with $5 million in expected value, even after splitting the gain with the preferred stockholders (see Table 2.2).

TABLE 2.1: MODERATE-DOWNSIDE HYPOTHETICAL A—
PREFERRED-STOCKHOLDER PERSPECTIVE

	Outcome to Firm	Expected Value to Preferred Stockholders
90% chance of failure	$20 million	$18 million
10% chance of success	$100 million	$5 million[140]
Expected Value of Continuing to Operate the Firm		$23 million

TABLE 2.2: MODERATE-DOWNSIDE HYPOTHETICAL A—
COMMON-STOCKHOLDER PERSPECTIVE

	Outcome to Firm	Expected Value to Common Stockholders
90% chance of failure	$20 million	$0 million
10% chance of success	$100 million	$5 million
Expected Value of Continuing to Operate the Firm		$5 million

Allen's *Credit Lyonnais* reasoning acknowledged that the common stockholders derived value from their option to continue operation but argued that directors should be empowered to consider other constituencies in pursuit of the overall "efficient" option.[141] In the hypothetical

140. Preferred stockholders receive only $5 million here as opposed to $10 million because 50% of the value above the liquidation preference will go to common stockholders.

141. *Credit Lyonnais*, 1991 WL 277613, at *34 & n.55.

depicted in Table 2, the expected value of the startup's equity as a going concern is only $28 million, $22 million *less* than the VC liquidation preference, making it clear that $50 million is socially optimal. Indeed, even if common stockholders have nothing to lose by continuing to operate the firm, preventing the board from taking this sale offer is likely to inflict *harm* on the preferred stockholders.

And yet, by rejecting the *Credit Lyonnais* dicta, *Gheewalla* made clear that, at least in the creditor context, common stockholders are *entitled* to have boards inflict this harm upon creditors if it means pursuing the best option for the common stockholders.[142] This conclusion is not nearly as curious as it may seem. Allen's *Credit Lyonnais* footnote approaches the problem *ex post*, assuming a transaction that *reduces* firm value. However, as discussed further in the next Part, Delaware's shareholder-primacy regime operates under the ex ante assumption that in general—that is, in the aggregate[143]—it is most efficient to defer to common-stockholder preference.[144]

To illustrate this point, assume again the facts depicted in Tables 2, 2.1, and 2.2, but now suppose that the startup has a 10% chance of increasing to a value of $300 million and a 90% chance of decreasing in value to $30 million (see Table 3). Notice that under these new facts, it is socially efficient to continue operating the startup, but preferred stockholders will favor a $50 million sale because their expected value from continued operation is only $42 million (Table 3.1), whereas common stockholders will prefer continued operation (Table 3.2). In other words, this time, if the preferred stockholders hold and exercise the option to sell the firm, the outcome will *destroy* value and therefore be socially inefficient.

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142. Cf. *Gheewala*, 930 A.2d at 103 ("The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors."). *Gheewala*'s conclusion that creditors are owed no fiduciary obligations (absent insolvency) paired with the conclusion that the board owes an unceasing obligation to common stockholders as residual claimants necessarily obliges boards of directors to take action favorable to common stockholders even when such action imposes harm in some form upon other classes of claimants.

143. Considering the problem in the aggregate as opposed to in the context of a single firm also helps to highlight costs that could emerge from interpretive and pricing ambiguity, as opposed to decisionmaking advantages. Specifically, it may be the case, as some have pointed out, that shifting corporate fiduciary obligations from shareholders to creditors in the "zone of insolvency" would impose transactional costs on the economy in the form of financial markets having to value creditor protections in the face of a hazy spectrum of fiduciary obligations. See Rutheford B. Campbell, Jr. & Christopher W. Frost, Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere), 32 J. Corp. L. 491, 521 (2007).

144. See infra section III.A.

TABLE 3: MODERATE-DOWNSIDE HYPOTHETICAL B

	Outcome to Firm	Expected Value
90% chance of failure	$30 million	$27 million
10% chance of success	$300 million	$30 million
Expected Value of Continuing to Operate the Firm		$57 million

TABLE 3.1: MODERATE-DOWNSIDE HYPOTHETICAL B—
PREFERRED-STOCKHOLDER PERSPECTIVE

	Outcome to Firm	Expected Value to Preferred Stockholders
90% chance of failure	$30 million	$27 million
10% chance of success	$300 million	$15 million
Expected Value of Continuing to Operate the Firm		$42 million

TABLE 3.2: MODERATE-DOWNSIDE HYPOTHETICAL B—
COMMON-STOCKHOLDER PERSPECTIVE

	Outcome to Firm	Expected Value to Common Stockholders
90% chance of failure	$30 million	$0 million
10% chance of success	$300 million	$15 million
Expected Value of Continuing to Operate the Firm		$15 million

Applied to *Trados* and *Nine Systems*, *Gheewalla* and the foregoing logic suggest that common stockholders cannot be stripped of their right to continue operating the firm in hopes of generating value, even when the most efficient choice in a particular instance would be to opt for a sale.

One could perhaps argue that the creditor context is different from the preferred-shareholder context in that creditors are entitled *only* to contractual protection whereas preferred stockholders are entitled to *both* contractual and fiduciary protection. This, however, seems unpersuasive for two reasons. First, VC preferred shareholders in the moderate downside, as in *Trados* and *Nine Systems*, act to benefit a *contractual* liquidation preference—to the extent they behave like creditors, it is

logical to demand that they be treated like creditors.[145] Second, even the fiduciary protection owed to preferred stockholders is simply the protection they share with common stockholders, namely, the right for the board to seek strategies that maximize value for the common stockholders.[146]

In sum, this Part has argued that *Trados* and *Nine Systems* failed to recognize that damage *was* inflicted upon common stockholders in the amount of the value of the option to continue operating the firm and that this failure of recognition is inconsistent with other areas of Delaware law.

III. A PATH FORWARD

Having argued that *Trados* and *Nine Systems* erred as a matter of economics and doctrine, this Comment now advocates for an alternative approach. Once one appreciates the "option value" of the common stock in *Trados* and *Nine Systems*, the question becomes how to assign a default rule—that is, whether preferred stockholders, on the one hand, or common stockholders, on the other, should have the burden of contracting for the right to capture this value. This Part proposes that as a default, and contra *Trados* and *Nine Systems*, VC preferred stockholders should have the burden of contractually specifying the right to capture the option value of the common stock (section III.A). This Part then considers a counterargument, based on political economy: Forcing VC preferred stockholders to contract for the right to capture this option value may discourage VCs from investing in Delaware firms (section III.B).

A. *Assigning the Default*

Recognizing that there *was* value associated with the *Trados* and *Nine Systems* common stock introduces a familiar contracting question: In the absence of terms (here, in the preferred-stock contract) specifying which of the contracting parties has the right to capture this value, which party should courts assume as a default rule has this right?[147] In *Trados* and *Nine Systems*, the courts effectively applied a default whereby VC-held preferred stockholders have the right to capture this value, placing the burden on common stockholders to claim it for themselves.

This section argues that, as a matter of policy, *Trados* and *Nine Systems* erred in effectively placing the burden on common stockholders to

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145. See supra notes 11–13 (noting Delaware's approach to claimants that have either contractual or fiduciary rights against the corporation).

146. See supra note 15.

147. Robert Gertner & Ian Ayres, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 87 (1989) ("Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them."); see also Daniel Fischel, Labor Markets and Labor Law Compared with Capital Markets and Corporate Law, 51 U. Chi. L. Rev. 1061, 1063 (1984) ("[C]orporate statutes provide a set of standard-form terms, but firms are generally free to alter these terms in their charters or bylaws.").

contractually specify the right to capture the option value of their stock.[148] There are at least two reasons to embrace this framework: First, Delaware jurisprudence itself assumes it is more efficient ex ante to grant this option to common stockholders. Indeed, given that VC preferred contracts are sophisticated and heavily negotiated documents, it would be imprudent for a court to depart from Delaware's shareholder primacy default without explicit contractual language requiring this departure. Second, VC firms tend to have superior bargaining leverage relative to the entrepreneurs with whom they contract and the resultant ability to secure terms they desire.

Given the care with which VC preferred contracts are drafted, it makes little sense to allow silence in a preferred contract to entitle preferred stockholders to capture value from the common stockholders when this marks a clear deviation from Delaware's shareholder primacy default. In other words, Delaware courts would not be assigning a default in a vacuum, but within a robust common law regime that expressly prioritizes common stockholder value-maximization.[149] Shareholder primacy is defended as a default rule on the ex ante expectation that—even if deferral to shareholder interests may lead in some cases to inefficient outcomes for a firm ex post—in the aggregate, shareholders as "residual claimants" will guide firms to the most efficient long-term outcomes.[150] Moreover, Delaware's "common stock-maximization principle" has already been taken to advise strict construction of preferred contracts.[151] It follows from Delaware's decision as a background default to prioritize the interests of common stockholders that preferred stockholders should be forced to specify, as a default, the right to capture value from common

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148. It seems likely that *Trados* and *Nine Systems* "effectively" placed the contracting burden on common stockholders because the courts failed to recognize the *existence* of positive option value, rather than because the courts actively sought to assign the default this way. See supra sections II.A–.B. This section attacks a counterfactual: If *Trados* and *Nine Systems* courts *had* recognized the value attached to the common stock, how should the burden to specify a right to this value be allocated?

149. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."); see also Leo E. Strine, Jr., The Dangers of Denial: The Need for A Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law, 50 Wake Forest L. Rev. 761, 767 (2015) ("It is . . . injurious to social welfare to declare that directors can and should do the right thing by promoting interests other than stockholder interests.").

150. See supra Tables 3, 3.1, 3.2; see also TW Servs. v. SWT Acquisition Corp., Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) ("[T]he interests of the shareholders as a class are seen as congruent with those of the corporation in the long run."); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 36–39 (1991).

151. See Bratton & Wachter, supra note 10, at 1890 ("The fiduciary common stock-maximization principle purports only to fill in a gap in an incomplete contract. Typically, the burden to contract around the corporate law default falls on the preferred."); Cane et al., supra note 16, at 416–28.

stockholders, particularly in contracts as carefully negotiated as VC preferred agreements.

The relative bargaining power of preferred-holding VCs to common-holding entrepreneurs provides another reason to apply a default in which the preferred must specify the right to capture option value of the kind at issue in *Trados* and *Nine Systems*. It has been widely noted that VC firms have considerable leverage vis-à-vis startup entrepreneurs as well as the incentive to tailor preferred stock contracts to the VC firms' situation-specific needs.[152] Thus, if VC investors wish to capture the value of the common stock's option value, VC investors should be forced to say so—to apply the opposite rule seems likely only to grant VCs a windfall in cases like *Trados* and *Nine Systems* while allowing VCs to avoid disclosing that they may choose to capture this value in the event of a moderate downside.

Default-rule scholarship is consistent with this proposal. While a major school of thought asserts that default rules should be applied to reflect what the contracting parties "would have" agreed to in order to maximize collective value,[153] it has also been recognized that this "hypothetical bargaining" interpretive regime faces challenges when the interests of parties (distributional or otherwise) are directly at odds—as in *Trados* and *Nine Systems*—and it is unclear what the agreement would have been.[154] When the hypothetical bargaining approach is unhelpful, several have argued that defaults should be designed to fulfill an information-forcing function, "compel[ling] each party to reveal to the other its intended use of discretionary powers."[155] This latter rationale seems particularly relevant to the tensions described in this Comment: Following *Trados* and *Nine Systems*, VCs have an incentive to remain

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152. See Strine, Poor Pitiful, supra note 8, at 2038–39 ("The need for equity to protect the preferred's noncontractual company-specific investments over those of the [common stock] remains questionable to me, given the abundant evidence of preferred stockholders' ability to get specific contractual protections."); see also Korsmo, supra note 10, at 1223 ("[T]he burden of drafting provisions providing the preferred with the powers they need would naturally fall upon the preferred . . . . VCs, being highly sophisticated repeat players, are well situated to perform this drafting."); Mitchell, supra note 13, at 470 ("[P]referred stockholders have the opportunity to specify their deal with the common in advance and . . . should be held to the bargain they made."); Walther, supra note 11, at 172 ("The [VC] has an unusual amount of leverage over an entrepreneur.").

153. See Lucian Arye Bebchuk & Assaf Hamdani, Optimal Defaults for Corporate Law Evolution, 96 Nw. U. L. Rev. 489, 491 n.8 (2002) ("The hypothetical bargains approach is the predominant theory of contractual interpretation.").

154. See Omri Ben-Shahar, A Bargaining Power Theory of Default Rules, 109 Colum. L. Rev. 396, 397 (2009) ("Yet the existence of a gap in a contract is often an indication that a consensus could not be reached because a single jointly preferable term does not exist.").

155. John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618, 1623 (1989); see also Gertner & Ayres, supra note 147, at 94 ("The strategic behavior of the parties in forming the contract can justify strategic contractual interpretations by courts.").

strategically silent regarding their right to capture this option value, securing this value via default while avoiding having to expressly convey to entrepreneurs their intent to wield discretionary control rights in order to capture this value. Given the strong bargaining position that VC firms often occupy, placing the burden on VC firms to make explicit their right to capture the option value of the common stock should make the VC–entrepreneur agreement more transparent without introducing significant transaction costs.

B. *Questions of Political Economy*

Before concluding, this section addresses an issue that complicates the foregoing default-rule analysis: If, as this Comment has argued, preferred stockholders in *Trados* and *Nine Systems* walked away from the challenged transactions holding something of value, it *may* be the case that—bracketing all other concerns—allowing this windfall to VCs desirably attracts VC business to the state of Delaware. VC firms are repeat players, responsible for injecting huge amounts of capital into the startup industry,[156] and, as others have noted, if "a number of [VC] firms experience bad results in Delaware litigation, Delaware could suffer a negative reputational effect in the [VC] community."[157]

In other words, even if VC preferred stockholders have the necessary bargaining power and incentive to specify contractual terms suited to their needs without needing to rely on a default; and even if Delaware's emphasis on maximizing value for common stockholders warrants interpreting highly negotiated VC preferred contracts as not transferring value from common to preferred unless so stated; *even then*, considerations of political economy may warrant allowing VCs to capture this value if the goal and result is to draw more VC capital into Delaware.

Still, there is a tradeoff: Just as permitting VC preferred holders to capture this option value would be a boon to VC firms, so too would this outcome harm entrepreneurs, who might eventually decide to incorporate in other jurisdictions with less VC-favorable defaults.[158] This Comment does not venture a guess as to whether the risks of upsetting the VC community would be outweighed by the possibility of entrepreneurs seeking to incorporate outside of Delaware—the aim here is only to underscore another dimension of the policy tradeoff obscured by the unwillingness of *Trados* and *Nine Systems* to recognize that value was indeed left on the table in both cases. If nothing else, were the Delaware

156. See supra note 12 and accompanying text.

157. William W. Bratton, Venture Capital on the Downside: Preferred Stock and Corporate Control, 100 Mich. L. Rev. 891, 938 (2002).

158. Some critics of the *Trados* decision have explicitly suggested that the finding of unfair process, even absent a damage award, may reflect Delaware's desire to cater to common stockholders. See, e.g., Bratton & Wachter, supra note 10, at 1901 ("Delaware sells a product, the buyers of which tend to be holders of common stock . . . .").

courts (or legislature[159]) to recognize the existence of this value and to craft a default designed to favor either VC-held preferred or entrepreneur-held common stock, this would help to resolve the doctrinal tensions introduced by *Trados* and *Nine Systems*.

CONCLUSION

This Comment has argued that the opinions in *Trados* and *Nine Systems* incorrectly concluded that the challenged transactions inflicted no damage upon common stockholders. Specifically, this Comment has explained that the harm inflicted upon common stockholders in *Trados* and *Nine Systems* was the deprivation—via clearly disloyal acts by conflicted directors—of common stockholders of the ability to continue operating the firm in hopes of generating future value. This argument is not simply an exercise in doctrinal "gotcha," but rather an attempt to both rationalize an increasingly important area of law and draw into the sunlight a policy tradeoff that has been obscured.

159. See Bratton, supra note 157, at 938 ("Delaware lawmakers are famous for trimming their sails upon becoming aware that actors in the capital markets disapprove of a ruling.").