

Shareholder Wealth Maximization as Means to an End

*Robert P. Bartlett, III**

I. INTRODUCTION

Imagine you are a director of a Delaware company whose once promising business plan has not worked out as hoped. Faced with a deteriorating cash position, the firm must now decide between two courses of action. The first option (the “Gamble”) is potentially lucrative but also risky with the odds of success estimated at just 25%. Under this option, all company assets would be redeployed towards a new business plan and, if successful, should result in the sale of the company for \$200 million. If it fails, however, the company would be left with nothing. The alternative option (the “Sure Thing”) is less risky and would involve liquidating the company for \$100 million with virtual certainty. Which option should you support? Which option should society support?

To those unfamiliar with Delaware law, it may be surprising to learn that the answers to these two questions are not necessarily the same. From a social welfare perspective, there seems little doubt that the Sure Thing (with its expected value of \$100 million) is far superior to the Gamble (with its expected value of just \$50 million).¹ For company directors, however, recent pronouncements by the Delaware judiciary requiring directors to maximize returns to common stockholders make this choice dependent on how the firm happened to have financed its operations.² If the company financed itself through issuing only common stock, the Sure Thing does indeed emerge as the superior option for directors given that it maximizes common stockholder returns. On the other hand, if the company happened to have also financed itself with senior

* Professor of Law, UC Berkeley School of Law. For helpful discussions and comments, I thank Ken Ayotte, Ryan Bubb, Tony Casey, Oliver Hart, Rob Jackson, Prasad Krishnamurthy, Frank Partnoy, Usha Rodriguez, Eric Talley, Zenichi Shishido, Steven Davidoff Solomon, Lynn Stout, and participants at the Sixth Annual Berle Symposium. All errors are my own.

1. Assuming that any private benefits of control associated with continuing the business in the Gamble are less than \$50 million. Liquidating the business in the Sure Thing, of course, would preclude these private benefits from occurring. For a discussion of how private benefits of control can affect the efficiency analysis of such a decision, see *infra* text accompanying notes 79–80.

2. See *infra* Part IV.

contract claims (e.g., debt or preferred stock), the Gamble may represent directors' superior option if the proceeds from the Sure Thing would be absorbed by these senior claims. In such a situation, only the Gamble would provide a chance for common stockholders to realize a return. As summarized by the Delaware Chancery Court in analyzing this latter situation, "the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants [i.e., common stockholders] . . . not for the benefit of its contractual claimants."³

That directors might be forced to pursue socially suboptimal investments in these situations is peculiar to say the least. Those familiar with corporate finance theory no doubt find this outcome especially perplexing. While theories abound for why firms depart from all equity financing,⁴ there is certainly far less consensus on the subject than might be expected for a company's choice of capital structure to dictate that its directors support a socially inefficient project.⁵ More generally, this approach would also seem to require as a matter of complying with directors' fiduciary duties the type of reckless, go-for-broke gambles known to plague leveraged firms nearing financial distress and commonly associated with the lead up to the 2008 financial crisis. To the extent this is the state of Delaware law, it would seem we have come a long way from the days when corporations were chartered by the state to pursue the public good.⁶

This paper's chief contention is that this puzzling and unfortunate state of affairs is the result of several recent Delaware chancery opinions that have erroneously confused shareholder wealth maximization as a means to maximize firm value with shareholder wealth maximization as an end in itself.⁷ While these opinions correctly note that directors' duties

3. *In re Trados, Inc.*, 73 A.3d 17, 40–41 (Del. Ch. 2013). For a thoughtful analysis anticipating how prevailing notions of directors' fiduciary duties might induce directors to take inefficient corporate actions depending on a company's choice of capital structure, see Frank Partnoy, *Financial Innovation in Corporate Law*, 2006 J. CORP. L. 799, 806–09 (2006).

4. See Robert P. Bartlett, III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORD. L. REV. 1976, 1986–91 (2008) (summarizing finance literature).

5. See Partnoy, *supra* note 3, at 808–09 (discussing arbitrariness of privileging common stock with fiduciary duties in light of firms' divergent capital structures).

6. See Elizabeth Pollman, *Reconceiving Corporate Personhood*, 2011 UTAH L. REV. 1629, 1635–36 (2011); see also Simeon E. Baldwin, *History of the Law of Private Corporations in the Colonies and States*, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 236, 251 (AALS ed., 1909) (first published in TWO CENTURIES' GROWTH OF AMERICAN LAW (1901)) ("The American corporation could only come into existence legitimately for the public good.").

7. The analysis that follows focuses on the governance of for-profit firms where it is generally assumed that, absent special charter provisions to the contrary, maximizing firm value is a central

have been doctrinally tethered to a mandate to maximize the value of the corporation for its residual claimants, they err by assuming this mandate should be the ultimate benchmark for evaluating all director decisions. As shown below, a shareholder wealth maximization norm need not require this assumption, and the norm can easily be reconciled to situations where directors approve the Sure Thing in the earlier hypothetical regardless of a company's capital structure.

The mechanism by which this reconciliation is made possible is the acknowledgement that the centrality of a board to a company's business strategy makes it a natural venue for investors to bargain over the company's future direction. As scholars of "team production" have long maintained, directors are commonly called upon to mediate conflicting interests within a firm, and central among these conflicting interests are those of its investors.⁸ It is a perspective that informs virtually every proxy fight when common stockholders jockey to elect representatives that can advance their particular views on a company's board. And it is no less relevant to understanding the dynamic that occurs with fixed-claim investors such as lenders who, in lieu of securing board representation, extract from a company's board various restrictive covenants.⁹ For a board that promises to obtain a lender's consent before acquiring a business or changing its name is effectively binding itself to negotiate with the lender in the event it wants to undertake such conduct.

In either case, both director representation and restrictive covenants are merely mechanisms to address an incomplete contracting problem faced by all investors. Unable to write a contract that addresses every future contingency, investors must write investment contracts that anti-

goal of a business enterprise. See *infra* text accompanying note 55 (summarizing court opinions); ASWATH DAMODARAN, *APPLIED CORPORATE FINANCE* 3 (3d ed. 2010) ("The objective in conventional corporate financial theory when making decisions is to maximize the value of the business or firm."); see *infra* note 13 (defining firm value). As a result of this default rule, where maximizing firm value is not the intended goal for a firm, its promoters will generally be required to contract explicitly concerning the firm's ultimate goal or to choose a noncorporate form of organization. *E.g.*, VA. CODE ANN. §§ 13.1-787, 13.1-626, 13.1-782 (Lexis 2011) ("A benefit corporation shall have as one of its purposes the purpose of creating a general public benefit," and "may identify one or more specific public benefits that it is the purpose of the benefit corporation to create. . . . This purpose is in addition to [the purpose of engaging in any lawful business]."). In these latter situations, this explicit contracting over a firm's nonmonetary ends greatly diminishes the concern that is the focus of this Article—namely, the risk that courts will mistakenly impute to such a firm a single-minded objective of maximizing *stockholder* welfare.

8. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (discussing a team production theory of the board of directors that applies to publicly traded firms).

9. See RICHARD WIGHT ET AL., *THE LTSA'S COMPLETE CREDIT AGREEMENT GUIDE* 337-88 (2009) (describing common negative covenants made by borrowers to lenders in credit agreements).

pate the need for future renegotiation as circumstances change. From a financial contracting perspective, the choice of whether an investor obtains covenants or director representation to force these renegotiations is simply a question of whether a security's cash flows justify concentrated oversight and monitoring in anticipation of frequent renegotiation (thus pointing toward director-designees) or only periodic oversight in anticipation of renegotiation upon certain events (thus pointing toward contract covenants).¹⁰

Appreciating the role of the board in effecting these renegotiations highlights the useful role a shareholder wealth maximization norm can play in ensuring directors maximize corporate value, but only if this norm is viewed as a means to this end. In particular, by creating a background default rule for how directors should view their fiduciary duties, such a norm minimizes transactions costs for initial equity investors while inducing future investors to negotiate investment agreements that restrict corporate action in those instances where the interests of the investor and common stockholders are likely to diverge. A classic example is a loan covenant prohibiting a borrower from changing its primary line of business without the consent of the lender.¹¹ In a world where directors must (by default) maximize common stockholder returns, a rational lender will recognize the incentive a board has to substitute existing corporate assets for riskier ones, thereby resulting in this common negative covenant.¹²

Rather than constitute an absolute prohibition on modifying business lines, however, the covenant operates to force a renegotiation with

10. For instance, cash flows to equity securities are likely to be more sensitive to operating performance than those of fixed claims such as loans. As such, stockholders may be more inclined to look for director representation as a means to monitor and/or replace management and to otherwise monitor a company's operating performance. In contrast, creditors may be content to limit renegotiation only upon events that might substantially affect an issuer's ability to make fixed payments of interest and principal. For a formal model of this dynamic, see Elazar Berkovitch & Ronen Israel, *The Design of Internal Control and Capital Structure*, 9 REV. FIN. STUD. 209 (1996); see also David Erkens, K.R. Subramanyam & Jieying Zhang, *Affiliated Bankers on Board and Conservative Accounting*, 89 ACCT. REV. 1703 (2014) (noting that while banks typically rely on covenant violations to protect against agency conflicts with equity holders, banks occasionally "obtain ongoing control rights through affiliated banks on boards [to] allow affiliated banks to protect their rights in a timelier manner than through debt covenants").

11. See, e.g., WRIGHT ET AL., *supra* note 9, at 363 ("Neither the Borrower nor any Subsidiary shall engage to any substantial extent in any line or lines of business activity other than [the types of businesses engaged in on the date hereof by the Borrower and its Subsidiaries.]").

12. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 338 (1976) (noting the role of covenants as a means for bondholders to protect against the incentive managers have to appropriate wealth from bondholders in favor of equity holders).

the lender if the company's board later decides to change its business. Critically, as shown below, the board will be able to reach a satisfactory renegotiation with the lender only if the board can show that changing business lines will maximize the value of the firm.¹³ Moreover, the same analysis applies where an investor has secured this negotiation leverage through obtaining a director-designee with board veto rights rather than through a loan covenant. In either case, shareholder wealth maximization leads to an investor veto right that forces the board and investors to engage in classic Coasian bargaining over whether the company can engage in the proscribed conduct. The primary difference is that the appointment of the director-designee requires an opting out of the director's need to consider shareholder wealth maximization as the primary means to maximize the value of the firm. In so doing, this opting out enables the director to consider firm value from the perspective of the investor's personal cash flows. In the parlance of contract scholars, shareholder wealth maximization is simply a default rule that investors opt out of by appointing their own director-designees.¹⁴

While this analysis tracks in large part a purely contractarian approach to the firm, it is important to emphasize the role that fiduciary duties play in this bargaining process, thus distinguishing it from contractarian approaches that advocate a complete abandonment of fiduciary duties.¹⁵ First, imposing a fiduciary duty to the firm imbued with a

13. "Firm value" is defined here in the conventional sense used in corporate finance as all future cash flows to the firm discounted to present value. As such, the bargaining model of the board described in this paper focuses primarily on bargaining among a firm's capital providers, as is typical in corporate finance. At the same time, nothing prohibits other noninvestor stakeholders from seeking similar rights to force a renegotiation upon future events that would require directors to take into account the need to pay off these noninvestor stakeholders as well as its capital providers. Indeed, as noted below, it is management's de facto veto right over the sale of a financially distressed firm that often forces boards to create special management incentive plans to motivate managers to find an acquisition partner when the acquisition proceeds will be absorbed by investors' senior contract claims. *See infra* text accompanying note 62.

14. In general, default rules are legal rules that individuals can modify through contract. *See* Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 390 (1993) (comparing default rules and immutable rules). One theory of default rules is that they are commonly used to lower transaction costs by mimicking what most parties would agree to on their own where implementing the default rule is less expensive than negotiation. *See* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligations*, 69 VA. L. REV. 967, 971 (1983) (suggesting that default rules should provide for the rule parties would negotiate on their own). When a default rule fails to reflect the bargain desired by contracting parties, its existence will induce parties to contract explicitly for a more desirable contract term. *See* Schwartz, *supra*, at 399 (noting that default rules are "enacted to solve problems for parties, so it follows that parties whose problems are not solved should be free to create their own deal").

15. *See, e.g.*, Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1323 (2008) (arguing that directors should "merely be obliged to honor the terms of the

default norm of maximizing common stockholder value provides the initial inducement for investors to bargain for negative covenants and/or board representation. At the same time, this default fiduciary duty encourages noninvestor designees to continue to place a thumb on the scale of common stockholder welfare when considering how to maximize firm value in any subsequent renegotiations. In so doing, these directors can help disseminate information concerning a company's full choice set.

Second, fiduciary duties can help minimize the costs typically associated with *ex post* renegotiation. As with all Coasian bargains, the ability of parties to reach a socially efficient result depends on the ability of parties to overcome transaction costs, including parties' incentives to shade private values or to engage in other forms of strategic behavior that often impede negotiation.¹⁶ The prospect of renegotiation itself also raises the potential for strategic, opportunistic demands to renegotiate, which can adversely affect parties' *ex ante* contracting incentives.¹⁷ Imposing fiduciary duties on directors can help minimize both forms of strategic behavior, particularly when these duties are construed as running to the corporation itself—an articulation of director duties having an especially long pedigree.¹⁸ Specifically, while directors might bargain to maximize cash flows to a particular constituency (e.g., a preferred stockholder or common stockholders), the fact that directors owe an ultimate duty to maximize the value of the firm serves as a backstop against directors' ability to privilege a particular constituency over the overriding goal of maximizing the value of the enterprise.¹⁹

firm's investment contracts"); see also Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 379 (2013) (arguing that with respect to constituency directors, the "choice of [which corporate constituency] benefits from the residual control rights of directors should be left to party autonomy").

16. See Schwartz, *supra* note 14, at 398.

17. See *infra* text accompanying note 39.

18. See Sabin Willett, *Gheewalla and the Director's Dilemma*, 64 BUS. LAW. 1087, 1097 (2009) ("Cases in which courts recite that directors owe a fiduciary duty to the corporation are myriad."); see also *infra* Part IV.

19. In this regard, the ultimate content of a director-designee's fiduciary duties would resemble the analysis of directors' duties suggested by Jesse Fried and Mira Ganor, which they viewed as informing Delaware's approach to directors elected by preferred stockholders in *Oban v. Field*, Civil Action No. 12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997). See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 993 (2006) ("[A] preferred-controlled board can make business decisions that serve the preferred at the expense of common, as long as those decisions can be defended as in the best interests of the corporation."). This interpretation of *Oban*, however, was expressly—and in the view of this author, erroneously—rejected in *In re Trados* when Chancellor Laster concluded that Fried and Ganor's interpretation of directors' fiduciary duties "does not comport with how I understand the role of fiduciary duties or the ruling in *Orban*" *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 42 n.16 (2013).

Finally, the fact that directors ultimately have a fiduciary duty to the firm itself also works to constrain intraboard bargaining to conflicts that arise from investors' differentiated cash flow rights. As illustrated below, directors bargaining over these cash flow rights can ordinarily justify this behavior as consistent with their fiduciary duties given that a successful renegotiation will maximize the value of the firm.²⁰ In contrast, the same cannot be said of a director seeking to maximize his or her private benefits (such as the personal satisfaction of running a company), thus limiting director bargaining to the former class of conflicts.²¹

As discussed below, conceptualizing board decisionmaking in this fashion would not necessarily alter the outcome of decided cases that have used shareholder wealth maximization as an end in itself. Notwithstanding their articulation of this view of director duties, these cases typically punish boards for taking actions that make it difficult to conclude whether the board has bargained honestly to maximize the value of the corporation. In the process, however, the opinions' sweeping pronouncements about directors' duties to common stockholders have thrown into uncertainty the ability of investors to use director-designees to facilitate socially efficient renegotiation. These pronouncements also make it equally unclear how directors should comport themselves when faced with situations that pit common stockholder value against firm value. The consequence of these sweeping pronouncements is particularly troublesome in light of the tendency of corporate directors and their counsel to interpret Delaware case law as guidance on how directors should behave in the future.²² As such, a primary goal of this Article is to beat back any temptation of corporate directors to view themselves as having an immutable duty to maximize common stockholder value and to establish how a bargaining model of the board is consistent with both economic theory and traditional Delaware case law. Under this model, investors can and should use director-designees to promote their financial interests so long as these directors engage in good faith bargaining with other directors to maximize the value of the firm.

This Article proceeds as follows. Part II introduces the bargaining model of the board by mapping the lessons of incomplete contracting theory onto the governance structure of ordinary corporations with its

20. See *infra* Part III.

21. Whether or not this bargaining constraint is optimal is beyond the scope of this paper. For a discussion of its possible ramifications on social welfare, see text accompanying note 79.

22. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); see also *infra* note 172 and accompanying text (noting influence of recent Delaware case law on the model financing documents of the National Venture Capital Association).

emphasis on the board of directors. Part III adds to this contract analysis the effect of subjecting directors to fiduciary duties, concluding that when properly construed, directors' fiduciary duties can enhance the ability of the board to maximize the value of the firm. Having established the bargaining model, Part IV then examines its compatibility with conventional corporate law, with special emphasis on Delaware's jurisprudence. In the process, Part IV highlights how recent Delaware Chancery Court opinions potentially undermine the bargaining model of the board and, consequently, the ability of Delaware's corporate law to achieve its oft-cited aim of maximizing the value of the corporation. Part V concludes.

II. A BARGAINING MODEL OF THE BOARD

The bargaining model of the board used here builds on the large literature on incomplete contracting that focuses on the critical role of corporate control rights in capital formation.²³ This scholarship begins with the premise that because of transaction costs, bounded rationality, and nonverifiable information, an investor in a firm will ordinarily be unable to write a financing contract that addresses every possible contingency.²⁴ As such, contract renegotiation may be required as the future unfolds. While the Coase Theorem suggests such *ex post* renegotiation should result in efficient outcomes, a problem arises in that the party holding residual control rights over the firm's assets might hold up the other party or otherwise engage in rent-seeking in the course of bargaining.²⁵ Among other things, this behavior might thwart an efficient renegotiation from occurring or produce *ex ante* inefficiencies such as preventing the initial financing contract in the first place.²⁶ As initially set forth by Sanford Grossman and Oliver Hart,²⁷ one way parties can address this chal-

23. For an overview, see generally Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSP. 181 (2011).

24. *See id.* at 182.

25. Edward M. Iacobucci & George C. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 560 (2007) ("[Contracting parties] might complete their contract *ex post* through renegotiation, but the *ex post* bargaining process allows one party to hold up the other—that is, to appropriate some of the value created by the other party's specific investment in their relationship.").

26. Richard Holden & Anup Malani, *Renegotiation Design by Contract*, 81 U. CHI. L. REV. 151, 152 (2014) ("Asset ownership affects this bargaining because it reflects outside options that parties to a transaction have if renegotiation breaks down, and this, in turn, affects incentives for *ex ante* relationship-specific investments.").

27. Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986).

lenge is through explicit bargaining over who holds these residual control rights.²⁸

The bargaining model of the board maps these insights onto the structure of corporate law, which vests a corporation's residual control rights in its board of directors.²⁹ As shown below, the result is a model of the board where bargaining over board power occurs across a spectrum of settings. One end involves settings where a hypothetical investor and founder share control of the board to engage in frequent renegotiations through their board designees (typical of early-stage venture capital finance). The other end involves settings where such an investor and founder agree to vest one party with control of the board, but the other party might secure the right to renegotiate with the board in specific instances (typical of debt finance).

A. Shared Control

Consider a private firm (NewCo) founded by a liquidity-constrained founder (Founder). As with most start-ups, Founder assigns to NewCo all legal right to Founder's business plan, but being liquidity constrained, Founder lacks the capital to develop it. Moreover, because NewCo's principal asset is the business plan, NewCo also lacks the ability to secure traditional bank financing, and Founder's liquidity constraint limits Founder's ability to overcome NewCo's lack of bankable collateral with a personal guarantee.

As is well known, an external equity investor (VC) can remedy this financing challenge through an array of contractual devices widely used in venture capital finance.³⁰ These include the acquisition of a senior equity security having certain economic preferences such as a priority on dividends and a liquidation preference (commonly equal to the VC's original investment amount) that is payable to the VC upon an acquisition or liquidation of the firm before any payments can be made on the company's common stock. The preferred stock is also convertible into shares of common stock to enable the VC to participate in the appreciation of the firm's value beyond the VC's original investment. Often, this conversion right may even permit the VC to participate on an as-

28. This "property rights theory" of the firm was further developed in Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1132 (1990).

29. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

30. See generally Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 48–56 (2006) (providing an overview of venture capital contracting).

converted-to-common stock basis in any liquidation proceeds that remain following payment of the liquidation preference. Because Founder will ordinarily hold shares of common stock, these economic preferences provide strong incentives for Founder to execute the business plan while also providing downside protection to the VC.

Critical to the VC investor are four additional mechanisms designed to address the considerable risk and uncertainty associated with the future cash flows from this investment. Each helps solve the fundamental incomplete contracting problem at the heart of the VC's investment. In keeping with standard incomplete contracting framework,³¹ the overall effect of these provisions is to induce Coasian bargaining in future situations where the interests of the VC and Founder might diverge.

First, the VC will typically stage its investment over time.³² In addition to preserving the real option to abandon the investment depending on the progress of the business, the continual need for Founder to return to VC for funding sets the stage for periodic bargaining between VC and Founder as the future unfolds. Similarly, to ensure bargaining with Founder in interim situations where the interests of Founder and VC might diverge, the VC will secure a variety of stockholder veto rights over corporate actions such as selling additional equity securities, altering the primary line of business, selling the firm, or modifying the charter. Third, to ensure its ability to monitor the business's progress and facilitate informed renegotiation, the VC will secure various monitoring and information rights, such as the right to receive periodic financial disclosures. Finally, to enhance both the frequency and the quality of these renegotiations, the VC will also obtain board representation,³³ often with its director-designee holding specific veto rights over a variety of corporate actions.³⁴

This last mechanism deserves special attention, as it is central to solving the VC's incomplete contracting challenge. While VC might attempt to specify stockholder veto rights over all actions that might raise VC–Founder conflicts, such a financing contract would still offer inade-

31. *See supra* text accompanying notes 23–28.

32. Each of these mechanisms is described more fully in Bartlett, *supra* note 30, at 48–56.

33. *See, e.g.*, NAT'L VENTURE CAPITAL ASS'N, SAMPLE TERM SHEET FOR SERIES A PREFERRED STOCK FINANCING 3 (2009) [hereinafter NVCA TERM SHEET], available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=75&Itemid=93 (providing for specific number of “Series A Directors”).

34. *See, e.g.*, NVCA TERM SHEET, *supra* note 33, at 9–10 (providing for Board approval, which must include the affirmative vote of the Series A Director, of ten corporate actions including changing the principal business of the Company, entering into a strategic relationship involving payments in excess of specific amounts, or hiring, firing, or changing the compensation of the executive officers or approving any option grants).

quate protection for the reasons suggested by incomplete contracting theory.³⁵ At the same time, a common solution to this problem—giving residual control of the firm to VC through allowing it to control the board of directors—will be unacceptable to Founder. For instance, Founder may have concerns that VC’s senior liquidation preferences will induce it to favor a premature sale of the company or that Founder’s liquidity constraint will allow VC to issue additional securities to VC and not to Founder, diluting Founder’s economic interest. A compromise solution commonly used in venture capital finance is therefore for VC to share board control with Founder, often giving a third-party “industry” director a tie-breaking vote in the event of a deadlock.³⁶ If an unanticipated event occurs, such as the sudden collapse of the company’s product market, the VC will therefore have the ability to bargain with Founder over how to restructure the business. Likewise, while the ability to obtain information concerning the performance of the firm could be done exclusively through periodic disclosures, a VC will be in a far superior position to engage in informed bargaining by securing a board position with direct access to company management.

Significantly, securing a board position for the VC also facilitates renegotiation at the board level even for those corporate actions over which VC obtained specific stockholder veto rights. Since board approval will almost always be required for these actions, any VC–Founder conflicts implicated by these actions will first arise in the boardroom and become the subject of VC–Founder bargaining in light of the shared control of the board.³⁷ While one might view this as simply a side effect of VCs obtaining board representation, there are good reasons to believe

35. See *supra* text accompanying note 24. In addition, Delaware courts have traditionally read preferred stock rights narrowly, further limiting the ability of VC to contract expressly over future conflicts. See Bartlett, *supra* note 30, at 105 (analyzing Delaware courts’ approach to interpreting the scope of preferred stock preferences).

36. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis Of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 287–89 (2003) (finding that firms financed by venture capital allocate one-quarter of their board seats to third-party directors from within a firm’s industry, with more than half of such firms giving industry directors a tie-breaking vote in the event of deadlock between the entrepreneur and VC investors). While several papers have sought to model the VC investment contract as representing the contingent-control mechanism studied in Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 486 (1992) (see, e.g., William W. Bratton *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002)), the evidence provided by Kaplan & Strömberg indicates that the dominant control arrangement for VCs is the simpler form of shared control. See Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 470 (2010).

37. As noted previously, contract provisions negotiated by VC might also formally require the director-designee’s approval of specific corporate actions. See *supra* note 34.

that forcing VC and Founder to renegotiate in the boardroom minimizes the primary challenge of using renegotiation to address VC's incomplete contracting problem. In particular, a key tenet of incomplete contracting theory is that while using shared control or investor veto rights to facilitate future renegotiation can lead to *ex post* efficient outcomes, these arrangements can also exacerbate *ex post* holdup problems given that either party will have more frequent opportunities to threaten a veto of a proposed course of action and force the firm to a standstill.³⁸ As a result, *ex post* renegotiation rents are likely to be high, potentially undermining VC's or Founder's incentive to participate in a collaborative venture at all.³⁹ By locating this renegotiation within the board of directors, however, VC and Founder can potentially diminish these holdup problems. As Brian Broughman has explained, the common use of industry directors within VC-backed firms creates a mechanism to facilitate renegotiations that diminishes the risk of opportunistic holdups.⁴⁰ The reason arises from the fact that by holding a tie-breaking vote, such a director can reduce holdup risk by moderating each party's *ex post* threat position.⁴¹

Thus, rather than view the board as a wholly legal institution that must blindly follow a mandate to maximize common stockholder value, VCs directly incorporate boards into their contracting model with the express purpose of using the board as the central mechanism to induce *ex post* renegotiation between VC and Founder.

38. Aghion & Bolton, *supra* note 36, at 486.

39. See Grossman & Hart, *supra* note 27, at 701–04 (demonstrating how *ex post* renegotiation may cause underinvestment *ex ante*); Aghion & Bolton, *supra* note 36, at 486 (finding that joint control between an investor and entrepreneur results in equilibrium expected investor returns of zero). This *ex ante* incentive problem is likely to be especially acute in investment contexts where Founder has substantial bargaining power and, consequently, the ability to extract considerable renegotiation rents from VC in any future renegotiation. Aghion & Bolton, *supra* note 36, at 480–81. In contrast, in settings where Founder and VC mutually depend on one another's firm-specific investments in the firm, each party will have significant bargaining power, diminishing this concern. See *id.* at n.9 (“[W]here each agent's financial contribution is similar and where each agent participates in the management of the business . . . joint ownership may well be the most efficient arrangement.”). To the extent this latter situation more properly characterizes VC investment, it may be a further reason why shared control is so often used in VC finance.

40. Broughman, *supra* note 36, at 482–84.

41. Under Broughman's model, VC and Founder must propose actions to the Board, and only one proposal will win the approval of the industry director, thereby assuring its adoption. Similar to the dynamic at work in final offer arbitration, the competition for the industry-director's vote induces Founder and VC to offer reasonable proposals that will be favored by the industry director, lest the other party's proposal be adopted. See *id.*; see also Bratton, *supra* note 36, at 918–19 (emphasizing the importance of a tie-breaking vote held by an industry director to induce cooperate renegotiation between Founder and VC).

B. Unilateral Control

While the shared control model has emerged in venture capital finance as a workable solution to VC's incomplete contracting challenge, it is important to emphasize the conditions that have given rise to its use in that setting. In the example involving NewCo, for instance, NewCo was a new firm developing a highly uncertain business plan. This required VC to invest through an equity claim whose cash flows largely depended on how the board exercised its residual discretion to adapt in an unpredictable future. In light of Founder's concern with vesting residual control entirely with VC,⁴² the result was therefore shared control of the board.⁴³

Absent these conditions, bargaining over board control is likely to depart from this structure. For instance, in their seminal article on financial contracting, Philippe Aghion and Patrick Bolton examined the conditions under which an entrepreneur and an investor would enter into a financing contract where a liquidity-constrained entrepreneur enjoys large private benefits from controlling a firm.⁴⁴ In the case of NewCo, the preceding discussion ignored the possibility that Founder might enjoy private benefits from running NewCo, such as the satisfaction of developing an innovative new business. Aghion and Bolton demonstrated that where Founder enjoys such private benefits, giving VC either complete or shared control of the board will likely be unacceptable to Founder given Founder's liquidity constraint.⁴⁵

As an example, imagine a situation where the action that maximizes NewCo's cash flows is to fire Founder as CEO. Because this action maximizes the value of NewCo, VC and the industry director are likely to support it. In theory, Founder might attempt to negotiate with the other directors to work out a bargain where Founder remains in charge, but Founder's lack of liquidity will prevent this arrangement. Anticipating this possibility, Founder will therefore resist granting VC any form of board control. Yet Founder's resistance does nothing to address VC's original incomplete contracting problem. Namely, Founder's retention of residual control rights means VC might have to offer up a Coasian bribe to ensure Founder maximizes the value of the firm. In fact, considering

42. See *supra* text accompanying notes 35–36.

43. Zenichi Shishido, *The Incentive Bargain of the Firm and Enterprise Law: A Nexus of Contracts, Markets, and Law*, in ENTERPRISE LAW: CONTRACTS, MARKETS, AND LAWS IN THE U.S. AND JAPAN 1, 9 (2014) (describing the bargaining challenge facing a venture capitalist and a founder as one that requires a mechanism to “motivate each . . . to invest their respective monetary and human capital”).

44. Aghion & Bolton, *supra* note 36, at 475–90.

45. *Id.* at 483–84.

Founder's private benefits, the amount of this Coasian bribe might have to be considerable.

Given VC's expectation of achieving a return on its investment (referred to as VC's "participation constraint"), Aghion and Bolton demonstrated why allowing Founder to have permanent control of the board may therefore be infeasible for many VCs.⁴⁶ They also showed that one alternative is to give Founder control of the firm contingent on an external signal that is correlated with states of the world where it is socially optimal for Founder to retain residual control rights.⁴⁷ In particular, the arrangement resembles the contingent control mechanism seen in debt contracts where Founder remains in control of NewCo so long as NewCo is not in default.⁴⁸ Gordon Smith has also documented how staged financing in VC finance might also be a mechanism for shifting control of the board entirely to VC investors when a firm becomes distressed.⁴⁹ For instance, in "down-round" financings of venture-backed companies,⁵⁰ a firm's VCs may obtain so much control of the board that they effectively dominate board voting. In this regard, one might view such firms as transitioning between shared control to VC control where a firm becomes distressed.⁵¹

Finally, Aghion and Bolton demonstrated that where an investor can anticipate certain actions that pose a conflict between an investor and an entrepreneur, the contingent control model can be improved by including investor veto rights over these actions.⁵² Specifically, they showed that control allocations without any action restrictions on the entrepreneur are more likely to provide large renegotiation rents to the

46. *Id.* at 481–82.

47. *Id.* at 484–86. For instance, in the example used here, the financing contract would guarantee that control of the Board shifted from Founder to VC when the total returns to VC and Founder (including Founder's private benefits) associated with firing Founder exceed those when Founder remains as CEO.

48. *Id.* at 486.

49. D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 337 (2005).

50. A down-round financing represents a financing transaction in which the pre-transaction valuation of the start-up company is less than the valuation of the company immediately following its last round of financing. Because of the lower valuation used in the new financing, nonparticipating stockholders are likely to have their voting interests significantly diluted when a company seeks to raise a significant amount of capital. See Bartlett, *supra* note 30, at 82–90 (describing down-round financings).

51. Smith, *supra* note 49, at 327 ("Control is thus contingent only in the sense that it shifts from common stockholders to preferred stockholders over successive stages of financing, and this can occur either because the venture capitalists bargain for additional seats on the board or because the venture capitalists acquire a majority voting stake in the company.").

52. Aghion & Bolton, *supra* note 36, at 486–90.

entrepreneur who undertakes these conflict-laden actions.⁵³ While an investor can bargain *ex post* with the entrepreneur to avoid these actions, the need to make an *ex post* payoff to the entrepreneur will make it harder for the investor to meet its *ex ante* participation constraint than if some action restrictions had been specified in the initial contract.⁵⁴ In effect, these specific veto rights simply change the distributional consequences for a firm to propose a restricted action: if the entrepreneur-controlled board wishes to undertake it, a Coasian bribe may now have to be paid to the investor.

As in the context of early-stage venture capital finance, bargaining for unilateral board control can represent an alternative mechanism for addressing an investor's incomplete contracting challenge. The primary difference is that the circumstances surrounding a particular investment may induce the investor and Founder to vest control of the board with a particular party either permanently or on a contingent basis.

III. DIRECTOR FIDUCIARY DUTIES AND THE BARGAINING MODEL OF THE BOARD

So far, the analysis has focused on describing how investors commonly use the board of directors to solve an incomplete contracting problem. In this regard, the analysis has been a straightforward application of incomplete contracting theory to the legal structure of the corporation. A potential wrinkle with this approach, however, is that the bargaining environment used in the incomplete contracting literature assumes a freedom of contract regime where parties maximize their individual interests and, in the process, maximize social welfare. Directors, however, are subject to fiduciary duties whose ultimate goal is commonly articulated as the maximization of firm value (as opposed to social welfare).⁵⁵

53. *Id.*

54. *Id.* at 489.

55. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (observing that directors of a firm “‘comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm’s value’”) (quoting *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 797 (Del. Ch. 2004)); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 204 (Del. Ch. 2006), *aff’d*, 931 A.2d 438 (Del. 2007) (“Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.”); *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004) (“Having complied with all legal obligations owed to the firm’s creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm’s equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm’s value.”); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No. 12150, 1991 WL 277613, 1157 (Del. Ch. 1991) (“[T]he MGM board or its executive committee had an obligation to

Moreover, these duties are frequently articulated as requiring directors to act in the best interests of the corporation through maximizing returns to the residual claimants: the common stockholders.⁵⁶ As such, fiduciary duties would seem to be a suboptimal constraint on the bargaining model of the board given the freedom of contract paradigm used in incomplete contracting theory.

The imposition of fiduciary duties on directors, however, can easily be incorporated into the bargaining model subject to an important condition. In particular, we will need to assume that private benefits of control are small or nonexistent.⁵⁷ With this condition in place, imposing a fiduciary duty on directors that runs to the corporation then becomes entirely consistent with the bargaining model even if directors seek to advance their individual cash flow rights. Nor does the result change if we add to directors' mandatory fiduciary duty to the corporation a norm of maximizing common stockholder value, so long as this norm is viewed as a default means to maximize firm value. Indeed, imposing on directors fiduciary duties with this default norm can enhance the ability of the bargaining model to maximize firm value.

To illustrate this result, return again to the setting involving NewCo, Founder, and VC, and assume that Founder has no private benefits of control. Further assume that NewCo successfully obtains from VC an initial \$120 investment in NewCo's Series A Preferred Stock for \$1 per share. The investment results in VC holding 120 shares of the Series A Preferred Stock, which convert into Common Stock on a 1:1 basis. The terms of the Series A Preferred Stock provide for a \$120 liquidation preference, along with the right to participate on an as-converted basis in any remaining proceeds in an acquisition of the company. Assuming there are 120 shares of Common Stock outstanding (held by Founder and early investors), VC and Common Stockholders would therefore split any remaining acquisition proceeds 50/50. VC also obtains stockholder veto rights over certain corporate actions (including future financings and a sale of the company) and secures the right to appoint a NewCo director. Finally, Founder and VC agree to share control of the board with a third "industry" director who they will appoint by mutual agreement.

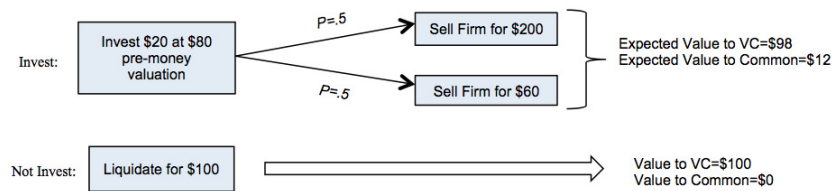
the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.").

56. See, e.g., *Gheewalla*, 930 A.2d at 101 (noting that "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*" (emphasis added)).

57. See *infra* text accompanying note 79.

Assume that after several years of languishing growth, NewCo is not yet cash-flow positive and returns to VC to seek further financing. Founder presents VC with the following two scenarios. Under Option 1, VC invests \$20. With this additional financing, Founder believes it can pursue a promising project and, if successful, will result in selling the company for \$200. If it fails, Founder estimates the company will be liquidated for \$60. Each scenario is equally likely. Option 2 would be the immediate liquidation or sale of the firm, which is estimated to yield \$100 in proceeds (all of which would be paid to VC because of its existing \$120 liquidation preference). Given the risk VC would be taking, Founder offers to sell to VC newly issued Series B Preferred Stock that would have a senior 1X liquidation preference of \$20. Founder further offers to allow VC to invest at a valuation of \$80, allowing it to increase its as-converted ownership claim from 50% to 60%.⁵⁸

Based on this offer, VC recognizes it is faced with the following choice:⁵⁹

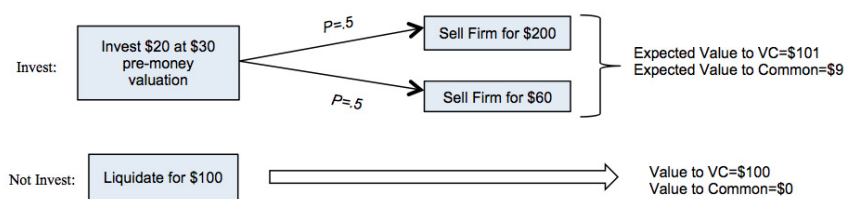


Investing on these terms is obviously not rational for VC given that VC would lose \$2 of expected value by investing rather than simply liquidating the firm. Examination of the payout to Common Stockholders, however, suggests there is room for negotiation. While the Common Stock has a net expected value of \$12 if VC invests, Common Stockholders would receive nothing in liquidation on account of VC's existing liquida-

58. At an \$80 pre-financing valuation, VC's investment of \$20 would yield VC an additional 60 shares (i.e., \$20 investment / (\$80/240 shares)). Following the financing, the total number of outstanding shares would be 300 (i.e., 240 + 60) of which VC would hold 180 (i.e., 120 + 60).

59. Under the Invest option, a successful sale of NewCo for \$200 would yield VC a payment of \$176 based on its preferred stock liquidation preference of \$140 and its preferred right to participate in 60% of the remaining proceeds of \$60. Common Stockholders would receive 40% of these proceeds, or \$24. If the firm were sold instead for \$60, all \$60 would go to the VC in light of its liquidation preference. Because each scenario is equally likely, VC's expected return would be $.5 * (\$140 + \$36) + .5 * \$60 - \$20 = \$98$. Common Stockholders' expected return would be $.5 * \$24 + .5 * \$0 = \$12$. If VC chose to liquidate NewCo for \$100, it would receive \$100 with certainty on account of its preferred stock liquidation preference.

tion preference. By agreeing to share some portion of this \$12 of net expected value, the Common Stockholders should be able to induce VC to invest, thus maximizing the expected return to all investors. In particular, were Common Stockholders to offer the same transaction but reduce the Series B valuation from \$80 to \$30, VC's as-converted share would increase to 70%, resulting in the following choice:⁶⁰



Fundamentally, a bargain is possible because the option to invest maximizes the value of the firm. Although VC will be required to invest \$20 of new capital, the expected value of the company with this capital is \$130 (i.e., $.5(\$200 + \$60)$). Net of the \$20 investment, this represents a value of \$110, which is \$10 more than would be realized by liquidating the firm for \$100. Conversely, were the estimated proceeds from the sale in Option 1 just \$160 rather than \$200, no amount of bargaining would be able to convince VC to proceed with Option 1.⁶¹ While liquidating the firm in this latter case would still forego potential value to Common Stockholders, liquidation for \$100 would maximize the value of the firm given the expected value of the firm under the “Invest” option would now be only \$90 (i.e., $.5(\$160 + 60) - \20). Finally, while this example assumes a bargain in which Common Stockholders will compensate VC, nothing requires side payments to flow in this direction. On the contrary, even in the situation where the optimal decision is to liquidate the firm, if doing so requires identifying a possible acquisition partner, VC might find itself having to share a portion of its liquidation preference with

60. Under this revised transaction, VC's investment of \$20 would yield VC an additional 160 shares (i.e., $\$20 \text{ investment} / (\$30/240 \text{ shares})$). Following the financing, the total number of outstanding shares would be 400 (i.e., $240 + 160$) of which VC would hold 280 (i.e., $120 + 160$). In a successful sale of NewCo at \$200, VC would then be entitled to participate in 70% (i.e., $280/400$) of the remaining \$60 of proceeds following payment of VC's \$140 liquidation preference. VC's expected value from funding NewCo therefore increases from \$98 to \$101 (i.e., $.5 * (\$140 + \$42) + .5 * \$60 - \20).

61. For example, even a Series B pre-money valuation that increased VC's share of the as-converted capitalization to 100% would yield just \$90 of expected value to VC under Option 1 (i.e., $.5 * (\$140 + \$20) + .5 * \$60 - \20). Taking Option 2 and liquidating the firm for \$100 would therefore maximize VC's expected return.

Common Stockholders to motivate Founder (and perhaps other members of management) to secure such a transaction.⁶²

This example is, of course, simply an illustration of Coasian bargaining triggered by the conflicting incentives of Common Stockholders and VC with respect to continuing NewCo. What complicates the picture is that VC is on the board of directors and is demanding a Coasian bribe in the form of additional equity from Common Stockholders. When VC's director-designee votes to approve the financing, the designee will therefore be approving a transaction that appears to be focused on maximizing VC's returns. Fortunately, directors' fiduciary duties are flexible enough to permit this behavior provided VC's director-designee can comply with well-known procedural safeguards involving conflicted director transactions. In Delaware, for instance, such transactions are permitted if approved by an informed majority of disinterested directors or stockholders or VC's director-designee can otherwise establish that the "transaction is fair as to the corporation as of the time it is authorized, approved, or ratified, by the board of directors"⁶³

To be sure, having to demonstrate that a transaction is intrinsically fair to the corporation is no small affair. The standard method courts use to ascertain whether a transaction meets this test is for the conflicted director to demonstrate both fair dealing and fair price.⁶⁴ Without question, this procedural process will constrain the VC director's freedom of action when bargaining with Founder, but significantly, it does so in a way that would appear to respond to a primary drawback of *ex post* renegotiation—that is, the risk of an opportunistic holdup. Knowing that her actions will need to satisfy either the fair dealing/fair price test or be approved by a vote of disinterested directors, VC's director-designee will be motivated to temper any threats to walk away from the negotiation table in hopes of extracting more of the \$10 of surplus. Accordingly, rather than undermining the bargaining model of the board, the existence of this procedural requirement can be viewed as addressing one of the model's principal limitations.

What about the oft-cited notion that a director's duty runs to the corporation for the benefit of its residual claimants?⁶⁵ Considering that Common Stockholders were originally faced with the prospect of a zero-

62. See Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384 (2010) (documenting this practice in a sample of VC-backed start-up companies).

63. DEL. CODE ANN. tit. 8, § 144(a)(3) (2010).

64. See 18B AM. JUR. 2d *Corporations* § 1510 (2014) (describing intrinsic fairness test).

65. See *supra* text accompanying note 56.

return liquidation of NewCo, the approved financing certainly improves the value of common stock. But does it maximize its value? Total surplus from financing the company is \$10 compared to \$9 being paid to Common Stockholders. Presumably, the \$1 difference is the price VC required to do the deal. But subjecting directors to a requirement that they maximize common stockholder value leaves the transaction vulnerable to a claim that the price was higher than necessary. The situation is even more problematic in the alternative scenario where the decision that maximizes firm value is to liquidate. In that scenario, financing NewCo would lead to a 50% chance of selling the firm for \$160 and a 50% chance of liquidating it for \$60. Because there would be a total of only \$140 of liquidation preference after the proposed financing, only a decision to fund NewCo would leave Common Stockholders with a chance of seeing some return on their shares. If VC's director-designee votes to liquidate NewCo in this scenario (the decision that maximizes firm value), would that be consistent with a fiduciary duty to maximize the value of the residual claim?⁶⁶

One might reasonably respond to this issue by returning to the fact that fiduciary duties run first and foremost to "the corporation."⁶⁷ As long as the VC director ultimately acts to maximize the value of the firm (e.g., by approving a liquidation in the last scenario), that should be consistent with this duty.⁶⁸ Cases suggesting directors discharge this duty for the benefit of common stockholders could then be confined to ensuring that any bargaining surplus is maximally distributed to common stockholders in the event of Coasian bargaining. As such, VC's director-designee would only have to worry about its duty to common stockholders where a Coasian bribe is paid or received to ensure firm value is maximized.

Of course, this returns us to evaluating the \$1 payment VC received in the scenario where it was optimal to finance NewCo. In theory, a court might try to operationalize a director's duty to common stockholders in this situation by comparing the \$1 to what would be received in a presumably "fair" bargain, perhaps by resorting to some criteria like the

66. See Willett, *supra* note 18, at 1087 (classifying such a scenario as posing a "directors' dilemma" in light of director's duties to shareholders).

67. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("It is well settled that directors owe fiduciary duties to the corporation.").

68. See, e.g., D.J. Baker, John Butler, Jr. & Mark A. McDermott, *Corporate Governance of Troubled Companies and the Role of Restructuring Counsel*, 63 BUS. LAW. 855, 870 (2008) (arguing that in such a setting, directors' duty of care to the corporation "may require consideration and pursuit of business options that are *more conservative* than those that may otherwise be considered and pursued by a healthy corporation" (emphasis in original)).

Nash Bargaining Solution.⁶⁹ Since such a benchmark would suggest VC would be entitled to \$5 of the surplus,⁷⁰ the meager \$1 payment to VC thus seems like the transaction is more than fair to Common Stockholders. But even the Nash Bargaining Solution rests on critical assumptions that make it an unreliable benchmark for evaluating real-life Coasian trades, such as the assumption that parties have equal bargaining power.⁷¹ The central problem is that the fairness of the side payment to VC is ultimately a function of the bargaining process between VC and Founder. However, this bargaining process is already being policed for opportunism and hold-out threat through the procedural requirement that the transaction be fair to the corporation.⁷² So long as parties bargain honestly and in good faith, imposing an additional requirement that the ultimate bargain be “fair” to common stockholders simply adds nothing new to the process. Meanwhile, courts that try to enforce such a requirement by way of an objective benchmark will risk disrupting fairly negotiated bargains.

In short, there seems little reason for directors to have an immutable duty to maximize common stockholder value in the bargaining model of the board. The same, however, cannot be said of using shareholder wealth maximization as the default means for how directors can maximize the value of the firm. The primary reason relates to the oft-noted challenge of imposing on the board a simple duty to maximize the value of the corporation.⁷³ As summarized by Chancellor Laster,

Among other problems, such an approach does not explain why the duty to maximize enterprise value should encompass certain contract rights (those of preferred) but not others (those of credi-

69. The Nash Bargaining Solution (NBS) postulates that under certain conditions two negotiating parties will settle for an equal split of the surplus created by their cooperation in reaching a bargain. See Ken Binmore, Ariel Rubinstein & Asher Wolinsky, *The Nash Bargaining Solution in Economic Modelling*, 17 RAND J. ECON. 176, 177 (1986). In recent years, courts have utilized the NBS as a benchmark for what constitutes a fair, hypothetical bargain. Most notably, some courts have used the NBS as a mechanism to determine the amount of a reasonable royalty payment in patent infringement suits. See Zelin Yang, *Damaging Royalties: An Overview of Reasonable Royalty Damages*, 29 BERKELEY TECH. L.J. 647, 662–64 (2014) (summarizing cases).

70. Recall that the total surplus was \$10 in the scenario where VC agreed to fund NewCo.

71. Where differences exist in parties’ bargaining power, the split of surplus will be uneven and will favor the party with greater power. For a general treatment of the Nash Bargaining Solution and a discussion of applications that endogenize bargaining power, see ABHINAV MUTHOO, *BARGAINING THEORY WITH APPLICATIONS* 9–39 (1999).

72. See *supra* text accompanying notes 63–64.

73. See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 577–84 (2003) (“The alternative to following the shareholder wealth maximization norm would, on the other hand, force directors to struggle with indeterminate balancing standards.”).

tors, employees, pensioners, customers, etc.). Moreover, while tolerably clear in the abstract and sometimes in real-world settings, the enterprise value standard ultimately complicates rather than simplifies the difficult judgments faced by directors acting under conditions of uncertainty The enterprise value standard compounds the number of valuation alternatives that must be solved simultaneously and the resulting multivariate fiduciary calculus quickly devolves into the equitable equivalent of a constituency statute with a concomitant decline in accountability.⁷⁴

Even in a setting where a corporation's only investors are common stockholders, a simple mandate for directors to maximize the value of the firm will therefore require *ex ante* contracting by stockholders to ensure that the board uses its discretionary authority to maximize cash flows to the firm for the benefit of common stockholders (as opposed to, for instance, employees or the board itself).⁷⁵ Given the transaction costs of such *ex ante* contracting, a default norm of maximizing common stockholder value can represent a desirable standard for how directors can satisfy their fiduciary duty to the corporation.⁷⁶ In other words, a norm of common stockholder maximization functions as a type of majoritarian default rule that minimizes *ex ante* transaction costs for a central class of investors in a common setting—the formation of a basic corporation.⁷⁷

74. *In re Trados, Inc.*, 73 A.3d 17, 41 n.16 (Del. Ch. 2013); see also Bainbridge, *supra* note 73, at 581 (“[A]bsent the shareholder wealth maximization norm, the board would lack a determinate metric for assessing options.”).

75. See Bainbridge, *supra* note 73, at 577–84 (discussing hypothetical bargain between board and shareholders and explaining why shareholders would insist on a shareholder wealth maximization norm because absent such a norm, boards cannot be held accountable for taking self-interested transactions and can otherwise advance the interests of corporate constituencies that “leave shareholders worse off”).

76. See *id.* at 583 (noting that, because of the transactions costs of contracting over the content of directors’ fiduciary duties, “society appropriately adopts the shareholder wealth maximization norm as a governing principle—it is the majoritarian default that emerges from the hypothetical bargain”).

77. Viewing the shareholder wealth maximization as a default rule for directors is common among corporate legal scholars subscribing to a contractarian view of corporate law. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 36 (1991) (“For most firms the expectation is that the residual risk bearers have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock.”); Bainbridge, *supra* note 73, at 583 (describing shareholder wealth maximization norm as a “majoritarian default” rule for directors’ fiduciary duties); Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 V.A. L. & BUS. REV. 177, 185 (2008) (“[T]he default rule is clearly that the corporate contract calls for the firm to maximize value for shareholders consistent with its other obligations under the law, as well as to employees, suppliers, customers, and other firms and individuals with which the firm is in contractual privity.”); Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 407 (2012) (“[E]ven if the firm cannot make the contracts complete, most corporate law contractarians would still argue that

Moreover, as with all majoritarian default rules, its existence should induce the aforementioned contracting over board discretion where common stockholder interests are likely to diverge from those of other investors or corporate constituencies.⁷⁸ In this light, negative covenants in bond indentures, VC board veto rights, and even collective bargaining agreements can all be viewed as efforts to opt out of this default norm. As a corporation navigates an uncertain future, such provisions ensure that its board will engage in Coasian bargaining rather than ruthlessly use its residual control rights to maximize common stockholder welfare. Again, rather than disrupt the bargaining model of the board, the conventional articulation of a board's fiduciary duties can be entirely consistent with it.

Yet while there is general compatibility between the bargaining model and board fiduciary duties, there is one class of cases where this compatibility breaks down. Recall that in our example with NewCo, we assumed that Founder experienced no private benefits of control. If instead Founder obtains more than \$10 of private benefits by continuing NewCo, it becomes socially optimal for VC to finance NewCo even in the scenario where cash flows to the firm are maximized by liquidating it. Under the bargaining model, Founder may therefore try to make a side payment to VC to induce VC to finance the company.⁷⁹ Such a payment, however, will likely be problematic in light of Founder and VC's immutable fiduciary duty to the corporation and their corresponding duties of loyalty. This modified hypothetical highlights how defining directors' fiduciary duties as running to the corporation potentially interferes with board bargaining in those situations where the board's residual control can affect parties' private benefits. As such, this restriction limits the

shareholder wealth maximization must be the default rule because the gaps in the shareholder contract are significantly greater than found in the contracts of other parties contracting with the firm.”).

78. See *supra* note 14. Notwithstanding the common depiction of shareholder wealth maximization as a default rule of corporate law, see *supra* note 77, there is a tendency among many scholars to view it as mandatory in practice. For instance, while Stephen Bainbridge describes the norm as a “majoritarian default,” see *supra* note 76, he treats it as a mandatory rule insofar that it does not appear to be a norm that any director can opt out of by agreement with a corporation's shareholders. Others view the norm as a true default that can be altered by agreement, but they focus on whether the board as a whole can opt out of the duty so as to enable the corporation to pursue a goal other than profit maximization. See, e.g., Macey, *supra* note 77, at 185 (“The goal of profit maximization for shareholders is the law, but it is only a default rule. If the shareholders and the other constituents of the corporate enterprise could agree on some other goal for the corporation, then the law clearly should not interfere.”). However, as suggested in the bargaining model of the board, one might want a corporation to maximize profits but nevertheless want to opt out of the norm that *every* director must maximize returns to common stockholders.

79. Assuming, of course, that Founder has sufficient liquidity to make such a payment. See *supra* text accompanying notes 44–45.

compatibility of the bargaining model and a board's fiduciary duties to those settings where private benefits are presumed to be small or non-existent. While the imposition of fiduciary duties can therefore raise some efficiency losses where this condition fails to hold, creating an immutable duty for directors to focus on the best interests of the corporation presumably produces offsetting benefits that have justified this long-standing policy.⁸⁰

IV. THE COMPATIBILITY OF THE BARGAINING MODEL WITH CURRENT TRENDS IN CORPORATE LAW

Based on the preceding discussion, the bargaining model of the corporation has two important implications for corporate law: one conceptual and one doctrinal. First, as a conceptual matter, the bargaining model of the board resembles Blair and Stout's team production theory insofar that it poses a challenge to the standard agency account of the board as an institution that is—and should be—independent from management with a focus on maximizing returns to common stockholders.⁸¹ While the bargaining model may very well yield a result that maximizes

80. While examining the overall efficiency consequences of directors' duties to the corporation is beyond the scope of this Article, it is worth noting that even if the average effect of this constraint is optimal for firms in general, there may very well be cases where the constraint is inefficient. Assume, for instance, that the primary benefit of having an absolute duty of loyalty to the corporation rests in deterring misappropriation of corporate assets by a company's founder. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991). To the extent this rule also prohibits *ex post* efficient renegotiations that allow a founder-director to capture large private benefits of control, its overall effect on social welfare will depend on the size of founder's private benefits relative to these deterrence benefits. Moreover, where there are opportunity costs associated with the founder's participation in the firm, prohibiting such bargaining might also create *ex ante* inefficiencies by violating founder's participation constraint, as might be the case if the prospect of private benefits is required to compensate the founder for her opportunity costs. See Brian J. Broughman, *Independent Directors and Shared Board Control in Venture Finance* (Indiana Legal Studies Research Paper No. 1123840, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1123840. Given the founder-specific character of these efficiency losses, the overall effect on social welfare of imposing this bargaining constraint can therefore be expected to vary across firms. For similar reasons, where founders have large private benefits of control, the inability to protect these private benefits in future, unknown board-level bargains may induce founders to turn to organizational forms (such as limited liability companies) where founder-directors are not necessarily prohibited from consuming and/or protecting private benefits. See, e.g., E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tension Facing Constituency Directors*, 63 BUS. LAW. 761 (2008) (noting that if fiduciary duty standards in corporation law are not sufficiently flexible to afford constituency directors discretion to vote their personal interests, constituents may wish to invest in an alternative entity governed by other law that will accommodate their needs). For an example of how directors' fiduciary duties can restrict directors from consuming private benefits, see *infra* text accompanying notes 114–142.

81. Blair & Stout, *supra* note 8, at 290 (critiquing “the prevailing grand-design principal-agent” paradigm of the board in which “directors are agents of the firms shareholders”).

common stockholder value, such a result will be a function of how a corporation's investors and other stakeholders bargain over the board's residual control rights rather than a function of an immutable mandate that the board maximize stockholder welfare.

At the same time, the model also challenges Blair and Stout's thesis that the board is—and should be—a neutral, unbiased decisionmaker who balances the interests of all affected by the corporation.⁸² Although bargaining among corporate constituents may in fact force directors to consider the interests of a variety of corporate stakeholders, directors will advance the interests of a particular investor by virtue of either an express relationship (e.g., to a VC) or by a default norm of promoting common stockholder value. As a purely descriptive matter, this reconceptualization of the board helps explain why in practice investors do not necessarily rely on the board to mediate conflicts but instead negotiate for express veto rights, board representation, or both in private and public company settings.⁸³

While the bargaining model helps explain how boards are used in practice, the normative desirability of this model hinges critically on how well directors manage the risk of holdup and opportunistic renegotiation. Here, the model suggests a simple but critical role for corporate law through legal institutions that reduce transaction costs and police against aggressive bargaining where this risk is likely to be high. As discussed in Part III, directors' fiduciary duties play a key role in serving this function given the enhanced likelihood of deadlock and opportunism that arises when investors seek to address the incomplete contracting challenge through periodic intraboard bargaining.⁸⁴ For reasons discussed earlier,

82. *Id.* at 291 (“Like trustees—whom the law permits to represent beneficiaries with conflicting interests—directors are allowed free rein to consider and make trade-offs between the conflicting interests of different corporate constituencies.”).

83. See Sepe, *supra* note 15, at 335–40 (documenting use of constituency directors across firms).

84. Outside of the insolvency context, investor bargaining over the board's residual control rights has traditionally been subject to less judicial oversight where investors seek to renegotiate rights purely through (non-director) contractual restraints on board discretion, such as negative loan covenants. So long as the board acts on an informed basis and directors are not affiliated with the investors, courts have deferred to the board's decision to renegotiate such terms under the business judgment rule while allowing the parties to bargain as in any ordinary contract setting. See, e.g., *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) (holding that bond indenture amendment obtained through allegedly “coercive” exchange offer is a permissible means for corporate issuers to renegotiate bond agreements given that bondholders are owed no fiduciary duties outside of insolvency); but see *infra* text accompanying notes 107–111 (examining argument that board owes fiduciary duties to creditors in the “zone of insolvency”). The refusal of courts to undertake a more searching review of such bargains (despite frequent invitations to do so) generally rests on a presumption that inducing better contract drafting to obtain renegotiation leverage is preferable to the

however, this approach to addressing dysfunctional bargaining will induce directors to maximize firm value only if directors' duties to maximize common stockholder value are viewed as a means to the ultimate end of maximizing firm value. As shown below, however, recent Delaware case law suggests courts are increasingly confusing means and ends, with potentially serious ramifications for the ability of boards to make value maximizing decisions.

A. Shareholder Wealth Maximization As Means to an End in Corporate Law

Before exploring these recent cases, it is first worth exploring the role that shareholder value maximization has traditionally played in corporate law, with a special focus on Delaware. As illustrated here, long-standing case law is consistent with the theoretical account set forth in Part III, in which courts viewed shareholder wealth maximization as a means to maximize firm value. As such, recent cases in Delaware departing from this approach should be viewed as doctrinal innovations.

In an important article, Gordon Smith analyzed the history of the shareholder primacy norm in corporate law where he demonstrated that the earliest articulation of the norm appeared in what would today be viewed as minority oppression cases.⁸⁵ In examining whether directors could be personally liable for a breach of their fiduciary duties to minori-

costs of judicial interference. See *Katz*, 508 A.2d at 879 (“[I]f courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of indenture provisions designed to afford such protection.”). In contrast, this presumption against legal intervention in ex post investor bargaining collapses for insolvent firms given the considerable costs that rent-seeking behavior can pose when investors seek to reorganize a failing firm. Indeed, it is for this reason that the bankruptcy system provides both judicial oversight of investor bargaining and institutional processes designed to minimize the transaction costs associated with having dispersed, unsecured creditors. See, e.g., *In re A & C Properties*, 784 F.2d 1377, 1381 (9th Cir. 1986) (court reviewing bankruptcy settlement must focus on the existence of good faith negotiations among creditors that resulted in a settlement maximizing the size of the estate). For similar reasons, recent trends involving distressed debt investing that have undermined this traditional approach to coalition building among creditors have led to no shortage of proposed interventions to ensure creditor bargaining is consistent with maximizing firm value. See, e.g., Douglas G. Baird & Robert K. Rasmusen, *Anti-bankruptcy*, 119 YALE L.J. 648, 669 (2010) (examining how the combination of lower transactions costs in bankruptcy and the emergence of sophisticated distressed debt investors have led to an “empty core” problem that impairs coalition formation among creditors); Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1073 (2011) (examining how courts can use the doctrine of good faith to police against opportunism in multilateral negotiations among creditors and debtors); Mark J. Roe & Federico Cenzi Venezze, *A Capital Market, Corporate Law Approach to Creditor Conduct*, 112 MICH. L. REV. 59 (2013) (analyzing how innovative capital market instruments can ensure that creditors have interests that are aligned with maximizing firm value).

85. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998).

ty stockholders, courts frequently evoked the language of trusts to analyze directors' duties.⁸⁶ According to these cases, just as a beneficiary had standing to bring claims against a trustee, so too could a stockholder bring a fiduciary duty claim against directors. These cases made clear that shareholders were the beneficiaries of directors' conduct.⁸⁷

In addition to establishing the possibility for directors to be directly liable to shareholders, however, these early cases also made clear that directors had a related—and seemingly superior—obligation to protect the value of the corporation itself. As stated in 1832 in *Taylor v. Miami Exporting Co.*:⁸⁸

I look upon it as clear, that all corporation are trustees for the individuals of which they are composed, and that those who act for the corporation and conduct its affairs, are trustees for the corporation and can not [sic] appropriate the corporate funds to their individual advantage, to gratify their passions or to serve any other purposes than those for the general interest of the corporation and its creditors.

By the 1930s, this view of director duties would ultimately find its expression in the seminal Delaware case of *Loft, Inc. v. Guth*.⁸⁹ In holding a director liable for appropriating a corporate opportunity, the court used the now classic incantation that directors' fiduciary duties run to "the corporation and its shareholders."⁹⁰

While cases alleging director self-dealing such as *Loft v. Guth* involved situations where there was a perfect correspondence between the interests of the corporation and its shareholders, other cases indicated that where the two potentially diverged, directors could satisfy their fiduciary duties through establishing that their conduct was in the best interests of the corporation. Indeed, such an outcome occurred in *Dodge v. Ford*⁹¹—perhaps the most commonly cited case for articulating the shareholder primacy norm.⁹² As is well known, the facts of the case involved an allegation that the board of the Ford Motor Company breached its fiduciary duties by withholding payment of special dividends in favor of pursuing a significant expansion of the company's business opera-

86. *Id.* at 301.

87. *Id.* at 306–07.

88. *Taylor v. Miami Exporting Co.*, 5 Ohio 162, 166 (1831).

89. *Loft, Inc. v. Guth*, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd sub nom. Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

90. *Id.* at 238.

91. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

92. See Smith, *supra* note 85, at 278.

tions. In requiring the company to declare a dividend, the case famously declared:

A business corporation is organized and carried on primarily for the benefit of the stockholders. The powers of directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself.⁹³

Though never cited by a Delaware court,⁹⁴ this language has commonly been used for the proposition that directors have an obligation to make decisions that are in the best interest of shareholders.⁹⁵

Closer inspection of the opinion, however, reveals a court that was unwilling to set aside a decision of Ford's directors that was alleged to advance the interests of the corporation rather than the short-term interests of its shareholders. Fundamentally, the shareholder complaint against the Ford Motor Company sought to accomplish two items: requiring the payment of a special dividend and enjoining Ford from using surplus capital to undertake a business expansion.⁹⁶ While the court sided with the plaintiffs on the former request, it refused to approve the latter, reversing a lower court decision that had previously enjoined the business expansion as being *ultra vires*.⁹⁷ In assessing this *ultra vires* claim, the court noted that the claim was best characterized as fiduciary in nature as the plaintiffs alleged that "the whole plan of expansion is inimical to shareholders' rights and was formulated and will be carried out in defiance of those rights."⁹⁸ The court then proceeded to assess whether the expansion "ought to be enjoined because [it is] inimical to the best interests of the company and its shareholders."⁹⁹ Having reintroduced the interests of "the company" into the legal standard, the court refused to enjoin the expansion in light of the fact that it appeared to be in the long-term interests of the firm: "It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs."¹⁰⁰ Notably, even the order for the company to pay the special dividend of \$20,000,000

93. *Dodge*, 170 N.W. at 684.

94. See LYNN STOUT, *THE SHAREHOLDER VALUE MYTH* 27 (2012).

95. See Smith, *supra* note 85, at 278.

96. *Dodge*, 170 N.W. at 671.

97. *Id.* at 681.

98. *Id.*

99. *Id.*

100. *Id.* at 684.

was approved only after the court concluded that the company had failed to advance any legitimate business purpose for retaining so much capital given the expected capital requirements of the business expansion.¹⁰¹

Likewise within Delaware jurisprudence, cases that are commonly cited for the proposition that directors' duties run to common stockholders can easily be read as imposing on directors a duty to maximize the value of the firm for which shareholder value is simply a reasonable proxy. The much-celebrated *Revlon* duties provide a case in point. These duties impose on directors an "obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control."¹⁰² Significantly, because these duties only apply when directors are selling the entire corporate enterprise,¹⁰³ basic finance theory dictates that maximizing shareholder value should maximize the value of the entire firm.¹⁰⁴ For this reason, *Revlon* itself oscillates between describing directors' duties as being about the "the maximization of the company's value at a sale for the stockholders' benefit"¹⁰⁵ and about directors simply "getting the best price for the stockholders at a sale of the company."¹⁰⁶

Yet while the foregoing suggests Delaware law has historically been amenable to the vision of fiduciary duties articulated in Part III, it would be a stretch to say that Delaware law has expressly articulated the proper standard for directors to follow when a conflict arises between actions that maximize the corporation's value and those that maximize common stockholder value. In part, this reflects the fact that common stock value is ordinarily a good proxy for firm value, making such conflicts rare. It also reflects the fact that where such conflicts are likely to

101. *Id.* at 685.

102. *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 46 (Del. 1994).

103. *See Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289–90 (Del. 1994) (noting that *Revlon* duties apply (i) when a corporation initiates an active bidding process seeking to sell itself; (ii) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (iii) when approval of a transaction results in a sale or change of control).

104. Under the Miller–Modigliani theorem, the total value of the firm must equal the total market value of all of its securities, or in the case of a company with only debt and equity outstanding: $\text{Value}_{\text{firm}} = \text{Value}_{\text{debt}} + \text{Value}_{\text{equity}}$. Because debt must be paid off or assumed in the sale of a company, maximizing $\text{Value}_{\text{equity}}$ will yield a transaction that maximizes $\text{Value}_{\text{firm}}$. To be sure, debt can be assumed in a transaction that shifts value from debtholders to shareholders (e.g., where the acquiring firm takes on additional debt that stands in parity with the target's preexisting debt). *See* Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts*, 6 REV. FIN. STUD. 959 (1993). The prospect of such acquisitions, however, should result in debt covenants (such as change-in-control puts) that diminish the possibility of such bondholder-to-stockholder wealth transfers, thus ensuring that when a board follows *Revlon* it will maximize overall firm value.

105. *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 182 (Del. 1986).

106. *Id.*

occur, Delaware courts have been notoriously vague regarding the proper standard of conduct for directors to follow.

Especially notable in this regard are those cases addressing directors' duties in the so-called "zone of insolvency." When leveraged firms near financial distress, boards must commonly decide between actions that benefit creditors (e.g., liquidating a firm with little or no payout to stockholders) and those that benefit stockholders (e.g., continuing a firm but putting at risk the company's remaining assets). In a famous footnote, Chancellor Allen explicitly recognized this potential conflict in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*¹⁰⁷ Moreover, he seemed to suggest that in such a case, directors' fiduciary obligations would run to the "community of interests that the corporation represents" even if the resulting conduct was inconsistent with conduct that would maximize returns to stockholders.¹⁰⁸ Yet uncertainty lingered after this decision, as courts generally declined creditors' invitations to second-guess director decisions that allegedly harmed creditors while benefiting stockholders when operating in the zone of insolvency.¹⁰⁹ In 2007, the Delaware Supreme Court sought to clarify the content of directors' duties in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*.¹¹⁰ However, the court merely

107. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) ("[D]irectors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.").

108. *Id.*

109. See, e.g., Brian E. Greer, *Fiduciary Duties When the Corporation is in the Zone of Insolvency*, 25 AM. BANKR. INST. J. 26, 26 (2006) ("When a corporation is in the zone of insolvency, the case law is unclear as to whether the fiduciary duties of directors and officers shift to creditors (as in the case of insolvency) or whether such duties continue to be owed to stockholders as well."). This uncertainty was promoted in no small part by explicit skepticism among some Delaware judges that *Credit Lyonnais* could be used by creditors to bring fiduciary duty claims against directors of a solvent firm. For instance, in *Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772 (Del. Ch. 2004), then-Vice Chancellor Leo Strine noted "[t]his view of the common law of corporations is not unproblematic" and suggested it "involves using the law of fiduciary duty to fill gaps that do not exist" in light of the strong covenants generally negotiated by creditors. *Id.* at 789–90. In a footnote, he further emphasized the uncertainty facing directors when operating in the zone of insolvency:

[T]he real world is . . . likely to generate situations when directors face a difficult choice between the pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors.

Id. at 790 n.57. As such, he "doubt[ed] the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone." *Id.*

110. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

continued to conflate directors' duties as running to both the "corporation" and "shareholders." According to the court,

[W]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: 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.¹¹¹

Not surprisingly, professional commentary following *Gheewalla* has continued to reflect uncertainty with respect to how directors should comport themselves in the zone of insolvency when faced with a conflict between maximizing firm value and maximizing stockholder value.¹¹² That said, directors looking to maximize firm value in such settings could take some solace in the absence of a clearly articulated standard. For the very uncertainty created by courts' oscillating approach to directors' duties would seem to justify viewing courts' occasional embrace of a shareholder wealth maximization norm as merely nonbinding "dic-

111. *Id.* at 101. Indeed, *Gheewalla* represents a particularly stark example of an opinion that oscillates between depicting directors' duties as running primarily to the corporation and primarily to shareholders. Compare *id.* at 101 ("It is well settled that directors owe fiduciary duties to the corporation."), with *id.* at 100 ("The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners.'"). As suggested above in the analysis of board's *Revlon* duties, this oscillating approach toward directors' duties has also been prominent in cases articulating these duties in the context of hostile takeovers. In such cases, boards have typically justified their use of takeover defenses on the basis that they advance the long-term interests of the company and its shareholders. See, e.g., *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1148 (Del. 1990) (describing Time's justification for its takeover defense as rooted in a "belief . . . that Paramount's bid posed a threat to Time's control of its own destiny and retention of the 'Time Culture.'"). While the cases can be read to pose a conflict between shareholders (who seek to realize an immediate acquisition premium) and "the corporation," they are also amenable to an approach that views them as pitting short-term shareholder interests against long-term shareholder interests. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) ("Although such considerations [of nonstockholder corporate constituencies and interests] may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."). The ability for courts to substitute a duty "to the corporation" and a duty "to long-term shareholders" has no doubt facilitated courts' tendency to oscillate between articulations of directors' duties as being "to the corporation" and "to shareholders."

112. Compare Willett, *supra* note 18, at 1087 (arguing that the "necessary consequence of *Gheewalla*, construed in light of other relevant authorities, is that where a business strategy may generate a return for equity holders, the board must favor that strategy and reject alternatives"), with 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1035.60, at 32 n.8 (Supp. 2008) (noting that after *Gheewalla*, Delaware law "hold[s] that duties at or near insolvency are owed both to shareholders and creditors").

ta.”¹¹³ The ability to maintain this perspective, however, has changed considerably in light of two Delaware cases decided in 2010 and 2013.

B. Confusing Ends and Means: eBay v. craigslist and In re Trados

The first case emerged from eBay’s much-followed (and ultimately, disastrous) 2004 equity investment in craigslist, Inc.¹¹⁴ Thinking that craigslist’s service would be a natural complement to its existing business, eBay initially believed that acquiring a significant common stock investment in craigslist might facilitate either an acquisition of the company or, alternatively, provide eBay with valuable knowledge it could use to launch its own competing site.¹¹⁵ Ultimately, eBay and craigslist’s two existing directors and majority stockholders—Craig Newmark and James Buckmaster—agreed to allow eBay to acquire 28.4% of the company’s outstanding common stock, subject to a variety of additional terms.¹¹⁶ Among other things, these additional terms required the board to consist of three directors to be elected by cumulative voting (thus guaranteeing the board would consist of an eBay director as well as Buckmaster and Newmark) and also addressed the effect of eBay forming a competing listing service. Specifically, were eBay to compete directly with craigslist, the parties agreed eBay would lose certain stockholder veto rights it held over various corporate actions (such as the right to veto the authorization of additional shares of capital stock) as well as its preemptive rights over the issuance of any additional shares.¹¹⁷

Shortly after its investment, eBay quickly came to the realization that Newmark and Buckmaster had no intention of ever selling craigslist—at least not so long as Newmark and Buckmaster remained among the living and in control of the company.¹¹⁸ eBay thereupon focused on developing a rival service, Kijiji, which it launched in the United States in 2007.¹¹⁹ Although the investment agreements clearly contemplated such a scenario, they did not, however, contemplate the incentive this move would have on Newmark and Buckmaster’s desire to end its relationship with eBay. Shortly after the U.S. launch of Kijiji,

113. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 170 (2008) (characterizing as “dicta” court references to a shareholder wealth maximization norm which must be considered in light of “contrary dicta indicating that directors owe duties beyond those owed to shareholders”).

114. See *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010).

115. *Id.* at 14.

116. *Id.* at 11.

117. *Id.* at 13.

118. *Id.* at 14–16.

119. *Id.* at 17–18.

Buckmaster asked eBay to “gracefully unwind the relationship,”¹²⁰ citing negative feedback craigslist had received from its users regarding the relationship in the wake of Kijiji’s launch. He also cited significant cultural differences. As summarized by the court,

[Buckmaster] . . . explained that craigslist did not think in terms of competition, but it was clear that eBay did, which made craigslist uncomfortable because eBay was a large stockholder privy to craigslist financials and other nonpublic information.¹²¹

When eBay rebuffed any discussion of unwinding their position, Newmark and Buckmaster commenced a strategy to preclude eBay from appointing a director, while locking eBay into a powerless minority position.

In general, their strategy rested on a three-pronged approach that was made possible, in part, by the automatic termination of eBay’s stockholder veto rights upon the launch of Kijiji.¹²² First, the company adopted a staggered board, thereby making it impossible for eBay to use cumulative voting to elect a director representative.¹²³ Second, the company offered all three stockholders the right to receive one newly issued share of common stock for every five shares then held if the stockholder executed a right of first refusal agreement in favor of craigslist.¹²⁴ Although Newmark and Buckmaster signed the agreement, eBay refused, causing its ownership interest to drop from 28.4% to 24.9%.¹²⁵ This dilution made it impossible for eBay to elect a director even without a staggered board.¹²⁶ Finally, craigslist adopted a shareholder rights plan that would be triggered if any stockholder other than eBay, Newmark or Buckmaster acquired more than 15% of the company’s common stock.¹²⁷ Even without signing the right of first refusal, this last provision locked eBay into a minority position with a significant constraint on its ability to transfer its stock.

eBay challenged all three measures as being in violation of the fiduciary duties Newmark and Buckmaster—as directors and controlling

120. *Id.* at 19.

121. *Id.*

122. *See supra* text accompanying note 117.

123. *See eBay*, 16 A.3d at 21–23. While the board size remained the same at three directors, the staggered board amendments divided the three directors into three separate classes, with one class elected each year. With cumulative voting, however, there needed to be at least two board seats in play for eBay to cumulate votes and direct those votes towards a single candidate.

124. *Id.* at 24.

125. *Id.* at 25.

126. *Id.*

127. *Id.* at 23.

stockholders—owed to eBay.¹²⁸ In an opinion written by Chancellor William Chandler, the court ultimately upheld the staggered board but struck down the stock issuance and the shareholder rights plan. For present purposes, Chandler's analysis of the rights plan is especially relevant. According to Chandler, the rights plan was distinctive because the usual concern about such plans being used to entrench management against the threat of a hostile takeover did not apply. Given their significant stockholdings, Newmark and Buckmaster already had sufficient power to prevent a hostile takeover and guarantee themselves board membership.¹²⁹ Yet Chandler nonetheless applied *Unocal*'s intermediate level of review, which required him to assess whether the rights plan was a reasonable response to a perceived threat to craigslist's corporate policy and effectiveness.¹³⁰ In so doing, Chandler effectively framed the issue as one where the board was arguably choosing to advance the corporation's interests over those of its stockholder, eBay.

The central issue faced by Chandler was that Newmark and Buckmaster justified their use of the rights plan by pointing to the threat an eBay acquisition posed to craigslist's corporate culture. As summarized by Chandler,

[Newmark and Buckmaster] contend that they identified a threat to craigslist and its corporate policies that will materialize after they both die and their craigslist shares are distributed to their heirs. At that point, they say, "eBay's acquisition of control [via the anticipated acquisition of Newmark's or Buckmaster's shares from some combination of their heirs] would fundamentally alter craigslist's values, culture and business model, including departing from [craigslist's] public-service mission in favor of increased monetization of craigslist."¹³¹

Chandler recognized that this argument was a clear attempt to fit within the scope of *Paramount Communications, Inc. v. Time Inc.*,¹³² which had previously approved a board's use of takeover defenses as a good faith effort to protect a specific corporate culture.¹³³ Chandler distinguished *Time*, however, by emphasizing that "*Time* did not hold that corporate culture, standing alone, is worthy of protection as an end in itself."¹³⁴

128. *Id.* at 25.

129. *Id.* at 31.

130. *Id.* at 28.

131. *Id.* at 32.

132. See *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

133. *eBay*, 16 A.3d at 32.

134. *Id.* at 33.

Rather, Chandler continued, the nonstockholder considerations that were tolerated in *Time* were limited to those that “must lead at some point to value for stockholders.”¹³⁵ Here, Newmark and Buckmaster “did not make any serious attempt to prove that the craigslist culture, which rejects any attempt to further monetize its services, translates into increased profitability for stockholders.”¹³⁶ As such, their effort to advance the corporation’s long-term interests failed *Unocal*’s test because they “failed to prove that craigslist possesses a palpable, distinctive, and advantageous culture that sufficiently promotes stockholder value to support the indefinite implementation of a poison pill.”¹³⁷

Notwithstanding this emphasis on stockholder value, it is important to emphasize that the decision as a whole is entirely consistent with the argument that fiduciary duties are fundamentally about maximizing firm value. For instance, Chandler made it clear several times that the flaw with Newmark and Buckmaster’s “culture” argument was that the craigslist culture did not maximize firm value in the conventional sense used in corporate finance:

Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. . . . Thus, I cannot accept as valid for the purposes of implementing the Rights Plan a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders.¹³⁸

In this regard, the case resembles other Delaware cases that speak simultaneously of duties that require maximizing stockholder value and duties that require maximizing the value of the corporation.

Yet the case also takes things one step further. Arguably, the most straightforward summary of the entire dispute is that Newmark and Buckmaster were simply seeking to maintain their private benefits of control rather than maximize the economic value of the firm. As directors, they were therefore trying to opt out of the default norm of maximizing stockholder returns in favor of maximizing their own private benefits. Indeed, Chandler sees as much:

^{135.} *Id.*

^{136.} *Id.*

^{137.} *Id.*

^{138.} *Id.* at 34 (emphasis in original).

[Newmark and Buckmaster] simply disliked the possibility that the Grim Reaper someday will catch up with them and that a company like eBay might, in the future, purchase a controlling interest in craigslist. They considered this possible future state unpalatable, not because of how it affects the value of the entity for its stockholders, but rather because of their own personal preferences.¹³⁹

For reasons that are not entirely clear, however, Chandler declines to view the case as simply a duty of loyalty problem and to call foul on the directors for impermissibly opting out of the norm of maximizing stockholder value for personal gain.¹⁴⁰ Instead, he opts to employ *Unocal* review, where he depicts the goal of maximizing stockholder value as the ultimate, immutable benchmark by which to evaluate director conduct.¹⁴¹ His stated rationale for applying this standard of review is especially telling in this regard. Even though the rights plan created no risk of board entrenchment, he nevertheless concluded that Delaware courts will apply *Unocal* to guard against both “the overt risk of entrenchment” and the “less visible, yet more pernicious risk that incumbents acting in subjective good faith might nevertheless deprive stockholders of value-maximizing opportunities.”¹⁴² Here, Chandler seems to be inviting enhanced review of not just those board decisions that, while made in good faith, fail to maximize stockholder value and therefore fail to maximize corporate value (arguably the issue in *eBay*). He also seems to be inviting review of those good faith decisions that maximize firm value but “deprive stockholders of value-maximizing opportunities.”¹⁴³ Directors have no choice, it would seem, but to always prioritize stockholder value in exercising their residual control rights.

This articulation of director duties was made even clearer in another case that was simultaneously proceeding through the Delaware courts. Eventually decided in 2013, *In re Trados Incorporated Shareholder Litigation*¹⁴⁴ presented the all-too-familiar dilemma of a VC-backed start-up that neither succeeded nor failed, but simply went sideways. Over the course of 2000 through 2003, the company undertook several rounds of venture capital finance such that by 2004, the company had outstanding seven series of preferred stock having an aggregate liquidation prefer-

139. *Id.*

140. See *supra* text accompanying notes 79–80 (noting how fiduciary duties restrict directors from capturing private benefits of control).

141. See *supra* text accompanying notes 135–137.

142. *eBay*, 16 A.3d at 32.

143. *Id.* at 30.

144. *In re Trados, Inc.*, 73 A.3d 17, 17 (Del. Ch. 2013).

ence of approximately \$58 million.¹⁴⁵ As is typical of VC financings, the multiple rounds of finance led to a board structure heavily influenced by designees of the company's VC investors. Among the company's seven directors, two were company executives, three were principals of the VC investors, one was a preferred stock investor with close personal ties to one of the VC directors, and one was an independent industry expert.¹⁴⁶

At the center of the legal dispute was the sale of the company in 2005 to a strategic buyer for \$60 million.¹⁴⁷ In 2004, the board instructed management to find a buyer for the company given its meager growth prospects, knowing that the proceeds of any such sale were likely to be absorbed by the preferred stock's \$58 million of liquidation preferences.¹⁴⁸ Moreover, given that company management held only common stock, the board also approved a management incentive plan (MIP) that entitled select executives to a percentage of any acquisition proceeds.¹⁴⁹ In light of the paltry proceeds common stockholders were likely to receive in an acquisition, the MIP was viewed as necessary to incentivize management to find a buyer.¹⁵⁰ The combination of the preferred stock liquidation preferences and the MIP, however, ensured that common stockholders received nothing in Trados's eventual sale.¹⁵¹ Common stockholders sued, alleging that the board violated its fiduciary duties by choosing to sell the company and adopt the MIP rather than continuing to operate Trados in an effort to generate value for the company's common stockholders.¹⁵²

In an opinion authored by Chancellor Travis Laster, the Delaware Chancery Court ultimately held that the board was not liable.¹⁵³ However, in the course of reaching this conclusion, Laster highlighted a number of problems with the board's decisionmaking. Citing *eBay*, he began with articulating the "standard of conduct" of directors, noting the usual duty "to promote the value of the corporation for the benefit of its stockholders."¹⁵⁴ Getting to the crux of the issue, Laster then analyzed how a director's duty should be viewed when—as in this case—directors undertook actions that benefited preferred stock and not common stock. Cen-

145. *Id.* at 21–25.

146. *Id.* at 44–54.

147. *Id.* at 20.

148. *Id.* at 26–29.

149. *Id.* at 32–33.

150. *Id.* at 26.

151. *Id.* at 33.

152. *Id.* at 20.

153. *Id.* at 76–78.

154. *Id.* at 36.

tral to Laster's resolution of this question were two cases in which Delaware courts refused to enjoin board action that allegedly benefited common stockholders at the expense of preferred stockholders.¹⁵⁵ Both courts concluded that, as between choosing actions that advance the interests of preferred stock and actions that advance the interests of common stock, directors should favor the latter. According to Laster:

Put differently, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.* . . . of preferred stock." . . . Consequently, as this court observed at the motion to dismiss stage, "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders."¹⁵⁶

Having established this standard of conduct, Laster next proceeded to determine the appropriate standard of review. Since a majority of directors had a material financial interest in the acquisition, Laster applied entire fairness.¹⁵⁷ In examining the first prong of fair dealing, Laster found overwhelming the evidence suggesting the board consistently disregarded common stockholder interests as it sought to secure and then execute the acquisition.¹⁵⁸ In particular, he faulted the VC designees for not evaluating Trados "from the perspective of the common stockholders, but rather as holders of preferred stock with contractual cash flow rights that diverged materially from those of common stock . . ."¹⁵⁹ He also faulted directors for not considering how to treat common stockholders fairly in designing the MIP and for failing to form a special committee to represent the interests of common stockholders.¹⁶⁰ Director approval of the transaction was therefore problematic because the "defendants in this case did not understand that their job was to maximize the value of the corporation for the benefit of the common stockholders, and they refused to recognize the conflicts they faced."¹⁶¹ Fortunately for

155. *Id.* at 40–42 (citing *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997)).

156. *Id.* at 41–42 (emphasis in original) (citations omitted).

157. *Id.* at 45.

158. *Id.* at 55–65.

159. *Id.* at 56.

160. *Id.* at 64–65.

161. *Id.* at 62.

the defendants, the plaintiffs' expert provided a valuation of Trados's common stock based largely on a comparable company analysis that Laster found unrealistic.¹⁶² He therefore deferred to the defendants' expert, whose more thorough valuation revealed that the common stock had no economic value.¹⁶³ Since using this value for common stock meant that common stockholders received fair value, common stockholders "received the substantial equivalent in value of what they had before, and the Merger satisfies the test of fairness."¹⁶⁴

Thus, even more so than in *eBay*, Laster's vision of directors' fiduciary duties is one in which all directors have an immutable obligation to maximize value for common stockholders. Significantly, this obligation exists even when investors negotiate in advance to have specific board representatives, as occurred with Trados. While Laster cites prior cases in advancing this vision, no prior ruling had so clearly stated that all directors—even those elected solely by preferred stockholders—had as their "job" the advancement of common stockholder interests when they might conflict with those of the preferred.¹⁶⁵ Notably, neither of the two cases cited by Laster for this proposition involved boards where preferred stockholders had director representatives. *Equity-Linked Investors, LP v. Adams*,¹⁶⁶ for instance, involved a similar situation as *Trados* in that the board faced a choice between liquidating a struggling firm (which would benefit preferred stockholders due to their liquidation preferences) and continuing the firm with borrowed funds (which would benefit common stockholders).¹⁶⁷ In contrast to *Trados*, however, the company's seven member board consisted of only management and outside directors; the preferred stock investors did not have any right to a designee.¹⁶⁸ The opinion's holding that directors should use their discretionary judgment to prefer the interests of common stockholders is thus consistent with the bargaining model of the board. Under this model, directors have by default a duty to maximize stockholder welfare as a means to maximize the value of the firm, but investors are free to demand board representation to ensure that investors' potentially unique financial interests can be given voice in board deliberations. Under *Trados*'s depiction of the board, however, an investor-designee's attempt

162. *Id.* at 74–75.

163. *Id.* at 76.

164. *Id.* at 76.

165. See *supra* text accompanying note 161.

166. See *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040 (Del. Ch. 1997).

167. *Id.* at 1041.

168. *Id.* at 1043.

to voice at the board his or her investor's unique financial interests would appear to be fraught with peril.

As with *eBay*, adhering to a bargaining model of the board would not necessarily have changed the outcome of the case. Under the bargaining model, investors are free to designate directors to advance their financial claims in board deliberations, but directors remain bound to their fiduciary duty to the corporation to facilitate Coasian bargaining. As such, the problem with the Trados board was not that its VC directors sought to advance the financial interests of their VC funds, but that no one on the board considered a surplus-generating bargain that might induce the VC investors to continue the firm. Even if unlikely, this possibility should have at least been raised by the non-VC designees given what this Article argues is their default duty to maximize common stockholder value.¹⁶⁹ Yet even the board's one independent director "volunteered that the Trados directors never considered the common stockholders."¹⁷⁰ Instead, the only bargaining that occurred was with respect to the MIP—a bargain initiated only after the decision to sell the firm had been made.¹⁷¹

The ultimate consequences of Delaware's move in this direction are potentially profound. As a matter of private ordering, *Trados's* view of the board can be expected to induce investors to contract specifically for more events to address an unknown future rather than to rely on board representation. Indeed, new contract provisions have already emerged within the venture capital community that are designed to address *Trados* by giving preferred stockholders the right to compel a company's acquisition regardless of the board's judgment.¹⁷² Aside from the questionable

169. See *supra* Part III.

170. *In re Trados, Inc.*, 73 A.3d 17, 62 (Del. Ch. 2013); see also *id.* at 64 ("When pressed, the directors could not recall any specific discussion of the common stock, and they could not comprehend the possibility that the economic interests of the preferred stockholders might diverge from those of the common.")

171. *Id.* at 26.

172. For instance, the Model Voting Agreement of the National Venture Capital Association now provides for a specific "Sale Rights" provision "designed to insulate the Board from a *Trados*-type claim." See NAT'L VENTURE CAPITAL ASS'N, NVCA MODEL VOTING AGREEMENT at n.32 (2014), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=76&Itemid=93. According to this provision, a company must commence a sales process upon the vote of a specified percentage of its preferred stockholders. In the event a buyer is found but the board of directors rejects the transaction, the preferred stockholders then have the right to force the company to redeem their shares at the price that would have been paid on the shares in the rejected acquisition. An annotation in the Voting Agreement explains that "since this section provides for redemption rights additional to any that may be included in the Certificate of Incorporation, selling the company may be the only means by which the Board is able to honor this contractual 'put' obligation." *Id.*

enforceability of such provisions, the idea that investors must turn entirely to explicit contracting to address possible future states of the world obviously does little to address investors' incomplete contracting challenge. More troublesome still is the potential for *Trados* to affect board behavior in certain settings. Recall that the Trados board ultimately escaped liability only because of the plaintiff's poor choice of valuation expert—a point unlikely to be lost on other boards and their advisors. Because more sophisticated, option-theoretic models can reveal positive common stock value even in distressed settings,¹⁷³ boards faced with the dilemma of whether to continue or liquidate a struggling firm may now have to take seriously decisions that might maximize stockholder value but not firm value.

V. CONCLUSION

Drawing on incomplete contracting theory, this Article has advanced a bargaining model of the board to illustrate how the use of constituency directors in both privately held and publicly traded firms can represent an efficient mechanism for boards to maximize firm value. Moreover, while directors' fiduciary duties have generally been omitted from formal incomplete contracting models, this Article has also demonstrated why imposing on directors a fiduciary duty to the corporation can facilitate this goal through reducing the risk of dysfunctional *ex post* bargaining within the board of directors. Yet for the model to function in this fashion, any related obligation for directors to maximize common stockholder value must represent merely a default rule that investors can opt out of through appointing their own director-designees.

While decisions such as *eBay* and *Trados* have called into question whether shareholder wealth maximization can be characterized in this fashion, close inspection of Delaware case law suggests both decisions are in tension with long-standing doctrine concerning the standard of conduct for Delaware directors. As doctrinal innovations, these decisions risk undermining the utility of the corporate form as a vehicle for maximizing firm value, potentially inducing investors and entrepreneurs to turn to noncorporate entities to finance new business enterprises or deterring investment altogether.¹⁷⁴ To ensure the continuing vitality of the corpo-

173. For an illustration, see Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011) (assessing option value of unsecured creditors in bankruptcy).

174. As rightfully noted by Simon Sepe, prohibiting an investor from using a director-designee to advocate an investor's position on the board may cause a potential investment to violate an investor's participation constraint. See Sepe, *supra* note 15, at 351–59; see also *supra* text accompanying

rate form, Delaware courts should, accordingly, abandon any pretense that corporate directors have an immutable duty to maximize stockholder value. Instead, courts should revert to their traditional focus on policing against the bargaining failures that can occur when investors use directors to address the incomplete contracting challenges that are replete in corporate finance.

notes 46–51 (discussing how granting entrepreneur all residual control rights may violate investor’s participation constraint).