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GAMING DELAWARE

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I. TRANSACTIONAL GAMING UNDER THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE

Back in 2000, at the World Trade Center in Portland, Oregon, Time Belden and other Enron electricity traders carefully studied the regulations governing California's new electricity market. Belden thought that the complex rules were "prone to gaming."¹ And game them he did. Under one strategy, Enron filed imaginary transmission schedules, creating nonexistent congestion, so as to draw on the rules' provision of payment to alleviate congestion.² They called it "Death Star."³ Then there was "Ricochet," or megawatt laundering, under which Enron circumvented price caps by exporting power out of California, only to bring the power back later, when the State, desperate for supply, had to pay a premium price.⁴ Eventually, with an energy-starved California up in arms and the Federal Energy Regulatory Commission investigating energy sales to the State, Enron's lawyers paid the traders a visit. The traders walked the lawyers through the transactions, demonstrating legality under what must have been highly technical applications of the rules. The lawyers, expecting litigation, said, "Alright, but is it too late to change the names? Can't you just call the strategies "Puppy Dog" and "Mama's Cooking"?⁵

Enron's North American trading desk made a profit of \$2.2 billion in 2000, much of it due to activities in Western region electricity and natural gas.⁶ The crisis in California implied political scrutiny of

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1. BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 266 (2003).

2. *Id.* at 269-70.

3. *Id.*

4. *Id.* at 270.

5. *Id.* at 274.

6. *Id.* at 282.

Enron's results, and the firm did not want the public to see the extent of its profits. So, still gaming the system, it booked \$1 billion of pot as a reserve against potential liability, without actually showing the reserve in its published financials.⁷

In a legal regime of form without substance, an opportunistic actor can exploit the system in much the same way as Enron's traders and accountants. In such a world, all law is rules-based and literally interpreted, and there are no backstop interpretive controls in the form of principles⁸ (to use the accountants' term) or standards (to use the lawyers' term).⁹

There is a family resemblance between these tales from Enron and the terms and operation of Delaware's bedrock doctrine of independent legal significance (ILS). ILS also elevates form over substance and invites gaming. In its classic form, where ILS operates as a rule of statutory interpretation,¹⁰ it is almost unique in its disavowal of substance. With ILS, the state court effectively announces that no body of substantive principles informs certain applications of the legislature's corporate code, inviting transaction planners to exploit the literal word at will. As with Enron and power provision to California, the gamers are those in a position to invest in expertise. As at Enron,

7. *Id.*

8. See Sarbanes-Oxley Act of 2002, Pub. No. 107-204 § 108(d), 116 Stat. 745 (calling on the Securities Exchange Commission to conduct a study of "principles-based" accounting in response to dissatisfaction with gaming of rules-based treatments in recent years).

9. For the classic description of the interplay of rules and standards in American jurisprudence, see Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

10. *Hariton v. Arco Elec. Inc.*, 182 A.2d 22 (Del. 1962), *aff'd*, 188 A.2d 123 (Del. 1963), is the classic case. There Delaware rejected the doctrine of de facto merger. Under the doctrine, a sale of assets followed by a liquidation that leaves the shareholders of the selling firm in the same place that a conventional merger would have left them, is treated as a merger de facto, with the result that the shareholders of the selling firm receive statutory appraisal rights as if the transaction had been structured as a merger. The operative notion is that technical provisions in the State's corporate code are undergirded by substantive policies, so that similarity of transactional result means that rights provided in one section of the code apply by implication under other sections. Such a substantive approach reduces room for transactional gaming. *But see* *Farris v. Glen Alden Corp.*, 143 A.2d 25 (Pa. 1958); *Rath v. Rath Packing Co.*, 136 N.W.2d 410 (Iowa 1965). In *Hariton*, Delaware rejected the doctrine, drawing on ILS, and quoting Judge Leahy in *Langfelder v. Universal Lab. D.C.*, 68 F. Supp. 209, 211 (D. Del. 1940): "The rationale is that a merger is an act of independent legal significance, and when it meets the requirements of fairness and all other statutory requirements, the merger is valid and not subordinate or dependent upon any other section of the Delaware Corporation Law." 182 A.2d at 26-27. In this affirmative statement, the rule can be described as one of "equal dignity" for the various sections of the Code. The effect is to open the door for transactional gaming.

the gamer wins; and if it does not necessarily take all, it does take quite a bit at the expense of actors disadvantaged by the game. The victims of ILS usually are minority shareholders, whether dissenters in a control transaction or a class of preferred holders whose preferences have been stripped. They bear a familial resemblance to California's hapless energy consumers. Both groups sacrifice wealth to empowered parties wielding the literal word of the law to their own advantage. They are distant cousins, admittedly, but cousins.

This author supplements Professor Smith's able discussion of ILS¹¹ with some additional thoughts on the question of why Delaware has made this extraordinary commitment to a form-over-substance jurisprudence. Upon reflection, ILS turns out to be less bad than it looks, at least in its statutory version. Three significant (and substantive) differences distinguish Delaware law gamers from the gamers at Enron.

First, when a firm relies on ILS to plan a transaction that exploits provisions of the corporate code, it games with the sanction of case law. And, in classic, statutory ILS cases, the courts' literal interpretation of the statute has the benefit of being correct: When Delaware's legislature enacted the corporate code's sections on charter amendments, mergers, and asset sales,¹² it intended whatever transaction structures the courts and the corporate bar later deemed appropriate.¹³ Enron's gamers played form over substance on riskier regulatory turf: They would "take the position" that form trumps substance without advance regulatory endorsement of their legal theories. As they did so, they incurred significant enforcement risks.¹⁴ Their counsel and auditor might have curbed the abuses, but neither proved willing to take responsibility for the exercise of judgment implied when sub-

11. See D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 827 (2004).

12. DEL. CODE ANN. tit. 8, §§ 242, 251, 271 (2001).

13. The statement in the text extrapolates from the documented relationship between the Delaware legislature and the State's corporate bar. The keeper of Delaware's code in reality is not the legislature, which acts as a rubber stamp, but the bar's corporate law section. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888-92 (1990).

14. The most famous case of this did not concern electricity trading but sham swaps entered into between Enron and special-purpose entities formed by the LJM1 and LJM2 limited partnerships controlled by its CFO, Andrew Fastow. These transaction structures went through an exhaustive planning process with the participation of Enron's outside counsel and auditor. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1305-20 (2002).

stance intervenes over form.¹⁵

Second, Delaware's regime of form over substance is not absolute. Delaware law holds out a possibility of ex post substantive scrutiny for some of the transactions that game its code under ILS. Breaches of fiduciary duty remain a possibility even where ILS formalizes the statutory framework and prevents statutory policies from constraining gaming. A minority shareholder fobbed out of appraisal rights in a case like *Hariton v. Arco Electronics*¹⁶ still may be able to package a process complaint in the framework of majority-to-minority fiduciary duty.¹⁷

Third, statutory ILS and Delaware transactional gaming should be distinguished from the more extreme versions at Enron because, historically, statutory ILS has held a central place in Delaware's competitive position in the charter market. *Federal United Corp. v. Havender*,¹⁸ in which ILS made its first appearance, was more than just a preferred stock case in which the Delaware Supreme Court used ILS to open a loophole for rights stripping.¹⁹ The case also signaled that Delaware would not subscribe to the antimanAGERIAL approach outlined in Berle and Means' *The Modern Corporation and Private Property*.²⁰ Berle and Means' book was still a recent publication in 1940, having first appeared in 1932. But it already was famous, having had a visible impact on Congress in the enactment of the federal securities laws.²¹ Berle and Means, in addition to advocating a mandatory disclosure regime, advocated a state law program in which management power would be curbed by a substance-over-form doc-

15. In recent years, we have seen widespread compliance problems stemming from gaming, and the consequent demand for bright line rules coming from legal and accounting professionals. The trend stems in part from the fact that the professionals are unwilling to say "no" to their clients absent the support of the clear rule. Without the rule, saying "no" requires a judgment call that jeopardizes the client relationship. See William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1049-51 (2003).

16. 182 A.2d 22 (Del. 1962), *aff'd*, 188 A.2d 123 (Del. 1963).

17. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (requiring a negotiating committee on behalf of minority shareholders in a cashout merger).

18. 11 A.2d 331, 337 (Del. 1940).

19. This loophole simultaneously extricated Delaware law from the then-current vested rights doctrine, to which it had subscribed a few years earlier in *Keller v. Wilson & Co.*, 190 A. 115 (Del. 1936).

20. ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1991).

21. *Id.* at 264-85 (showing the importance of full disclosure for the functioning of the stock market).

trine of fiduciary protection of minority shareholders.²² *Havender*, in effect, said that Berle and Means' antimanagement program would not influence the policy of the state of Delaware. Berle and Means had singled out the courts, including those of Delaware, as a redoubt of equitable intervention that protected against laxity in the drafting of corporate codes and charters and subsequent transactional gaming. *Havender*, in containing judicial discretion to police transactions for unfairness, falsified that description.²³

Delaware's move to form over substance paid dividends in the post-war charter market. Roberta Romano's study of firms reincorporating to Delaware during the period 1960-1982 shows that firms moved to Delaware in search of a cost-reductive, stable legal regime, and were about to either go public, promulgate antitakeover measures, or position themselves as actors in the mergers and acquisitions market.²⁴ The stability on offer did not come from a state-of-the-art statute—Delaware always has preferred to stick with its old form of code, changing it incrementally as the need arises. Nor, in those days, before the blockbuster merger and acquisition cases of the 1980s,²⁵ did Delaware offer a thick case law on mergers and takeovers. What the firms preferred was Delaware's formalism. Under Delaware's early case law, a reincorporating firm concerned about takeover defense found a nearly bulletproof zone of discretion: Defensive tactics could be sustained on a formal showing of a threat to company policy with no further judicial review.²⁶ Firms planning activities as acquirers, in turn, preferred ILS and Delaware's emphatic rejection of the de facto merger doctrine: ILS assured them that the courts would not disturb cost-effective reverse triangular acquisition structures.²⁷ Of course, fiduciary law regarding mergers and takeovers changed rapidly in the late 1970s and 1980s, limiting management's zone of discretion. Takeover defenses came under *Unocal* review,²⁸ cases like *Singer*²⁹

22. *Id.* at 196-203.

23. William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 766-67 (2001).

24. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 32-35 (1993).

25. *See, e.g.*, *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (instituting duty-of-care scrutiny of boardroom merger decisions); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (instituting proportionality scrutiny of tender offer defense).

26. *See Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

27. It should be noted that by the time a reverse triangle was attacked in a de facto merger jurisdiction, the de facto doctrine had run out of steam and the transaction was sustained. *See Terry v. Penn Cent. Corp.*, 668 F.2d 188, 192-94 (3d Cir. 1981).

28. *Unocal Corp.*, 493 A.2d at 946.

and *Weinberger*³⁰ brought protection for minority shareholders in cash-out mergers. But as everyone realized at the time, Delaware made the concessions only to deflect congressional attention from its management protection operation.³¹

Summing up, to the extent the charter competition system is desirable as a matter of economic welfare, statutory ILS is a defensible formalism.

II. THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE AND PREFERRED STOCK

Professor Smith's paper focuses on the contractual variant of ILS³²—the less defensible practice of invoking ILS in the interpretation of class-voting provisions in charters. Here the Delaware courts still perform for the benefit of the charter market. Traditionally, preferred stockholders do not wield control and therefore do not make jurisdictional choices for the firms issuing their stock. Decisions favoring preferred stock issuers in allocative contests with preferred stock holders accordingly perform a customer service function. The problem for this line of ILS jurisprudence lies in these cases' different interpretive postures. The document being interpreted is not a section of the State's corporate code, but the sections of the corporate charter creating and governing the preferred. The intent of the drafter of a charter can be expected to reflect very different concerns than that of the legislature enacting provisions of the corporate code.

Professor Smith makes an interesting excursion into history when he highlights the contractual variant's origins in the *Langfelder* case of 1946.³³ But the leading case in the contractual line came later. This was Chancellor William T. Allen's 1989 opinion in *Warner Communications v. Chris-Craft*,³⁴ which, like *Benchmark Capital*

29. *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977) (imposing strict fiduciary standards on parent firms in cashout mergers).

30. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (overruling *Singer* and relaxing inspection to process scrutiny).

31. In the mid-1970s, there was a cognizable threat that much conduct covered by state fiduciary law would be found fraudulent or manipulative under section 10(b) of the Securities Exchange Act of 1934. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), defused that threat. Later threats came from the Congress, in which preemptive legislation was introduced. See S. 2567, 96th Cong., 2d Sess. (1980).

32. Smith, *supra* note 11, at 831-40.

33. *Langfelder v. Universal Lab., Inc.*, 68 F. Supp. 209 (D. Del. 1946), *aff'd*, 163 F.2d 804 (3d Cir. 1947).

34. *Warner Communications Inc. v. Chris-Craft Indus.*, 583 A.2d 962 (Del. Ch. 1989).

Partners IV, L.P. v. Vague,³⁵ involved a class of preferred that had its rights stripped in a merger. Both cases interpret a charter's class-voting provision. Interestingly, the preferred in *Warner* had the stronger case of the two. There the charter had two class-vote provisions. The first granted the class vote in respect of impairing charter amendments.³⁶ The second more generally granted a class vote in respect of changes in rights that adversely affected the preferred.³⁷ Chancellor Allen read the second clause to cover only the same territory as the first,³⁸ which effectively rubbed it out of the charter. The justification was that language in the second clause tracked the language of the Delaware code's charter amendment section.³⁹ The tracking, in the court's interpretation, signaled that only charter amendments were covered, even though the second clause did not mention charter amendments. The court held the charter's drafter to the "general understanding" that ILS applied in Delaware interpretation.⁴⁰ Superficially, this makes sense. But on consideration, it must be the exact opposite of what that drafter was trying to accomplish.⁴¹ The manifest purpose of the second, more general provision was to reverse the ILS read of the statute, under which a court will not imply a class vote under the merger section of the statute based on the provision of a class vote under the statute's charter amendment section. Only by reversing that result could the drafter create viable voting protection for the preferred, given the constant possibility of rights stripping by merger with a wholly-owned subsidiary, as in *Benchmark*.⁴²

35. No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002).

36. *Warner*, 583 A.2d at 965 (section 3.4 of the charter).

37. *Id.* at 965 (section 3.3 of the charter).

38. *Id.* at 968.

39. DEL. CODE ANN., tit. 8, § 242(b)(2) (2001) (providing a class vote for a charter amendment that would "alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely").

40. 583 A.2d at 970. *See also* Sullivan Money Mgmt., Inc. v. FLS Holdings, CCH FED. SEC. L. REP. ¶ 97,292 (Del. Ch. 1992).

41. Later, in *Elliott Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843 (Del. 1998), a more explicitly drafted clause finally was held to mean what it said, but only after a trip to the Delaware Supreme Court to get a contrary Chancery opinion reversed.

42. But why did the *Warner* drafter track the charter amendment section of the code? To see why this technique was used, reference can be made to statutes of other jurisdictions under which a class vote would have been required in the *Warner* merger. *See, e.g.*, N.Y. BUS. CORP. §§ 804(a)(2), 903(a)(2) (McKinney 2003). The drafting technique employed in these statutes is noteworthy—the drafter makes a reference back to the provision requiring a class vote for a charter amendment. That is, the merger statute singles out for a class vote merger plans containing provisions that, if included in a certificate amendment, would trigger the

III. GOOD FAITH, PREFERRED STOCK CONTRACTS, AND VENTURE CAPITAL

Professor Smith rightly brings contract law's good-faith doctrine to bear against these ILS-based interpretations of class vote provisions. Unfortunately, the cards are stacked against the good-faith case. To see why, let us chart out the analytical route to the issue thus posed. The exercise shows that Delaware in effect already has rejected any recourse to good faith.

Consider a hypothetical case of rights stripping by merger, as in *Benchmark*, and assume further that the charter does not provide the preferred with a class vote. A Delaware court could still invoke the good-faith doctrine and conduct an ex post substantive review of the transaction crammed down by the majority on the minority. But is the contractual good-faith duty sufficiently robust to support such an intervention? There is a special formulation of good faith applied to financial contracts governing senior securities, under which good faith comes to bear only when the securities issuer traverses rights explicitly created in the contract.⁴³ In cases concerning bonds, this almost always cuts off good-faith review.⁴⁴ Interestingly, a similar

statutory class voting requirement for certificate amendments. This statutory drafting device requires a court to compare the effects of the merger with the specified transactions provided for in the amendment provision in order to determine whether a class vote is required in the merger.

In any event, it is plausible to interpret the phrase "alter or change any rights . . . so as to affect the holders of all such shares adversely" in the *Warner* certificate to include mergers. *Cf. Shidler v. All Am. Life & Fin. Corp.*, 298 N.W.2d 318 (Iowa 1980) (applying a statute requiring a class vote of common stockholders in respect of an amendment that would cancel shares to apply to a cashout merger). Thus, contrary to the court's analysis, the fact that the second provision in the *Warner* charter tracked the language of § 242 of the Delaware code arguably supported a class vote in a merger; the language in effect referred back to the basic section that defines situations appropriate for a class vote.

The ruling of the then-leading case interpreting language similar to that contained in the *Warner* charter also should be noted. In *Levin v. Mississippi River Fuel Corp.*, 386 U.S. 162 (1967), which concerned possible preemption of state corporate law on share voting by the Interstate Commerce Act, the Supreme Court held that a charter provision requiring a class vote in respect of an alteration or change in "the preferences, qualifications, limitations, restrictions and special or relative rights" of the preferred applied in the case of a consolidation with another railroad pursuant to which the preferred received common stock. Given this ruling, it is plausible to assume that the drafters of the subsequent generation of preferred stock contracts would have seen no reason to include more specific language respecting merger votes.

43. See William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 933-34 (2002).

44. *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 957 (5th Cir. 1981) (en banc), cert. denied, 454 U.S. 965 (1981), is the leading case.

cutoff should not occur in a preferred rights-stripping case. The stripped preferences are rights explicitly set out in the contract, and the merger does traverse them. So the good-faith case ought to go forward, even under the narrow formulation applied to senior securities. There is Delaware precedent that nominally holds open a door for just this case. *Jedwab v. MGM Grand Hotels, Inc.*⁴⁵ lays down a distinction in treatment between preferred preferences and rights shared among the preferred and the common. The preferences are covered by contract law, while fiduciary protection is conceded only for rights shared with the common. The split treatment invites application of the good-faith duty in rights-stripping cases. One merely makes a doctrinal deduction under which the rule of contract law for preferences imports the good-faith duty. *Quadrangle v. Kenetech*,⁴⁶ a 1999 Chancery decision, takes a small step in this direction, entertaining the suggestion that a series of actions taken by a distressed preferred issuer might have been taken with an intent to frustrate the preferred holders' right to a liquidation preference in violation of the good-faith duty.⁴⁷ But the facts of the case did not bear out the suggestion of bad faith, and the court denied the claim.⁴⁸

In any event, *Kenetech* is the outlier among the Delaware cases. Delaware's contract-fiduciary distinction more usually has the effect of closing the door to ex post scrutiny of the crammed down transaction. The refusal of fiduciary protection for the preferences implies an across-the-board refusal of ex post fairness review. In Delaware, "contract" tends to mean literal interpretation when the contract is the preferred stock contract. The upshot is that class vote emerges as the exclusive means of protection against rights stripping. Thus, Professor Smith finds himself in the fallback position of invoking good faith in a last-ditch attempt to get the class vote.

Should Professor Smith's association of good faith and the class vote find a receptive Delaware judiciary, a further question arises: How does Delaware articulate the good-faith rubric? Professor Smith correctly flags *Katz v. Oak Industries*⁴⁹ as the leading Delaware case

45. 509 A.2d 584 (Del. 1986). *Jedwab* expands on *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 942 (Del. 1979) (declining to impose fiduciary scrutiny).

46. *Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.*, No. 16362 NC, 1999 WL 893575 (Del. Ch. Oct 13, 1999), *aff'd*, 751 A.2d 878 (Del. 2000).

47. *Id.* at *12-13.

48. *Id.*

49. *Katz v. Oak Indus.*, 508 A.2d 873 (Del. 1986).

on point.⁵⁰ But he leaves open the question as to the appropriateness of its formulation. However, in my view the question is not open: The formulation is inappropriate. In *Katz*, Chancellor Allen, applying New York law, said that good faith implies a counterfactual finding that the parties would have drafted for the right asserted by the plaintiff had they thought about it.⁵¹ Law review articles may support that conclusion, but New York law does not. The good-faith constraint is triggered when a party exercises a right under the contract in such a way as to deprive the counterparty of core expectations.⁵² This ex post intervention presupposes a negative ex ante finding of intent. The court (perhaps implicitly) finds either that the parties did not intend the right to be exercised so as to impair those core expectations, or that the parties never thought about the matter. The law, however, does not go beyond the negative to require an affirmative ex ante showing of a term in some hypothetical bargain.

Kenetech holds out an alternative, subjective approach, keyed to the culpability of the officers of the preferred stock issuer who effect the action that injures the preferred.⁵³ But this reading of good faith falls short when the preferred needs a class vote to prevent the formal stripping of its rights. Here there is no question that the issuer "intends" to strip the rights. But that intent is irrelevant if the corporation's process machinery allows the action to be taken without the preferred being given a separate vote on the matter. The preferred class vote, in turn, presents a question of interpretation. At this stage, good faith can assist the preferred only if the court is willing to apply the doctrine in its broad form and inquire into the parties' core expectations.

These narrow readings of the good faith duty are defensible as a policy proposition if withholding judicial intervention makes the parties better off in the long run by forcing them to solve their problems through careful, self-protective drafting. Professor Smith offers a complete answer to this argument.⁵⁴ A contract forcing default rule sounds good in theory, but, in practice, parties in preferred stock deals just do not get it. The end-run merger with a wholly-owned subsidiary has been there in the form file for almost seventy years, and still law-

50. Smith, *supra* note 11, at 847.

51. 508 A.2d at 880.

52. *See, e.g., Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163, 167 (N.Y. 1933).

53. 1999 WL 893575 at *12-13.

54. Smith, *supra* note 11, at 848.

yers do not plug the loophole. So if the justification for literalism is to force parties into more careful drafting, the approach does not seem to work. Indeed, if contracting parties need a jolt, perhaps the courts should reverse the presumption and intervene aggressively on the side of preferred and other minority shareholders.

Such are my doctrinal glosses on Professor Smith's case for good faith. These apart, he has my complete support in protesting the negation of good faith and arguing on institutional grounds that Delaware should invigorate the doctrine. Twenty years ago, I made a similar argument in a paper on convertible bonds⁵⁵ that took on *Broad v. Rockwell International*,⁵⁶ the case that invented the special, delimited variant of good faith. Unfortunately, nobody paid the slightest attention to my intervention, and subsequent cases followed *Broad*.⁵⁷ So I reasserted the good-faith claim in a paper published during the *RJR Nabisco*⁵⁸ era.⁵⁹ But when the bond market thereafter signaled that it was just as happy to proceed without protection, in exchange for a couple of extra basis points in yield,⁶⁰ I gave up the quest for robust good-faith review of financial contracts for many years.

I renewed the quest a decade later in a discussion of venture capital preferred.⁶¹ It seemed to me that distinctive aspects of venture capital transactions permitted a distinction to be drawn. Formalism and literalism are defended more easily when the case concerns publicly traded bonds and traditional listed preferred. Venture capital deals, being anterior to public trading, look more like traditional relational contracts. Venture capitalists and entrepreneurs often find themselves in subtle, contingent control relationships.⁶² Given con-

55. William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 714-16.

56. 642 F.2d 929, 957 (5th Cir. 1981) (en banc), cert. denied, 454 U.S. 965 (1981).

57. See, e.g., *Gardner & Florence Call Cowles Found. v. Empire, Inc.*, 589 F. Supp. 669, vacated on other grounds, 754 F.2d 478 (2d Cir. 1985).

58. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (refusing to imply a good-faith duty protecting bondholders in a leveraged restructuring).

59. William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 119-21.

60. Protective contract terms that reversed the *RJR Nabisco* result, called "poison puts," appeared in new deals in the late 1980s. But they soon disappeared. The bond market decided that it was quite willing to take the risk of leveraged restructuring in exchange for a couple of basis points. See Marcel Kahan & Michael Klausner, *Anti-Takeover Provisions in Bonds: Bondholder Protection or Management Retrenchment?*, 40 UCLA L. REV. 931 (1993). In my view, the market thereby implicitly accepted the enervation of the good-faith duty.

61. Bratton, *supra* note 43.

62. *Id.* at 916-22.

tractual incompleteness, the properties of these relationships fall into the core territory in which contract law sanctions ex post judicial umpiring.

The case for a fresh start in the interpretation of venture capital preferred should resonate even in the special context of Delaware. With venture capital, the preferred stockholder participates equally in the choice of state of incorporation, perhaps even being the determining party in many cases. So long as the cases carefully cordon off venture capital relationships, ex post intervention need not give rise to disruptive implications for Delaware's principal customer base—the managers of publicly traded companies. Once freed of concerns about the customer base, Delaware judges are extremely good at evenhanded interpretation of financial contracts. Vice Chancellor Leo Strine's treatment of issues arising under a standard merger agreement in *IBP, Inc. v. Tyson Foods, Inc.*,⁶³ provides a good example. If the Delaware courts took a similar approach to disputes between venture capitalists and the entrepreneurs, a cogent, first-class body of case law would result.

Benchmark, of course, shows that Delaware courts still follow the traditional template. But, as Professor Smith shows, the fit is awkward, so we still might see the Delaware courts take a new look at venture capital contracts. Some kind of signal of dissatisfaction from the industry may be needed to focus their attention, however. Meanwhile, I am happy to leave the quest for good faith in financial contracting in Professor Smith's capable hands, albeit with a warning that he not get his hopes up.

Even as I concur with the project's wider objectives, I should admit to some doubts about the particulars of the case for intervention presented in *Benchmark*. First, I would at least entertain the suggestion that venture capital firms contemplate that a minority investor takes the risk of recapitalization by merger with a wholly-owned subsidiary. Venture capital charters tend to contain a one-size-fits-all merger provision. Such a provision treats a merger as a liquidation that triggers a right to redeem the preferred if the stockholders immediately prior to the merger own less than fifty percent of the voting power ex post the merger.⁶⁴ The clause picks up acquisitions by third

63. *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (Del. 2001) (balancing the interests of the parties in the transactional context in interpreting a material adverse change clause in a merger agreement).

64. Bratton, *supra* note 43, at 941. Significantly, the term overrules the result of *Rothschild Int'l Corp. v. Liggett Group*, 474 A.2d 133 (Del. 1984).

parties but excludes the wholly-owned subsidiary recapitalizations.⁶⁵ One can argue that the result is unintended, and that bounded rationality prevents the parties from appreciating the rights-stripping danger held out by a merger with a shell subsidiary. But the counterargument also is open: Recapitalizations that facilitate new financing benefit the enterprise and can be structured equitably; an antecedent minority venture capital interest could use a contractual veto in a recapitalization to hold up the other interest holders in the firm; therefore, the minority venture capitalist who does not negotiate for the veto expressly takes the risk of an unfavorable cram-down recapitalization.

Second, I find myself asking whether Benchmark Capital Partners IV, L.P. reasonably could be left to fend for itself, at least on the facts of this case. My doubts arise when I look past the doctrinal barriers to good-faith scrutiny and entertain the merits of Benchmark's hypothetical good-faith case. *Benchmark* poses a telling contrast with the other leading Delaware case on venture capital relationships, *Equity-Linked Investors, L.P. v. Adams*.⁶⁶ Both cases concern venture capital investors with minority stakes at the shareholder level and no control at board meetings. Both lie on downside fact patterns, with the investee firm facing insolvency unless new financing is procured. In both, the minority venture capitalist objects to the new financing. However, the two cases part company at this point. In *Adams*, a redemption trigger was manipulated to facilitate a last-minute, peanut-sized, secured-debt deal, with the stakes being a stub of salable assets, the enterprise otherwise not having proved viable.⁶⁷ The secured loan froze the venture capitalist's stake under water, where a present liquidation in the wake of the triggering of the preferred's redemption rights would have yielded the venture capitalist the stub of salable assets. A strong inference of investee opportunism arises. So does a clear-cut opening for good-faith intervention in respect of the investee's manipulative conduct. The investee, an enterprise that had lost its viability, intervened with Nasdaq to prevent delisting, where delisting would have triggered redemption rights and swift liquidation for the venture capitalist's benefit.⁶⁸

65. Bratton, *supra* note 43, at 944.

66. 705 A.2d 1040 (Del. 1997).

67. *Id.* at 1050-52.

68. *Id.* at 1047, 1051-52.

In *Benchmark*, serious money was on offer in the new financing, indicating a potentially viable investee.⁶⁹ The facts, as stated in the opinion, imply opportunism and intransigence all around. Significantly, *Benchmark*'s litigation objectives were not spelled out. It either sought to push the investee to liquidation, or it simply wanted a larger proportionate share of the going concern. Either way, it presented a holdout threat. Meanwhile, if the ex post fairness issue were joined, the judge would be left in indeterminate territory. When a start-up remains viable but shaky, needs successive rounds of financing, and financing remains available, what is a fair, continuing percentage participation for early-stage equity that has decided to make no further contributions? There is no easy answer.

Nor is it as if *Benchmark* was without alternatives. Because the merger altered its rights under the charter, it could have dissented and perfected its appraisal rights.⁷⁰ Opting for appraisal would have given *Benchmark* the chance to make a mathematical showing of the amount it thought represented its due under the original charter. Apparently *Benchmark* did not deem the probable returns on that exercise to be worth costs of the proof. Why should a court jump through the hoops under the good-faith rubric so as to accord *Benchmark*, a plaintiff of means, a right to hold up the new financing, a right that it might have reserved at the original negotiating table?

At this point, a telling comparison can be made between *Benchmark* as a plaintiff in a rights-stripping case and a plaintiff class of traditional, publicly traded preferred. Venture capital is relational and all that, but the public holders may have the stronger case for equitable intervention. Unlike *Benchmark*, the public holders never get a shot at negotiating the terms, and there might just be a couple Mom-and-Pop investors among the victims.

69. *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002), at *4-5.

70. See DEL. CODE ANN. tit 8, §§ 251(f), 262(b)(1) (2001).