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Opportunity-Cost Conflicts in Corporate Law

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Abstract

Delaware corporate law has a new brand of loyalty claim: the opportunity-cost conflict. Such a conflict arises when a fiduciary operates under strong incentives to withdraw human and financial capital for redeployment into new investment opportunities. The concept has its roots in venture capital investing, where board members affiliated with venture capital funds may have incentives to shut down viable start-ups in order to focus on more promising companies.

Recognizing this type of conflict has conceptual value—it provides a coherent framework for assessing a fiduciary's incentives, and it may help explain frequently criticized features of corporate fiduciary law. But this article argues that courts should invoke the doctrine sparingly to avoid upsetting the law's current balance between policing managerial abuse and litigation abuse.

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Introduction

Assume you establish a corporation to operate a restaurant, and you are lucky enough to know Warren Buffet and Bill Gates.[1] Imagine that (a) Buffet and Gates each loan the corporation $500,000 at a reasonable interest rate; (b) Buffet and Gates serve as officers and directors of the corporation; and (c) Buffet and Gates each receive 25.5 percent of the corporation's common stock as compensation for their service and advice. Assume the restaurant operates for five years with moderate success—enough to make the loan payments with only a small amount left over for shareholders. Now suppose you propose a new menu to boost profits, but Gates and Buffet decide their time and money could be put to better use elsewhere. They vote as board members to sell the restaurant for an amount that pays off the loans but leaves only a small amount for shareholders. Assuming Gates and Buffet obtained a good price for the restaurant at that time, have they violated their fiduciary duties to you because they turned their attention to other projects and denied you the chance to unveil your new menu?

The Delaware Chancery Court recently suggested that the answer is yes by recognizing for the first time what this article refers to as an "opportunity-cost conflict." This article argues that this novel fiduciary

1. For an entertaining account of the Buffet and Gates friendship, see Drake Baer, *How Bill Gates And Warren Buffett Overcame A Totally Awkward First Meeting To Become Best Friends*, Business Insider (Oct. 1, 2014, 4:15 PM), http://www.businessinsider.com/bill-gates-warren-buffett-friendship-2014-10 [http://perma.cc/87UD-ZT7X].

principle is a double-edged sword: conceptually valuable but difficult to enforce without unsettling the law of corporate fiduciaries.

An opportunity-cost conflict arises when corporate fiduciaries operate under strong incentives to withdraw human and financial capital for redeployment into new investment opportunities. This concept is rooted in the economic principle of opportunity cost—the cost of a course of action is the highest value alternative forsaken.[2] It recognizes that a true understanding of a fiduciary's incentives requires knowing the fiduciary's alternatives to continued dealings with the beneficiary.

Opportunity-cost conflicts are distinct from traditional duty of loyalty claims against corporate fiduciaries. Traditionally, such claims arise in two principal situations: (1) self-dealing between the fiduciary and the corporation to the detriment of the latter[3] and (2) misappropriation by the fiduciary of a corporate opportunity.[4] Unlike traditional self-dealing, a fiduciary with an opportunity-cost conflict does not enter into a transaction with the corporation—the fiduciary simply shuts down the business and withdraws. Unlike a fiduciary who misappropriates a corporate opportunity, a fiduciary with an opportunity-cost conflict does not pursue any business initiative that rightfully belongs to the corporation—the fiduciary simply abandons one corporation in order to focus on a more promising alternative.

Not surprisingly, the concept of opportunity-cost conflicts was born in the context of venture capital investing. Venture capital funds take an unusually active role in the start-ups in which they invest.[5] This hands-on approach requires venture capitalists to allocate their scarce time among portfolio companies.[6] In this setting, continued investment in a moderately promising start-up company may have a high opportunity cost for the venture capitalist because it comes at the expense of spending additional time on more promising companies in the fund's

2. A common illustration of the concept is that there is "no free lunch" because time is scarce and attending lunch forecloses alternative uses of time. *E.g.*, Russell Roberts, *Getting the Most Out of Life: The Concept of Opportunity Cost*, Library of Economics and Liberty (Feb. 5, 2007), http://www.econlib.org/library/Columns/y2007/Robertsopportunitycost.html [http://perma.cc/T8HM-2FHH] (discussing the proverbial free lunch).

3. *See infra* notes 33 and 175 (discussing claims based on self-dealing by a corporate director).

4. *E.g.*, Model Bus. Corp. Act § 8.70 (Am. Bar Ass'n 2013) (imposing special procedural requirements on the pursuit of a business opportunity belonging to the corporation); Broz v. Cellular Info. Sys., Inc., 673 A.2d 148 (Del. 1996) (applying the corporate opportunities doctrine under Delaware law).

5. *See infra* text accompanying notes 107-109 (discussing the active role that funds play in management decisions, and the decisions they face in allocating their time).

6. *See id.* (discussing the limited time resources of venture capital funds).

portfolio.[7] Indeed, commentators have long observed that venture capital funds may shut down viable companies in circumstances where company founders might prefer to forge ahead.[8] One can anticipate similar dynamics in any setting where active investors must allocate their efforts among competing projects.[9]

In the recent case of *In re Trados Incorporated Shareholder Litigation*[10] (*Trados*), the Delaware Chancery Court expressly invoked this shutdown dynamic while enshrining opportunity-cost conflicts into law.[11] The court held that start-up company board members affiliated with venture capital funds faced a conflict of interest when considering a merger that resulted in a payout to the funds, as preferred shareholders, but no payout to common shareholders.[12] Though an earlier opinion in the *Trados* litigation (*Pretrial Trados*)[13] received significant scholarly attention for allowing such a claim to survive a motion to dismiss,[14] only the most recent opinion, which has received less attention from scholars, fully articulates the court's novel reasoning.[15]

7. *See id.*

8. *See id.*

9. *See infra* text accompanying notes 113–114 (citing as possible examples: shareholders in a closely held corporation, activist hedge-fund investors, and parent corporations).

10. 73 A.3d 17 (Del. Ch. 2013).

11. *Id.* at 46–54.

12. *See id.* at 54 ("[Three directors] were not independent with respect to the Merger. They wanted to exit, consistent with the interests of the VC firms they represented.").

13. *In re* Trados Inc. S'holder Litig., No. 1512–CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

14. *E.g.*, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. Pa. L. Rev. 1815, 1874–1900 (2013) (discussing *Pretrial Trados* in articulating an over-arching "theory of preferred stock"); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 Brook. L. Rev. 1163, 1165, 1185–89 (2013) (discussing *Pretrial Trados* as a basis for "reassess[ing] the law's treatment of preferred stockholders in the venture capital context"); Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 Wash. U. L. Rev. 309, 314 n.12, 320 (2013) (discussing *Pretrial Trados* in an economic analysis of constituency directors); Leo E. Strine, Jr., *Poor Pitiful or Potently Powerful Preferred?*, 161 U. Pa. L. Rev. 2025, 2039 (2013) (discussing *Pretrial Trados* in a response to Bratton and Wachter).

15. The trial court opinion has been cited in a handful of law review articles. Most notably, several prominent authors discussed the opinion in a recent symposium issue of the *Seattle University Law Review. See* Robert P. Bartlett III, *Shareholder Wealth Maximization as Means to an End*, 38 Seattle U. L. Rev. 255, 290–95 (2015); Margaret Blair, *Boards of Directors as Mediating Hierarchs*, 38 Seattle U. L. Rev. 297, 330-34 (2015); Anthony J. Casey & M. Todd Henderson, *The Boundaries of "Team"*

Conceptually, *Trados* deserves credit for giving courts a coherent framework for identifying when a fiduciary's incentives are in fact impaired. Though courts and commentators have long recognized that disparate payouts from a transaction can affect incentives,[16] *Trados* reminds us that such cash flow rights are only part of the story. In the restaurant example above, Gates and Buffet may not have precisely the same financial incentives as you because only they receive a significant payout from transaction (repayment of their loans). But those payout differentials alone do not really answer the question of whether Gates and Buffet have materially different incentives than you. After all, they are also shareholders who would benefit from a wildly successful new menu, and they continue to receive interest payments on the loans as long as they are outstanding. What really puts you at odds with Buffet and Gates are their lucrative alternatives to your more pedestrian venture.

Another conceptual strength of *Trados's* new analysis is the light it sheds on contested normative questions regarding fiduciary duties, such as the vexing question of to whom director fiduciary duties should be owed. After deciding that the preferred and common shareholders in *Trados* had conflicting interests, the court determined that the board owed its fiduciary duty to the common shareholders alone (common maximization).[17] Prominent commentators have instead argued that corporate directors should seek to maximize overall enterprise value (enterprise maximization) rather than common stock value alone, because a rule of enterprise maximization increases combined welfare.[18] Focusing on opportunity costs may inform this debate and explain the court's choice of common maximization. For example, it is not clear that enterprise maximization is the right measure of combined welfare if it ignores gains from redeploying capital and effort to more promising

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Production of Corporate Governance, 38 Seattle U. L. Rev. 365, 383-86 (2015); Elizabeth Pollman, *Team Production Theory and Private Company Boards,* 38 Seattle U. L. Rev. 619, 627-36 (2015). But these authors did not focus on the opportunity-cost reasoning that this article analyzes.

16. *See infra* Part I.A (describing the relationship between incentive incompatibility and fiduciary duties).

17. *See In re Trados*, 73 A.3d at 42 n.16 ("As long as a board complies with its legal obligations, the standard of fiduciary conduct calls for the board to maximize the value of the corporation for the benefit of the common stock.").

18. *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 Stan. L. Rev. 1309, 1323–28 (2008) ("[I]ndeed coupling firm-maximization with a broad business judgment rule may in fact be a sensible way to think about the problem . . . ."); *see also* Bratton & Wachter, *supra* note 14, at 1894 ("An enterprise value-maximization principle presents a much stronger case for fiduciary scrutiny with a more balanced tradeoff of costs and benefits.").

opportunities.[19] Moreover, if venture capital investors labor under pervasive opportunity-cost conflicts, a rule of common maximization may be necessary to induce entrepreneurs to fully commit to corporate ventures.[20]

Despite these conceptual strengths, this article concludes that courts should interpret the doctrine of opportunity-cost conflicts narrowly. In Delaware corporate law, access to judicial process is conditioned on clear indicia of misconduct.[21] This feature of fiduciary law seems to reflect a considered judgment that the societal cost of allowing meritless litigation to proceed exceeds the societal cost of letting some fiduciary indiscretions go unlitigated.[22] Because opportunity-cost conflicts are nuanced, multilayered, and ubiquitous,[23] allowing liberal pursuit of such claims would upset the law's current balance between policing litigation abuse and managerial misconduct. Thus, *Trados* serves as an example of how doctrine can be both "right" and impractical to implement except for in the most egregious cases.

This replays a familiar dynamic in corporate law. Corporate law sometimes maintains lofty standards of conduct (what we ideally expect of a fiduciary) while evaluating individual cases under deferential standards of review (such as the business judgment rule) that decline rigorous judicial enforcement.[24] In other words, a court may announce an important principle based on unusually vivid evidence in a particular case, but the principle may not be worth actively policing in the ordinary case. A well-known example is the famous dispute between Henry Ford and shareholders of Ford Motor Company in which shareholders objected to Ford's expansion plans and curtailment of dividends on the basis that he was operating the company based on social rather than

19. *See infra* Part II.B.1 (suggesting the rule of enterprise value is too atomistic).

20. *See infra* Part II.B.2 (suggesting a plausible explanation for why a rule of common maximization is necessary to induce entrepreneurs to enter into venture capital bargains).

21. *See infra* Part III.A (discussing how standard of review in Delaware reserves judicial process for those instances in which the court's interest in policing managerial misconduct outweighs its interest in policing litigation abuse).

22. *See infra* Part III.A (providing an overview of empirical research and commentary regarding strike suits in shareholder litigation).

23. *See infra* Part II.A (identifying the many layers of information necessary to understand a party's opportunity costs); *infra* Part III (arguing that opportunity cost conflicts are ubiquitous in the sense that investors will frequently have better options (regrets) and therefore an incentive to redeploy capital and efforts into new projects).

24. *See infra* text accompanying note 173 (discussing diverging standards of review and standards of conduct).

financial goals.[25] Ford lost the case because he stubbornly insisted that he operated the company without regard to earning profits for shareholders.[26] Although the case remains good law and does conceptual work in the classroom (where it frequently introduces students to the corporate law norm of shareholder primacy),[27] courts have generally declined to enforce the principle vigorously.[28] Likewise, *Trados* is an important case, but one that should be invoked sparingly.

This article proceeds in four parts. Part I describes the importance of incentive structures in fiduciary law, the conceptual difficulties posed by the incentive structures of venture capital investors, and *Trados's* approach to addressing those difficulties. Part II identifies conceptual strengths in the court's framework of opportunity-cost conflicts, includeing its sound footing in models of economic decision-making and its implications for normative debate about the form and content of corporate fiduciary duties. Having acknowledged these strengths, this article advocates in Part III for a narrow reading of the case based on concerns that litigation is an inefficient mechanism for enforcing the duties *Trados* defines. Part IV anticipates and responds to potential objections.

I. A Novel Solution to the Problem of Quasi-Residual Claimants

This Part frames the problem that *Trados* sought to solve. In short, holders of traditional preferred stock have materially different incentives than holders of common stock, which may call into question whether a fiduciary associated with a preferred holder will discharge duties owed to common holders. But venture capital investors do not receive *traditional* preferred stock, making it difficult to discern their incentives. *Trados* offers a solution to this incentive ambiguity.

25. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 671 (Mich. 1919) (quoting testimony of Henry Ford).

26. *See id.* at 684 ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

27. *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. Corp. L. 277, 315 (1998) (describing the case as "[t]he most quoted—at least by academics—statement of the shareholder primacy norm" and noting its prevalence in law school curriculums).

28. *See id.* at 286–88 (asserting that the business judgment rule makes the shareholder primacy norm "virtually unenforceable" in the context of publicly traded companies). Smith argues that the shareholder primacy norm evolved into the modern doctrine of minority oppression in the context of privately held corporations. *Id.* at 279.

A. Loyalty and Incentive Incompatibility

The fiduciary duty of loyalty can be thought of as a collection of component obligations, each being more or less relevant in a particular context. Examples of such component obligations include: honesty and full disclosure to the beneficiary[29] ("honesty"), using the beneficiary's property only for the benefit of the beneficiary rather than the fiduciary[30] ("no misappropriation"), and giving the expected amount of effort in advancing the beneficiary's interests[31] ("full effort"). These obligations may sound in moral or economic theory.[32] In corporate law, courts enforce the duty of loyalty by more intensely policing fact patterns that seem likely to implicate one or more of the component loyalty obligations. For example, courts apply the exacting fairness standard, instead of the deferential business judgment rule, whenever a corporate director engages in self-dealing by entering into a contract with the corporation.[33]

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29. *See* Philosophical Foundations of Fiduciary Law 180–81 (Andrew S. Gold & Paul B. Miller eds., 2014) [hereinafter Foundations of Fiduciary Law] (discussing situations in which loyalty includes an obligation of "being true").

30. *E.g.*, Unif. P'ship Act § 404 6 U.L.A. 143 (1997) (requiring a partner to "account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business"). Gordon Smith describes the core obligation of loyalty in similar terms but uses the expanded concept of a "critical resource" instead of property. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1407 (2002) ("[A] wrong is committed in the fiduciary context when the fiduciary does or has something that is inconsistent with the beneficiary's interest in the critical resource.").

31. *See* Foundations of Fiduciary Law, *supra* note 29, at 179–80 (discussing situations in which loyalty includes an obligation of "affirmative devotion"); Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 Del. J. Corp. L. 27, 37–42 (2003) (identifying a notion of loyalty requiring the fiduciary to affirmatively advance the beneficiary's interests); Sepe, *supra* note 14, at 319 (discussing the economic concept of "insufficient effort" and relating the concept to fiduciary duty law).

32. *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 889–92 (1988) (discussing the disconnect between traditional law and economics analyses of fiduciary duties and the moral tone of judicial opinions delineating these rights).

33. *See* Model Bus. Corp. Act § 8.61 (Am. Bar Ass'n 2013) (requiring that a "director's conflicting interest transaction" (1) be approved by independent directors or shareholders or (2) be fair to the corporation); Del. Code Ann. tit. 8, § 144 (2015) (requiring that a self-dealing transaction be fair to the corporation or subject to special approval procedures).

In some circumstances, it is difficult to identify precisely why a particular claim lies in loyalty rather than the duty of care.[34] On the one hand, betrayal by a fiduciary through misappropriation or deception clearly enough offends ethical or moral sensibilities. Perhaps, not surprisingly then, the obligations of honesty and no misappropriation likely form the core of the duty of loyalty.[35] In contrast, the obligation of full effort has been less prominent in loyalty jurisprudence, perhaps because offending conduct resembles a less culpable negligence claim.[36] In some cases, a fact pattern implicates loyalty only as a matter of degree—consequences of impaired effort are particularly severe in a particular setting,[37] conduct is particularly egregious or intentional,[38] lapses are particularly likely because incentive structures are noticeably impaired,[39] or violations are particularly easy to police because they are easy to identify.[40]

34. *See* Johnson, *supra* note 31, at 37–42 (discussing overlap between care and loyalty concepts); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 103 (1991) ("[T]here is no sharp line between the duty of care and the duty of loyalty. What is the difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)?").

35. *See* Johnson, *supra* note 31, at 37–42 (discussing a minimum condition of loyalty (non-betrayal) and a "maximum condition" of loyalty (affirmatively advancing the beneficiary's interests)).

36. *See id.* Prior to the court's decision in *Stone v. Ritter,* 911 A. 2d 362 (Del. 2006), it may not have been clear under Delaware law that extreme nonfeasance constitutes a breach of loyalty rather than care or a separate duty of good faith. *See Stone,* 911 A.2d at 369-70.

37. For example, Delaware courts may scrutinize sale transactions that constitute an "end-game" for shareholders. *See In re* Smurfit-Stone Container Corp., No. 6164–VCP, 2011 WL 2028076, at *15 (Del. Ch. May 20, 2011) (explaining circumstances triggering scrutiny under the *Revlon* standard). In extreme cases, a failure to obtain the best price for shareholders in such a transaction constitutes a duty of loyalty claim. *See* Stephen Bainbridge, *The Geography of Revlon-Land*, 81 Fordham L. Rev. 3277, 3314–3320 (2013) (discussing circumstances in which *Revlon* claims implicate the duty of loyalty).

38. *E.g.*, Stone, 911 A.2d at 369–70 (holding that insufficient director oversight might constitute a breach of loyalty in cases of "utter failure" or "conscious disregard").

39. *See infra* notes 41–50 (discussing impaired incentives in the context of self-dealing and capital structures with fixed and residual claimants).

40. *See* Easterbrook & Fischel, *supra* note 34, at 103 ("It is . . . easier for courts to detect appropriations than to detect negligence, so the costs of inquiry and error are lower.").

For example, courts might closely police self-dealing because it severely impairs a director's incentives to give full effort in protecting the corporation's interests with respect to the subject matter of the self-dealing.[41] Though a fiduciary may act benevolently towards his or her beneficiary in such a situation, a self-dealing transaction has an undeniable distributional aspect. With respect to many basic terms of a transaction—price, for example—the fiduciary's gain will be the corporation's loss.[42] When a director engages in self-dealing, he or she does not necessarily violate his or her fiduciary duty. But experience warns that breaches are more likely than in the case of an arms-length bargain, and so corporate law places a high burden on the director to establish that he or she remained loyal.[43]

Self-dealing is only one example of impaired incentives giving rise to loyalty claims. For instance, legal scholars have given significant attention to a fact pattern that William Bratton and Michael Wachter refer to as the "moderate downside."[44] When a corporation is neither

41. *See* FOUNDATIONS OF FIDUCIARY LAW, *supra* note 29, at 178 (discussing the proposition that anti-conflict rules are a prophylactic device to ensure full affirmative devotion); William T. Allen, et. al., *Function Over Form: A Reasonable Reassessment of Standards of Review in Delaware Corporate Law*, 56 BUS. LAW. 1287, 1302 (2001) ("[W]here a majority [of the board] have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the highest transaction price the market will permit."). One could also view self-dealing as a violation of the no-misappropriation obligation to the extent the fiduciary misappropriates value through a one-sided transaction.

42. In an arms-length transaction without fraud or duress, one can assume that exchange transactions are mutually beneficial at some level (or they would not occur). *See* Gerald B. Wetlaufer, *The Limits of Integrative Bargaining*, 85 GEO. L.J. 369, 373–90 (1996) (discussing the mutually beneficial aspects of exchange transactions). One cannot make that same assumption when a conflicted fiduciary sits on both sides of the deal. Moreover, even in a mutually beneficial transaction, there are many distributional aspects that a self-dealing fiduciary may tilt to his or her advantage. *Id.*

43. *See* FOUNDATIONS OF FIDUCIARY LAW, *supra* note 29, at 184 ("The anti-conflicts rules are sometimes taken to be protective of fiduciary loyalty, rather than an example of fiduciary loyalty itself.").

44. Bratton & Wachter, *supra* note 14, at 1874–75, 1885–87 (using the terminology "moderate downside"). *See also* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 994–97 (2006) (describing incentive distortions that may occur when "the firm is neither a complete failure nor a stunning success"); Baird & Henderson, *supra* note 18, at 1329–33 (providing an example based on the case of *Orban v. Field* and making comparisons to zone of insolvency cases); Korsmo, *supra* note 14, at 1186–89 (discussing the *Trados* fact pattern). Simone Sepe uses game theoretical examples that depict what one might call the moderate downside, but with a fuller range of potential actions and outcomes than in Hypothetical A below. Sepe, *supra* note 14, at 351–55.

wildly successful nor hopelessly insolvent, conflicts can arise between common stock holders, as residual claimants, and a corporation's fixed claimants.[45] Fixed claimants include parties with discrete claims on the corporation's assets or cash flow, such as lenders with the right to loan repayment, trade creditors with the right to payment for goods and services, employees with the right to salary and other cash compensation, and traditional preferred stock holders entitled to receive a stated periodic dividend and payout at liquidation.[46] In contrast, residual claimants such as common stock holders (1) receive financial benefit from the corporation only after payment of fixed claims and (2) enjoy unlimited participation in a company's "upside" value in excess of fixed claims.[47]

At the moderate downside, a fixed claimant may want the corporation to act conservatively in order to ensure satisfaction of fixed obligations while residual claimants may favor riskier strategies with greater upside potential.[48] Bratton and Wachter illustrate these incentives through a hypothetical similar to the following:[49]

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45. *See* Sepe, *supra* note 14, at 312–15 (discussing potential conflicts).

46. *See id.* at 314 n.12, 320 (listing payments owed to creditors, dividends owed to preferred shareholders, and wages owed to employees as examples of fixed claims).

47. *See* Easterbrook & Fischel, *supra* note 34, at 67 ("[S]hareholders are the residual claimants to the firm's income. . . . The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line."); Sepe, *supra* note 14, at 313 (describing the rights of common shareholders as residual claimants).

48. *See* Fried & Ganor, *supra* note 44, at 972–95 (stating that holders with fixed claims "sometimes gain less from increases in firm value than they lose from decreases in firm value" resulting in fixed claimants choosing "lower-risk, lower-value investment strategies over higher-risk, higher-value investment strategies"). More generally, incentive incompatibility between debt and equity is a common theme in corporate finance literature. *E.g.*, Lucian Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. of Fin. 445, 447 (2002) ("Equityholders (and managers seeking to maximize the value of equity) might favor a risky project over a safer one even if the risky project offers a somewhat lower expected return, because the returns from favorable outcomes of the risky project would be captured by the equity holders, whereas the losses from its unfavorable outcomes would be partly borne by the debtholders."); Robert E. Scott, *The Truth About Secured Lending*, 82 Cornell L. Rev. 1436, 1449 (1997) ("If the project succeeds, the equity interests capture all the gains, but if the project fails, the losses are shared with the debtholders. The debt cushion, in other words, can lead to excessively risky investments.").

49. *E.g.*, Bratton & Wachter, *supra* note 14, at 1886 (including a similar example with a preferred stockholder as fixed claimant). I have used a creditor rather than a preferred stockholder in this example because I delay my explanation of preferred stock terms to the next subsection. Moreover, those who have illustrated the moderate-downside fact pattern through preferred-stock

Hypothetical A: Purely Fixed and Purely Residual Claimants at the Moderate Downside

	Value	**Probability**
Acquisition offer for Company A	$30,000,000	
Fixed claim (e.g., lender)	$30,000,000	
Turnaround (if successful)	$50,000,000	75%
Turnaround (if unsuccessful)	$20,000,000	25%

In this hypothetical, Company A receives an offer to sell its assets for $30 million—a price that satisfies an outstanding loan (the fixed claim) but leaves the common with nothing. Company A's alternative is to attempt a turnaround that involves some risk but is more likely than not to produce value for the common. All other things being equal, the fixed claimant will want to accept the offer because it ensures repayment and the fixed claimant has nothing to gain by the turnaround, but the common holders will want to attempt the turnaround for at least a chance at obtaining value. If either stakeholder has assumed a fiduciary obligation to the other, such as by serving on the corporation's board of directors, courts may scrutinize the fiduciary's conduct because this incentive structure may compromise the fiduciary's effort to maximize value for the beneficiary.[50]

B. Venture Capital as Quasi-Residual Claimants

Sometimes, when the cash flow rights of various stakeholders are not so distinctly fixed or residual, the incentives are ambiguous. Employees are fixed claimants with respect to salary but may also be

hypotheticals have expressly analogized to the debtor-creditor context. *See id.* at 1886 (noting that the *Trados* fact pattern "replays the familiar problem of debt and equity on the downside"); Fried & Ganor, *supra* note 44, at 997 (referring to preferred stock's "debt-like cash flow rights" in the course of discussing the moderate-downside fact pattern).

50. The most commonly discussed instance involves a common-controlled board of an insolvent corporation. In that situation, some courts have suggested that the board owes a fiduciary duty to the company's creditors and may labor under a conflict-of-interest to the extent it is beholden to common holders. *See* Bratton & Wachter, *supra* note 14, at 1886–87 (discussing Credit Lyonnais Bank Nederland v. Pathe Commc'n, 324 See Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991)("*Credit Lyonnais*") and subsequent cases reducing the importance of *Credit Lyonnais*); Baird & Henderson, *supra* note 18, at 1324–28 (discussing *Credit Lyonnais*).

compensated with stock or stock options.[51] Lenders or vendors may be fixed claimants with respect to certain payment obligations but may also be paid with stock rights in order to conserve the corporation's cash.[52] Stakeholders possessing these hybrid economic rights could be called "quasi-residual claimants" because they have fixed claims on the corporation's assets but also share somewhat in the corporation's residual value.[53] *Trados* grapples with a frequently occurring example of a quasi-residual claimant—venture capital investors in start-up companies.

Trados Incorporated (Trados) was once a promising company that developed and sold popular translation software.[54] The company attracted roughly $30 million in investment from venture capital funds, which received preferred stock (Trados preferred) and the right to name several members of the board of directors in exchange for their investment.[55] A mix of company founders, key employees, and strategic investors owned the bulk of the company's common stock and had the right to designate the remaining board members.[56] This subpart examines the terms of the Trados preferred in detail to illustrate how preferred holders—traditionally categorized as fixed claimants—defy easy categorization.

1. Fixed Claim: Liquidation Preference

Typical of preferred stock in a variety of contexts, the Trados preferred had a fixed claim on the corporation's assets in the form of a

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51. *See* Therese H. Maynard & Dana M. Warren, Business Planning: Financing the Start-Up Business and Venture Capital Financing 319–22 (2010) (discussing equity compensation practices with respect to employees and non-employee service providers).

52. *See id.* at 319–321.

53. Sometimes the term quasi-residual claimant is used to describe how the incentives of fixed claimants change when the corporation is insolvent and fixed claimants therefore have a residual-like interest in increasing firm value to ensure repayment. *See, e.g.*, Sepe, *supra* note 14, at 332–35 (discussing how low asset value and other factors place a fixed claimant in a position similar to that of a residual claimant). Elsewhere, the term quasi-residual claimant is used to describe a claimant with a mix of cash flow rights. *See, e.g.*, Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 Del J. Corp. L. 189, 211–14 (2000) (describing how employees become quasi-residual claimants when salary is supplemented by equity-based compensation such as stock options). This article uses the term in the latter sense.

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

55. *Id.* at 20, 33.

56. *See* Defendants' Brief in Opposition to Plaintiff's Motion for Class Certification at 1–4, *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (2013) (No. 1512-VCL) (identifying members of the plaintiff class).

liquidation preference.[57] In the event of a merger or liquidation of the company, the liquidation preference entitled the preferred holders to certain payments before common stockholders could receive anything.[58] The preference was equal to the amount originally invested by the funds plus an additional amount representing an eight percent annual dividend that accrued but was not actually paid out.[59] The liquidation preference totaled roughly $60 million by 2005, meaning that preferred holders would receive *all* proceeds of any sale[60] at or below $60 million.[61]

2. Quasi-Residual Claim: Conversion Rights

In addition to a fixed claim on the liquidation preference, holders of the Trados preferred could also share in the company's successes through conversion rights. Specifically, the preferred stock was convertible into common shares at the election of the venture capital investors or if the company demonstrated a high level of success by completing an initial public offering (IPO).[62]

Such conversion rights are ubiquitous in venture capital financings.[63] Outside of the venture capital industry, preferred stockholders often have only debt-like financial rights that entitle preferred holders to a stated dividend and a liquidation preference with any residual value inuring to the benefit of the common holders.[64] Because this more conventional model of preferred stock places a ceiling on the holder's possible gains, it would be unsuitable to venture capital investing where most start-ups fail and investors must rely on a few big successes in

57. *See* Maynard & Warren, *supra* note 51, at 471 ("[P]referred stock is generally distinguished by having the right to receive dividends or liquidation distributions before common stock. . . ."); Korsmo, *supra* note 14, at 1171–72 (listing a liquidation preference as a core attribute of preferred stock).

58. *See In re Trados*, 73 A.3d at 21–24 (describing the terms of the Trados preferred).

59. *Id.*

60. Theoretically, sale could mean either (1) piecemeal sale of individual assets or (2) sale of the company as a going concern through a merger or sale of substantially all assets. Following the facts of *Trados*, this article uses the term in the latter sense.

61. *See In re Trados*, 73 A.3d at 20 (describing the result of the transaction for common and preferred shareholders).

62. *See id.* at 21–22 (describing the conversion terms of the *Trados* preferred).

63. *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 Harv. L. Rev. 874, 879 (2003).

64. *See* Melissa M. McEllin, *Rethinking* Jedwab: *A Revised Approach to Preferred Shareholder Rights*, 2010 Colum. Bus. L. Rev. 895, 899–902 (2010) (describing terms of traditional preferred stock).

order to achieve acceptable rates of return on a portfolio basis.[65] Accordingly, venture capital funds almost always receive the right to convert into common stock, give up their liquidation priority and dividend rights, and share in value beyond such fixed amounts.[66]

On an as-converted basis, Trados preferred holders owned about half of the company's shares.[67] In other words, holders would convert into common and forfeit their liquidation preference if the company could sell, or complete an IPO, at a high enough price. For example, had Trados sold to Microsoft for $500 million net proceeds, the preferred holders would have converted and been entitled to approximately $250 million as common holders rather than being limited to their $60 million liquidation preference.

3. Quasi-Residual Claim: Participation Rights

Finally, some of the Trados preferred had "participation rights" up to a multiple of the amount invested. Participation rights allow preferred holders to share in moderate successes by receiving both their liquidation preference and a portion of any remaining proceeds from a merger or liquidation that might otherwise go to common shareholders.[68] It is customary for participation rights to be limited to a multiple of the amount invested.[69] The participation right becomes valuable when the company is acquired for a price that does not justify

65. *See* Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 195, 232 (2013). As a rule of thumb, the bulk of investment returns to venture capital funds are believed to come from 20% or fewer of their portfolio companies. *See id.* at 230 n.202. Empirical research supports the proposition that a very small number of successful investments drive returns to venture-capital investors. *See id.* (reviewing empirical research); John Cochrane, *The Risk and Return of Venture Capital,* 75 J. FINANCIAL ECON. 3, 30 (2005) (analyzing venture capital investments and observing, even among companies that have achieved exit through an acquisition or IPO, a "small possibility of earning a truly astounding return, combined with the much larger probability of a more modest return"). There are, however, significant methodological challenges in empirically assessing the performance of investments in startups. *See id.* at 4-6 (describing selection-bias problems because investment outcomes are primarily observed in connection with positive exits such as IPOs and acquisitions).

66. See Gilson & Schizer*, supra* note 63, and George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 317–20 (2001), for a more comprehensive explanation of why convertible stock is appropriate for venture capital investments.

67. *See In re Trados*, 73 A.3d at 34 (showing ownership percentages of various stockholders).

68. *See* MAYNARD & WARREN, *supra* note 51, at 499–517 (describing participation rights).

69. *Id.* at 507.

conversion into common but that does create some value above the liquidation preference.[70] For example, had Trados sold for $120 million and assuming all Trados preferred had participation rights, the venture capital funds would have received a total of $90 million ($60 million liquidation preference plus $30 million representing one-half of the remaining proceeds). In fact, the preferred stock was issued in various series, only some of which had these participation rights.[71]

C. The Conceptual Problems Posed by Quasi-Residual Claimants

The *Trados* litigation arose when the Trados board approved sale of the company through a merger transaction in which preferred holders recovered the bulk of their liquidation preference but common holders received nothing.[72] Disgruntled common holders responded with both an appraisal proceeding alleging that the transaction undervalued their shares and duty of loyalty claims against board members affiliated with the venture capital funds.[73]

At first blush, the disproportionate payouts alone might seem to warrant exacting fairness scrutiny for the loyalty claims. For example, under the well-known case *Sinclair Oil Corporation v. Levien*,[74] Delaware courts apply fairness when a controlling shareholder receives a benefit "to the exclusion and at the expense of" other shareholders.[75] One might think the case applies to *Trados* because preferred shareholders received merger consideration to the exclusion of common shareholders. A closer examination of *Sinclair*, however, suggests otherwise and reveals the novelty of the questions posed by *Trados*.

Sinclair involved claims by minority shareholders of Sinclair Venezuelan Oil Company (Subsidiary) against its majority shareholder,

70. *See id.*

71. The participating shares constituted approximately one-third of the preferred shares. *See In re Trados*, 73 A.3d. at 21–23 (describing the terms of the Trados preferred).

72. *Id.* at 20.

73. *Id.* at 34–35.

74. 280 A.2d 717 (Del. 1971).

75. *Id.* at 720. Though *Sinclair* involved claims against a controlling shareholder rather than board members, it is still instructive. Generally, fiduciary duties of controlling shareholders are more circumscribed than fiduciary duties of board members. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255, 1273 (2008) (explaining that "shareholder fiduciary duties are commonly understood to exist only for controlling shareholders" and in limited contexts). Therefore, board action that benefits a director's affiliate to the exclusion and at the expense of other corporate stakeholders is presumably as (or more) problematic than similar action by a controlling shareholder.

Sinclair Oil Corporation (Parent).[76] Plaintiffs accused the Parent of self-dealing.[77] More specifically, the Parent used its control to orchestrate a contract between the Subsidiary and another affiliate that required the latter to buy a specified level of output from the Subsidiary.[78] The Parent then allowed its affiliate to breach the contract by making late payments and failing to buy the specified amounts.[79] Because the contractual breaches resulted in improper benefit to the Parent at the Subsidiary's expense, the court applied fairness review to the Parent's actions.[80]

Nothing in *Sinclair* warrants fairness review based solely on the receipt of a negotiated liquidation preference by a venture capital investor. Unlike the contract and subsequent breaches at issue in *Sinclair*, the terms of the Trados preferred were apparently negotiated at arm's length with an independent board.[81] Courts treat preferred stock rights as contractual rights, and corporate law sanctions contracts (and their subsequent performance) between insiders and a corporation where properly approved at the outset.[82]

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76. *Sinclair*, 280 A.2d at 719.

77. *Id.* at 720–21.

78. *Id.* at 722–23. In addition to these self-dealing claims, the plaintiffs accused the Parent of "denial of expansion opportunities" through large (though statutorily permitted) dividends and channeling new business to other subsidiaries. *Id.* at 720–21. The court concluded that those claims should be evaluated under the deferential business judgment rule. *Id.* at 722.

79. *Id.* at 723.

80. *Id.*

81. There are cases in which venture capital funds obtain board representation and then use their insider position to extract favorable terms in subsequent financing rounds. *E.g.*, Carsanaro v. Bloodhound Tech., Inc., 65 A.3d 618, 628 (Del. Ch. 2013). But those allegations were not made in *Trados*.

82. *See* Model Bus. Corp. Act § 8.61 (Am. Bar Ass'n 2013); Del. Gen. Corp. L. § 144 (citing corporate-law statutes that permit self-dealing when approved by independent directors or shareholders); Bratton & Wachter, *supra* note 14, at 1892 ("Value was taken in *Trados*, but only pursuant to the ex ante contract."). Even those who view a board's duties to preferred shareholders narrowly recognize the validity of preferred-stock preferences. *See* Strine, *supra* note 14, at 2027 ("The prevailing theory is simple: preferred stockholders are *preferred* to the extent that they secure *preferences* (i.e., additional rights that may have economic value) in their contract."). *But see* *Orban v. Field,* 92 No. 12820, 1997 WL 153831 at n.26 (Del. Ch. Apr. 1, 1997) (suggesting that in some circumstances a board might have a fiduciary obligation to engage in efficient breach of a contract with preferred holders).

Accordingly, the *Trados* plaintiffs had to make a less straightforward claim. They focused their arguments on the *timing* of the transaction rather than the division of proceeds.[83] They alleged that Trados was viable as a standalone entity, had been enjoying improving fortunes by some measures, and could be sold at a better price if given more time to operate as an independent company.[84]

With nothing more, a poorly timed sale sounds like a duty of care rather than loyalty issue. To imbue the claims with a loyalty element, the plaintiffs argued that the preferred holders' fixed claim (the liquidation preference) created the same incentive incompatibility as the creditor example in Hypothetical A above.[85]

There is a problem, however, with this story: the venture capital investors were quasi-residual holders. All of the preferred holders had conversion rights, which entitled them to share in any large-scale successes.[86] Some of the preferred holders also had participation rights, which entitled them to share in any proceeds above the liquidation preference.[87] If there was additional value to be squeezed out of Trados, why would these investors pull the plug too early?

To illustrate the court's difficult task, it is useful to first recast the payouts from Hypothetical A in terms of a preferred stock financing. While this and other hypotheticals in this article are artificial in several respects,[88] the exercise is nonetheless valuable in illustrating the additional conceptual challenges posed by quasi-residual claimants:

83. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *6–*7 (Del. Ch. July 24, 2009).

84. *See id.* (describing the plaintiffs' fiduciary duty claim).

85. See *In re Trados*, 73 A.3d at 49 (characterizing preferred stock cash flow rights as "debt-like").

86. *See supra* Part I.B.2 (describing conversion rights).

87. *See supra* Part I.B.3 (describing participation rights).

88. Most fundamentally, courts never have such concrete knowledge of expected outcomes. *See* Strine, *supra* note 14, at 2037 (discussing the difficulty of assessing competing expert testimony regarding the value of corporate entities and transactions). In addition, I have, like other commentators, assumed a risk-neutral investor. *E.g.,* Brian Broughman, *The Role of Independent Directors in Startup Firms,* Utah L. Rev. 461, n. 35 (2010). Finally, I have assumed that any discount rate for the time delay of a turnaround or pivot in strategy is already reflected in the expected values presented.

Hypothetical B: VC Preferred and Common at the Moderate Downside

	Value	**Probability**
Acquisition offer for Company B	$30,000,000	
Liquidation preference (investment amount + accrued dividends)	$30,000,000	
Turnaround (if successful)	$50,000,000	75%
Turnaround (if unsuccessful)	$20,000,000	25%

If one focuses on the liquidation preference alone, this hypothetical produces precisely the same incentive incompatibility as Hypothetical A. The residual holder will want to roll the dice on a turnaround because there is no upside in accepting the offer. Putting aside participation rights for the moment, the fixed claimant (in this case, a preferred shareholder) will want to act conservatively because it has nothing to gain by taking the risk. If preferred shareholders control the board, there may be serious question whether we can trust that board to guard the interests of common holders.[89]

Now consider the effect of participation rights on the parties' incentives. Assume that all of the preferred shares in Hypothetical B have such rights and the preferred shareholders own half the company on an as-converted basis. In that event, the turnaround would have an expected value of $35 million to the preferred shareholders because they are entitled to both their liquidation preference and a portion of any additional value (up to a specified cap).[90] The question becomes: does an extra $5 million in average expected value adequately motivate the preferred holder to attempt the turnaround?

Next, consider how conversion rights affect incentives, even without participation rights. First, assume a wider range of possible outcomes than presented in Hypothetical A. In *Trados*, for example, management presented the board with a variety of strategies with varying levels of

89. As discussed further below, the Chancery Court clearly identified the common holders as the primary beneficiaries of the board's duties, though commentators have advocated for a different rule. *See infra* text accompanying notes 136–38.

90. The amount is calculated as follows: (.25 * $20,000,000) + (.75 * ($30,000,000 + (($50,000,000 - $30,000,000) / 2)).

risk and potential reward.[91] The highest risk strategy was to significantly revamp the company's business plan—a "pivot" in start-up company jargon.[92] If successful, this pivot strategy would have opened up a much larger market for the company and potentially resulted in considerably more value than immediate sale. To illustrate the potential effects of such a pivot, consider a new hypothetical with an expanded range of expected outcomes:

Hypothetical C: Preferred and Common With Potential Pivot[93]

	Expected Value	**Probability**
Acquisition offer for Company C	$30,000,000	
Liquidation preference (investment amount + accrued dividends)	$30,000,000	
Pivot (if successful)	$300,000,000	20%
Pivot (if no improvement)	$30,000,000	40%
Pivot (if unsuccessful)	$0	40%

Even without participation rights, the pivot has an average expected value of $42 million to the preferred holders because they have at least some opportunity to convert and participate in a large success.[94] Does an extra $12 million in expected value adequately motivate the preferred holders to attempt the pivot?

Under these payout scenarios, the incentives of preferred and common holders appear to point in at least the same general direction.

91. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 29 (Del. Ch. 2013) (describing three strategies for the company named "Merge-Up," "Harvest," and "Merge-Up Adjacent").

92. For a list of well-known pivots by successful start-ups such as Twitter, Groupon, Paypal, and Instagram, see Jason Nazar, *14 Famous Business Pivots*, Forbes (Oct. 8, 2013 10:46 AM), http://www.forbes.com/sites/jasonnazar/2013/10/08/14-famous-business-pivots/ [http://perma.cc/8AUK-PYE6].

93. For relevant assumptions, see note 88.

94. The amount is calculated as follows: (.4 * $30,000,000) + (.2 * ($300,000,000 / 2)). For a discussion of why the acquisition price does not reflect the value of the pivot, see *infra* note 110.

The question, therefore, is not whether common and preferred incentives are compatible. Rather, the question is a more nuanced one: are the preferred holder's incentives *adequate*?

To be clear, there are payout scenarios where participation and conversion rights have limited effects and the incentives of preferred and common holders clash as in Hypothetical A and the examples typically used to illustrate the moderate downside.[95] Specifically, when a turnaround has an expected value that is especially close to the preferred stock liquidation preference, participation and conversion rights might fail to capture much value and receipt of the liquidation preference is clearly preferable for the holder of preferred stock.[96] But this limited range of clear incentive incompatibility arises in precisely the situation where common holders have the least to gain by continuing and suffer the least severe consequences from a sale. As soon as we introduce some meaningful chance at higher values above the liquidation preference, participation and conversion rights begin to align incentives.[97]

The law has never required *perfect* incentive alignment. For example, most corporate directors for U.S. publicly traded companies are quasi-residual claimants. Annual cash compensation in the form of director fees constitutes a fixed claim on corporate assets.[98] In an attempt to better align the interests of board members and shareholders, directors also receive equity compensation such as restricted stock or stock options.[99] While these residual-like claims may bring the board members into better alignment with common shareholders than purely fixed compensation, this is a different sort of equity interest than that of a long-term shareholder. Board members typically receive

95. See *supra* note 44 (referring to examples of moderate downside).

96. For example, if Hypothetical C is altered so that a pivot has an eighty percent chance of producing \$35 million and a twenty percent chance of a total loss, then the preferred holders might prefer the \$30 million sale because participation rights do not give the preferred sufficient interest in the pivot's success. But doing so forecloses an opportunity for the common holders to realize \$2 million in value (their share of the average expected value of a pivot).

97. For instance, if we alter the example in note 96 so there is just a five percent chance of a \$300 million exit, the expected value of the turnaround to preferred holders exceeds the sale price and the question becomes one of incentive adequacy rather than incompatibility. Similarly, if one assumes an eighty percent chance of a \$50 million (rather than \$35 million) outcome and a twenty percent chance of a total loss, the expected value of a turnaround to the preferred holders exceeds the sale price and the question is one of incentive adequacy rather than incompatibility.

98. *See* Katherine M. Brown, *New Demands, Better Boards: Rethinking Director Compensation in an Era of Heightened Corporate Governance*, 82 N.Y.U. L. Rev. 1102, 1121–22 (discussing annual cash fees to directors).

99. *See id.* at 1122–29 (describing equity compensation practices).

annual or semiannual grants of equity awards, meaning that board members potentially profit from stock price volatility that fails to produce value for long-term shareholders.[100] If this imperfect alignment of incentives resulted in close judicial scrutiny, there would be little room for the business judgment rule.

In fact, even where all shareholders hold the same type of residual cash flow rights, differing ownership percentages can skew incentives. Consider a company with an all-common structure and a board comprised of: a representative of a corporate conglomerate that owns 25 percent of the company's stock, a representative of a private equity fund that owns 15 percent of the company's stock, an activist hedge fund that owns 5 percent of the company's stock, and an individual who is unaffiliated with any of the foregoing and owns 0.01 percent of the company's stock. Based on differing ownership percentages alone, a gain or loss by the company has substantially different economic implications for each shareholder just described. Presumably, the intensity of each director's incentives vary accordingly.[101] Yet a showing of proportional financial benefit (distribution of cash flow in proportion to common share ownership) has ordinarily been sufficient to defeat allegations of conflict.[102] If the law required perfect incentive alignment, proportional financial benefit would not be sufficient.

In short, there was no bright-line rule in Delaware law requiring fairness review of the Trados board's actions.[103] Instead, the court was required to perform a more nuanced and fact-intensive analysis of incentives.

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100. *See id.* at 1130 (footnotes omitted) ("Critics of using stock options . . . argue that options do not in fact properly align the interests of directors and shareholders. Unlike holders of 'straight' equity, option holders 'share in the creation of shareholder value but not in its erosion' because options asymmetrically reward only stock price appreciation. This asymmetry can make directors too risk-inclined.").

101. For an example of these incentive effects outside of corporate law, see Steven D. Levitt & Stephen J. Dubner, Freakonomics: A Rogue Economist Explores the Hidden Side of Everything 72 (2005) (finding that real estate agents receiving percentage commissions sell houses faster and for lower prices than when they sell their own houses). *See also* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B. U. L. Rev. 1039, 1041 (2011) (using the real-estate commission example to illustrate the intractability of incentive misalignment between beneficiaries and fiduciaries).

102. *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 65–66 (Del. 1989); *In re* Morton's Rest. Grp. Inc. S'holders Litig., 74 A.3d 656, 662 (Del. Ch. 2013); *In re* Synthes, Inc. S'holder Litig., 50 A.3d 1022, 1040 (Del. Ch. 2012).

103. *But see infra* Part IV.A (acknowledging, but disfavoring, an alternative reading of *Trados* that hinges fairness review on the imperfect incentive alignment between common and preferred).

D. The Trados Solution: Opportunity-Cost Analysis

The trial court directly confronted the analytical challenge of quasi-residual rights by discussing incentives of directors affiliated with funds possessing participation rights. This analysis marks an important step forward in analyzing the moderate-downside fact pattern in venture capital financings. *Pretrial Trados* gave only lip service to the defendants' arguments that their incentives were aligned with common holders.[104] Legal scholarship to date, though deserving credit for many key insights on which this article builds,[105] has sometimes analyzed the moderate-downside with stylized fact patterns that assume away participation or conversion rights.[106]

The trial court grounded its analysis of the defendants' incentives in a well-chronicled pattern of behavior in venture capital investing. The court explained:

> Venture capitalists will sometimes liquidate an otherwise viable firm, if its expected returns are not what they (or their investors) expected, or not worth pursuing further, given limited resources and the need to manage other portfolio firms. This may seem irrational, but it makes perfect economic sense when viewed from the venture capitalist's need to allocate [his] time and resources among various ventures. Although the individual company may be economically viable, the return on time and capital to the individual venture capitalist is less than the opportunity cost.[107]

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104. *See In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del Ch. July 24, 2009) (briefly acknowledging defendants' arguments that incentives of common and preferred holders were aligned).

105. For example, Bratton and Wachter provide a particularly strong analysis of the difficulty parties will have contracting around *Trados*—an insight that is aligned with this article's ultimate recommendation for a narrow interpretation of the case. *See infra* Part IV.C. In addition, a number of legal scholars have usefully introduced the shut-down dynamic to legal scholarship. *See infra* note 107.

106. Principally, Bratton and Wachter demonstrate incentive-incompatibility through an example similar to Hypothetical B. In that example, they disregard participation rights, and they choose value ranges for which conversion rights are not relevant. Bratton & Wachter, *supra* note 14, at 1886. In contrast, other commentators use examples that implicate conversion rights (but do not include participation rights). *See, e.g.*, Brian J.Broughman, *supra* note 88, at 471–74; Fried & Ganor, *supra* note 44, at 995–97; Sepe, *supra* note 14, at 351–55.

107. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 51 (Del. Ch. 2013) (quoting William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations,* 27 J. Fin. Econ. 473, 507 (1993); Michael A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture-Capital Financed Firms*, 2002 Wisc. L. Rev. 45, 110, n. 218; Michael A. Utset, *High-Powered (Mis)incentives and Venture Capital Contracts,*

An example helps illustrates the "shut-down" dynamic as depicted in legal scholarship and invoked by the court. Assume that the preferred holder in Hypothetical C is a $200 million venture capital fund (Fund C) that invested $20 million in ten separate start-up companies. Company C's preferred controlled board must now decide whether to accept the $30 million offer (equal to the liquidation preference) or attempt the pivot with an average expected value of $42 million. How would the fund decide?

One way to answer the question is to focus on the effort the fund will exert in attempting a pivot. Company C will look to the fund for assistance with hiring new executives with relevant experience, performing market research, making budgeting decisions, evaluating progress by analyzing sales results, considering and negotiating financing alternatives for new initiatives, and assessing exit strategies if the initiatives are successful.[108] The fund managers have only so much time; continuing with Company C limits the time available for other portfolio companies.[109] In other words, Company C's pivot has opportunity costs that will likely drive the fund's decision.

7 Ohio St. Entrep. Bus. L. J. 45, 56 (2012)). In its discussion of the shut-down dynamic, the court also cited additional sources, such as Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. Rev. 37, 56 n.78 (2006); Broughman & Fried, *infra* note 153; Fried & Ganor, *supra* note 44; D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315, 356 (2005).

108. Venture capital investors are recognized as particularly active investors, providing companies with significant managerial assistance. *See* Maynard & Warren, *supra* note 51, at 435 ("Venture capital investors make their knowledge, contacts, and expertise available to their portfolio companies and consult with and assist management on almost every key decision the company faces."); Korsmo, *supra* note 14, at 1169–70 (discussing venture capital investors' active role in management of portfolio companies and their expertise in finance and management); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. Small & Emerging Bus. 133, 138–40 (1998) (discussing a wide range of managerial assistance provided by venture capital managers, including advice related to marketing, strategy, financing, and recruiting).

109. One might ask why funds do not hire additional personnel to maintain an active role in all viable companies. In short, hiring and supervising additional agents is expensive. For example, researchers have considered an analogous question—the optimal size for a venture capital fund. *See generally* Douglas J. Cumming, *The Determinants of Venture Capital Portfolio Size: Empirical Evidence*, 79 J. Bus. 1083 (2006) (modeling venture capital portfolio construction); Josh Lerner, et al., Private Equity, Venture Capital, and the Financing of Entrepreneurship: The Power of Active Investing 349-71 (2012) (describing the effects of increasing fund sizes); Diane Mulchaney, et al., *"We Have Met the Enemy . . . and He Is Us": Lessons From Twenty Years of the Kauffman Foundation's Investments in Venture Capital and the Triumph of Hope Over Reason* (2012) (noting superior performance of smaller funds in the Kauffman Foundation's own

For example, assume (1) the fund has seen four of its portfolio companies file for bankruptcy without any return to equity; (2) two of the remaining portfolio companies have prospects similar to Company C, and (3) the remaining three portfolio companies have slightly better prospects such as a thirty percent chance for a $300 million outcome, a forty percent chance for $30 million outcome, and a thirty percent chance for a total loss. If the fund only has the time and resources to continue with three companies, the fund will want to sell Company C *even if attempting the pivot has a higher expected value.*[110] Put another way, opportunity costs impair the fund's incentives to wring out additional value available from Company C.

Some of the evidence in *Trados* fits this account particularly well. The court summarized one director's testimony as follows:

> [T]he evidence at trial established that Gandhi faced a conflict and acted consistent with Sequoia's interest in exiting from Trados and moving on. As Gandhi explained at trial, when

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portfolio); Sven Weber & Jason Liou, *Dialing Down: Venture Capital Returns to Smaller Fund Sizes*, Silicon Valley Bank (May 31, 2010), https://www.svb.com/Blogs/Aaron_Gershenberg/Dialing_Down___Venture_Capital_Returns_to_Smaller_Size_Funds/ [http://perma.cc/4833-QQJC] (discussing the advantages of smaller sized venture capital funds). According to this literature, adding companies to a portfolio initially has benefits, such as diversification and complementary investments. *See* Cumming, *supra*, at 1087 (modeling fund portfolio construction and explaining why the projected marginal benefits curve will initially slope upwards). At some point, however, marginal costs increase due to agency costs associated with any additional personnel, inattention if additional personnel are not hired, potential conflicts and competition among portfolio companies, and other factors. *See* Cumming, *supra*, at 1087–90 (discussing increasing marginal costs of expansion); Lerner, *supra*, at 360-62 (discussing the costs of expansion, including managing additional personnel). Consistent with this model, empirical research indicates that fund performance eventually declines with size. Lerner et al., *supra*, at 357-370 (observing declining performance at $280 million fund size); Weber & Liou, *supra*, at 6–7 (identifying $250 million as an optimal fund size); Mulchaney et al., *supra*, at 23–26 (criticizing the performance of funds over $500 million).

110. In such a circumstance, one might wonder why an entrepreneur cannot convince a third party of a pivot's value and engineer a more advantageous sale transaction or other take-out of Fund C. The primary obstacle to such a transaction is information asymmetry—entrepreneurs will have a difficult time convincing third parties of the value of pivot. *See* Gilson & Schizer, *supra* note 63, at 878–79 (discussing problems of information asymmetry in early stage companies); Brian J. Broughman & Jesse M. Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some Evidence from Silicon Valley*, 18 J. Corp. Fin. 1104 (2012) (discussing how "informational lock-in" makes it difficult for startups to obtain financing from sources other than existing venture-capital investors). In addition, the most likely sources of financing—other venture capital funds—are likely to be just as lukewarm as Fund C regarding a moderate success.

> Sequoia invests, it hopes for "really fast" growth and "very large outsized returns." Within six months after the Uniscape merger,[111] Gandhi had concluded that Trados would not deliver outsized returns and that Sequoia's "real opportunity" was only "to recover a fraction" of its $13 million investment in Uniscape. By the end of 2002, Gandhi had decided not to put significant time into Trados beyond Board meetings and only to attend by phone unless meetings were held locally. From his perspective, this was simply a matter of prioritizing his time based on how Trados would perform for Sequoia relative to other opportunities with "a lot of upside." He later elaborated: "[M]y most, you know, limited resource is just where I'm putting my time. And it's just better to work on something brand-new that has a chance. . . . Is [the next Sequoia investment] going to be Google?"[112]

As characterized by the court, this testimony is a rather frank admission that Trados was a low priority for this director and that he was trying to reallocate his time to more promising companies in his fund's portfolio.

Extrapolating from the specific facts of the case, the court is identifying a novel, or rarely discussed, fact pattern of opportunity-cost conflicts. The concept is separate from the conflicts that may arise between preferred and common cash-flow rights. One can imagine opportunity-cost conflicts arising even between common shareholders. Any active investor may be faced with choices among alternative investments and may allow such concerns to influence decisions made as a fiduciary. Possible examples include a shareholder in a close corporation like that depicted in the introduction to this article, active hedge fund investors,[113] and parent corporations with multiple subsidiaries.[114] In each case, separate and apart from any conflicts created by divergent cash flow rights, these active investors may have salient alternatives (opportunity costs) that improperly influence their abilities to serve in fiduciary capacities.

While novel, the opportunity-cost conflict fits within existing conceptions of corporate fiduciary law. Returning to the component loyalty obligations discussed above, opportunity-cost conflicts most

111. Sequouia invested in Trados indirectly—it initially invested in Uniscape, which then merged with Trados. *See Trados,* 73 A. 3d at 23.

112. *In re Trados*, 73 A.3d at 52.

113. *See* Anabtawi & Stout, *supra* note 75, at 1278 (discussing increased activism by hedge funds).

114. For example, the plaintiffs in *Sinclair* could have framed their "denial of expansion opportunities" claims as opportunity-cost conflicts. *See supra* note 78. Notably, the court was hesitant to evaluate those claims under fairness review, arguably consistent with recommendations in Part III of this article.

directly implicate the loyalty obligation of full effort.[115] The corporate director who allows alternative investment possibilities to influence his or her exercise of board power has arguably not pursued the beneficiary's interests with the level of effort expected of a fiduciary. As with self-dealing, operating under an opportunity cost conflict (that is, exercising board power with incentives to redeploy capital and service) is not itself a breach of fiduciary duty.[116] In *Trados*, the court determined that the board in fact acted fairly towards the common shareholders because their prospects of obtaining value for their shares was negligible.[117] But the court had strong evidence that some directors were allowing extraneous factors to influence their choices on behalf of the common holders, and so it was understandable that the court departed from its typical deference to board judgment and examined the fiduciaries' conduct closely.[118]

II. Conceptual Strengths

Pretrial Trados received significant attention from legal scholars not only because it affected an economically important method of finance, but also because it implicates key conceptual considerations. The opinion has been a springboard for examining fundamental questions such as who fiduciary duties should protect,[119] the important role that constituency directors play in today's financing market,[120] and the correct "theory" of preferred stock.[121]

The trial court's opinion is an important elaboration of *Pretrial Trados* but has received little attention in legal scholarship to date. This Part therefore considers the conceptual strengths of the court's new reasoning. These strengths include: providing a theoretically sound framework for analyzing fiduciary behavior, undermining a prominent alternative to the court's chosen rule of common maximization, and providing at least a plausible rationale for common maximization.

115. *See supra* text accompanying notes 31–41 (discussing full effort as a loyalty obligation).

116. *See supra* text accompanying note 43.

117. *See In re Trados*, 73 A.3d at 77–78 (determining that the merger was fair to the common shareholders).

118. To be clear, under *Trados* a fiduciary is not irrevocably required to continue pursuing the beneficiary's interests—he or she can resign and cease to be a fiduciary. What the fiduciary cannot do under *Trados* is let extraneous factors like opportunity costs influence exit decisions that are supposed to be made on the common holders' behalf.

119. *See* Korsmo, *supra* note 14, at 1185–89 (discussing *Trados*).

120. *See* Sepe, *supra* note 14, at 345–50 (discussing *Trados*).

121. *See* Bratton & Wachter, *supra* note 14, at 1874–1900 (discussing *Trados*).

A. Sound Underpinnings

The *Trados* court's portrayal of investor behavior—and the influence of investment alternatives—is well grounded in economic theory. In other words, consideration of opportunity costs may be necessary to the extent courts are committed to analyzing incentive structures of venture capital and other investors.

In economics, it is axiomatic that individuals make decisions on the basis of opportunity costs.[122] Opportunity costs are distinct from the undesirable consequences of a decision and from the types of expenditures and accruals categorized as costs by accountants.[123] Instead, the opportunity cost of a proposed course of action is the highest value alternative forsaken.[124] The concept takes on vital importance in economics because in a world of scarce resources economic actors cannot pursue every course of action with positive expected value in the sense of producing desirable outcomes or attributes in excess of undesirable outcomes or attributes. Instead, economic actors must make decisions by comparing the value of alternatives.[125] Thus, when one considers whether to build a swimming pool, the costs that drive the decision are not cash outlays for concrete or the pain of digging or supervising the work. Though unpleasant in some sense, these factors are not choice influencing in the absence of a comparator such as buying a new car, spending time with family, or saving for retirement.[126]

Some observers have nibbled away at the edges of this insight by questioning how effectively people make such comparisons.[127] One

122. *See* N. Gregory Mankiw, Principles of Economics 5–6 (6th ed. 2011) (identifying the concept of opportunity costs—"The Cost of Something Is What You Give up to Get It"—as one of his "10 Principles of Economics"); Karen I. Vaughn, *Does it Matter That Costs Are Subjective?*, 46 Southern Econ. J. 702 (describing opportunity costs as a "benchmark of 'economic thinking'").

123. *See* Armen Alchian, Economic Forces at Work 301 (1969) (contrasting opportunity costs with the "undesirable attributes of some event"); Vaughn, *supra* note 122, at 705 (contrasting opportunity costs with "outlays" or expenditures).

124. *See* Alchian, *supra* note 123, at 301 ("In economics, the cost of an event is the highest-valued opportunity necessarily forsaken.").

125. *See id.* at 302 (explaining that one "cannot choose all events whose desirable features more than offset their undesirable ones").

126. *Id.* at 303–04.

127. *E.g.*, Dan Ariely, Predictably Rational: The Hidden Forces That Shape Our Decisions 55–74 (2010) (describing experimental research in which participants' choice of products was irrationally affected by setting the price of one item at zero).

entertaining survey suggests that even economists struggle with the concept.[128]

But in venture capital and similar contexts, where active investors must allocate effort among competing projects,[129] it seems likely that whether a particular course of action is worth it does depend on the investors' alternatives. The same might not be true of all portfolio investors—more passive investors may be able to inexpensively add new securities to a broadly diversified portfolio without foreclosing alternatives.[130] But without adding additional personnel, which may be costly,[131] a venture capital fund only has so much human capital to invest.[132]

What this means for fiduciary duty analysis is that a court may have difficulty analyzing incentives without expanding the inquiry beyond transaction terms and payouts between the parties. The factors that influence the decision to sell or continue with an investment may be exogenous to the direct business relationship between the fiduciary and the beneficiary. In the *Trados* example, these exogenous factors at least include the fund's expectations for its other portfolio companies. But even the portfolio may be too narrow a view. For instance, if Fund C in the example above has a relatively weak portfolio, then Company

128. *See* P. J. Ferraro & L. O. Taylor, *Do Economists Recognize an Opportunity Cost When They See One? A Dismal Performance from the Dismal Science*, 4 Contributions to Econ. Analysis & Pol'y 7 (2005) (describing survey results in which a majority of economists failed to correctly answer a basic question regarding opportunity costs); *but see* Joel Potter & Shane Sanders, *Do Economists Recognize an Opportunity Cost When They See One? A Dismal Performance or an Arbitrary Concept?*, 79(2) S. Econ. J. 248, 248–56 (2012) (suggesting that Ferraro and Taylor's question was not so basic).

129. *See supra* note 108 (describing the managerial assistance provided by venture capital funds to their portfolio). This section focuses on the fund manager's allocation of time, rather than its allocation of financial capital, because the latter is not available for re-investment in other startups under the terms of the fund's agreement with its limited partners. *See* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements,* 76 U. Chi. L. Rev. 161, 175 (2009) (explaining that "proceeds are distributed (usually) promptly after profits are realized"). Thus, the shutdown dynamic involves a redeployment of *time* and not financial capital.

130. For example, the capital asset pricing model assumes that investors are compensated for only systematic risk because they can easily diversify away company-specific risk by holding a broad market portfolio. *See* Burton G. Malkiel, A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing 757–76 (2012).

131. *See supra* note 109 (discussing the costs of expanding a fund).

132. At least one financial economist invokes the concept of opportunity costs in modeling a fund manager's investment decisions. *See* Cumming, *supra* note 109, at 5 n.4. ("For example, if there are 5 firms in the original portfolio, the opportunity cost of adding a 6^{th} firm are the assistance and resources allocated to the 6^{th} firm that would have been allocated to the original 5 firms.").

C may be among its better performers.[133] In that case, it is tempting to assume Fund C is motivated to shut down its other companies to focus attention on Company C. But Fund C will want to do so only if continuing with Company C exceeds the opportunity cost of starting a new fund (if Fund C's poor performance hasn't foreclosed that possibility), changing careers, or spending time with family or a new hobby.

The reference to nonpecuniary uses of time (spending time with family or friends) is worth expanding on because it underscores the limits of opportunity cost analysis. In their purest and most provocative form, opportunity costs are fundamentally subjective and accordingly difficult to observe. Nobel Laureate James M. Buchanan, who devoted an entire book to the concept of opportunity costs, concluded "[c]ost cannot be measured by someone other than the decision-maker because there is no way that subjective experience can be directly observed."[134] Like economists, therefore, courts may never have full visibility regarding a fiduciary's incentives and choices.[135] But courts, like economists, may find suitable enough indicia of opportunity costs and make defensible enough predictions about an economic actor's choices.[136]

In short, by invoking the shut-down dynamic the court properly identified the type of external considerations that induce economic choice and define a fiduciary's incentives. Precisely how this clever doctrinal solution should be implemented for future cases is the subject of Part III below. For now, it is sufficient to acknowledge that the court sensibly framed the issue at a conceptual level.

B. Normative Implications of Opportunity-Cost Conflicts

So far, this article has assumed that the *Trados* court was correct in selecting a rule of common maximization. In other words, it has assumed that when an affiliate of a preferred holder serves on a board

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133. *See* text accompanying notes 107–108 (discussing a hypothetical venture capital fund incentivized to shut down a viable company).

134. James M. Buchanan, Cost and Choice: An Inquiry in Economic Theory 43 (1969).

135. For Buchanan, this subjectivity was deeply unsettling to prevailing applications of economic theory. Even market prices for factors of production do not always capture full opportunity costs except in particular states of equilibrium that Buchanan found unlikely in practice. *See* Vaughn, *supra* note 122, at 707 (discussing Buchanan's requirements). Hence, Buchanan warned that efforts by economists to guide policy decisions through cost-benefit analysis were fraught with methodological failures. For example, Buchanan noted the difficulty of calibrating punishment to crime if choice-influencing opportunity costs are not measurable. *See* Buchanan, *supra* note 134, at 93–94 (discussing the work of Gary Becker).

136. *Cf.*, William Baumol, *Review of Cost and Choice*, 8 J. Econ. Literature 1210 (1970) (stating that Buchanan is correct in principle but overstates the problem because market prices closely approximate subjective costs).

of directors, his or her primary duty is to protect the *common* shareholders. In fact, this issue is hotly debated. Commentators disagree on whether the beneficiary of corporate fiduciary duties should be common holders, preferred holders, the corporation as an entity, or some combination of those alternatives.

In particular, an alternative rule of "enterprise maximization" has received significant support in recent scholarship.[137] Under a rule of enterprise maximization, directors would owe fiduciary duties to the corporation, as distinct from any particular group or class of investors.[138] In the *Trados* fact pattern, a rule of enterprise maximization would mean the board should be trained on the goal of increaseing enterprise value, regardless of how that value was to be distributed among investors, and should sell if the expected value of doing so exceeded the expected value of remaining a standalone entity.

This Part explores how an opportunity-cost focus implicitly supports the court's rule of common maximization by (1) exposing the rule of enterprise value as too atomistic and (2) suggesting a plausible explanation for why a rule of common maximization is necessary to induce entrepreneurs to enter into venture capital bargains.

1. Why Stop at the Enterprise?

At first blush, the rule of enterprise maximization is normatively compelling. Proponents of enterprise maximization envision the rule as a default that the parties could override by specific contractual arrangement.[139] In traditional law-and-economics scholarship, such default corporate law rules are ordinarily conceived as majoritarian or bargain mimicking rules, meaning they are an attempt to approximate what most parties want most of the time.[140] The value in setting such defaults

137. *See* Bratton & Wachter, *supra* note 14, at 1885–86 (discussing enterprise maximization); Baird & Henderson, *supra* note 18, at 1323–28 (noting case law discussing the concept of enterprise maximization).

138. *See* Bratton & Wachter, *supra* note 14, at 1884–86 (discussing enterprise maximization).

139. *See* Bratton & Wachter, *supra* note 14, at 1895–99; Baird & Henderson, *supra* note 18, at 1328–33 (suggesting that venture capitalists should be able to negotiate their fiduciary duties through contract). Baird and Henderson are somewhat ambivalent towards enterprise maximization because they question more broadly whether fiduciary-duty analysis, as opposed to contract principles, should govern. *Id.* at 3332-38. This author shares the view that parties should have ability to contract around *Trados's* rule. *See infra* Part IV.C (discussing some of the difficulties parties will encounter trying to contract around the case).

140. *See* Easterbrook & Fischel, *supra* note 47, at 92 ("Socially optimal fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained (and enforced their agreements) at no cost."); Baird & Henderson, *supra* note 18 at 1327 (describing fiduciary duties as gap-fillers); Thomas A. Smith, *The*

is to reduce transaction costs of the parties entering into a business relationship through a corporate vehicle.[141]

At the risk of stating the obvious, it is important that a majoritarian default rule in fact approximates what most parties want. In a hypothetical world, featuring a large array of organizational choices, the standard might not be so high. A particular package of default rules would serve a useful purpose as long as *some* constituency finds it acceptable. Others could simply pick a different entity.

But in practice, there is a fairly limited range of entities from which entrepreneurs choose.[142] These entities differ across a wide range of variables including management rights, mechanics of equity compensation, and tax treatment.[143] With a small number of entities varying across a wide range of attributes, it seems likely that choosing an entity is largely a matter of tradeoff, and parties are likely to accept a great many suboptimal features of secondary importance as they emphasize

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Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 Mich. L. Rev. 214, 216–17 (1999) (discussing the approach of "leading economic analysis of corporate law" and citing Frank Easterbrook, Daniel Fischel, and Jonathan Macey).

141. *See* Easterbrook & Fischel, *supra* note 34, at 92 ("The fiduciary principle is an alternative to elaborate promises and extra monitoring."); Baird & Henderson, *supra* note 18, at 1315 n.28 ("The principal virtue of using fiduciary duties is contracting efficiency.").

142. The primary choices are corporations and limited liability companies (LLCs). Yoichiru Taku, *What type of entity should I form?*, Startup Co. Lawyer (Mar. 12, 2009), http://www.startupcompanylawyer.com/2009/03/12/what-type-of-entity-should-i-form/ [http://perma.cc/N4PG-JEZH] [hereinafter *What type of entity?*] (discussing the choice between corporations and LLCs). The vast majority of high-growth start-ups seeking venture capital financing are structured as corporations. *See generally* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. Rev. 1737 (1994) (considering why entrepreneurs and venture capitalists use C-corporations despite arguable tax advantages of LLCs); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 Tax L. Rev. 137 (2003) (considering reasons for use of C-corporations); Gilson & Schizer, *supra* note 63, at 879 (asserting that tax treatment largely explains use of convertible preferred stock in venture capital financings); Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-up: The Myth of Incorporation*, 55 Tax Law. 923 (2002) (discussing tax considerations in choice of entity decisions); Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Decision*, 14 Fla. Tax Rev. 319 (2013) (reviewing legal scholarship on choice of entity for venture-backed start-ups). An LLC is considered more suitable for a livelihood business that is intended to primarily generate income for those working in the business. *See What type of entity?, supra* 142 (using the example of a consulting firm).

143. *See* Fleischer, *supra* note 142, at 173 (discussing the role of management rights and equity compensation practices in choice of entity).

a few key features in their decision-making. In many cases, considerations outside of corporate law may drive the decision,[144] and the parties may have limited appetite to fine-tune a large number of corporate governance features. The upshot is that an unpopular corporate default rule can itself become a transaction cost as parties make do with it.

With that background, is it reasonable to assume that, *ex ante*, parties to a corporate financing will ordinarily want a rule of enterprise maximization? To understand the case for the rule, start with the assumption that, all other things being equal, the parties to a transaction want to maximize the size of their combined welfare so there is more to divide between them.[145] For the moment, also assume that the parties' combined welfare is measured by firm or enterprise value.[146] Common maximization may not achieve the goal, framed in this way.

The following payout scenario, which is similar to Hypothetical B but with worse prospects for a turnaround, helps illustrate the concept:

Hypothetical D: Value-Destroying Turnaround

	Value	**Probability**
Acquisition offer for Company D	$30,000,000	
Liquidation preference (investment amount + accrued dividends)	$30,000,000	
Turnaround (if successful)	$50,000,000	25%
Turnaround (if unsuccessful)	$20,000,000	75%
Average expected value of turnaround	$27,500,000	

Looking at these payouts alone, the common holders would hazard the turnaround because they have nothing to lose by doing so—the preferred have claims on the entire acquisition price through their liquidation preference. But the average expected value of an attempted

144. *See id.* at 155–59, 167–73, 182–83 (discussing the tax preferences and constraints of venture capital limited partners, tax consequences of equity compensation practices, and the availability of tax-free mergers at exit).

145. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 550–54 (2003) (providing a game-theoretical explanation of why "sophisticated parties at the negotiation stage prefer to write contracts that maximize total benefits" rather than preferring "a larger share of a smaller pie").

146. *See* Baird & Henderson, *supra* note 18, at 1313 ("[E]x ante investors presumptively are interested in maximizing the value of the firm.").

turnaround is only $27.5 million for the enterprise as a whole, lower than the $30 million acquisition price. By requiring the board to risk the turnaround in the interest of common holders, a rule of common maximization sacrifices enterprise value.

The opposite problem can arise if the law permits a preferred-controlled board to act solely in the interests of the preferred holders. Consider again the payout scenario in Hypothetical B, where a turnaround has better chances of succeeding but the preferred holders have no claim on value above the liquidation preference. In that case, the average expected value of the turnaround is $42.5 million for the enterprise as a whole, substantially exceeding the $30 million acquisition price.[147] Unconstrained by fiduciary duties, a preferred-controlled board might sacrifice enterprise value by acting too conservatively and accepting the acquisition offer in the interests of preferred holders.

Proponents of enterprise maximization have a seemingly clever solution to this apparently value-destroying conflict—they place the entity (rather than any subset of shareholders) at the center of the board's duties. So oriented, the board evaluates each decision it makes by a single yardstick of enterprise value without any regard for the distribution of that value among investors.[148] Thus, in Hypothetical D the board would be compelled to approve the sale because the offer price exceeded the average expected value of the turnaround, and in Hypothetical B, the board would be compelled to attempt the turnaround because its average expected value exceeded the acquisition price.[149] These decisions maximize combined welfare in the sense of producing the most value from the entity in question.

An opportunity-cost focus, however, complicates this tidy analysis by expanding our focus beyond the enterprise to opportunity costs that affect combined welfare more broadly conceived. Consider again Fund C, which chose to shut down Company C in order to focus on more promising portfolio companies.[150] In that hypothetical, the pivot had an average expected value of $72 million for the enterprise as a whole, higher than the $30 million acquisition offer. Under a rule of enterprise maximization, the board would be compelled to attempt the pivot. But

147. Note that the hypothetical, like others in this article, assumes that all parties are risk-neutral. *See supra* note 88. But in reality, significant dispersion of expected returns may in fact affect value for some parties. In other words, determining enterprise value may be far more complicated for courts than stylized examples suggest.

148. *See* Bratton & Wachter, *supra* note 14, at 1885–86 (discussing enterprise maximization); Baird & Henderson, *supra* note 18, at 1323-28 (noting case law discussing the concept of enterprise maximization).

149. *But see* Strine, *supra* note 14, at 2037 (espousing the view that it is impractical for courts to discern enterprise value in this manner).

150. *See supra* text accompanying notes 107–108.

doing so forecloses Fund C from redirecting its efforts to its more promising portfolio companies. In other words, it has a high opportunity cost to the fund that may very well outweigh the marginal value to common of continuing.

The example illustrates that enterprise value is in fact a very incomplete measure of combined welfare. If we expand our focus just slightly to include effects on the fund's entire portfolio, rather than limiting our focus to payouts from Company C, the parties maximize combined welfare by redeploying effort to more promising portfolio companies. Put another way, directing the preferred to squeeze more value from Company C is a misallocation of resources because the fund has a higher value alternative. If it is true, as proponents of enterprise maximization argue,[151] that the entrepreneur and venture capital fund want to maximize combined welfare so there is more to divide between them, it is unclear why they would adopt such a narrow view of combined welfare.[152]

Proponents of enterprise maximization might counter that parties can always strike a Coasian bargain—the venture capital fund can make a side payment to the common holders at the time a higher value alternative emerges for the fund. In fact, there is evidence that this type of pay-off occurs in the venture capital context.[153] But there are also good reasons to think such "midstream" bargains are difficult to strike.[154] More to the point, if a corporate default rule occasions too

151. *See supra* text accompanying notes 145–146 (discussing the rationale for enterprise maximization).

152. There is another more subtle way in which enterprise maximization may not serve the interests of either class of shareholders—common or preferred. In some cases, venture capital investors are motivated to embrace the same long-shot (and enterprise-value sacrificing) strategies as underwater common holders in order to satisfy investor expectations. *See* Cable, *supra* note 65, at 230 (discussing a rule of thumb that investors expect a twenty percent internal rate of return on an investment in a venture capital fund). If a fund manager has a relatively weak portfolio, he or she may need to gamble on the best of his or her remaining portfolio companies even if the expected value of those gambles falls below immediate acquisition offers. In other words, some venture capital managers have especially low opportunity costs of continuing with a portfolio company because they can only invest the limited partners' money once, and they need several large successes to offset high failure rates for start-ups. *Id.* at 230–31. *See also* Darian M Ibrahim, *The New Exit in Venture Capital,* Vand. L. Rev. 1, 28-29 (2012) (discussing funds' incentives to seek large exits).

153. *See* Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. Fin. Econ. 384, 391 (2010) (observing instances in which common shareholders receive cash payouts in excess of contractual cash flow rights).

154. *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 Mich. L. Rev. 891, 910 (2002) (identifying

many Coasian bargains, one has to begin questioning whether it really captures the majoritarian bargain. In theory, *any* rule (including common maximization) can be bailed out by Coasian bargains, but a majoritarian default aspires to be more than an arbitrary starting point.

In the end, enterprise maximization—despite its elegance—loses at least some of its shine when one takes into account the whole portfolio. One might wonder whether the majoritarian bargain has a different logic.

2. The Difference Between VCs and Entrepreneurs

In addition to undermining the case for enterprise maximization, a focus on investors' alternatives suggests a plausible story for why *common* maximization would be the majoritarian bargain. In short, a credible commitment to capital lock-in may be necessary to induce high-quality entrepreneurs to enter into venture capital bargains.

In a passage that does not make any explicit normative claim, the *Trados* opinion states that equity capital is "permanent capital."[155] In support of this descriptive statement, the court cites to law review literature that provides a normative justification of capital "lock-in" through the corporate form.[156]

In one of the cited articles, Margret Blair argues that capital lock-in was in fact the core innovation of the corporate form because it helped induce the type of asset-specific investment necessary for increasingly complex production problems faced by businesses in the nineteenth century.[157] Blair details how common forms of business association in the nineteenth century—sole proprietorships, partnerships, and joint stock companies—were inadequate for the scale of industrial organizations emerging at the time.[158] The primary shortcoming of these early entities was the ability of financial or other investors to

frequently cited obstacles to corporate midstream bargains, such as endowment effects and collective-action problems).

155. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37 (Del. Ch. 2013).

156. *See id.* at 37 n.4.

157. *See* Margaret M. Blair, *Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387, 388–95 (2003) (discussing the concept of capital lock-in and its role in the historical origins of the corporate form).

158. *See id.* at 404–23 (discussing sole proprietorships, partnerships, and joint stock companies).

withdraw unilaterally, thereby destroying value of specialized investments of labor and physical assets.[159] Blair asserts that increasing availability of the corporate form essentially solved this problem with its perpetual existence and limited rights of investor withdrawal.[160]

This historical account may tell us something about the conditions necessary to induce entrepreneurs into venture capital bargains. Entrepreneurs are asked to dedicate themselves for years on end to a single enterprise with an unproven idea rather than applying and building their skills and knowledge towards proven technologies and business plans.[161] The result may be a tailoring of their most valuable asset—their human capital—in a very firm specific way.[162]

Trados reminds us that venture capital funds are different. They operate on a model of diversification, giving them a ready destination (and incentive) to redeploy their efforts. Of course, they will also make some firm-specific investments of time. But fundamentally, their expertise is of a more general nature. Venture capital managers have expertise in "professional management," meaning formal methodologies of accounting, finance, and management taught in business schools and intended to be applicable across a range of business settings.[163]

159. *See id.*

160. *See id.* at 423–37 (discussing the corporate form). For the view that the corporate form was not necessary for all that Blair ascribes to it, see Larry E. Ribstein, *Should History Lock in Lock-in?*, 41 Tulsa L. Rev. 523, 531-37 (2006).

161. *See* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 Wis. L. Rev. 45, 57–58 (discussing non-compete obligations or other contractual penalties imposed on entrepreneurs for exiting a start-up).

162. *See* Strine, *supra* note 14, at 2037 (noting that entrepreneurs make "company-specific investments just as real as those made by the preferred"); Manuel A. Utset, *High-Powered (Mis)Incentives and Venture-Capital Contracts*, 7 Ohio St. Entrep. Bus. L.J. 45, 61–62 (2012) (discussing firm-specific contributions of human capital by entrepreneurs). Labor economist Edward Lazear explains how even skills that on their face appear transferable to other employers may lose their marketability when combined in idiosyncratic ways. He gives the example of a tax-preparation software company in which employees acquire an unusual mix of tax accounting knowledge and Java programming skills that are not easily transferable in combination. Edward P. Lazear, *Firm-Specific Human Capital: A Skill-Weights Approach* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 9679, 2003), http://www.nber.org/papers/w9679.pdf [http://perma.cc/ZUR9-FEE9].

163. *See* Utset, *supra* note 161, at 97–99 (discussing the role of venture capital managers in "professionalizing" start-ups); Korsmo, *supra* note 14, at n.31 ("[Venture capital] investors are usually experienced professionals with formal academic training in business and finance and on-the-job training as apprentices at a venture fund or financial institution.") (quoting 1 Joseph W. Bartlett, Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations § 1.1, at 4 (2d ed. 1995)); *supra* note 108 (discussing the managerial contributions of venture capital managers).

A plausible way of understanding common maximization is as a bargain that is necessary to induce entrepreneurs to make firm specific investments in start-ups in a context where venture capital investors, if unconstrained by fiduciary duties, would operate under pervasive opportunity-cost conflicts. A rule of common maximization protects entrepreneurs by placing exit decisions under the control of a board charged with acting like fully committed entrepreneur.

Admittedly, it cuts against grain of current commentary to focus on what is necessary to induce *entrepreneurs* to enter into venture capital contracts. In policy discussions, we tend to focus on what is necessary to induce financial investment in high-risk entrepreneurship. Policy makers refer to a "funding gap," implying a large stable of investment ready start-ups without adequate capital.[164] Blogs targeted at entrepreneurs recount the flood of funding proposals received by each venture capital fund annually and the long-shot odds faced by each entrepreneur.[165] Similarly, proponents of enterprise maximization are careful to deem the rule a default so that *venture capitalists* can negotiate for additional protections to induce investment.[166]

But there is a counter-narrative. Some within the venture capital industry believe that the asset class has grown too large and too many venture capital funds chase too few good opportunities.[167] While this circumstance can be viewed as only a temporary disequilibrium, returns in the venture capital industry have always been driven by a small number of very large successes.[168] Entrepreneurs may be easy to come by, but one would expect competition among venture capital firms for

164. *See* Cable, *supra* note 65, at 207–08 (describing the funding gap that entrepreneurs face between the amount they can raise from personal resources (typically less than $500,000) and the minimum amounts venture capital funds are willing to invest (typically $5 million)).

165. *See* Dileep Rao, *Why 99.95% Of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital*, Forbes (July 22, 2013, 10:00 AM), http://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time-seeking-venture-capital/ [http://perma.cc/R7GA-WVH8] (stating that venture capital funds reject 98-99% of business plans they receive).

166. Bratton & Wachter, *supra* note 14, at 1895–99; Baird & Henderson, *supra* note 18, at 1328–33.

167. *E.g.*, Paul Kedrosky, *Right-Sizing the U.S. Venture Capital Industry* (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456431 [http://perma.cc/4N34-AUXH] (arguing that there are too many venture capital funds relative to investment-ready start-ups); Mulchaney, et. al., *supra* note 109, at 3 ("Speculation among industry insiders is that the VC model is broken, despite occasional high-profile successes like Groupon, Zynga, LinkedIn, and Facebook in recent years.").

168. *See supra* note 65 (discussing the percentage of portfolio companies that accounts for the bulk of returns on venture capital investments).

the most talented entrepreneurs with the biggest ideas. Therefore, it seems at least plausible that lock-in is the majoritarian bargain.[169]

To be clear, I am not necessarily arguing that this account of common maximization is more compelling than the case for enterprise maximization. Commentators identify costs of capital lock-in that may outweigh its benefits in particular contexts and market conditions.[170] The majoritarian bargain is hard to discern in this case.

Still, there is value in simply providing *some* coherent story for common maximization. If nothing else, knowing the reason for common maximization might tell us something about the rule's parameters.

For example, one could read *Pretrial Trados*, with its compact reasoning, as requiring a preferred-controlled board to pursue extreme long-shot opportunities on behalf of the common. In other words, it is hard to see how a board could ever sell a company below liquidation value if the rule is as simple as *act in the best interest of the common shareholders*. The common will always prefer that the company live to see another day even if continuing is almost certain to destroy value that would go to the preferred holders.

But a more palatable rule emerges if we recognize that common maximization rests on comparative opportunity costs and charges the board with *making decisions like a fully committed entrepreneur in control of the company.* Because even if venture capital funds tend to have higher opportunity costs because of their more generalizable skills and ready portfolio of alternatives, entrepreneurs have *some* opportunity costs of continuing to pour their efforts into a start-up with questionable prospects. *Starting* salaries for software engineers are rumored to exceed $165,000 in Silicon Valley.[171] While an entrepreneur's opportunity cost is difficult to measure precisely, courts should have in mind that they exist. If continuing with a company has an average

169. *See* Strine, *supra* note 14, at 2037–39 (questioning why a rule that is favorable to preferred shareholders is more conducive to innovation than common maximization).

170. Ibrahim, *supra* note 152 (arguing that "investor lock-in" was particularly problematic when the IPO market froze following the financial crisis); Ribstein, *supra* note 160 ("[C]apital lock-in may have significant costs in some contexts that must be balanced against any economic benefits. The cost-benefit tradeoff depends on the circumstances of particular firms and may vary over time.").

171. Julie Bort, *In Silicon Valley, Salaries For Engineers Are Starting at $165,000*, Business Insider (Oct. 16, 2013, 3:41 PM) http://www.businessinsider.com/record-salaries-for-valley-programmers-2013-10 [http://perma.cc/YJB9-A6T2]. An entrepreneur will often collect a salary from a startup, but at a reduced rate. *See* Allison Shontell, *Most Startup Founders Pay Themselves This Totally Reasonable Salary*, Business Insider (May 28, 2014, 10:37 A.M.) http://www.businessinsider.com/startup-founder-salaries-y-combinator-2014-5 [http://perma.cc/CJ67-945P] (reporting that company founders participating in a prominent incubator typically received salaries well below $100,000).

expected value below or only slightly above the liquidation preference, it is hard to see why a preferred-controlled board should be forced to continue when the founders themselves likely would not if they were in control.[172]

III. Operationalizing Opportunity-Cost Conflicts

For all of the questions *Trados* answers, a key question remains open: how aggressively will Delaware courts police opportunity-cost conflicts? Specifically, *Trados* is ambiguous regarding what facts presumptively trigger rigorous fairness review. This Part begins by explaining the important role that standard of review (the choice between fairness review and the business judgment rule) plays in Delaware fiduciary law. It concludes by endorsing a doctrine of opportunity-cost conflicts that would reserve fairness review for exceptional cases.

A. Corporate Law's Distinctive Balance

More so than in other legal fields,[173] corporate law articulates relatively demanding standards of conduct for fiduciaries (conduct standards) but then declines a role in enforcing those expectations due to deferential standards of review applied by courts (review standards).[174] Most prominently, the business judgment rule prevents litigants from challenging most actions by corporate fiduciaries. Even disastrous decision-making by a board member is ordinarily beyond

172. In a crude sense, the entrepreneur's opportunity cost is the expected financial payout (*e.g.*, salary) of alternative employment or entrepreneurial ventures. But, admittedly, comparison of financial payouts is an incomplete model of the entrepreneur's decision. For example, he or she may irrationally overvalue the startup's prospects or derive subjective psychic benefits from its existence. *See* Utset, *supra* note 107 (discussing empirical studies suggesting that entrepreneurs are overly optimistic about their ventures).

173. *See* Allen, *supra* note 41, at 1296 ("In most areas of law, standards of conduct and standards of review tend to conflate and become one and the same, but in corporate law the two standards often diverge."); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437, 437 (1993) (citing negligence in the context of personal injury law as an example of conflated standards of review and conduct).

174. *See* Allen, *supra* note 41, at 1295 (comparing standards of conduct and standards of review); Eisenberg, *supra* note 173, at 437 ("A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."); Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 Wm. & Mary L. Rev. 519, 521 (2012) (distinguishing standards of conduct and standards of review).

judicial scrutiny unless there are clear indicia of betrayal or impaired incentives on the part of the fiduciary.[175]

Importantly, the business judgment rule does more than give defendants the benefit of the doubt *at trial.* Claims that are subject to the business judgment rule are ordinarily denied judicial process altogether. Typically, a Delaware court will stay discovery pending the outcome of a motion to dismiss.[176] A court will grant a motion to dismiss if it determines "'with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief.'"[177] Where courts apply the business judgment

175. *See* Eisenberg, *supra* note 173, at 443 ("[A] director or officer will not be liable for a decision that resulted in a loss to the corporation, even if the decision is unreasonable, as long as the conditions of the business judgment rule have been met and the decision is rational."); Velasco, *supra* note 174, at 547 (stating that under the business judgment rule "evidence of a very bad decision is insufficient" and "plaintiffs must establish that the decision was utterly irrational and amounted to waste"). For the most part, the exceptions to this deferential approach are variations on the single theme of self-dealing, where courts apply more rigorous fairness review. *E.g.*, Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989) (scrutinizing a management buyout); Weinberger v. UOP, Inc., 457 A.2d 701 (Del 1983) (scrutinizing a cash-out merger of minority shareholders); Carsanero v. Bloodhound Tech., Inc., 65 A.3d 618 (Del. Ch. 2013) (scrutinizing financing transactions between a director and the corporation); Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. Sup. Ct. 1944) (scrutinizing business dealings between a corporation and its CEO's wife). *See generally* Allen, *supra* note 41, at 1290 (stating that the duty of loyalty "addresses primarily (but not exclusively) situations involving self-dealing"). A few other specialized situations that receive "intermediate scrutiny" round out the bulk of viable claims against fiduciaries in corporate law. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (regarding takeover defenses); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (regarding certain sales of control).

176. *See* Orloff v. Shulman, No. Civ.A. 852-N, 2005 WL 333240, at *1 (Del. Ch. Feb.2, 2005) (granting stay of discovery); *In re* McCrory Parent Corp., Civ. a. No. 12006, 1991 WL 137145, at *1 (Del. Ch. July 3, 1991) (denying stay of discovery and discussing circumstances under which Delaware courts grant such motions); Del. Trial Handbook 2:4 ("It is recognized that efficiency is promoted by a rule that, absent special circumstances, discovery should be stayed pending determination of a motion to dismiss where the grounds for the motion offer a reasonable expectation that if the motion is granted, litigation will be ended."), http://www.delawgroup.com/delaware-trial-handbook-%C2%A7-24-motion-to-stay-discovery/ [http://perma.cc/4MSF-NXDQ]. The circumstances in which Delaware courts typically deny a motion to stay discovery are: "(1) where the motion does not offer a 'reasonable expectation' of avoiding further litigation, (2) where the plaintiff has requested interim relief, and (3) where the plaintiff will be prejudiced because 'information may be unavailable later.'" *Orloff,* 2005 WL 333240, at *1 (citing *In re McCrory*, 1991 WL 137145, at *1).

177. Gantler v. Stephens, 965 A.2d 695, 703 (Del. 2009) (quoting VLIW Tech., LLC v. Hewlett-Packard Co., 840 A.2d 606, 610–11 (Del. 2003)).

rule, motions to dismiss are ordinarily granted and the proceeding ends before discovery; where courts apply entire fairness, motions to dismiss are ordinarily denied and discovery proceeds.[178]

What accounts for this stark divergence of review and conduct standards in corporate law? One possible answer is that corporate litigation occurs in a distinctive context where the costs of allowing meritless litigation to proceed (false positives) exceed the costs of dismissing some claims that actually involve fiduciary misconduct (false negatives).[179] In other words, fiduciary law may reflect a considered balance between policing managerial misconduct and preventing litigation abuse, and that balance may take into account the specific context in which shareholder litigation takes place.

1. The Substantial Cost of Hearing Meritless Litigation

For over seven decades, commentators have expressed concern that *shareholder* litigation is especially susceptible to strike suits—meritless claims brought for settlement value (and attorneys' fees).[180] Shareholder litigation exhibits a number of features that commentators associate with litigation waste. Corporate litigation often concerns high-stakes and time-sensitive matters, such as corporate acquisitions, giving a shareholder suit substantial hold-up value even if it lacks merit in the long run. The costs of litigation, including discovery burdens, often fall disproportionately on corporate defendants, giving suits nuisance value

178. Lewis H. Lazarus, *Standard of Review in Conflict Transactions*, 26 Del. J. Corp. L. 911, 913–14 (2001).

179. Another explanation is that courts are not well equipped to second-guess business decisions of fiduciaries, and mistaken determinations of liability would chill beneficial directorial and corporate activity. *E.g.*, Allen, *supra* note 41, at 1296; Velasco, *supra* note 174, at n.153 (collecting cases). This view is contestable. First, a specialized business court like the Chancery Court may be relatively well equipped to scrutinize at least some types of business decisions. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. Penn. L. Rev. 1619, 1696 (2001) (stating that Delaware judges may have expertise and credibility within certain realms of corporate practice). Also, one might question the importance of judicial competency because cases almost always settle and courts rarely adjudicate at trial. *See infra* note 196. It is even unclear how much the precedent established in adjudicated cases influences settlement. *Cf.* Tom Baker & Sean J. Griffith, *How the Merits Matter, Directors' and Officers' Insurance and Securities Settlements*, 157 U. Penn. L. Rev. 755, 787–91 (2009) (discussing empirical research revealing a complicated relationship among technical legal merits, "sex appeal" of a claim, and settlement amounts).

180. *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand. L. Rev. 133, 135–38 (2004) (discussing historical reform efforts).

at relatively low cost to plaintiffs.[181] Dispersed shareholders may be ineffective monitors of their attorneys, resulting in litigation that serves the interests of plaintiffs' firms more than shareholders.[182] The law is conducive to "cosmetic settlements"—such as agreements for nominal disclosure supplements or governance concessions—that provide a basis for recovery of attorneys' fees without substantial benefit to shareholders.[183] The insurance companies that ultimately bear the cost of litigation may be ineffective monitors of litigation costs or settlement amounts.[184]

Though it is tempting to give each plaintiff its day in court, these long-standing concerns about litigation abuse might help explain why corporate law not only views most potential fiduciary claims with suspicion but also denies those claims legal process altogether through pretrial motion practice. After all, strike suits are by definition frivolous and gain their leverage simply by threatening untimely or expensive litigation. A doctrine that only affected how courts view cases *at trial* might do little to curb meritless claims.[185] Accordingly, courts develop proxies for merit—ascertainable fact patterns that are likely to signal managerial abuse—and apply them early in the litigation process so that only claims with a high probability of success survive.

2. The Muted Effects of Dismissing Valid Claims

While fear of litigation abuse might explain sparing use of judicial review, any proxy for merit will be imperfect. Is curbing litigation abuse

181. *See* John C. Coffee, Jr., *Rethinking the Class Action: A Policy Primer on Reform*, 62 Ind. L.J. 625, 637 (1987) (citing securities class actions as an example of likely cost differentials between plaintiffs and defendants).

182. *See* Thompson & Thomas, *supra* note 180, at 148 ("While in theory clients can and should control all litigation decisions, closely monitoring the actions of their attorneys, the reality in representative litigation is that no individual shareholder has a sufficiently large stake in the outcome of the case to spend much time monitoring the attorneys.").

183. *See* Coffee, *supra* note 181, at 634 (asserting that "cosmetic settlements tend to be a more pervasive problem in derivative actions and securities class actions than in product liability or mass tort actions"); Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 Tex. L. Rev. 557 (2014) (finding that disclosures compelled by settlement do not affect voting results and therefore provide questionable benefit to shareholders).

184. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Geo L.J. 1795, 1814–17 (2007) (explaining that D&O insurers do not select defense counsel under customary policy terms and, therefore, monitor costs and settlements less intensely than in other insurance contexts).

185. *See* Strine, *supra* note 14, at 2035–36 (criticizing standards of review proposed by Bratton and Wachter because they would preclude motions to dismiss, allow discovery, and thereby give claims holdup value).

worth letting some incidents of managerial abuse fall through the cracks? In other words, shouldn't we be equally concerned about the costs of false-negatives (*i.e.,* cases that will be dismissed under deferential review standards even when the defendants in fact violated standards of conduct)?

First, litigation operates in combination with a number of other mechanisms for policing managerial misconduct. Examples include the market for corporate control, disclosure-based regulation through federal securities laws, mandated governance features through federal securities laws and exchange requirements, private contracting, and reputational constraints.[186]

In fact, according to an influential analysis by Edward Rock and Michael Wachter, the primary purpose of the corporate form is to incubate non-legal mechanisms for managing relationships among stakeholders.[187] Examples include boardroom practices, corporate governance norms, compensation practices, and other elements of corporate culture.[188] These nonlegally enforceable rules and standards (NLERS) are most effectively disseminated and enforced through market dynamics and reputational constraints rather than judicial decisions.[189] NLERS may be particularly strong in the corporate context because of the sustained interactions of corporate stakeholders, as opposed to one-off commercial transactions.[190]

Second, even where judicial involvement can play a useful rule, it may not be necessary to provide legal remedies in every instance. Corporate fiduciaries may follow judicial *guidance* even without judicial *enforcement.* For example, social scientists have studied individuals' motivations for legal compliance and concluded that fear of punishment is only one factor.[191] Other motivations include perceptions of legitimacy, personal morality, social consequences, psychological inclination toward obedience and conformity, and altruistic impulses.[192] Corporate-

186. *See* Thompson & Thomas, *supra* note 180, at 142–43 (describing a wide range of mechanisms for checking managerial abuse).

187. Rock & Wachter, *supra* note 179, at 1621–22.

188. *Id.* at 1642–43.

189. *See id.* at 1645, 1649 (discussing how "competitive forces" and reputational concerns contribute to NLERS).

190. *See id.* at 1669 (comparing corporate law to other professional malpractice settings).

191. *See* Velasco, *supra* note 174, at 571–80 (noting that "'normative perspectives' of personal morality and legitimacy" and "social consequences" are also strong motivators).

192. *Id.*

law scholar Julian Valesco relies on this literature in concluding that "the unenforced duty is a meaningful concept" in fiduciary law.[193]

In sum, there are reasons to be sparing with judicial process in corporate law. In the corporate context, litigation is particularly susceptible to abuse and alternative mechanisms for influencing corporate conduct are particularly strong.

3. Some Evidence of an Effective System

It is difficult to reach a definite conclusion regarding whether corporate fiduciary law currently strikes an optimal balance between policing managerial and litigation abuse. Though there is substantial empirical literature considering the question, this research, by its own admission, faces very difficult methodological challenges such as how researchers can define and measure a claim's "merit."[194]

There is, however, some indication that the system works well relative to other forms of shareholder litigation. Specifically, evidence suggests that Delaware class actions alleging breach of fiduciary duty (fiduciary class actions) occasion less litigation waste than class actions brought in federal court under federal securities law (securities class actions).[195] Traditionally, many empirical studies of shareholder litigation conflate different types of proceedings and find signs of litigation

193. *Id.* at 580.

194. *E.g.*, Baker & Griffith, *supra* note 179, at 780–83 (discussing methodological challenges).

195. The primary forms of shareholder litigation are securities class actions, derivative suits, and fiduciary class actions. *See* Thompson & Thomas, *supra* note 180, at 135–38 (noting an increase in "class action lawsuits filed under state law challenging director conduct" compared to derivative and securities fraud claims). Securities class actions are brought under federal securities law in federal court and typically allege inadequate disclosure by the corporation. *Id.* at 144. The other two forms of shareholder litigation typically allege breach of fiduciary duty by corporate managers and must be brought in state court. When the alleged misconduct harms the corporation as a whole, such as embezzlement by a corporate manager, claims are characterized as derivative and can be pursued by shareholders only if the board is unable (typically due to a conflict of interest) to itself pursue the matter. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 Vand. L. Rev. 1747, 1758 (2004). Most other fiduciary-duty actions—including those that allege harm to a particular group of shareholders or that challenge the price paid to shareholders in a merger transaction—are not subject to derivative procedures and are brought "directly" as fiduciary class actions. *See* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004); Edward P. Welch et al., Folk on the Delaware General Corporation Law at § 327.2 (discussing whether certain merger-related claims are treated as direct or derivative). *Trados* is an example of a fiduciary class action. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 34 (Del. Ch. 2013) (describing the background of the litigation).

waste in the aggregate.[196] In contrast, Robert Thompson and Randall Thomas studied a data set consisting of only fiduciary class actions, and they paint a rosier picture of such litigation.[197] They found some evidence of litigation agency costs in the form of cookie-cutter complaints filed quickly and repeat plaintiffs.[198] But they also found evidence of a better functioning litigation system such as (1) more significant monetary relief to shareholders[199] and (2) settlement amounts correlated with indicators of managerial abuse, suggesting the "merits matter" in this context.[200]

Arguably, this evidence suggests that the structure of fiduciary law—sparing use of fairness review and a robust business judgment rule—is doing some helpful work in balancing efforts to police managerial misconduct and litigation abuse. If nothing else, one might simply conclude that Delaware fiduciary duty law is likely to influence the balance between policing managerial misconduct and mitigating litigation abuse. And in the absence of convincing evidence that the law currently leans too far in favor of one or the other, courts should try to implement *Trados's* novel theory in a manner that maintains the current balance.[201]

B. Lessons from Entrenchment: The Other-Facts Standard

In considering how to implement opportunity-cost conflicts consistent with the guidance above, it is useful to review how courts treat a close cousin: entrenchment claims. An entrenchment claim alleges that

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196. Thompson and Thomas review empirical research that combines securities class actions, derivative suits, and fiduciary class actions. The studies indicate that a majority of these shareholder suits settle. *See* Thompson & Thomas, *supra* note 180, at 158–59 (reviewing empirical research of shareholder litigation by Roberta Romano and others). Most of the rest are dismissed or voluntarily withdrawn. *Id.* at 158. Among the very small number of cases that go to trial, almost none result in judgments for plaintiffs. *Id.* at 159. Settlement payouts to shareholders tend to be small as a percentage of share price, with a large amount going towards attorneys' fees. *Id.* at 159–61.

197. *Id.* at 138.

198. *Id.*

199. *Id.*

200. *Id.* at 139.

201. Based on recent evidence, there is little to suggest litigation abuse is fading from concern. A recent study of large mergers produced striking statistics. Over 97% of such transactions in 2013 were challenged by shareholder litigation. The study reported that nearly 85% of settlements provided for disclosure concessions (and attorneys fees) of questionable value and no monetary payout to shareholders. Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2013* (Ohio State Univ., Working Paper No. 236, 2014), http://ssrn.com/abstract=2377001 [http://perma.cc/2PTW-8RUH].

board members scuttled a sale in order to keep their jobs.[202] It is basically the flip-side of the opportunity-cost conflict at issue in *Trados*, where directors were criticized for selling the company in order to focus on other opportunities.

Entrenchment and opportunity-cost claims share common characteristics. They are, in a sense, ubiquitous in corporate acquisitions. Every fiduciary either lacks higher value alternatives and, there-fore, operates under an entrenchment conflict, or has higher value alternatives and, therefore, operates under an opportunity-cost conflict. If courts liberally inferred such conflicts at the motion-to-dismiss stage, fairness review would be common and the business judgment rule would have little role in corporate acquisitions. Therefore, it is useful to con-sider how Delaware courts view entrenchment claims at the motion-to dismiss stage.[203]

Gantler v. Stephens[204] is an instructive case. In *Gantler*, the plaintiff claimed that board members pursued a corporate restructuring instead of a merger because only the former would permit them to keep their jobs.[205] The Delaware Supreme Court overturned the lower court's dismissal of the claims but did so in a way that still acknowledged the need for meaningful scrutiny at early stages of the proceeding.[206] The court began by noting that even the traditionally deferential standard for a motion to dismiss has its limits:

> In reviewing the grant or denial of a motion to dismiss, we view the complaint in the light most favorable to the nonmoving party, accepting as true its well-pled allegations and drawing all reasonable inferences that logically flow from those allegations. We do not, however, blindly accept conclusory allegations unsupported

202. *See infra* text accompanying notes 204–208 (describing an example entrenchment case).

203. By use of the term "entrenchment," I do not mean to invoke cases employing the court's intermediate level of scrutiny, though those cases are sometimes associated with the concept of entrenchment. The courts' approach to those intermediate-scrutiny cases is, however, similar in effect to the other-facts standard described in this subpart, at least when the corporation's charter includes a customary exculpatory clause that extinguishes duty of care claims. *E.g.*, *In re* Morton's Rest. Grp., Inc., 74 A.3d 656, 672–76 (Del. Ch. 2013) (dismissing complaint). *See also* Lewis Lazarus, *Chancery Court Dismisses Revlon and Quasi-Appraisal Claim*, Del. Bus. Lit. Report (July 24, 2014), http://www.delawarebusinesslitigation.com/2014/07/articles/articles/chancery-court-dismisses-revlon-and-quasi-appraisal-claim/ [http://perma.cc/A9NL-U2ZH].

204. 965 A.2d 695 (2009).

205. *Id.* at 699–703.

206. *Id.* at 703–07.

> by specific facts, nor do we draw unreasonable inferences in the plaintiffs' favor.[207]

The court then noted the special problems associated with ubiquitous types of conflicts such as entrenchment:

> Here, the plaintiffs allege that the Director Defendants had a disqualifying self-interest because they were financially motivated to maintain the status quo. A claim of this kind must be viewed with caution, because to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological. By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.[208]

The court then applied this standard of "other facts" to the case at hand.[209] The court determined that the plaintiff met the standard by pointing to specific business relationships that were at risk if the company was sold, such as one director's ownership of a heating and air conditioning company that counted the bank as a major customer.[210]

Gantler offers two lessons for future judicial analysis of opportunity-cost conflicts. First, only facts that *strongly* indicate impaired incentives should trigger fairness review. Second, those facts must be ascertained early in the litigation process in order to warrant discovery. To preserve corporate law's current balance, courts should evaluate claims of opportunity-cost conflict consistently with these principles. As described further below, that means requiring plaintiffs to plead something more than a disappointing result for plaintiff shareholders.

C. What Qualifies as Other Facts?

What should qualify as "other facts" sufficient to sustain an opportunity-cost claim? To an extent, the answer will depend on context. As described above, an opportunity-cost conflict could arise in connection with any active investor.[211]

Nonetheless, we can start bracketing the possibilities by considering categories of evidence presented in *Trados.* In that case, the court considered three types of evidence: testimony revealing improper intent,

207. *Id.* at 703–04 (footnote omitted).

208. *Id.* at 707.

209. *Id.*

210. *Id.* at 707–08.

211. *See supra* text accompanying notes 113–114.

industry-wide generalizations regarding behavior of venture capital investors, and indirect or circumstantial evidence of improper intent.

This subpart concludes that direct evidence of intent will be the most compelling other facts, and industry-wide generalizations are unlikely to qualify as other facts. Between those two extremes lie indirect and circumstantial indications of conflict, which are unlikely to qualify as other facts ordinarily but also difficult to rule out altogether.

1. Direct Evidence of Intent Qualifies

The most clearly qualifying facts would be statements of intent consistent with the shut-down dynamic. As described above, at least one Trados director essentially admitted that he allowed his time-allocation preferences (his desire to spend time on other portfolio companies) to affect exit decisions that were supposed to be made on behalf of the common holders.[212] This may be a perfectly understandable impulse for an active portfolio investor. But under the reasoning of *Trados,* it is an impulse that a fiduciary is expected to suppress when making a decision in a fiduciary capacity.[213]

If a future court had similar evidence before it when considering a motion to dismiss,[214] that would be a compelling basis for letting the litigation move forward under the other-facts standard.

Of course, this raises the question of how plaintiffs will uncover such evidence at the outset of a proceeding and prior to discovery. In many cases, an entrepreneur will have board representation and be privy to discussions and correspondence regarding exit decisions. Shareholders also have shareholder inspection rights that permit them access to documents concerning board decisions.[215] Plaintiffs in securities class actions have used a variety of investigative techniques to uncover facts without the use of discovery.[216] Some plaintiffs alleging opportunity-cost conflicts may even have the benefit of some discovery prior to a motion-to-dismiss. For example, the plaintiffs in *Trados* conducted significant discovery in connection with their appraisal claim.[217]

212. *See supra* text accompanying notes 81–82 (summarizing testimony at trial).

213. As stated above, this does not mean the fiduciary is forced to allocate time to the subject company—he or she could resign as a fiduciary. *See supra* note 118.

214. It does not appear that Ghandi's incriminating statements were available to the court in hearing the motion to dismiss. Therefore, the court might have dismissed the claim under the recommendations of this article. *See infra* Part IV.B.

215. *See* Del. Code Ann. tit. 8, § 220

216. *See* Baker & Griffith, *supra* note 179, at 769-71 (discussing investigative techniques of plaintiffs' lawyers, such as former-employee interviews).

217. *See Trados,* 73 A.3d at 34.

In other cases, plaintiffs obtain some abbreviated discovery in connection with requests for injunctive relief.[218]

In short, plaintiffs are not wholly without means to uncover a smoking gun.

2. Industry-Wide Generalizations Do Not

Industry-wide generalizations are another candidate for other facts. For example, perhaps future courts can presume that every director affiliated with a venture capital fund labors under a significant opportunity-cost conflict because the shut-down dynamic is an observed pattern of behavior in the venture capital industry.[219]

At first blush, this approach has some appeal as a potentially effective compromise between policing managerial misconduct and limiting strike suits. If opportunity-cost conflicts are especially prevalent in certain realms of economic activity, perhaps courts should take a harder look at cases arising in those contexts. Both precedent and policy, however, work against this approach.

First, *Trados* itself cautions against industry-wide generalizations in a portion of the opinion unrelated to any of the analysis in this article. The court found that a supposedly independent director (one not employed by any venture capital fund) was in the pocket of the preferred holders because he valued having a business relationship with prominent venture capital funds.[220] In so holding, the court referenced "the web of interrelationships that characterizes the Silicon Valley start-up community" and cited legal scholarship to that effect.[221] The court, however, clarified that "[a]t trial, the plaintiff could not rely on general characterizations of the VC ecosystem."[222] Instead, the court required the plaintiff to prove that the director in question "was not disinterested or independent *in this case*."[223]

In a subsequent case involving sale of a start-up company, the Delaware Chancery Court reiterated that general characterizations are insufficient to increase judicial scrutiny. In *Chen v. Howard-Anderson*,[224] the plaintiff claimed that board members were conflicted due to their

218. *E.g., In re Morton's Restaurant Group*, 74 A.3d 656, 662 (Del. Ch. 2013); *see also* Del. Ch., Court of Chancery Guidelines for Expedited Discovery in Advance of a Preliminary Injunction Hearing, http://courts.delaware.gov/chancery/docs/PIDiscoveryGuidelines.pdf [http://perma.cc/4L8F-S657] (last visited Oct. 08, 2015).

219. *See supra* note 107 (listing legal scholarship discussing the shut-down dynamic).

220. *In re Trados*, 73 A.3d at 54–55.

221. *Id.* at 54.

222. *Id.*

223. *Id.* (emphasis added).

224. 87 A.3d 648 (Del. 2014).

affiliation with venture capital funds that were near the end of their ten-year term.[225] The plaintiff argued that the looming termination date skewed the funds' incentives by necessitating liquidation of the funds' holdings.[226] Citing *Trados*, the court rejected that argument and stated:

> It is not enough . . . for a plaintiff simply to argue in the abstract that a particular director has a conflict of interest because she is affiliated with a particular type of institution. There must be evidence sufficient to permit a finding that the director in fact faced a conflict *in the specific case*.[227]

Based on this article's reasoning, there are good reasons why courts have been skeptical of hinging judicial scrutiny on industry-wide generalizations. To understand a fund's true incentives, we would need to know how the fund viewed the company's prospects in relation to the rest of its portfolio, the prospects for raising a new fund with a new portfolio of companies, and the fund managers' prospects for exiting the venture capital business altogether.[228] In short, it is one thing to observe a pattern of conduct that sometimes results in shut-down of a viable entity and quite another to infer from every disappointing transaction that investors abandoned the company for greener pastures.

3. Indirect Evidence of Intent Is Difficult to Imagine

According to the preceding subparts, clear statements of intent and industry-wide generalizations are the easy cases. The former is a compelling additional fact; the latter is not.

Between these easy cases are various forms of indirect or circumstantial evidence of opportunity-cost conflict. While it is hard to rule out a compelling collection of indirect facts, it is hard to think of an example that would not undermine the standard's purpose of meaningfully screening meritless litigation.

For example, *Pretrial Trados* emphasized that the company had enjoyed some positive business developments.[229] In the year prior to the sale, the company obtained additional debt financing and beat revenue projections under the guidance of a new CEO that was selected by the venture capital funds.[230] But what do these signs of a possible upswing really tell us? At most, they suggest Trados was not an altogether lost

225. *Id.* at 671.

226. *Id.*

227. *Id.*

228. *See supra* Part II.A.

229. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958 at *3,*14 (Del. Ch. July 24, 2009).

230. *Id.*

cause, which is something we probably already knew from the fact that a purchaser was willing to spend $60 million to buy the company.

Another influential fact in *Trados* was diminishing time commitment by one of the allegedly conflicted directors.[231] This gets closer to the gravamen of an opportunity-cost conflict—withdrawal of effort from a fiduciary relationship in order to pursue better alternatives. There are at least two problems with focusing on reduced time commitment, however.

First, it is unclear what the proper benchmark is for a board member's time commitment. For example, it is plausible to think that, when fully engaged, a board member affiliated with a venture capital investor is more active than the average board member.[232] Should that board member then be held accountable for reducing involvement to what might be more typical levels?

Second, if reduced effort alone is a qualifying additional fact, what separates a *Trados* claim from a simple negligence (duty of care) claim that would ordinarily be governed by the business judgment rule? It may be inevitable that the line between care and loyalty occasionally blurs.[233] But given what is at stake when the court categorizes a claim as sounding in loyalty or care, courts should be wary of too quickly equating shirking with disloyalty.[234]

Looking beyond *Trados,* what other type of facts, short of direct evidence of intent, might qualify as other facts? In theory, a court could draw inferences from a portfolio investor's or parent corporation's internal valuations or assessments of alternatives. Such assessments may suggest a prioritization of the fiduciary's efforts. But such reports may be produced according to industry conventions that fail to capture the fiduciary's subjective assessments. Managers of venture capital funds, for example, provide their limited partners with periodic estimates of portfolio-company values in accordance with agreed upon valuation methods that may not reflect their subjective assessments.[235]

So while it is difficult to rule out some combination of indirect evidence that together makes a compelling case for an opportunity-cost conflict, it is equally hard to think of a good example.

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231. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 52 (Del. Ch. 2013) (stating that one director stopped attending meetings in person).

232. *See supra* note 108 (describing the active involvement of venture capital investors).

233. *See supra* notes 34–40 (discussing overlap between care and loyalty).

234. *See supra* notes 34–40 (exploring the conceptual differences between claims arising out of care and claims arising out of loyalty).

235. *See* Association Française des Investisseurs en Capital et al., International Private Equity and Venture Capital Valuation Guidelines 7 (2012); *see supra* text accompanying notes 122-136 (discussing the subjective nature of opportunity costs).

IV. Potential Objections

The first three parts of this article argued that courts should rarely invoke *Trados's* novel theory of opportunity-cost conflicts, despite its conceptual value. This Part anticipates objections and offers brief responses.

A. *Opportunity-Cost Analysis Was Dicta in* Trados

This article takes the position that opportunity-cost analysis was integral to the court's selection of fairness review. It does so for several reasons. First, that is a natural reading of the *Trados* opinion; why else would the court engage in such elaborate and novel reasoning? Second, the law has never required perfect incentive alignment,[236] and quasi-residual rights go far in mitigating incentive distortion.[237]

This is not the only plausible reading of *Trados.* One could read the case to say that the mere ambiguity of quasi-residual incentives triggers fairness review at the moderate downside. The court stated that opportunity-cost conflicts "reinforce" incentives created by quasi-residual cash flow rights without explicitly indicating whether either source of conflict alone is sufficient to trigger fairness review.[238]

Even if the opportunity-cost conflict was dicta in *Trados*, the concept still warrants serious analysis. It is conceivable that future plaintiffs will invoke the concept of opportunity-cost conflicts in other contexts, such as an all common capital structure.[239] Eventually courts may be called upon to assess whether an opportunity-cost conflict, standing alone, is a viable claim. Put another way, sometimes dicta matters because it foreshadows the future direction of the law.[240]

B. Why Wasn't Trados *Dismissed?*

In *Trados*, the plaintiffs' best evidence was testimony of one director *at trial*.[241] In fact, it is not clear that any other evidence cited in *Trados* was sufficient under the other-facts standard described in this

236. *See supra* text accompanying notes 98–102

237. *See supra* Part I.B.2 (discussing how conversion rights align incentives when there is a meaningful chance at significant upside); *supra* Part I.B.3 (discussing how participation rights align incentives when there could be moderate increases in enterprise value); *supra* Part I.C (discussing the largely aligned interests of common shareholders and venture-capital investors); *supra* text accompanying notes 96–97 (discussing the limited range of outcomes in which common and venture capital preferred conflict).

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

239. *See supra* notes 1113–1124 and accompanying text.

240. Mohsen Manesh, *Damning Dicta: The Default Duty in Delaware*, 39 J. Corp. L. 35, 57–62 (2013) (discussing use of dicta by Delaware courts).

241. *See supra* note 1132.

article.[242] How then did the plaintiffs' claims survive motion to dismiss in *Pretrial Trados*?

In short, this article argues that the plaintiffs' claims should have been dismissed contrary to the outcome of *Pretrial Trados.* Where did *Pretrial Trados* go wrong? One possibility is that the court focused only on the potential conflict between residual and quasi-residual cash flow rights, contrary to the position articulated in Part IV.A above. Alternatively, maybe the court implicitly relied on opportunity-cost analysis and concluded there was sufficient indirect evidence of improper intent, contrary to the analysis in Part III.C.3 above. In either case, this article views *Trados* as a necessary improvement to the more cursory reasoning of *Pretrial Trados.*

C. Contracting or Processing Around Trados

This article argues for a cautious approach to judicially enforced fiduciary duties, primarily out of concern for litigation abuse.[243] One might argue that this caution is unnecessary because parties to financing transactions can follow ratification procedures (approval by independent directors) to cleanse any conflict or contract around *Trados* through negotiated shareholder rights.[244] Bratton and Wachter, however, ably identify the difficulties preferred holders will encounter contracting or processing around *Trados.*

Even if independent directors are reasonably available,[245] it will be hard for those directors to conclude beyond litigation risk that a pivot lacks significant value to the common holders to whom duties are owed.[246] As Bratton and Wachter note, even a fairness opinion that pegs enterprise value well below the preferred liquidation preference probably must admit to some nontrivial chance at a turnaround.[247] Under *Trados*, such an opinion risks making the plaintiffs' case.[248]

242. *See* Part III.C.3 (discussing alleged indications of opportunity-cost conflict in *Trados* and *Pretrial Trados*).

243. *See supra* Part III.C (suggesting that courts should scrutinize opportunity-cost conflicts only in cases with extraordinary evidence); *see infra* Part IV.A (suggesting that conflicts between the cash flow rights of common and preferred are mild and should not trigger fairness review).

244. *E.g.*, Strine, *supra* note 14, at 2040 (stating that Delaware's jurisprudence relating to preferred stock "creates good incentives for parties with the powerful leverage of preferred stockholders to get their rights where they should—in the contract").

245. *Trados's* skepticism towards the supposedly independent director in that case highlights the difficulty of the task. *See supra* Part III.C.2.

246. *See* Bratton & Wachter, *supra* note 14, at 1888–89 (discussing procedural workarounds).

247. *Id.* at 1888.

248. *Id.*

Ex ante contracts are no panacea either. Because an opportunity-cost conflict sounds in loyalty rather than care, such a claim cannot be released in the company's charter.[249] Instead, the parties must rely on less direct contractual solutions at the shareholder level.

A minority of venture capital financings include redemption rights that amount to an eventual shutdown right in favor of the venture capital investor.[250] This is an extremely blunt instrument—a nuclear option at a date certain in favor of investors. With so much uncertainty at the time of contracting, it is no wonder that such fixed time limits for a venture are unpopular.

Drag-along rights are more common in venture capital financings.[251] Such rights permit a specified set of shareholders to compel other shareholders to vote in favor of a sale.[252] Though helpful in overcoming some holdout problems, drag-along rights do not avoid the statutory requirements for board approval of a merger.[253] As a result, drag-along rights cannot be exercised without exposing the board to *Trados* claims.[254]

The foregoing contracting challenges are an additional reason—on top of litigation abuse—for weaker fiduciary restraints. More rigorous fiduciary review might foreclose governance structures to which entrepreneurs and investors might resort in the face of noncontractible problems. For example, Brian Broughman models how a customary board configuration featuring an independent and mutually agreed upon director as tie breaker can lead to optimal exit decisions. This result

249. *See* Del. Code Ann. tit. 8 § 102(b)(7) (2015) (permitting elimination of director liability for duty of care violations but not duty of loyalty violations).

250. Cooley LLP, 2014 Venture Financing in Review—A Banner Year for Deal Volume and Invested Capital 7 (2015), http://www.cooley.com/venture-financing-report-2014-year-in-review [http://perma.cc/RE7N-KT4Q].

251. *Id.* at 6.

252. *See* Maynard & Warren, *supra* note 51, at 665–66 (discussing drag-along rights).

253. *See* Del. Code Ann. tit. 8 § 251 (2015) (requiring board approval for a merger).

254. In response to *Pretrial Trados*, Silicon Valley lawyers (acting through the National Venture Capital Association) tried to enhance conventional drag-along rights by adding a contractual "sale right." Bratton & Wachter, *supra* note 14, at 1892. The sale right requires the company to hire an investment banker and conduct a sale process, and gives the exercising shareholders a redemption right at the highest bid obtained. *Id.* But such a provision necessarily falls short of compelling a sale—that would require board approval and ensnare the directors in *Trados* analysis. As Bratton and Wachter note, "[r]edemption in lieu of a merger is not the same as a merger." *Id.*

obtains even if the directors act in self-interested ways that might offend a more robust version of fiduciary loyalty.[255]

D. When Can a Board Pull the Plug?

If a venture-capital fund's opportunity costs are inappropriate motivation for selling or shutting down a company, what would be an appropriate motivation? Does *Trados* require a board to let a company limp along indefinitely just to appease common-holding entrepreneurs?

Trados does not compel a board to prolong the life of a company for the purpose of generating private benefits for entrepreneurs. Salary and individual prestige may motivate entrepreneurs to continue even when there is no meaningful chance of company value exceeding the preferred holders' liquidation preference. In that circumstance, a board (even one controlled by venture-capital investors) is justified in terminating the project over the entrepreneur's objections. Without smoking-gun evidence of improper intent,[256] a court should give deference to a reasonably informed determination that common-stock value is near zero.

E. Heightened Pleading Standards Haven't Worked

On its face, the other-facts standard resembles heightened pleading standards such as those enacted by the Private Securities Litigation Reform Act of 1995[257] (PLSRA) or mandated by recent judicial opinions such as *Bell Atlantic Corp. v. Twombly*[258] and *Ashcroft v. Iqbal*.[259] Some commentators question whether those reforms have been helpful in distinguishing between meritless and valid claims.[260]

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255. Broughman, *supra* note 106, at 480–86.

256. *See supra* Part III.C.1 (discussing "direct evidence of intent").

257. The PSLRA enacted heightened pleading requirements, modified procedures for selecting lead plaintiffs, and narrowed discovery rights in securities class actions. *See* 15 U.S.C. § 78u (Supp. I 1995–96).

258. 550 U.S. 544 (2007). There is some disagreement whether *Twombly* itself constitutes a "heightened" pleading standard, but together with *Iqbal* the current pleading regime is generally considered more demanding than what preceded. *See* Scott Dodson, *New Pleading, New Discovery*, 109 Mich L. Rev. 53, 65 (2010) ("The only study currently available of *Twombly* and *Iqbal* together finds that dismissal rates have increased across the board . . . .").

259. 556 U.S. 662 (2008).

260. *E.g.*, Alex Reinert, *The Cost of Heightened Pleading*, 86 Ind. L.J. 119 (2011) (presenting an empirical analysis of the effects of *Twombly* and *Iqbal* and concluding that the effects have been more random than merit-based); Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. Empirical L. Stud. 35 (2009) (presenting evidence of PLSRA's effects and concluding, "Congress's efforts to discourage frivolous litigation may have succeeded," but that

Unlike a wide-ranging pleading hurdle, the other-facts standard resides in a broader doctrinal context of review standards. If this system of review standards works properly, litigants face additional hurdles only with respect to fact patterns where risk of litigation abuse is likely to outweigh risk of managerial abuse. For other fact patterns—where there is ascertainable and heightened risk of managerial abuse—plaintiffs have easier access to courts. That is a different, and perhaps more promising, approach than the PLSRA's or *Twombley's* broadly applicable pleading hurdles. Put another way, the backdrop of substantive law affects how pleading hurdles operate.[261]

F. Plaintiffs Can Plead Anything

Tacking the other direction, one might view the other-facts standard as too lenient. The standard does not require proving any particular facts—just pleading them. What prevents a plaintiff from manufacturing facts just to get over the pleading hurdle?[262]

Both ethics rules and rules of civil procedure require that a lawyer have some basis for including facts in a complaint.[263] While these may be under-enforced requirements,[264] changes in filing patterns before and

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success comes at the price of "discouraging securities fraud class actions that would likely have been deemed meritorious prior to the PSLRA").

261. *Cf.* Richard L. Marcus, *The Puzzling Persistence of Pleading Practice*, 76 Tex. L. Rev. 1749, 1771 (1998) (providing examples of when substantive elements of a tort or other claim might provide a framework for "tailored scrutiny of the pleadings").

262. *Cf.* Bratton & Wachter, *supra* note 14, at 1889 ("[N]othing prevents a lawyer from drafting the same 'might have waited' complaint that survived a motion to dismiss in *Trados*—maybe waiting a year would have yielded $75 million. Such a claim is as hard to falsify as it is easy to draft.").

263. Ethical rules require that there be a basis in fact for any proceeding. *See* Model Rules of Prof'l Conduct r. 3.1 (Am. Bar Ass'n 2013) ("A lawyer shall not bring . . . a proceeding . . . unless there is a basis in law and fact for doing so that is not frivolous."); Del. Rules of Prof'l Conduct. r. 3.1 (2003) (including language identical to the model rules). Rules of civil procedure provide that every time a lawyer files a complaint he or she certifies that "to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances . . . the factual contentions have evidentiary support or, if specifically so identified, will likely have evidentiary support after a reasonable opportunity for further investigation or discovery." Fed. R. Civ. P. 11(b); *See also* Del. Ct. Ch. R. 11(b) (using similar language).

264. In particular, ethical standards regarding frivolous complaints appear to be a rarely used tool. *See* Peter A. Joy, *The Relationship Between Civil Rule 11 and Lawyer Discipline: An Empirical Analysis Suggesting Institutional Choices in the Regulation of Lawyers*, 37 Loy. L.A. L. Rev. 765, 795–797 (2004) (discussing the low frequency of disciplinary referrals in connection with Rule 11 sanctions).

after PSLRA, *Twombly*, and *Iqbal* suggest that litigants are constrained in what they can plead.[265]

G. Fix Civil Procedure Instead

Concern about litigation abuse motivates this article's recommendations. In the long run, more squarely procedural reforms might be the most effective way to balance the courts' interests in policing managerial and litigation abuse. For example, civil-procedure scholars have suggested reformulating the discovery system[266] and corporate-law scholars have proposed new standards for awarding attorneys fees to discourage cosmetic settlements.[267]

Nothing in this article precludes such reform. For now, courts have to decide what to do with *Trados's* novel theory without the benefit of those initiatives. This article advocates a cautious approach.

H. Entrepreneurs Don't Litigate Much

Some observers have noted an anti-litigation norm in Silicon Valley.[268] In addition, some of the factors driving heightened concern about litigation abuse might not apply in the context of a privately held company with relatively few shareholders.[269]

But recent cases still evidence a willingness to bring suit against venture capital investors.[270] And many of the factors motivating

265. *See supra* note 260 (citing empirical analysis of heightened pleading requirements).

266. *E.g.*, Dodson, *supra* note 258, at 68–85 (proposing discovery reforms tailored to the new pleading regime, including circumscribed pre-suit investigative discovery with cost-shifting mechanisms); *see* Thomas Y. Allman, *The 2015 Civil Rules Package As Approved By the Judicial Conference*, Am. Bar Ass'n (March 11, 2015), http://www.americanbar.org/content/dam/aba/administrative/litigation/materials/2015-sac/written_materials/5_1_2015__summary_of_rule_package.authcheckdam.pdf [http://perma.cc/4GAX-VSP4] (describing ongoing efforts at discovery reform by the Committee on Rules of Practice and Procedure of the Judicial Conference).

267. *E.g.*, Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. Rev. 1, 46–59 (2015) (proposing changes to doctrines under which attorneys are awarded fees for procuring a benefit for shareholders).

268. Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley,* 21 L. & Soc. Inquiry 679, 699–702 (1996).

269. For example, a more concentrated shareholder base may have an easier time monitoring class counsel. *See supra* note 182 (discussing monitoring problems in public company shareholder litigation).

270. The following recent Delaware cases involve venture capital defendants: Chen v. Howard-Anderson, 87 A.3d 648 (Del. 2014); *In re* Trados Inc. S'holder Litig.*,* 73 A.3d 17 (Del. Ch. 2013); Carsanaro v. Bloodhound Tech., Inc., 65 A.3d 618 (Del. Ch. 2013).

shareholder litigation do pertain in this context, including insurance dynamics, the potential for hold-up value, and the disproportionate cost to defendants of discovery.[271] One might even project increased litigation against venture capital funds in the near future, as investment levels increase and stakes grow higher.[272] Finally, though the concept of opportunity-cost conflict emerged in the venture capital context, it is not limited to that setting.[273]

CONCLUSION

Decades ago, Melvin Eisenberg summarized the state of Delaware fiduciary law as follows:

> If directors or officers who violate the standards of reasonableness and fairness sometimes escape liability because of a less demanding standard of review, it is not because they have acted properly, but because utilizing standards of review that were fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability.[274]

Most instances of opportunity-cost conflict are likely to fit the pattern. *Trados* provides a coherent argument for why a fiduciary should suppress the shut-down dynamic. But rooting out every transgression through litigation hardly seems worth the cost.

271. *See supra* text accompany notes 179–184 (describing features of corporate litigation that may contribute to litigation abuse).

272. *See* Lizette Chapman, *'Unicorn' Startups Say High Valuations Justified, Citing Big Growth Ahead*, WALL ST. J. (May 7, 2015, 4:25 PM) http://blogs.wsj.com/venturecapital/2015/05/07/unicorn-startups-say-high-valuations-justified-citing-big-growth-ahead/ [http://perma.cc/5YZ9-N8CB] (providing examples of venture-backed companies with pre-IPO valuations in excess of $1 billion).

273. *See supra* text accompanying notes 113–114 (providing examples of other active investors likely to encounter opportunity-cost conflicts).

274. Eisenberg, *supra* note 175, at 467–68.