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NOTES

The Limited Fiduciary Duties Owed by Corporate Managers to Preferred Shareholders: A Need for Change

BY NOELLE M. HOLLADAY

INTRODUCTION

It is well established that corporate managers owe fiduciary duties to shareholders. Therefore, because preferred shareholders are shareholders of the corporation, the officers and directors of a corporation have a duty to maximize wealth for both common shareholders and preferred shareholders. Managers can enhance the value of shareholders’ stock by either increasing corporate value or reallocating wealth among the corporation’s constituencies. To the extent that managers

* J.D. expected 2000, University of Kentucky The topic of this Note was suggested by Rutheford B Campbell, Jr., Willburt D. Ham Professor of Law, University of Kentucky College of Law.


3 See Rutheford B Campbell, Jr., A Positive Analysis of the Common Law of Corporate Fiduciary Duties, 84 KY. L.J. 455, 469 (1996) [hereinafter Campbell, A Positive Analysis].

4 See id. at 460.
maximize wealth by transferring value from preferred shareholders to common shareholders, a "horizontal conflict" exists among these two groups. However, by contractually agreeing to the terms of preferred stock, preferred shareholders may be viewed as having opted out of their rights to fiduciary duties associated with these terms. Various methods to deal with the conflict between preferred shareholders and common shareholders (and the significance of the "opt-out issue") are proposed by commentators. This Note examines the rule adopted by courts and the various methods proposed to fairly address the rights of all parties and provide preferred shareholders with meaningful protection in situations of horizontal conflict.

Part I describes the vulnerable nature of preferred stock and the fiduciary duties owed by corporate managers to preferred shareholders. Part II discusses the horizontal conflict that exists between preferred shareholders and common shareholders where the managers' method of maximizing shareholder wealth is to transfer wealth from one group to another (and which is worsened by the differing goals of the preferred shareholders and the common shareholders). Part III explains the opt-out issue through the examples of redemption of preferred stock and old dividend credit cases, and discusses various opinions on the significance which should be placed on the opt-out issue.

Part IV of this Note describes the method used by courts in dealing with the horizontal conflict between the preferred shareholders and the common shareholders and the related opt-out issue. Despite the fact that preferred shareholders occupy a vulnerable position in relation to the corporation, the rule used by courts affords them little protection. The

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5 A "horizontal conflict" exists in a corporation when one corporate constituency's gains result in another corporate constituency's losses. See infra notes 29-32 and accompanying text.

6 See Mitchell, supra note 2, at 446. Mitchell notes that a conflict exists where advantages to one corporate constituency come at the expense of another constituency. See id.

7 See Campbell, A Positive Analysis, supra note 3, at 494-95 (illustrating the opt-out issue through the example of a redemption of preferred stock); infra notes 37-39 and accompanying text.

8 See infra notes 14-28 and accompanying text.

9 See infra notes 29-36 and accompanying text:

10 See infra notes 37-62 and accompanying text.

11 See infra notes 63-123 and accompanying text.
Jedwab rule\textsuperscript{12} provides that preferred shareholders are entitled to fiduciary protection for only those rights that are common to all shareholders. All other rights are deemed "preferred" and are governed by the corporate contract from which they originated. In addition, courts will judge whether a breach has occurred in cases of preferred rights by strictly construing the contract in favor of the corporate drafter, not the preferred shareholders.

Part V examines the various methods proposed by commentators to deal with the conflict between the preferred shareholders and the common shareholders, as well as the significance of the opt-out issue in cases of such conflict.\textsuperscript{13} Most of the proposed methods agree that preferred shareholders should be provided with more meaningful protection than what is currently afforded by the Jedwab rule. The new rule recommended by this Note builds on these proposed methods and provides preferred shareholders with meaningful protection in situations of horizontal conflict while also fairly addressing the rights of the common shareholders and the corporation.

I. THE NATURE OF PREFERRED STOCK AND FIDUCIARY DUTIES

Preferred shareholders, like common shareholders, have an ownership interest in the corporation and are therefore recognized as a corporate constituency.\textsuperscript{14} However, preferred shareholders are distinct from common shareholders in that they have additional contractual rights which attach by way of the corporate charter.\textsuperscript{15} These contractual rights, often called "preferred rights" or "preferences," include: (1) the priority over common shareholders in the right to receive dividends and (2) the priority in the right to receive distributions in the event of the liquidation of the corporation.\textsuperscript{16} Despite these preferences, preferred shareholders are a vulnerable corporate constituency because they cannot vote\textsuperscript{17} and because directors favor common shareholders, the group responsible for their election to the board.\textsuperscript{18}

\textsuperscript{12} See infra notes 53-54 and accompanying text.
\textsuperscript{13} See infra notes 124-37 and accompanying text.
\textsuperscript{14} See Mitchell, supra note 2, at 445.
\textsuperscript{15} See id. at 446; Barrett, supra note 1, at 260.
\textsuperscript{16} See Mitchell, supra note 2, at 446.
\textsuperscript{17} This Note assumes the existence of nonparticipating preferred stock.
\textsuperscript{18} See Rutheford B Campbell, Jr., Voluntary Recapitalizations, Fairness, and Rule 10b-5: Life Along the Trail of Santa Fe, 66 KY. LJ. 267, 270 (1977)
in the corporation, Professor Lawrence Mitchell states, "[A]ll is not well jurisprudentially with preferred stock. . . . [T]he position of the preferred shareholder in the corporate firmament, fiduciary rhetoric notwithstanding, is more vulnerable than any other financial participant." 19

Corporate managers 20 owe fiduciary duties to shareholders to the exclusion of other corporate constituencies. 21 Since preferred shareholders are shareholders of a corporation, 22 managers owe fiduciary duties to both common shareholders and preferred shareholders. 23 A manager’s fiduciary duty to shareholders is measured by the duties of loyalty and care 24 and includes an obligation to maximize shareholder wealth. 25 Shareholder wealth can be maximized in one of two ways. First, managers can increase the overall value of the corporation and allocate this wealth among shareholders accordingly. Second, wealth can be expropriated from one group and reallocated among other groups in the corporation. 26

To the extent that managers attempt to maximize shareholder wealth by transferring wealth from preferred shareholders to common shareholders and vice versa, a horizontal conflict exists between these two groups. 27 However, as will be discussed below, preferred shareholders may consent to wealth transfers to the degree that such terms are agreed upon contractually at the time of investment. Therefore, preferred shareholders may be viewed as having opted out of any fiduciary rights associated with an expropriation of wealth from one group for the sole purpose of transferring wealth to another corporate constituency. 28

[hereinafter Campbell, Voluntary Recapitalizations].

19 Mitchell, supra note 2, at 443-44.
20 The term “corporate managers” will be used in this Note to refer to both officers and directors of a corporation.
21 See Barrett, supra note 1, at 259-60.
22 See Mitchell, supra note 2, at 445.
23 See Campbell, Corporate Fiduciary Principles, supra note 1, at 577.
25 See Campbell, A Positive Analysis, supra note 3, at 469 (explaining that the maximization of shareholder wealth can be accomplished if managers engage in all transactions which move shareholders to “Pareto superior states,” in which no shareholder is made worse off and at least one shareholder is made better off).
26 See id.
27 See Mitchell, supra note 2, at 446.
28 See Campbell, A Positive Analysis, supra note 3, at 494-95.
II. THE CONFLICT BETWEEN PREFERRED SHAREHOLDERS AND COMMON SHAREHOLDERS

As discussed previously, a horizontal conflict exists between common shareholders and preferred shareholders because managers can maximize shareholder wealth by reallocating wealth at the expense of one group, often the preferred shareholders.\(^2\) In addition, because shareholder returns are a fixed sum game (inasmuch as one gains while the other loses), transfers to preferred shareholders come at the expense of the common shareholders, which results in an inherent conflict among the two groups.\(^3\)

The conflict between preferred shareholders and common shareholders is also apparent in the differing goals of the two constituencies. While common shareholders benefit mainly from an appreciation in stock price, preferred shareholders realize their gain from fixed dividends and "receive little benefit from improved corporate performance."\(^5\) This horizontal conflict between corporate constituencies is not unique to common shareholders and preferred shareholders; it is also a problem between majority shareholders and minority shareholders.\(^3\)

The conflict involving preferred shareholders and common shareholders can be illustrated by the example of a corporate recapitalization.

In a recapitalization, preferred rights are often changed in a way that benefits common shareholders to the detriment of preferred shareholders, thus resulting in a horizontal conflict. A recapitalization plan must be proposed by a board of directors,\(^3\) which is usually elected by common shareholders. Professor Campbell describes the conflict resulting from this situation as follows: "[W]hen managers facilitate such recapitalizations, 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 that they are treated unfairly..."\(^5\)

Although courts in past cases were "ineffective" in dealing with this

\(^2\) See Mitchell, \textit{supra} note 2, at 446.

\(^3\) See id.

\(^5\) Id. at 451.

\(^5\) See Campbell, \textit{A Positive Analysis, supra} note 3, at 478 (discussing the conflict between the majority shareholders and the minority shareholders in the context of an affiliated merger).

\(^5\) See id. at 475.

\(^5\) Id. at 477.
conflict, modern cases hold that managers' actions in recapitalizations must not amount to constructive fraud.

III. THE PREFERRED SHAREHOLDER CONTRACT AND THE OPT-OUT ISSUE

Managers owe fiduciary duties to preferred shareholders. However, these duties may be waived in part to the extent that preferred shareholders opt out of their rights by agreeing to the terms of their preferences as stated in the corporate charter. The "opt-out issue" is explained below through the examples of a redemption by a corporation of preferred stock and the old dividend credit cases.

Redeemable preferred stock may be called at the option of the corporation to prevent preferred shareholders from realizing gains of an appreciated stock price, a benefit normally associated with falling interest rates. However, preferred shareholders do not claim, and a court would not hold, that a fiduciary duty has been breached in this situation because preferred shareholders are viewed as having contracted for this risk. In other words, preferred shareholders agree to take on the risk of redemption in exchange for favorable price terms and other preferences. Therefore, courts will uphold corporate redemption of preferred shares since preferred shareholders opted out of their right to challenge such transactions on fiduciary duty grounds.

The opt-out issue is also apparent in the holdings of the old dividend credit cases. In these cases, preferred shareholders argued that directors had breached their fiduciary duties in failing to pay preferred shareholders their non-cumulative dividends. However, courts refused to find a breach

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35 See Campbell, Voluntary Recapitalizations, supra note 18, at 300.
36 See Campbell, A Positive Analysis, supra note 3, at 477.
37 See supra notes 23-24 and accompanying text.
38 See Campbell, A Positive Analysis, supra note 3, at 494-95.
39 See id. at 494.
40 See id. at 495.
41 See id. (noting that preferred shareholders are "paid to take the risk of redemption").
43 See id.
of fiduciary duty in these cases because this refusal to pay past dividends was permitted by the corporate charter and was thus bargained for in advance by the parties.44 The rule developed from these cases was that once the preferred shareholder plaintiffs met their burden of showing that managers’ actions had caused the value of their stock to decline, the burden was on management to demonstrate that the shareholders had consented to this action.45 In other words, preferred shareholders could generally only prevail in dividend credit cases if there was no showing that the shareholders had contractually opted out of their fiduciary rights to claim dividends. Nonetheless, the rule “provides an incentive to better bargaining”46 in that it “will encourage the corporation to draft clear language regarding the rights of preferred stockholders to dividends and to call these terms to the attention of preferred stockholders.”47

There are differing views as to the significance of the opt-out issue in transactions in which managers’ actions negatively affect the rights of preferred shareholders. “Contractarians” advocate that shareholders and managers should be able to determine all of their respective rights and duties contractually, not by imposing mandatory fiduciary duties on their relationship.48 Contractarians support their case by citing the economic benefits of freedom of contract and personal autonomy.49 Those who support the imposition of mandatory fiduciary duties are concerned about transactions resulting from the horizontal conflict between preferred shareholders and common shareholders in which wealth is expropriated from the preferreds to benefit the commons. For example, Professor Campbell opposes the Contractarians’ position and argues that contractual rights do not adequately address all of the problems caused to preferred shareholders because of this inherent conflict.50 Instead, Campbell argues that fiduciary duties should be imposed for two reasons. First, mandatory fiduciary duties are necessary to protect preferred shareholders in instances where these investors are harmed by risks that were not bargained for contractually. For example, preferred shareholders need fiduciary pro-

44 See id. at 497.
45 See Campbell, Corporate Fiduciary Principles, supra note 1, at 619.
46 Id. at 620.
47 Id.
48 See id. at 562.
49 See id. at 565-67.
50 See id. at 623. Professor Campbell argues against a Contractarian world where “greed” is a virtue and in favor of fiduciary principles that recognize the societal values of “grace and kindness.” Id.
tection in situations where common shareholders receive unfair compensation in a corporate recapitalization. Second, mandatory fiduciary duties are supported by the societal value placed on Pareto\(^5\) superior moves by corporations in which no shareholder is made worse off and at least one shareholder is made better off.\(^2\)

The courts generally seem to agree with Professor Campbell. The ground-breaking case of *Jedwab v. MGM Grand Hotels, Inc.*\(^3\) established the following general rule:

> [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 the contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.\(^4\)

Therefore, under the *Jedwab* rule, a preferred stockholder’s preferred rights are protected only contractually while the rights that a preferred stockholder shares with common stockholders are governed by fiduciary duties. The opt-out issue is thus important under the *Jedwab* rule only in situations where a preferred shareholder claims injury in relation to a preferred right.

Professor Mitchell finds fault with this rule.\(^5\) Mitchell states that analysis under the *Jedwab* rule first requires one to determine whether a right is preferred, and thus contractual, or inherent in common stock ownership, and thus fiduciary.\(^6\) This, he states, creates a “paradox” in which directors are required to interpret the terms of the contract in order to determine the scope of their own fiduciary duties to preferred shareholders.\(^7\) Thus, instead of mandating a duty of care owed by corporate

\(\footnote{51}{\textit{See supra} note 25.}\)
\(\footnote{52}{\textit{See Campbell, Corporate Fiduciary Principles}, \textit{supra} note 1, at 569-72; Campbell, \textit{A Positive Analysis}, \textit{supra} note 3, at 469.}\)
\(\footnote{53}{\textit{Jedwab v. MGM Grand Hotels, Inc.}, 509 A.2d 584 (Del. Ch. 1986).}\)
\(\footnote{54}{\textit{Id.} at 594.}\)
\(\footnote{55}{\textit{See Mitchell, \textit{supra} note 2, at 443-44} (stating that “all is not well jurisprudentially with preferred stock” and “the position of the preferred stockholder . . . is more vulnerable than any other financial participant”).}\)
\(\footnote{56}{\textit{See id.} at 448.}\)
\(\footnote{57}{\textit{See id.}}\)
managers to preferred shareholders, courts have allowed managers to define the duty themselves. Therefore, Mitchell, like Campbell, argues that "the answer should be to give preferred stockholders some meaningful fiduciary rights."\(^{58}\) Furthermore, since the equity in preferred stock exists prior to the preferences, "fiduciary duty trumps contract,"\(^{59}\) and the real question in these cases should be whether the transaction is fair, not whether the right is based in contract or on basic stock ownership. Therefore, according to Mitchell, fiduciary rights are superior to contractual rights and the opt-out issue should be left to the courts, not the directors.\(^{60}\) In other words, directors should not be permitted to strictly construe the preferred rights in the contract, as would a party in an arms-length transaction with preferred shareholders. Instead, Mitchell argues, directors, as fiduciaries to the preferred shareholders, should be required to interpret the contract in the light most favorable to preferred shareholders. However, because the Jedwab rule permits directors to interpret contractual terms with preferred shareholders strictly (as if parties were engaged in an arms-length transaction instead of in a fiduciary relationship), Mitchell suggests that for the moment preferred shareholders should plan to rely solely on contractual rights.\(^{61}\) Mitchell proposes that preferred shareholders bargain for contracts which incorporate the concept of a fiduciary duty owed by managers, instead of opting out of such rights.\(^{62}\)

IV. How Courts Deal with Horizontal Conflict and the Opt-Out Issue

Before analyzing the case law discussing the conflict between preferred and common shareholders, and the effect of the opt-out issue on this

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58 Id. at 449.
59 Id. at 459.
60 See Goldman v. Postal Tel., 52 F. Supp. 763, 767 (D. Del. 1943); Wood v. Coastal States Gas Corp., 401 A.2d 932 (Del. 1979); Benzing, supra note 24, at 522. It should be noted that courts strictly construe preference rights in corporate charters, since at common law all shares are equal and preferences are the exception to the rule.
61 See Mitchell, supra note 2, at 444.
62 See id. at 476. Professor Mitchell notes that issuers would be unlikely to accept a contract incorporating fiduciary concepts. However, the solution to this problem may be for underwriters to "induce issuers to include the provision as a signal of good faith to prospective preferred stockholders." Id. at 477.
conflict, it is necessary to point out that the law of the state of incorporation is controlling with respect to the fiduciary duties owed by corporate managers to shareholders.\(^6\) Given that the general rule in *Jedwab* was set out by a Delaware court of chancery,\(^6\) many of the cases discussed will involve Delaware law.

In *Jedwab v. MGM Grand Hotels, Inc.*,\(^6\) the preferred shareholders sought to enjoin a proposed merger of the corporation because the proceeds of the merger were to be allocated unfairly among the commons and the preferreds, to the detriment of the preferred shareholders.\(^6\) Although the court ruled against the preferred shareholders, an important rule of law was established: if preferential rights are implicated, the duty to preferred shareholders is contractual; if, however, the rights asserted are ones shared with the common stockholders, the duty owed to preferred shareholders is fiduciary.\(^6\) As the following cases illustrate, *Jedwab* is often cited for the rule that preferred shareholders are only owed fiduciary duties insofar as common shareholders are owed fiduciary duties.

To the extent that preferred shareholders are injured by the exercise of a preferred right, the contract will govern. In *HB Korenvaes Investments v. Marriott Corp.*,\(^6\) a group of preferred shareholders challenged the proposed spin-off of a corporate subsidiary in which the common shareholders were to be paid prior to the preferred shareholders by way of a “special dividend.”\(^6\) The preferred shareholders claimed that the directors of the corporation had breached their fiduciary and contractual duties to the preferred shareholders, who were entitled to dividends in preference over the common shareholders.\(^6\) With respect to the fiduciary duties, the court found that the contract governed the transaction because a priority right to receive dividends is a preference right, not one shared with common shareholders.\(^6\) Therefore, no fiduciary duties were implicated under the facts of the case, as the “contractual protections and limitations provided

\(^6\) See Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374 (7th Cir. 1984).

\(^6\) Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584 (Del. Ch. 1986).

\(^6\) Id.

\(^6\) See id. at 587.

\(^6\) See id. at 594; *supra* note 54 and accompanying text.


\(^6\) See id. at 517, 525.

\(^6\) See id. at 525-26.
for in the certificate of designation deprived the preferred shareholder of the fiduciary protection commonly afforded to a common shareholder. In addition, the court strictly construed the terms of the contract to determine that the facts did not support the claim for breach of contract. Korenvaes is a perfect example of the dilemma facing preferred shareholders: to the extent that their rights can be labeled "preferred," they are subject to the strict construction of a contract most likely drafted by an issuer interested only in favorable terms for the corporation.

Redemption of preferred stock, like the priority in the right to receive dividends, is considered a preferred right. Therefore, redemption rights will be governed by a court’s strict construction of a contract, not by the more shareholder-friendly fiduciary duties. In Dart v. Kohlberg, Kravis, Roberts & Co., preferred shareholders claimed injury resulting from the corporation’s leveraged buy-out, as their dividend rights became subordinate to the corporation’s debt obligations. The court found that because the contract allowed for redemption of preferred stock at the option of the corporation, the protection accompanying redemption was merely contractual. Therefore, it found no breach of fiduciary duty. The claim was dismissed as a matter of law because the preferred shareholder’s argument was insufficient to withstand the court’s strict interpretation of the certificate of incorporation. Dart, like Korenvaes, illustrates how preferred shareholders claiming injury based on preferred rights face a tough battle in court.

In Rothschild International Corp. v. Liggett Group Inc., preferred shareholders brought suit after being "cashed-out" by the corporation pursuant to a merger agreement. The preferred shareholders claimed both breach of fiduciary duty and breach of contract. The Delaware Supreme Court recognized that preference rights are contractual and governed by a corporation’s certificate of incorporation, the provisions of which are to be strictly construed by the court. Under these rules, the court found that the

72 Id. at 526.
73 See id. at 527-29.
75 See id. at *5.
76 See id.
77 See id. at *6.
79 See id. at 135.
80 See id. at 136.
shareholders' claims were unfounded. First, no fiduciary duties were implicated given that the right to receive a certain value upon liquidation (or merger) was fixed by the contract. Second, the contractual claim failed the court's strict construction in that it was based on the false assumption that the corporation was "liquidated" within the meaning of the contract. Finally, the court noted that where a merger is allowed by law, preferred shareholders are charged with the knowledge that their preference rights are subject to alteration. Not only does Rothschild confirm the dilemma faced by preferred shareholders with preferences which have been allegedly violated, it makes the task of getting relief for these shareholders in a post-merger situation virtually impossible.

There is some good news for preferred shareholders whose claims are to be governed, even though strictly construed, according to the contract or certificate of incorporation. In Winston v. Mandor, the court cited Jedwab and restated the general rule that if the actions complained of are in the nature of preferred rights contemplated by the contract, they are governed by contractual provisions, not a fiduciary duty. Nonetheless, the court stated that a "corporation, like any contracting party, must interpret and apply the applicable provisions in the certificate in good faith." Therefore, if a preferred shareholder's claim is governed by the contract, the shareholder may have some protection in the requirement that the officers and directors must interpret and apply the contract fairly, or in good faith. This may have been the answer that Professor Mitchell was waiting for.

Preferred shareholders are owed some fiduciary duties. In Eisenberg v. Chicago Milwaukee Corp., preferred shareholders attacked the validity of an offer made by the corporation for its preferred stock. The court held that the offer was invalid due to the breach of two fiduciary duties by the

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81 See id.
82 See id.
83 See id. at 136-37.
85 See id. at 845.
86 Id. at 836.
87 See supra notes 55-62 and accompanying text. After Winston, managers are arguably required to interpret and apply the contract as fiduciaries, not as a party at arms-length with the preferred shareholders. Therefore, perhaps the Jedwab rule does in fact provide preferred shareholders with "some meaningful fiduciary rights." Supra note 58 and accompanying text.
88 Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051 (Del. Ch. 1987).
89 See id. at 1053.
directors. First, because the directors failed to disclose their significant
ownership interest in the corporation’s common stock, the court held that
the directors breached the duty of candor owed to the preferred sharehold-
ers by failing to adequately disclose a potential conflict of interest in the
transaction.\(^9\) The court noted that the duty of candor entitled the preferred
shareholders to disclosure of “all material facts relating to the Offer”\(^9\)
and “an accurate, candid presentation of why the self-tender offer [was]
being made.”\(^9\) Second, the directors breached their duty of loyalty to the
preferred shareholders by issuing a threat to delist the stock if the offer was
not accepted by the preferreds.\(^9\) This threat, said the court, was impermis-
sible coercion and a violation of the fiduciary duty owed by directors to
preferred shareholders.\(^9\) Eisenberg defines the scope of fiduciary duties
owed by corporate managers to preferred shareholders as including not
only the duty of candor and the duty not to coerce,\(^9\) but also the duty to
safeguard all the other interests shared with common shareholders.\(^9\)

Preferred shareholders’ right to receive dividends, a right shared with
common shareholders, was recognized as a fiduciary right in \textit{Baron v. Allied Artists Pictures Corp.}\(^9\) In \textit{Baron}, the court held that preference
rights are contractual rights to be strictly construed,\(^9\) but determined that
the right to receive cumulative dividends is nonetheless governed by a
fiduciary duty.\(^9\) Therefore, the court held that the board of directors had a
fiduciary duty “to see that the dividends were brought up to date as soon as
possible in keeping with prudent business management.”\(^9\) It is important
to note, however, that \textit{Baron} was decided before the court set out the
\textit{Jedwab} rule. A present court might hold that the right to receive cumulative
dividends is a preference right which must be governed by contractual
principles of strict construction.

The court in \textit{Barrett v. Denver Tramway Corp.}\(^9\) determined that
corporate recapitalizations are transactions governed by a fiduciary duty to

\(^9\) See id. at 1057-58.
\(^1\) Id. at 1056.
\(^2\) Id. at 1059.
\(^3\) See id. at 1062.
\(^4\) See id. at 1056.
\(^5\) See id.
\(^6\) See id. at 1062.
\(^7\) Baron v. Allied Artists Pictures Corp., 337 A.2d 653 (Del. Ch. 1975).
\(^8\) See id. at 657.
\(^9\) See id. at 660.
\(^10\) Id.
preferred shareholders. In *Barrett*, a preferred shareholder brought suit challenging the validity of a recapitalization plan by the corporation which involved alteration of the rights of preferred stock. The court recognized that a preferred shareholder in this situation has fiduciary rights, but also has the burden of showing that there has been constructive fraud on the part of the directors in order to support a claim alleging breach of fiduciary duty. Therefore, a preferred shareholder must demonstrate “bad faith” or “gross unfairness” by the directors to prove a breach of fiduciary duty. Because the preferred shareholder in *Barrett* did not satisfy this heavy burden, the challenge to the validity of the recapitalization plan was dismissed.

As in *Barrett*, a breach of fiduciary duty was stated in terms of constructive fraud in *Security National Bank v. Peters, Writer & Christensen, Inc.* In *Security National Bank*, the preferred shareholders alleged that the directors had breached their fiduciary duty to the preferreds. The directors refused to redeem preferred stock upon dissolution of the corporation because redemption would have required the sale of common stock, which the directors thought would increase in value. In other words, the directors resolved the horizontal conflict between the commons and the preferreds in favor of the common shareholders (as they are apt to do because they are elected by the common shareholders), given that only the commons gain from an appreciation in stock price while the preferreds are merely interested in receiving their fixed dividends. The court recognized this underlying conflict and determined that the directors committed constructive fraud by resolving the issue in favor of the common shareholders and to the complete detriment of the preferred shareholders.

In effect, the directors gambled with property which should have been used to redeem the preferred shares of PWC, and they did so without

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102 See id. at 199.
103 See id. at 201.
104 Id. at 205.
105 Id.
106 See id.
108 See id. at 881.
109 See supra notes 33-34 and accompanying text.
110 See supra note 31 and accompanying text.
111 See Security Nat'l Bank, 569 P.2d at 881.
informing the preferred shareholders as to their plan. By these actions, the defendants breached the fiduciary duty they owed plaintiffs, and their conduct constitutes constructive fraud as a matter of law.\textsuperscript{112}

In cases of redemption, preferred shareholders may reasonably rely on \textit{Security National Bank} for the proposition that corporate managers cannot refuse to redeem preferred shares solely to benefit common shareholders. However, to the extent that redemption is now viewed by the courts as a contractual right under \textit{Dart}, to be governed according to the rules of strict construction, the holding in \textit{Security National Bank} may be of little help to preferred shareholders.

In \textit{Dalton v. American Investment Co.},\textsuperscript{113} the preferred shareholders who were not cashed-out by the corporation pursuant to the acquisition merger claimed that the corporate directors had breached their fiduciary duty to the preferreds.\textsuperscript{114} In response, the defendant directors argued that the claim involved preference rights which were contractually traded away by the preferred shareholders in return for a favorable dividend rate.\textsuperscript{115} The directors said the rights were “a result of arms-length bargaining”\textsuperscript{116} and that the preferred shareholders “had nobody to blame but themselves.”\textsuperscript{117} In other words, the directors contended that since the preferred shareholders had opted out of their fiduciary rights in the context of a merger acquisition, the preferred shareholders are protected solely by contractual rights. The court, in holding that there was no breach of fiduciary duty by the directors, based its decision not on contractual rights but on the fact that the directors did not solicit the offer made to the corporation for the acquisition merger.\textsuperscript{118} Therefore, it seems that to the extent directors do not solicit offers made for the acquisition of their corporations, the resulting alteration in the rights of preferred shares will not be attributed to the directors. Thus, yet another obstacle was placed in the path of relief for preferred shareholders whose rights have been impaired due to the inherent conflict with common shareholders.

\textsuperscript{112} \textit{Id.}
\textsuperscript{113} \textit{Dalton v. American Inv. Co.}, 490 A.2d 574 (Del. Ch. 1985).
\textsuperscript{114} See \textit{id.} at 575.
\textsuperscript{115} See \textit{id.} at 581.
\textsuperscript{116} \textit{Id.}
\textsuperscript{117} \textit{Id.}
\textsuperscript{118} See \textit{id.} at 582-83.
It is important to note that the business judgment rule\textsuperscript{119} may be implicated in cases involving the conflict between the commons and the preferreds. For instance, in \textit{Robinson v. T.I.M.E.-DC, Inc.},\textsuperscript{120} a preferred shareholder challenged a corporate decision to spin-off a subsidiary corporation.\textsuperscript{121} Although the court recognized that directors owe fiduciary duties to preferred shareholders, it also sympathized with the impossible position directors are placed in by being forced to make decisions in the face of conflicting interests among shareholders. As such, the court employed the business judgment rule in evaluating the decision.

The board of directors of T.I.M.E.-DC owed a fiduciary duty not only to the preferred shareholders, but also to T.I.M.E.-DC’s common shareholders. These duties can sometimes conflict, and balancing them is a difficult task. As a result, the courts will ordinarily refuse to disturb the decisions of a board of directors, which enjoy a presumption of sound business judgment, if they can be attributed to any rational business purpose.\textsuperscript{122}

Applying the business judgment rule, the court stated that the directors’ decision to spin-off the subsidiary did not violate their fiduciary duty to preferred shareholders.\textsuperscript{123}

V. A SUMMARY OF THE METHODS PROPOSED TO ADDRESS HORIZONTAL CONFLICT

There are several different ways to address the dilemma faced by preferred shareholders. The method used by courts seems to be one of compromise. The \textit{Jedwab} rule provides that preferred rights are protected only by the contract while all of the other rights that preferred shareholders

\textsuperscript{119} The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).


\textsuperscript{121} \textit{See id.} at 1079.

\textsuperscript{122} \textit{Id.} at 1084.

\textsuperscript{123} \textit{See id.}
share with common shareholders are protected by fiduciary duties. In addition, preference rights governed by the contract are to be strictly construed. This rule provides little protection to a constituency which is already disadvantaged given that it cannot vote, and is, therefore, not highly favored by directors who are elected solely by the common shareholders. Under the Jedwab rule, a preferred shareholder who claims that directors have violated a preferred right faces a tough battle. The court will look at the contract and construe it strictly according to its terms. The problem with this rule, however, is that the contractual terms were drafted by the issuing corporation and not negotiated between parties in equal bargaining positions. Therefore, the Jedwab rule allows for wealth to be expropriated from preferreds to the commons and for the horizontal conflict between preferred shareholders and common shareholders to almost always be resolved in favor of the commons. Furthermore, even when a preferred shareholder is entitled to fiduciary protection by showing unfairness associated with a right shared with common shareholders, the preferred shareholder must overcome the presumption favoring director action afforded by the business judgment rule.

For the reasons mentioned above, many commentators propose different methods to address the preferred shareholder dilemma. Although Contractarians argue that the contract should always control (because of the positive effects of personal autonomy and bargaining by freedom of contract), this is not the solution to the horizontal conflict problem. Under the courts’ strict construction rule, the Contractarian’s method would only make the problem worse for the preferred shareholders. Instead, because preferred shareholders are in a disadvantaged position and are often the ones harmed by the conflict, the better methods are the ones proposing more, not less, protection for the preferred shareholders.

As discussed above, Professor Mitchell contends that courts should give “some meaningful fiduciary rights” to preferred shareholders. Mitchell points out the flaws in the courts’ way of dealing with the conflict. He argues that the rule of strict construction creates a paradox in which directors, when attempting to make decisions in compliance with the court’s rules of law, are permitted to interpret the contract as a party in an arms-length relationship with, not as fiduciaries to, preferred shareholders.

124 See supra notes 53-54, 65-67 and accompanying text.
125 See supra notes 68-73 and accompanying text.
126 See supra notes 119-23 and accompanying text.
127 See supra notes 48-49 and accompanying text.
128 Supra note 58 and accompanying text.
Therefore, contract rights drafted by the corporation and interpreted narrowly by the courts (and therefore narrowly by directors when actions are taken), provide little protection to preferred shareholders in situations in which wealth is transferred to common shareholders at the expense of the preferreds. Mitchell notes that “fiduciary duty trumps contract” and that directors should interpret the contract as fiduciaries to the preferreds. In other words, the first question should be whether the action is fair, not whether it is allowed by the contract. If courts adopt Mitchell’s proposal, preferred shareholders would have some fiduciary protection when their interests conflict with common shareholders’ interests.

Professor Campbell’s position is very similar to the alternative proposed by Mitchell. Campbell argues that Pareto principles should govern corporate transactions where at least one shareholder would be made better off and no shareholder would be made worse off. This is substantially the same as Mitchell’s argument because Pareto principles, like fiduciary duties, require the maximization of shareholder wealth. Therefore, under the rules proposed by Professors Campbell and Mitchell, transactions in which wealth is expropriated from preferred shareholders to common shareholders (with no resulting increase in corporate value) are inherently unfair and should be protected by a fiduciary duty and not by contractual rights drafted by and construed in favor of the corporation.

Professor Victor Brudney would go even further and permit administrative agencies to step in and enforce these fiduciary rights in favor of preferred shareholders. In an article addressing modifications in preferred stock, Brudney noted that alterations in the terms of preferred stock usually comply with the contractual requirements. However, because of the superior bargaining power of corporate managers and the common shareholders, such alterations often result in unfairness to the preferreds. Therefore, courts should develop standards of fairness to apply to these attempted alterations, possibly with the assistance of administrative agencies.

129 See supra note 57 and accompanying text.
130 See Mitchell, supra note 2, at 473-74.
131 Supra note 59 and accompanying text.
132 See supra note 59 and accompanying text.
133 See supra notes 50-52 and accompanying text.
135 See id. at 446.
136 See id. at 448.
137 See id. at 487.
The method currently used by courts to address the horizontal conflict between preferred shareholders and common shareholders is one which unilaterally favors the commons and allows wealth to be transferred from the preferreds to the commons, with no increase in corporate value. The rule needs to be altered to give preferred shareholders some meaningful protection and to prevent this unilateral transfer of wealth. One way of doing this would be to require corporate directors to act as fiduciaries when interpreting contractual terms. However, interpreting a contract will be of no help to preferreds if the contract has been drafted by a corporate issuer in terms unilaterally favorable to itself. Preferred shareholders might therefore protect themselves by bargaining for contractual terms which will protect their preferred rights. Even this method is unrealistic, as corporate issuers are unlikely to be willing to accept these terms.

Another solution might be to impose some mandatory fiduciary standards upon directors faced with a horizontal conflict. Directors owe fiduciary duties to both common shareholders and preferred shareholders and should not be permitted to steal wealth from one constituency to benefit the other. Doing so provides no cumulative gain to the corporation. Therefore, courts should realize that this action violates the directors' fiduciary duty to maximize wealth for all shareholders. Such action should not even be upheld under the generous business judgment rule because there is no rational basis for taking an action which does not provide a benefit for the corporation as a whole. However, to the extent that courts recognize the opt-out issue, fiduciary duties are unlikely to be mandated for preferred rights which have been created by a contract agreed upon by both parties. Furthermore, imposing a fiduciary duty on directors regarding preference rights would be unfair to the corporation, which probably gave preferred shareholders a favorable price, a high dividend rate, or both, in exchange for these contractual terms.

The answer is for courts to impose new contract interpretation rules. The strict interpretation rules presently used by courts are premised on the view that preferred stock is the exception to the common law rule of common stock. However, courts need to realize that preferred stock is now

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138 See Mitchell, supra note 2, at 449.
139 See id. at 476.
140 See id.
141 See Campbell, Corporate Fiduciary Principles, supra note 1, at 562-63; Mitchell, supra note 2, at 449.
a corporate reality deserving protection of its own. Therefore, preference rights should not be strictly construed. Instead, courts should treat the contract for what it is: a contract drafted by the party with superior bargaining power (the corporation), with terms likely to be unilaterally favorable to the corporation. Courts should thus resolve ambiguous contractual terms against the corporate drafter and in favor of preferred shareholders. With the imposition of this new rule, preferred shareholders will gain some protection in cases of horizontal conflict. Further protection for preferred shareholders may also be found in the courts’ willingness to impose good faith standards on directors in their application of preferred rights.¹⁴²

Preferred shareholders are in a position of unequal bargaining power vis-a-vis corporate managers. However, as courts level the playing field by resolving contractual ambiguities in favor of the preferred shareholders and requiring directors to apply these terms in good faith, the practice of expropriating wealth from one group to benefit another will be eliminated. Corporations can then focus on their job of producing profits, and corporate managers can perform their duty of maximizing wealth for all shareholders, both the commons and the preferreds.

¹⁴² See supra note 86 and accompanying text.