RETHINKING *JEDWAB*: A REVISED APPROACH TO PREFERRED SHAREHOLDER RIGHTS

Melissa M. McEllin*

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* J.D. Candidate 2011, Columbia University School of Law; B.S. Economics 2008, Duke University. The author wishes to thank Professor Curtis Milhaupt for his guidance and the staff of the *Columbia Business Law Review* for its editorial assistance.

I. INTRODUCTION

Although preferred stock is often overlooked in corporate law,[1] it nevertheless plays an important role in many U.S. corporations. In the final fifteen years of the twentieth century, U.S. firms issued over $300 billion of preferred stock,[2] and that amount continues to grow today. Though slightly less than one percent of NYSE-listed stock issued in 2003 was preferred stock, the market value of those preferred shares totaled $43.8 billion.[3] By early 2008, the size of the preferred stock market in the United States was estimated at $100 billion, but the existence of "a large market in privately placed preferreds, the size of which is difficult to gauge,"[4] indicates that preferred stock is even more prevalent than the statistics for publicly-traded corporations suggest. In addition to the substantial value of preferred shares on U.S. securities exchanges and in private markets, such shares are also important to companies because of the role they frequently play in separating corporate governance from economic interest in the company. Moreover, the liquidation and dividend preference rights of

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[1] The relative dearth of scholarship addressing the rights of preferred stockholders illustrates this assertion. For a fairly recent, detailed analysis of preferred shareholders' rights and the problems that arise in their application, see Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (1996) [hereinafter Mitchell, *Puzzling Paradox*]. This Note seeks to expand upon and update Mitchell's analysis by examining the case law developments since his publication and critiquing his proposed solution in light of those developments.

[2] *See* Mukesh Bajaj, Sumon C. Mazumdar & Atulya Sarin, *The Costs of Issuing Preferred Stock*, 25 J. FIN. RES. 577, 577 (Winter 2002), *available at* http://www.allbusiness.com/finance-insurance/357006-1.html.

[3] *See* NYSE LISTED SECURITIES YEAR-END, http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=230&category=4 (last visited Dec. 1, 2010).

[4] *See* STANDARD & POOR'S, PREFERRED STOCK PRIMER 3 (Mar. 25, 2009), http://www2.standardandpoors.com/spf/pdf/index/Preferred_Stock_Primer_2009.pdf.

preferred stock have increasing significance in the current economic climate.[5]

Preferred stock is thus an integral aspect of modern corporate law in the United States, and the rights and interests of preferred shareholders play an important role in this field. However, those interests often come in direct conflict with the interests of common shareholders, as each group seeks to draw separately from the same pool of resources, thereby creating a "horizontal conflict."[6]

[5] *See id.* at 2 (outlining the basic features of preferred stock). While the rights of preferred stock can vary among companies depending on the precise terms of each particular stock certificate, preferred stockholders typically enjoy both dividend and liquidation rights. This means that preferred stock will usually provide for dividend payments to preferred shareholders before any dividends are distributed to common shareholders. The other advantage of preferred stock is that its holders benefit from priority over common stockholders in the event of a company's liquidation or bankruptcy, where they may enjoy seniority over common shareholders in distributions of the company's assets. *Id.* at 2. These rights, and their limitations, will therefore be particularly critical for preferred shareholders in times of economic recession because of the increasing frequency of company liquidations and bankruptcies. Corporations also frequently issue preferred stock when they are financially unstable for two reasons. First, preferred stock can attract additional investors to augment corporate wealth. Second, preferred stock gives the company flexibility because it is not obligated to make dividend payments to preferred shareholders. *See id.* at 3–4. In contrast to the mandatory dividend payments owed to bondholders, dividend payments to preferred shareholders are optional. *See id.* Therefore, the increase in the number of companies facing financial difficulties in the current economic climate may also lead to an increase in preferred stock issuances.

[6] *See generally* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1189–90 (1990) [hereinafter Mitchell, *Fairness Rights*] (introducing the concept of horizontal conflicts and distinguishing between vertical and horizontal situations of conflict in a corporate setting). In this Note, the term "horizontal conflict" is used in a general sense and includes not only situations of "pure" horizontal conflict, where the conflict is solely between common and preferred shareholders, but also situations where director ownership of common stock or the presence of a controlling shareholder affects the conflict between common and preferred shareholders. See *infra* Section II.B for an expanded discussion of the characteristics of these two types of horizontal conflict.

Consequently, the law governing which group of shareholders is owed fiduciary duties or other rights in situations of horizontal conflict has substantial implications. The highly influential Delaware Chancery decision of *Jedwab v. MGM Grand Hotels, Inc.* establishes the following analytical framework for resolving horizontal conflicts: when the "preferential" rights of preferred shareholders are invoked, the contractual terms of the preferred stock certificate strictly govern, whereas when "equitable" rights (those shared equally with the common shareholders) are invoked, preferred shareholders are entitled to the same fiduciary duties as common shareholders.[7]

This Note argues that the *Jedwab* rule for resolving horizontal conflicts between common and preferred shareholders is unsatisfactory for two reasons. First, it provides opportunities to justify favoritism towards common shareholders when "equitable" rights are invoked. Second, recent case law developments indicate that when "preferential" rights are invoked, the *Jedwab* rule leads to overly strict interpretation of contractual terms and fails to address the current trend of favoring fiduciary duties owed to the common shareholders over contractual obligations owed to the preferred shareholders. The already vulnerable preferred shareholders are thus left with little or no true rights regardless of whether the horizontal conflict in question is classified as one concerning preferential rights or one concerning equitable rights. Accordingly, although the *Jedwab* framework has been in place for several years, recent applications of it in case law have caused confusion and poor results. As such, the problem is one of particular current relevance.

This Note further argues that a possible remedy for this problem, by way of analogy to the close corporation context, is to provide preferred shareholders with meaningful rights through contracting for fiduciary duties. Alternatively, relaxing the strict interpretation of contractual terms and reading an implied covenant of good faith into the terms of

[7] 509 A.2d 584, 594 (Del. Ch. 1986).

the stockholder contract could ameliorate the problem of vulnerable preferred shareholders. A final potential solution could be the creation of special committees to represent preferred shareholders during certain corporate transactions.

Section II of this Note provides context for shareholder conflicts by examining the reasons for issuing preferred stock, the types of companies that typically do so, and the various situations in which horizontal conflicts are most severe. Section III of this Note briefly reviews the evolution of the treatment of preferred shareholders' rights in horizontal conflict situations and examines the *Jedwab* decision in detail. Section IV discusses recent case law developments that highlight the undesirable results of the current rule and expands upon the existing scholarly analysis of the rule. Finally, Section V elaborates on and critiques the previously proposed solutions to the preferred shareholder dilemma in light of these case law developments. It suggests alternative remedies to the *Jedwab* conflict, proposing the inclusion of broad fiduciary rights in preferred stock certificates, the imposition of good faith contract interpretation requirements on courts, or the creation of special committees to represent preferred shareholders during certain corporate transactions.

II. CONTEXTUAL REALITIES OF SHAREHOLDER CONFLICT SITUATIONS

A. Distinguishing Features of Preferred Stock: Who Issues It, Who Buys It, and Why?

Both common stock and preferred stock represent an ownership interest in a company. While the rights of preferred stock can vary by issuer depending on the terms set out in the stock certificate, owners of preferred stock typically acquire certain liquidation rights and dividend preference over common stockholders.[8] However, preferred

[8] *See* 18B AM. JUR. 2D *Corporations* § 1079 (2009).

stock ownership does not offer the same opportunity as common stock ownership to directly benefit from company growth or improved corporate performance, because while the value of common stock is tied to the performance of the company, preferred stock returns come primarily from the fixed dividends provided for by their certificate's dividend preference terms, with any additional value improvements based on interest rates. In this respect, preferred stock operates in a manner similar to bonds.[9] Unlike bonds or other debt instruments, though, a company is not legally obligated to make any dividend payments to its preferred shareholders. Rather, it simply must treat preferred shareholders as senior to common shareholders if it chooses to make such distributions. Similarly, the preferred shareholders' claim to liquidation proceeds is merely senior to that of the common shareholders, who have only residual rights to those proceeds.[10] Despite these seniority rights that preferred shareholders hold over common shareholders, common shareholders have the significant advantage of the right to vote. While preferred shareholders are technically entitled to vote,[11] corporations often include provisions in their charter or bylaws that limit or deny these rights.[12] Even when preferred shareholders are not explicitly denied voting rights, they typically constitute a minority of outstanding stockholders and thus cannot prevail in any vote against the common shareholders.[13] Furthermore, though preferred stocks traditionally have high yields and serve as valuable instruments of diversification, they simultaneously have lower liquidity than common stocks.[14] These various rights and limitations of preferred stock, particularly in comparison with those of common stock, highlight the

[9] *See* STANDARD & POOR'S, *supra* note 4, at 5.

[10] *Id.* at 2.

[11] *See* 18B AM. JUR. 2D *Corporations* § 871 (2009).

[12] *See, e.g.*, Winston v. Mandor, 710 A.2d 835, 839 (Del. Ch. 1997).

[13] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 473 n.157.

[14] *See* STANDARD & POOR'S, *supra* note 4, at 5.

conflicting interests between common and preferred shareholders.

In light of the atypical rights and limitations of preferred stock, it may be helpful to explain the incentives for companies to issue preferred stock, as well as the incentives for investors to purchase it. Preferred stock is particularly common in private companies because it is often useful to separate investors' economic interests from the actual governance of such companies.[15] In a typical situation, a company issues common stock to its founders and options to purchase common stock to its employees and others close to the company, while offering preferred stock to investors. Separating classes of stock in this way can preserve the company's ability to issue options to purchase common stock at a discount from the preferred stock price. This structure also keeps voting rights, and thus governance, with the founders and parties close to the company. Despite their lack of governance power, investors are still motivated to purchase preferred stock because of the dividend rights, high yields, and downside protections of liquidation preference rights that come along with the stock.

Public companies also issue preferred stock, but stock exchange and government regulations often discourage them from doing so.[16] Many public companies nevertheless choose to issue preferred stock to attract risk-averse investors and to provide the company with increased flexibility because the company can always choose to withhold dividend payments from preferred stockholders (unlike bondholders). Those public companies that do issue preferred stock are usually banks or other financial institutions seeking to meet capital adequacy requirements.[17]

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[15] *Common Stock vs. Preferred Stock*, ALLBUSINESS.COM, INC., http://www.allbusiness.com/business-planning/business-structures-corporations-stock/3779142-1.html (last visited Dec. 1, 2010).

[16] *See id.*

[17] *See* STANDARD & POOR'S, *supra* note 4, at 2 (stating that issuing preferred stock is viewed as an efficient way to meet capital adequacy requirements).

Finally, it is important to note that in many instances, company directors may own both common and preferred stock, which has significant implications for horizontal conflicts in certain factual settings.[18]

B. Factual Settings for Shareholder Conflicts

Many different types of conflict may arise between holders of common stock and holders of preferred stock, and the severity of such conflicts will vary based on the factual setting. Since common shareholders realize gains through corporate preservation and improved corporate performance, while preferred shareholders realize gains from their liquidation rights and fixed dividends, the interests of the two groups are not typically aligned. Taking into account that preferred and common shareholders seek to gain in these conflicting ways from the same pool of resources—the corporate wealth—this mutual reliance on a fixed sum of resources means that gains for one category of shareholders often come at the expense of the other.[19] Consequently, when corporate managers increase shareholder gains by transferring corporate wealth from one group of shareholders to another, rather than by increasing the overall value of the corporation, a horizontal conflict arises,[20] and the relative rights of preferred and common shareholders must be balanced against each other.

One type of horizontal conflict is a "pure" horizontal conflict—a direct dispute between common and preferred shareholders. In a pure horizontal conflict, the common shareholders, acting through the directors by way of their voting power, can work against the interests of the

[18] *See, e.g.*, Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 595 (Del. Ch. 1986) (stating that controlling common shareholders of the company—including company directors—also owned preferred stock); see also *infra* Section II.B for a discussion of horizontal conflict situations, including the implications of director ownership of both common and preferred stock.

[19] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 445–46.

[20] *See* Rutherford B. Campbell, Jr., *A Positive Analysis of the Common Law of Corporate Fiduciary Duties*, 84 KY. L.J. 455, 460–62 (1996).

preferred.[21] For example, such a conflict could arise when a company is considering a potential merger. If a merger occurs, preferred shareholders can be merged out and given only the merger consideration and relevant appraisal rights. As a result, preferred shareholders may instead want the company to liquidate so that they have the opportunity to invoke their liquidation preference rights. Common shareholders, on the other hand, will prefer that the company complete the merger due to their preference for preservation of the corporate entity and their solely residual rights in the event of liquidation.[22] When corporate directors make decisions that affect the future of the company, they consider not only their personal interests in corporate preservation, but also the interests of the common shareholders to whom they owe fiduciary duties. The fact that common shareholders vote for directors can also influence this sense of loyalty to the common shareholders. This combination will thus generally weigh against the preferred shareholders, such that in this scenario, a merger would likely result.

Recapitalizations are another situation in which "pure" horizontal conflicts can arise. Directors, who are elected by common shareholders, decide on the ultimate recapitalization plan, and "their interests are aligned with common stockholders, and thus they are in a conflict of interest with respect to the preferred stockholders in the transaction. Not surprisingly, therefore, preferred stockholders subjected to recapitalizations often complain

[21] The notion that directors tend to favor common shareholders in situations of conflicting shareholder interest is supported by examination of case law as well as existing scholarly analysis. The prevailing belief is that directors often act on behalf of the common shareholders either because of a perceived duty to do so or due to the confines of the law. *See, e.g.*, Mitchell, *Puzzling Paradox*, *supra* note 1, at 450 ("[B]oth the doctrine and the structure of modern corporate law mandate that directors always act in the interests of the common.").

[22] *See, e.g.*, Rothschild Int'l Corp. v. Liggett Grp., Inc., 474 A.2d 133, 136 (Del. 1984) (rejecting merged-out preferred shareholders' claim that a merger was in effect a liquidation that therefore triggered their liquidation preference).

that they are treated unfairly."[23] As a result of the directors' personal interests and "perceived duty" to act on behalf of the common shareholders, preferred shareholders rarely prevail in cases involving pure horizontal conflicts, and these types of factual settings present the most severe interference with preferred shareholder rights.

In addition to those "pure" horizontal conflicts, a more frequent—though often less severe—type of conflict between common and preferred shareholders occurs when there is some level of director interest in the common stock, meaning that the conflict entails a vertical element as well.[24] To illustrate, this type of "vertical-horizontal" conflict could occur if a leveraged buyout of common stockholders, supported by directors who own a large amount of common stock, leaves the holders of the preferred shares with devalued stock in companies where their rights are significantly less favorable. If directors own common stock, or if they own more common stock than preferred stock, they will likely support such a buyout in order to optimize their personal gain.

Therefore, horizontal conflicts that involve director interest are similar to purely horizontal conflicts in terms of their tendency to favor the interests of the common over those of the preferred. However, these vertically-influenced conflicts are limited in one key sense: while the presence of a director conflict of interest is not sufficient in itself to trigger judicial scrutiny of a particular course of action, additional wrongdoing by interested directors may lead to the rejection of a common-shareholder-friendly plan.[25] Therefore, while vertical-horizontal conflicts will often unfold similarly to pure horizontal conflicts, the possible existence of director wrongdoing beyond a mere conflict of interest—such as lack of candor, coercion, or threats[26]—can lead to results that tend

[23] Campbell, *supra* note 20, at 477 (footnote omitted).

[24] *See* Mitchell, *Fairness Rights*, *supra* note 6, at 1190.

[25] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 467.

[26] *See, e.g.*, Eisenberg v. Chi. Milwaukee Corp., 537 A.2d 1051 (Del. Ch. 1987) (holding that a corporation's self-tender offer for its preferred stock was materially misleading).

to be more favorable to the rights of preferred shareholders than purely horizontal conflict situations. However, even this type of factual setting is not ideal for preferred shareholders, as the additional protections only apply where there is very explicit wrongdoing on the part of directors. Thus, in practice, preferred shareholders still rarely prevail over common shareholders and often do not realize the full extent of their contractual rights. Furthermore, as with purely horizontal conflicts, many directors own both common and preferred stock, so it is easy for them to make a convincing argument that they are not opportunistically favoring the interests of the common shareholders over those of the preferred shareholders because they have a strong personal interest in the preferred stock as well.[27]

In sum, because of the competition between common and preferred shareholders for a fixed amount of corporate wealth, there are many situations where horizontal conflicts arise. These situations are most severe, and consequently least favorable to preferred shareholders, in situations of purely horizontal conflict between common and preferred shareholders. Furthermore, when directors own both common and preferred stock, it is often difficult to show that those directors are acting against the interests of the preferred, potentially increasing the severity of the horizontal conflict.

[27] *See, e.g.*, Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 595 (Del. Ch. 1986) (presenting the defense argument that because controlling common shareholders also owned preferred stock, their decision to apportion merger consideration by offering common shareholders four dollars more per share than preferred shareholders was impartial).

III. THE EVOLUTION OF PREFERRED SHAREHOLDER RIGHTS IN HORIZONTAL CONFLICT SITUATIONS

A. Preferred Shareholder Rights Prior to the *Jedwab* Decision

The distinguishing features of preferred stock are that it entitles its holders to priority over common stockholders in the payment of dividends,[28] and that it provides its holders the right to receive distributions of assets senior to common shareholders in the event of dissolution or liquidation of the corporation.[29] These "preferential" features of preferred stock are contractual terms, set forth either in the corporation's charter or bylaws or, alternatively, in the preferred stock certificates.[30]

Prior to the *Jedwab* decision, preferred shareholders' rights were treated as solely contractual in nature.[31] By considering all preferred shareholder rights as contractual, rather than only those rights pertaining to their preferential rights to dividends and distributions, the Delaware Supreme Court implied that the preferences stated in the stock certificate or corporate charter were the only rights that preferred shareholders could claim. The court's pre-*Jedwab* decisions rejected any notion of extra-contractual fiduciary rights for preferred shareholders,[32] and instead promoted the

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[28] *See* 18B AM. JUR. 2D *Corporations* § 1079 (2009).

[29] *See* 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5295 (perm. ed., rev. vol. 2009).

[30] *See In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 533 (Del. Ch. 2001).

[31] *See, e.g.*, Rothschild Int'l Corp. v. Liggett Grp., Inc., 474 A.2d 133, 136 (Del. 1984) ("Preferential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation.").

[32] *See, e.g.*, Judah v. Del. Trust Co., 378 A.2d 624, 628 (Del. 1977) ("Generally, the provisions of the certificate . . . govern the rights of preferred shareholders . . . *with only those rights which are embodied in the certificate granted to preferred shareholders*." (emphasis added)).

idea of fixed and predetermined rights,[33] noting that, "[f]or most purposes, the rights of the preferred shareholders as against the common shareholders are fixed by the contractual terms agreed upon when the class of preferred stock is created."[34]

While the Delaware Supreme Court continued to issue strong opinions classifying preferred shareholder rights as strictly contractual up until the 1986 *Jedwab* decision, a few decisions by Delaware Chancery courts began to hint at more expansive interpretations of preferred shareholder rights. In granting a preliminary injunction to halt a merger, the court in *Lewis v. Great Western United Corp.* considered the failure of the defendants-controlling common shareholders to adequately take into account the entire fairness of the merger transaction to preferred shareholders.[35] Other decisions similarly applied fiduciary duties to preferred shareholder claims.[36] However, this practice was not expressly standardized until the *Jedwab* decision.

B. *Jedwab*'s Seeming Clarification of Preferred Shareholder Rights

The *Jedwab* decision established a new framework for analyzing the extent to which preferred shareholders are entitled to fiduciary duties or other extra-contractual protections ("equitable" rights) as compared to common shareholders. In *Jedwab*, plaintiff-preferred shareholders brought a class action to enjoin a proposed merger by MGM because they were dissatisfied with the defendant-

[33] *See* Wood v. Coastal States Gas Corp., 401 A.2d 932, 937 (Del. 1979).

[34] *Id.* at 937. While the phrase "[f]or most purposes" could be interpreted to permit certain fiduciary exceptions, it is unlikely that the *Wood* court intended this phrase to allow for such exceptions, in light of both the precedent at the time and the *Wood* court's express rejection of an extra-contractual remedy that would have benefited the preferred shareholders. *Id.*

[35] No. 5397, 1978 WL 2490, at *1 (Del. Ch. Mar. 28, 1978).

[36] *See, e.g.*, David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30, 33 (Del. Ch. 1971).

controlling shareholder's proposed division of the proceeds of the merger between common and preferred shareholders.[37] Because the controlling shareholder owned a much larger amount of common stock than preferred stock,[38] the preferred shareholders contested the impartiality of his decision to apportion the merger consideration by offering common shareholders $18 per share from the proposed merger while only offering preferred shareholders $14 per share.[39] Since the terms of the preferred stock certificate did not cover mergers, the preferential rights of the preferred shareholders were not invoked. Thus, the traditional view that preferred shareholders had only contractual rights would have left preferred shareholders with no rights. The *Jedwab* court sought to ameliorate that situation by establishing some other method for the preferred shareholders to assert meaningful rights,[40] resulting in the following rule: when the "preferential" rights of preferred shareholders are invoked, the contractual terms of the preferred stock certificate strictly govern, whereas when "equitable" rights (those shared equally with the common shareholders) are invoked, preferred shareholders are entitled to the same fiduciary duties as common shareholders.

The intent of the *Jedwab* rule was to give preferred shareholders greater rights and thus reduce some of the vulnerability inherent in their position as a corporate constituency. The rule is based on the notion that preferred stock, while differentiated from common stock by its preferential rights, is nevertheless a form of stock and therefore deserving of the rights that come along with such a classification. At common law, and in the absence of an agreement to the contrary, all shares of stock are equal.[41]

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37 *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 587 (Del. Ch. 1986).

38 *See id.* at 591.

39 *Id.*

40 *See id.* at 594.

41 *See* Shanghai Power Co. v. Del. Trust Co., 316 A.2d 589, 593 (Del. Ch. 1974). The notion here is that preferred and common shares are equal

The *Jedwab* idea, then, is that when a specific right claimed by the preferred shareholders is not addressed within their contractual rights and limitations, it should be treated the same as the common shareholders' corresponding right. The preferential rights of preferred stocks are "built onto (or carved from) the foundation of the stockholder's basic equity. In other words, the equity is obviously prior to the preference. It is the equity that thus establishes the basis for the fiduciary relationship."[42]

The resulting *Jedwab* rule is two-pronged. When "preferential" rights—matters of "preferences or limitations that distinguish preferred stock from common stock"—are at issue, "the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract . . . ."[43] Therefore, the treatment of preferential rights remains unchanged by the *Jedwab* decision. On the other hand, *Jedwab* holds that when a "right asserted is not to a preference as against the common stock but rather a right shared equally with the common" (an "equitable" right), fiduciary duties apply.[44] Briefly, *Jedwab* establishes that the "equitable" rights of preferred stock are fiduciary, while the "preferential" rights and limitations are contractual.

While some decisions suggest that *Jedwab* is simply an aberration and that the prior rule, under which no fiduciary duties were owed to preferred shareholders, is still valid,[45]

and have equal rights, except as otherwise provided in the preferred stock certificate. The contractual rights of preferred shareholders are thus additions to the preexisting rights that they share with the common shareholders by nature of being stockholders, rather than replacements of those rights.

42 Mitchell, *Puzzling Paradox*, *supra* note 1, at 459.

43 *Jedwab*, 509 A.2d at 594.

44 *Id.*

45 *See, e.g.*, RGC Int'l Investors, LDC v. Greka Energy Corp., No. 17674, 2000 WL 1706728, at *16 (Del. Ch. Nov. 8, 2000) (characterizing *Jedwab* as an exception to the general rule that "the rights of preferred stockholders are largely governed by contract law and that corporate

the vast majority of recent cases dealing with situations of horizontal conflict apply a *Jedwab*-type rule, and the framework is generally accepted not only in Delaware, but also in most jurisdictions throughout the United States.[46]

The *Jedwab* rule resolves one issue inherent in the preexisting framework—namely, that preferred stock certificates are by nature short and incomplete, such that substantial duties outside of or beyond the specific and limited contractual terms are necessary in order to guarantee meaningful rights for preferred shareholders. However, the extent to which extending fiduciary rights to preferred shareholders solves the problem of ineffectual preferred shareholder rights is a more contentious issue. While *Jedwab* seemingly clarified the questions of what rights preferred shareholders hold and when those rights can be invoked, subsequent case law has cast doubt on whether preferred shareholders can successfully claim those rights in practice, particularly when they interfere with the rights of common shareholders.

IV. THE UNSATISFACTORY RESULTS OF APPLYING THE *JEDWAB* FRAMEWORK

While the *Jedwab* framework is ostensibly clear, application of the rule in practice leads to inconsistent results that starkly contrast with the *Jedwab* court's intent to provide preferred shareholders with more meaningful rights and to reduce their inherent vulnerability. Existing scholarly analysis, viewed in combination with recent case

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directors do not owe preferred stockholders the broad fiduciary duties belonging to common stockholders.").

[46] *See, e.g.*, 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5295 (perm. ed., rev. vol. 2009) (including both equitable and preferential rights in the definition of preferred shareholder rights for the United States generally, as well as within numerous individual state law definitions, including California, Texas, and New York). However, the scope of this Note will be limited to Delaware law because, while private companies often issue preferred stock, litigation over preferred shareholder rights occurs more commonly in larger public companies, which are typically incorporated in Delaware.

law developments, indicates that the rights of preferred shareholders remain weak regardless of whether preferential or equitable rights are at issue.

A. The Impact on Equitable Rights

Under *Jedwab*, managers owe fiduciary duties to all stockholders—both preferred and common—except to the extent that preferred shareholders waive those rights by contracting for their own preferential terms.[47] These fiduciary duties are the "equitable" rights created by the rule, shared equally among preferred and common shareholders. A corporation's directors "are fiduciaries for the [p]referred stockholders, whose interests they have a duty to safeguard, consistent with the fiduciary duties owed by those directors to [the corporation's] other shareholders and [the corporation] itself."[48] However, *Jedwab* is "often cited for the rule that preferred shareholders are only owed fiduciary duties insofar as common shareholders are owed fiduciary duties."[49] Delaware courts have read *Jedwab* to further restrict preferred shareholder rights by asserting that "preferred stockholders have no fiduciary duty claims against directors that are not also fiduciary duty claims of common stockholders."[50] This interpretation of the *Jedwab* rule limits the ability of preferred shareholders to claim breaches of fiduciary duty.

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[47] *See* MCG Capital Corp. v. Maginn, No. 4521-CC, 2010 WL 1782271, at *15 (Del. Ch. May 5, 2010) (stating that if preferred shareholders "share a right equally with the common shareholders the directors owe the preferred shareholders the same fiduciary duties they owe the common shareholders *with respect to those rights*." (citing *Jedwab*, 509 A.2d at 594)); *see also* Fletcher Int'l, Ltd. v. Ion Geophysical Corp., No. 5109-VCP, 2010 WL 1223782 (Del. Ch. Mar. 24, 2010).

[48] Eisenberg v. Chi. Milwaukee Corp., 537 A.2d 1051, 1062 (Del. Ch. 1987).

[49] Noelle M. Holladay, Note, *The Limited Fiduciary Duties Owed by Corporate Managers to Preferred Shareholders: A Need for Change*, 88 KY. L.J. 87, 96 (1999–2000).

[50] Amazon.com, Inc. v. Hoffman, No. 2239-VCN, 2009 WL 2031789, at *3 (Del. Ch. June 30, 2009).

Because directors owe equivalent fiduciary duties to both the common and the preferred shareholders, and because the interests of these two groups often conflict, there is a valid concern that a board of directors may act with favoritism when it must balance the interests of the two groups in its decision-making. If favoritism is a motivating factor in a corporate decision, the board seems more likely to favor the interests of the common shareholders because they have greater rights to vote for (or against) the directors in board elections. Moreover, board decisions favoring common shareholders are unlikely to be successfully challenged, as they are protected by the deferential standard of the business judgment rule.[51]

Recent court decisions have validated the theoretical concerns noted above. In *Kohl's v. Kenetech Corp.*, preferred shareholders brought suit against the corporation's directors for breach of fiduciary duty of loyalty stemming from the directors' failure to ensure that the preferred shareholders were paid their special distribution when the company neared insolvency.[52] The court found that because it was in the best interests of the common shareholders of the corporation to maximize the sale price of the corporation and therefore potentially retain some value for the common shareholders rather than to file for bankruptcy, the corporation's decisions were "reasonable in light of [the corporation's] situation and comported with the board's

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[51] *See* Holladay, *supra* note 49, at 102. When the interests of the preferred and common shareholders conflict, the directors' balancing of those interests is protected by a presumption of business judgment if the directors acted in good faith, on an informed basis, and with the belief that their decision was in the best interests of the corporation. So long as these factors are met, courts will not disturb the decision of a board in favoring common shareholders unless the preferred shareholders satisfy their burden of rebutting the business judgment presumption. See *supra* note 21 and accompanying text for further discussion of board favoritism for common shareholders.

[52] 791 A.2d 763, 765 (Del. Ch. 2000).

fiduciary duties towards its common shareholders."[53] Because the interests of the preferred and common shareholders conflicted, the board could not satisfy its fiduciary duties to both groups and was allowed to favor one group in order to fulfill its duties to the greatest extent possible. Although the preferred shareholders were owed fiduciary rights, they did not have a valid claim for violation of those rights when their interests conflicted with those of the common shareholders.

Furthermore, in considering whether, beyond these basic fiduciary rights, there existed any special fiduciary duty to preferred shareholders distinct from the duties to the common shareholders, the *Kenetech* court explained that while a preferred shareholder's rights are typically only those specified in the certificate of designation, the existing Delaware precedent "also supports the proposition that in so far as their interests are harmonious, preferred shareholders share with common shareholders the right to demand loyalty and care from the fiduciaries entrusted with managing the corporation."[54] Because the case at issue involved rights antagonistic to those of the common shareholders, the court concluded that no additional fiduciary duties were owed.[55]

Therefore, despite *Jedwab*'s apparent intent to extend the rights of preferred stockholders by affirming their fiduciary rights in situations where the rights are shared equally with the common shareholders, board favoritism for common shareholders combined with the business judgment rule's deferential protection for board decisions means that in practice, preferred shareholders seem to lack any true "equitable" rights and do not fully benefit from the fiduciary duties owed to them when their interests conflict with those of the common stockholders.

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[53] *Id.* at 771 (quoting Quadrangle Offshore (Cayman) LLC v. Kenetech Corp., No. 16362NC, 1999 WL 893575, at *8 (Del. Ch. Oct. 13, 1999)) (emphasis added by *Quadrangle* court omitted).

[54] *Id.*

[55] *Id.*

B. The Impact on Preferential Rights

When "preferential" rights are at issue, the duty owed to preferred shareholders under *Jedwab* is entirely defined by contract.[56] While a challenged transaction may often be classified as one of the type that invokes preferential rights, interpretation of the specific contract in question is required to determine whether or not the terms of that contract cover the particular facts at issue. According to Mitchell, the "paradox"[57] produced by the *Jedwab* framework when directors are put in a position of interpreting and thus establishing the terms of the contract essentially allows directors to determine the extent of their own fiduciary duties to preferred shareholders.[58] Courts will define a transaction as one that involves preferential rights whenever a possible preferential right is invoked, leaving preferred shareholders with no recourse but their contractual terms. However, once they are in "preferential rights" mode, the preferred shareholders cannot prevail on a horizontal conflict claim unless the particular situation in question is covered

[56] *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract."); see also Nemec v. Shrader, 991 A.2d 1120, 1129 (Del. 2010), for a recent decision reaffirming this rule.

[57] *See* Mitchell, *Puzzling Paradox, supra* note 1, at 445–49. For Mitchell, *Jedwab* creates a paradox in determining preferential rights of preferred stock. "To the extent that the directors interpret and define the contract, they very much determine the scope of their own fiduciary duties, a role traditionally . . . left to the courts." *Id.* at 449. Mitchell argues that *Jedwab* leaves unanswered the question of whether such director interpretation should be conducted at arm's-length or as fiduciaries. While Mitchell is a proponent of interpretation as fiduciaries (and the thesis of his paper is an argument for precisely this), he notes that case law reveals that courts have instead used an arm's-length analysis, permitting directors to interpret contractual terms more strictly and consequently leaving preferred shareholders with meaningless fiduciary rights. *See id.*

[58] *Id.* at 449.

under the literal terms of the contract, which courts interpret narrowly at arm's-length. The solely contractual preferential rights of preferred stockholders are thus very limited.

Just as post-*Jedwab* scholarly analysis suggested that this framework had the theoretical potential to lead to overly strict and opportunistic interpretation of the contractual rights at issue,[59] recently decided cases affirm those concerns in practice. For example, in *HB Korenvaes Investments v. Marriott Corp.*, preferred shareholders challenged a spin-off proposed by the Marriott board whereby a large dividend would be issued to the common shareholders and not to the preferred shareholders.[60] The preferred shareholders claimed that they should receive dividend rights because of their contractual preferential rights to dividends.[61] The court found that the preferred shareholders' contract governed the transaction (and thus the preferential rights analysis was invoked) because the right to receive dividends is generally a preferential right. However, the court further noted that the specific certificate in question should be interpreted narrowly. In so interpreting the certificate, the court found that though the certificate contemplated certain dividend distributions, the facts of the particular transaction at issue were not specifically contemplated by the contract and thus did not constitute breach of the contract's terms.[62]

A comparable situation occurred in *Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.*[63] In that case, preferred shareholders brought suit alleging that the corporation had violated their liquidation rights by favoring common shareholders in a liquidation-like transaction. Preferential rights were again invoked because liquidation rights are traditionally preferential. However, the court found that, "to the extent that the [preferred] shareholders enjoy liquidation

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[59] *See, e.g.*, Holladay, *supra* note 49, at 95; *see also* Mitchell, *Puzzling Paradox*, *supra* note 1, at 453.

[60] No. 12922, 1993 WL 257422, at *1 (Del. Ch. July 1, 1993).

[61] *Id.*

[62] *See id.* at *14–16.

[63] No. 16362NC, 1999 WL 893575 (Del. Ch. Oct. 13, 1999).

rights preferential to those of the common shareholders, those rights must be spelled out in the Certificate. 'Nothing is to be presumed in favor of the preferences attached to stock . . . .'"[64] Because the preferred stock certificate at issue did not expressly contain terms covering the particular type of liquidation proposed, the preferred shareholders' claim was denied.[65] More explicitly, the court found that the actions of the corporation did not fall within the precise meaning of "liquidation" as the term was used in the preferred stock certificate.[66]

Similarly, in *Elliott Associates, L.P. v. Avatex Corp.*, the court asserted that "[t]his Court's function is essentially one of contract interpretation against the background of Delaware precedent. . . . Any rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated . . . . [They] will not be presumed or implied."[67] This strong language advocating strict and literal interpretation of contractual language greatly limits the recourse of preferred shareholders when they do not think that they are getting the full benefit of their contractual bargain. These recent court decisions, among others, confirm the trend toward strict and opportunistic interpretation of the contractual rights of preferred stockholders that Mitchell and other scholars predicted years earlier.

A recently decided case further clarifies the Delaware view of preferential rights. In *LC Capital Master Fund, Ltd. v. James*, the court summarized the reasoning of *HB Korenvaes* and other cases:

> When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further

[64] *Id.* at *8 (quoting Rothschild Int'l Corp. v. Liggett Grp. Inc., 463 A.2d 642, 646 (Del. Ch. 1983)).

[65] *Id.* at *9–10.

[66] *Id.* at *12.

[67] 715 A.2d 843, 852–53 (Del. 1998).

> and extend some unspecified fiduciary beneficence on the preferred at the expense of the common.[68]

While the problems of strict interpretation of preferential rights were anticipated, recent judicial analysis of the *Jedwab* rule reveals a further undesirable consequence of *Jedwab* that has not yet been analyzed. This consequence, relating to the current *Jedwab* framework's treatment of preferential rights, stems from the notion that "fiduciary duty trumps contract."[69] Under this reasoning, even if the preferred stock certificate contains terms that directly address the disputed transaction, the board may still give preference to the common stockholders' fiduciary interests in certain situations where they conflict with the contractual interests of the preferred stockholders. For instance, in *In re Trados Inc. Shareholder Litigation*, a proposed merger agreement provided preferred shareholders with $57.9 million to satisfy their liquidation preference, with common shareholders receiving nothing.[70] When common shareholders brought suit alleging breach of fiduciary duty, the court had to determine the nature of the conflict. Because the preferred shareholders' liquidation preference was invoked, the case was classified into the "preferential rights" category of the *Jedwab* framework. Furthermore, because the preferred shareholder contract dealt with the situation in question, the terms of the contract were applicable to the questioned transaction even when read

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[68] 990 A.2d 435, 448–49 (Del. Ch. 2010).

[69] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 458. Fiduciary duty is a notion that stems from disparities in bargaining power and is governed by the bilateral standard of fairness. Because of its origins in situations of power disparity, fiduciary duty ensures that the fiduciary acts to the benefit of its beneficiary. Contractual good faith, on the other hand, is simultaneously a response to the bounded rationality in contract formation and a respect for individual autonomy in decision-making; therefore, the focus of contractual interpretation is protection of the terms that the parties intended to agree upon. If a fiduciary relationship exists, the self-sacrifice required of the fiduciary may defeat some of the fiduciary's own contractual expectations. In these situations, fiduciary duty trumps the terms of the contract. *See id.* at 457–58.

[70] No. 1512-CC, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009).

narrowly.[71] Thus, it seemed that the provisions of the contract would govern the rights of the preferred shareholders and that the proposed liquidation payment would be upheld.

The *In re Trados* court disagreed. Relying on newer interpretations of the *Jedwab* rule, the court held that even where the right claimed by the preferred is a preference against the common stock (i.e., a preferential right), it will generally be "the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights . . . of preferred stock, where there is a conflict."[72]

Therefore, where the interests of the common shareholders conflict with those of the preferred shareholders in "preferential" rights situations, it is possible that a director could breach her duty by favoring her contractual obligations to the interests of the preferred shareholders over her fiduciary obligations to the common shareholders. Consistent with the idea that fiduciary duty trumps contract, when a director owes a fiduciary duty to the common shareholders (she often will owe a duty to maximize shareholder value), this duty can trump contractual obligations to the preferred shareholders whenever the two obligations are in conflict. While this consequence is intuitive from the very notion that fiduciary duty trumps contract, the *In re Trados* decision is a concrete example of this hierarchy occurring in practice, and it illustrates the low probability that preferred shareholders will prevail in preferential rights situations.

Because the interests of the common shareholders will so often conflict with those of the preferred, the fiduciary duties that directors owe to the common shareholders will nearly always outweigh the contractual interests of the preferred. Not only does this appear to negate any contractual rights of

[71] *See id.* at *7.

[72] *Id.* (quoting Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997)).

the preferred shareholders, but it also creates a scenario in which preferred shareholders may in fact have more meaningful rights when their non-preferential equitable rights are invoked than when their preferential rights are invoked, thereby demonstrating yet another counterintuitive result of the *Jedwab* rule.

In summary, under the current framework, preferred shareholders have extremely limited rights and almost never prevail when, as is typically the case, their interests conflict with the interests of common shareholders. The "equitable" fiduciary rights of preferred shareholders are virtually meaningless when they conflict with common shareholders' interests, because a board is likely to favor the common's interest and can safely do so under deferential business judgment rule protection. Likewise, courts strictly interpret the contractual "preferential" rights of preferred shareholders to cover only a narrow, limited scope of activity. Furthermore, recent case law developments reveal a trend toward subordinating preferred shareholders' contractual preferential rights to the fiduciary duties owed to common shareholders when the interests of the two groups diverge. This lack of meaningful preferred shareholder rights in both equitable and preferential situations, previously explored in theory and now affirmed by recent case law developments, indicates that a revised framework for dealing with horizontal conflict situations is needed.

V. POSSIBLE SOLUTIONS TO THE LACK OF PREFERRED SHAREHOLDER RIGHTS

Preferred shareholders lack legitimate and meaningful rights in horizontal conflict situations, and the *Jedwab* solution has not ameliorated this problem. Although preferred shareholders can engage in self-help by diversifying their portfolio and relying on the specific contractual rights of their total portfolio rather than those of any particular preferred stock offering, this solution is unsatisfactory by itself because it simply addresses the problems of each individual preferred shareholder, rather than addressing the underlying problem of preferred stocks as a whole; namely, that although they occupy positions similar to and sometimes senior to common shareholders, the preferred shareholders nevertheless almost never prevail in situations of horizontal conflict.[73] A revised framework is necessary not only because the current lack of clarity creates uncertainty for investors and limits the rights of preferred shareholders, but also because the litigation costs stemming from the implementation of the *Jedwab* rule generate needless social waste. Several solutions outside of or in addition to the *Jedwab* framework have been proposed to address the dilemma of preferred shareholders. The recent Delaware court decisions discussed in Section III of this Note help illustrate the advantages and disadvantages of each of these proposals and provide a baseline for finding a new, functional solution.

A. The "A Contract is a Contract" View

A commonly proposed solution for the preferred shareholder dilemma is a reversion back to the pre-*Jedwab* notion of reliance solely on the contract, where the contract alone governs any and all of the rights of the preferred.[74] Proponents of this method praise the personal autonomy benefits that result when preferred shareholders are able to specify their preferences and are held to their own

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[73] Diversification theory is the notion that by spreading one's investments according to certain investment principles, overall risk in one's portfolio is reduced or even eliminated. A well-diversified portfolio reduces or eliminates "unsystematic risk": company-specific risk, such as that which stems from faulty management decisions, rather than risk related to the price volatility of entire securities markets. *See, e.g.*, Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721, 752 (1976). While this type of diversification would certainly lessen the blow to an individual investor if a corporate decision were to favor the common over the preferred, it does not satisfactorily address the problem that this Note focuses on—that preferred shareholders as a whole are systematically being denied their rights in favor of the interests of the common shareholders.

[74] *See, e.g.*, FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 93 (1991).

bargains.[75] When all preferences and limitations are determined by contract, relative rights among the parties are clear and fewer problems of informational asymmetry exist. Furthermore, although each of the individual preferred stockholders "may not have had an opportunity to bargain out the terms of the contract face to face, they have no obligation to buy preferred stock, the terms of which they dislike."[76] These various arguments provide support for the notion that "a contract is a contract" and that holding preferred shareholders to the terms of that contract alone will simplify and clarify the respective rights of common and preferred stockholders. While specifying the rights of the preferred shareholders clearly in the operative instrument may be easier said than done, contractual specificity in the governing certificate may help to avoid later litigation and may also prevent valuation disputes in the appraisal context.[77]

However, this proposed solution has been widely criticized. Early scholars' objections focused on the fact that the contractual terms of the preferred stock certificates are typically unilaterally drafted by the corporation prior to the issuance of the shares, eliminating any notion of truly autonomous action by the preferred shareholders.[78] Mitchell, on the other hand, critiques the contractual solution from a different angle. By referencing the baseline from which preferred rights begin, Mitchell argues that defining preferred stock rights as solely contractual ignores the reality that preferred shareholders are more similar to

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[75] *See id.*

[76] Mitchell, *Puzzling Paradox*, *supra* note 1, at 470.

[77] *See, e.g.*, *In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 902 n.25 (Del. Ch. 2009) (holding that preferred shareholders could not extract additional value for their shares through the appraisal process in the event of a merger that exceeded what the preferred stock certificate defined as their right because "[t]he rights of preferred holders, however, are clearly defined by the instrument (the certificate of designation) that created the security, and that instrument provides all the 'fair value' to which they are legally entitled in this appraisal.").

[78] *See* Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1973).

common shareholders than they are to creditors and other contractual claimants.[79] Because both groups hold ownership interests in the corporation, and because the corporation has no obligation to pay the preferred shareholders at all, their position as corporate participants is closely analogous to that of the common shareholders,[80] which suggests that fiduciary duty may be a more suitable vehicle for defining the rights of the preferred than strict contract interpretation.

In addition to these criticisms, the case law developments discussed in Section III of this Note demonstrate how the contractual argument fails in practice. Because courts have interpreted preferred stock certificates strictly,[81] the rights of preferred shareholders would be greatly reduced if only their contract governed. Moreover, *In re Trados* illustrates that fiduciary rights of the common shareholders can supersede even valid contractual rights of the preferred.[82] Therefore, if preferred shareholders could only rely on contractual rights, not only would courts interpret their contracts narrowly, but even the rights encompassed within that narrow interpretation would be subject to displacement by common shareholder rights when they conflicted.

Finally, reverting back to a framework that extinguishes any fiduciary or equitable rights of the preferred, while keeping the preferential rights unchanged, serves only to take some of the current rights of preferred shareholders away without adding any rights, and therefore does not strengthen their position. While this solution would contribute an additional degree of certainty to the horizontal conflict system, such certainty would come at the expense of increased investor vulnerability and would result in even fewer rights for preferred shareholders. This tradeoff, combined with the critiques of Mitchell and earlier scholars, illustrates that the "a contract is a contract" solution is not

[79] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 472.

[80] *See supra* note 19 and accompanying text.

[81] *See supra* Section IV.A–B.

[82] No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

an ideal method for resolving horizontal conflicts between common and preferred shareholders, particularly if increased preferred shareholder rights is a goal.

B. Solutions Involving Expanded Contractual Interpretation

Mitchell suggests that a duty could be imposed on directors, consistent with the rest of corporate law, to provide preferred shareholders with meaningful fiduciary rights by incorporating a fairness notion into directors' decision-making.[83] By prohibiting directors from harming the interests of preferred stockholders for the benefit of the common unless the decision is motivated by legitimate business reasons, Mitchell's solution would probably not have altered the results of recent court decisions. For example, by reference to the *Kenetech* decision, a corporation could easily argue that wealth maximization and a desire for some degree of self-continuation through sale of the corporation is a legitimate business motivation where the alternative is filing for bankruptcy.[84] So long as corporate directors could muster up some plausible business reason for their action, the incidental harm to the preferred shareholders would be allowed.

There may be more merit, however, in what Mitchell suggests as an "interim solution" for preferred shareholders, namely, the inclusion of a broad covenant in their stock contracts in order to protect their expectations.[85] While Mitchell only touches on this notion briefly, it is promising because it can be used as a means of incorporating fiduciary rights to expand the traditional scope of contract interpretation. Because contractual rights alone are insufficient to guarantee meaningful rights for preferred shareholders in horizontal conflict situations, some fiduciary rights are necessary. The inclusion of a broad covenant that precludes the corporation from behaving in a manner that

[83] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 474.

[84] *See supra* notes 52–54 and accompanying text.

[85] *See* Mitchell, *Puzzling Paradox*, *supra* note 1, at 476.

defeats the preferred shareholders' legitimate fiduciary expectations would require that those contracts be interpreted more expansively, with directors acting as fiduciaries to the preferred shareholders rather than at arm's-length. Such a covenant would thus serve to discourage both opportunistic behavior by the corporate directors and narrow interpretation by courts. No longer could a corporation or court strictly construe contractual terms against the preferred shareholders, as in the *Quadrangle*, *Avatex*, or *In re Trados* decisions. Rather, this solution would require a broader and thus more preferred-shareholder-friendly interpretation.

A covenant encompassing fiduciary duties for the preferred shareholders would simply prohibit a corporation from acting in a way that reduces the value of preferred stock or infringes on their rights solely for the gain of the common shareholders in a type of wealth transfer. This solution parallels the close corporation context, as minority shareholders in close corporations occupy a similar position relative to majority shareholders as preferred shareholders do relative to the common. Like preferred shareholders, minority shareholders are stock owners and therefore enjoy the benefits inherent in stock ownership. However, in spite of this ownership interest, minority shareholders of close corporations still occupy a vulnerable position because the dominance of the majority shareholder means that the minority lack meaningful voting rights, just like preferred shareholders. Furthermore, the fact that preferred stock is most commonly issued by private corporations strengthens the comparison between the two groups, because the lack of a large or public market for the shares of both minority shareholders and preferred shareholders increases their vulnerability to their respective dominant parties: the controlling shareholder and the common shareholders. While these situational similarities and comparable problems of horizontal conflict between minority shareholders and preferred shareholders have been previously noted,[86] no attempts have yet been made to use the close corporation setting as a guide for developing a solution to the horizontal conflict problem of preferred shareholders.

In the close corporation context, where minority shareholder rights are closely scrutinized, the Delaware Supreme Court's solution, in *Nixon v. Blackwell*, was to specify that minority shareholders do not get the benefit of special, extra-contractual protections unless they specifically contract for them ex ante.[87] The *Nixon* court thus took the strong view that minority shareholders in close corporations are not owed fiduciary duties or any other special protections unless they specifically contract for them up front.[88] Applying the same reasoning to the preferred shareholders' situation, perhaps the best way to assure fiduciary or other protection for the preferred is to require that such protection be included in their stock certificates.

Despite the benefits of giving preferred shareholders both fiduciary rights and contractual rights that become meaningful due to more lenient interpretation, two arguments can be made against this solution. First, one could argue that that the inclusion of such a broad covenant in the preferred stock contract could cause directors to violate their fiduciary duties to common shareholders. However, directors owe the same fiduciary duties to both common and preferred shareholders, and the adoption of a similar solution in the comparable close corporation context indicates that this practice accords with existing corporate norms and is likely to be accepted by the courts. Moreover, this type of covenant would only forestall those types of transactions that amount to wealth transfers from preferred to common shareholders, and thus would not prohibit a corporation from engaging in a transaction that is truly wealth creating or socially optimal. Some courts, such as the

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[86] *See, e.g.*, Holladay, *supra* note 49, at 91 (stating that horizontal conflict is "also a problem between majority shareholders and minority shareholders" and identifying similarities between the two groups).

[87] 626 A.2d 1366, 1377, 1380 (Del. 1993).

[88] *See id.*

In re Trados court, that held that explicit contractual rights of the preferred do not trump the fiduciary rights of the common may be reluctant to accept this solution. But the fact that the contractual rights at issue here would be fiduciary in nature, and that similar solutions have been accepted in analogous settings, suggest that they, too, may accept this solution.

A second argument against this solution is that because the corporate issuer drafts its own preferred stock certificates unilaterally,[89] it seems doubtful that such a provision would ever realistically be included within the preferred shareholder contracts. Even coordinated preferred shareholder bargaining for inclusion of such a provision seems unlikely to succeed, as the corporation could always resist, and preferred shareholders would neither be entitled nor obligated to purchase the stock under the given terms. While it is true that directors may be hesitant to reject a covenant that only precludes direct wealth transfers in order to avoid the implication that they are not acting in good faith, the possible inclusion of such a covenant carries with it a problem of increased uncertainty about investor rights. Regardless, this solution is nevertheless promising given that it overcomes the limitations of narrow contractual interpretation.

Another potential solution to the *Jedwab* dilemma would likewise overcome the limitations of narrow contract interpretation while also addressing the issue of the unilateral drafting of preferred stock certificates. This solution is for courts to use contract interpretation methods analogous to those utilized in the bond setting by imposing an implied covenant of good faith rather than fiduciary duties. In other words, in order to limit the board's traditionally strict interpretation of express contract terms, an implied covenant of good faith could be read into the

[89] *See supra* note 78 and accompanying text.

contract, as is done with certain bond indentures.[90] This solution gives preferred shareholders meaningful rights in horizontal conflict situations outside of the fiduciary duty context, by precluding the directors from taking actions that deprive the preferred shareholders of the expected benefits of their bargain. If courts, in their interpretation of preferred shareholder contracts, read those contracts to include an implied covenant of good faith, it would then be acceptable for preferred shareholders to rely solely on their contractual rights because the contracts would no longer be read as strictly. The reality is that preferred shareholders, like bondholders, are often in positions where their contractual terms are their only true rights. Because the terms of those contracts are unilaterally drafted and inherently limited by bounded rationality, courts should interpret those contractual terms in favor of preferred shareholders and impose good faith standards on corporate directors in their application of those rights.

The Delaware courts have recognized this potential solution in a small number of cases. In *Gale v. Bershad*, the court read an implied covenant of good faith into the "fair value" terms of a preferred stockholder contract and thus extended the express language beyond its strict terms and in favor of preferred shareholder rights.[91] The plaintiffs' preferred stock contract stated that in the event of preferred stock redemption, preferred shareholders were entitled to a fair value for their shares. However, in the same certificate, "fair value" was simply defined as the value that the defendant-board calculated based on its own valuation methodology.[92] Consequently, the amount calculated by the board in this instance was unreasonably and unfairly low. Because the implication within the notion of "fair value" was that the board's ultimate calculation should in fact be fair, the court read an implied covenant of good faith into its

[90] *See, e.g.*, 6A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2748 (perm. ed., rev. vol. 2009).

[91] No. 15714, 1998 WL 118022, at *4 (Del. Ch. Mar. 4, 1998).

[92] *See id.*

interpretation of the stock certificate and held that, despite the express contractual language to the contrary, the good faith interpretation of fair value meant that the value should be fair in actuality. The court therefore rejected the board's calculation.[93] By reading in an implied covenant of good faith, the court thus extended the express language of the contract beyond its strict terms and in favor of the preferred shareholder rights.[94] By constraining the discretion of the board to act against the interests of the preferred shareholders, the *Gale* court successfully provided preferred shareholders with meaningful rights that extended beyond their strict contractual terms, in stark contrast to *In re Trados* and other decisions where such contracts were strictly construed, thus limiting preferred shareholder rights.

Similarly, in *Winston v. Mandor*, the court noted that good faith is elementary in contract law, and thus "the corporation, like any contracting party, must interpret and apply the applicable provisions in the certificate in good faith."[95] Despite relying solely on the contractual preferential rights of preferred shareholders, the *Gale* and *Winston* decisions nevertheless provide the preferred shareholders with meaningful rights by extending the scope of contract interpretation and imposing implied good faith standards. Furthermore, unlike Mitchell's interim proposal of inclusion of a covenant providing for fiduciary rights in the preferred stock certificate, this solution addresses the issue of unilateral contractual drafting by interpreting ambiguous or limited terms against the corporation drafter and in favor of the preferred shareholders.

This solution would especially benefit preferred shareholders in situations where courts have strictly construed contractual terms against preferred shareholders, such as in the *Quadrangle* or *Avatex* cases.[96] For example, if

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[93] *Id.*

[94] *Id.*

[95] 710 A.2d 835, 836 (Del. Ch. 1997).

[96] *See supra* Section IV.B.

the *Quadrangle* court had instead operated under the assumption that an implied covenant of good faith and fair dealing must be applied in its interpretation of the stock certificate, the preferred shareholders would likely have been more successful. In *Quadrangle*, preferred shareholders were denied liquidation rights because the particular actions taken by the corporation were not the same as the precise actions spelled out in the definition of "liquidation" in their preferred stock certificate, and the court held that any preferred liquidation rights senior to the rights of the common shareholders needed to be spelled out explicitly in the certificate.[97] This was the case even though the corporation at issue was undergoing what would traditionally be classified as liquidation.[98] If, instead, the *Quadrangle* court had implied a *Gale*-like covenant of good faith in its interpretation of the preferred stock certificate, it is very likely that the court would have found that the certificate intended to cover all corporate events that would traditionally be classified as liquidation, as is typical for preferred stock contracts. As in *Gale*, the *Quadrangle* court could have read in an implied covenant of good faith to extend the express language of the contract beyond its strict terms and in favor of the preferred shareholder. Due to the presence of the liquidation clause and the clear intent of its terms, the court almost certainly would have read such a covenant in if presented with the option. Therefore, the events in *Quadrangle* likely would have been deemed covered by the preferred stock certificate under the liquidation clause, and the preferred shareholders would have received liquidation rights.

This solution is preferable to the actual result in *Quadrangle* because it more clearly and accurately reflects the intentions of the parties and the implications of the contractual language,[99] and because it does not penalize

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[97] *See* Quadrangle Offshore (Cayman) LLC v. Kenetech Corp., No. 16362NC, 1999 WL 893575, at *13 (Del. Ch. Oct. 13, 1997).

[98] *See id.*

[99] *See Gale*, 1998 WL 118022, at *3–4 (discussing how the imposition of the implied covenant of good faith into the interpretation of the

preferred shareholders for contractual language that is inherently limited and cannot possibly address every potential fact scenario.[100] Furthermore, such a covenant would prevent directors or common shareholders, who typically occupy more influential positions in the corporation, from using their relative positions of power to construe vague contractual language against the already more vulnerable preferred shareholders or to act in opportunistic ways that avoid falling under those strict contractual terms. Finally, imposing an implied covenant of good faith on contractual interpretation is particularly preferable in situations such as *Quadrangle*, where the contractual right at issue is one that is a typical preferred shareholder right, like a dividend or liquidation preference, where it is likely that most affected parties would have or at least should have assumed that the full extent of the related rights already rested with the preferred.

While courts may be reluctant to follow the lead of *Gale* and *Winston* in imposing implied good faith standards to the contractual interpretation of preferential rights, this may be the most promising solution to the *Jedwab* dilemma because it addresses the issue of unilateral drafting of preferred stock certificates and has been successfully applied by some courts. Nonetheless, this solution is not without flaws. One concern is that it may remove some certainty from the horizontal conflict system. Because stock certificates would no longer be strictly construed according to their precise terms, the extent of the preferred shareholders' rights—and the residual common shareholder rights—may not be as straightforward. This could create increased uncertainty about investor rights and potentially lead to more litigation. However, because this approach only extends contractual

preferred stock certificate language, as compared to a strict reading, both reflects the common sense meaning of the terms and better aligns with what the parties likely intended).

[100] This is the reason that implied covenants of good faith are imposed in the interpretation of bond indentures. *See, e.g.*, 6A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2748 (perm. ed., rev. vol. 2009).

language to the extent necessary to ensure good faith and to overcome the inherent limits of drafting, and because it more accurately reflects the true intentions and expectations of the parties, it could be argued that this solution in fact creates more certainty.

An additional concern with this solution is that for courts like the *In re Trados* court, which have held that even express contractual rights of the preferred do not trump the fiduciary rights of the common, this solution may have no effect. Because an implied covenant of good faith would only serve to align the contractual language with the transaction at issue, thus giving the preferred shareholders express contractual rights, fiduciary duties of the common could still override these rights and make them meaningless. At this time, it is difficult to know how such a court would interpret an implied covenant of good faith, particularly because the *In re Trados* decision is a very recent decision that extends the existing framework, and it has not yet been either replicated or overturned. It is possible, though, that the success of such a covenant in *Gale*, combined with the many benefits of this solution, would lead to its adoption in many courts. Still, the possibility exists that a court could override these contractual rights with the fiduciary rights of the common. In such a case, combining this implied covenant interpretation with Mitchell's interim solution of contracting for fiduciary duties may be a potential means of ensuring greater preferred shareholder protection. Overall, in light of the advantages that this solution provides over other proposals, particularly its promotion of legitimate investor expectations and its handling of the problem of unilateral stock certificate drafting, the imposition of implied covenants of good faith in courts' interpretation of preferred stock certificates is the most promising solution to the horizontal conflicts between preferred and common shareholders.

C. The Special Committees Solution

A final possible solution to the *Jedwab* dilemma involves the creation of special committees to represent each of the different classes of stock during certain corporate transactions. In *LC Capital*, for example, the preferred shareholders challenged the allocation of the corporation's merger consideration between common and preferred shareholders because the allocation decision was made by a single special committee of independent company directors, where every member of the special committee owned common stock, including one member who owned over five million dollars worth of common stock.[101] The preferred shareholders argued that such directors could not fairly balance the interests of the preferred against their personal interest in maximizing the value of the common stock. An implied argument here is that the board could have "charged certain directors with representing the preferred, and enabled them to retain qualified legal and financial advisors to argue for the preferred and to value the preferred . . . ."[102]

However, the *LC Capital* court rejected the preferred shareholders' argument in that case, because there was an objective contractual basis to determine whether the committee fairly allocated merger consideration between common and preferred shareholders, such that additional committees representing the preferred would be unnecessary.[103] Notably, this holding leaves open the question of whether such committees would be useful in situations where no contractual terms govern corporate decision-making or the allocation of the proceeds of a particular transaction between common and preferred shareholders. Because of its ability to give the preferred shareholders a unified voice and to counteract personal interests of directors who own common stock, the special committees solution is a promising one that companies could consider to mitigate conflicts and deter litigation.

In summary, the "a contract is a contract" view is an unsatisfactory solution to the *Jedwab* dilemma because of the narrow interpretation of preferred stock contracts as

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[101] *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 445 (Del. Ch. 2010).

[102] *Id.*

[103] *See id.* at 446–47.

illustrated by modern court decisions. However, the interpretation of those contracts could be expanded in two ways. First, preferred shareholders could contract for broad fiduciary provisions ensuring that their legitimate expectations are met. While this solution expands the scope of contract interpretation and provides fiduciary rights that typically trump contractual rights, the unilateral drafting of preferred stock certificates by the corporate issuers limits any realistic expectation that this solution would be adopted in practice. Alternatively, by following the lead of the *Gale* and *Winston* decisions and reading an implied covenant of good faith into the contracts, courts could transform the previously subordinated preferential rights of preferred shareholders into meaningful rights in horizontal conflict situations by interpreting these contracts in a manner that favors preferred shareholders over corporate drafters. Finally, the *Jedwab* dilemma could also be mitigated by the creation of two special committees, one representing the common shareholders and the other representing the preferred, to steer the process of corporate decision-making and the allocation of distributions from certain transactions.

VI. CONCLUSION

The *Jedwab* rule established a new framework for determining the rights of preferred shareholders in situations of horizontal conflict with the common shareholders: when the "preferential" rights of preferred shareholders to dividends and distributions are invoked, the contractual terms of the preferred stock certificate strictly govern, whereas when the "equitable rights" shared equally with the common shareholders are invoked, preferred shareholders are entitled to the same fiduciary duties as common shareholders. While this framework clarifies the respective rights of common and preferred stock, application of the rule in practice has caused preferred shareholder rights to border on worthlessness.

Recent case law developments confirm that, just as scholarly analysis of the *Jedwab* rule predicted, the equitable rights of preferred shareholders are subordinated to the fiduciary rights owed to common shareholders when the interests of the two groups conflict. Modern court decisions also illustrate how the preferential rights of preferred shareholders are greatly limited by strict contractual interpretation. However, restrictions on preferential rights have extended far beyond expectations in more recent cases such as *In re Trados*, which have held that even those contractual rights that fall within the narrow scope of interpretation can be subordinated to the fiduciary interests of the common shareholders in situations of horizontal conflict. These decisions demonstrate that in practice, the *Jedwab* rule provides very few meaningful rights to preferred shareholders. Therefore, despite the *Jedwab* court's intention to clarify shareholder rights and provide preferred shareholders with means of enforcement, the case law applying the *Jedwab* framework illustrates that this goal was not met.

To adequately provide preferred shareholders with meaningful rights while avoiding reliance on self-help portfolio diversification, courts will have to read the contractual terms of the preferred stock certificates in a more expansive way. This can be achieved in one of two ways. First, the preferred shareholders can contract for a covenant in their stock certificates that sets out the fiduciary duties they are owed. If, however, this ex ante contracting proves ineffective, courts can follow the lead of the *Gale* and *Winston* decisions and treat preferred stock certificates as contracts warranting the imposition of an implied covenant of good faith and fair dealing. This would allow courts to interpret ambiguous or limited contractual terms against the corporate drafter and in favor of the preferred shareholders. A final way to provide preferred shareholders with more meaningful rights would be for companies to assign a special committee representing the preferred shareholders during certain transactions and allocations.

In light of their vulnerable position in the corporation due to limited voting rights and unequal bargaining power against the corporate managers who draft their stock certificates, it is important that preferred shareholders be provided with meaningful rights. This is particularly true due to the frequency with which preferred shareholder interests will conflict with the interests of the common shareholders who compete for the same corporate resources. Because the *Jedwab* rule has proven to be insufficient to protect their interests in these horizontal conflict situations, preferred shareholders must take steps to expand the scope of interpretation of their stock certificates by contracting for fiduciary rights and arguing for an implied covenant of good faith or special committees. Such steps could provide increased protection for this vulnerable and often overlooked corporate constituency.