

# INDEPENDENT LEGAL SIGNIFICANCE, GOOD FAITH, AND THE INTERPRETATION OF VENTURE CAPITAL CONTRACTS

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## INTRODUCTION

Benchmark Capital (hereinafter Benchmark) ensured its position among the elite venture capital firms in Silicon Valley when it made one of the most storied venture capital investments ever: a \$5 million investment in eBay that ultimately returned more than \$4 billion.<sup>1</sup> Benchmark also drew attention in 1999, when it raised the enormous sum of \$1 billion for a single venture capital fund.<sup>2</sup> But its most lasting impression on venture capital investing may be the result of a lawsuit that Benchmark filed against one of its portfolio companies, as well as that company's founders, officers, directors, and one of its other investors. In *Benchmark Capital Partners IV, L.P. v. Vague*,<sup>3</sup> the Delaware Court of Chancery considered Benchmark's claim that it was entitled to veto a merger constructed for the sole purpose of stripping bargained-for rights and preferences from two series of pre-

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1. Russ Mitchell, *Too Much Ventured, Nothing Gained*, FORTUNE, Nov. 25, 2002, at 135. Benchmark has had other successes, including 1-800-Flowers, Ariba, Handspring, and Red Hat Software. It also has had some spectacular flops, most notably WebVan. One of its most discussed investments was Loudcloud, Inc., which changed its name to Opsware, Inc. in 2002. Loudcloud was Marc Andreesson's effort to follow his success with Netscape.

2. George Anders et al., *Digits*, WALL ST. J., Sept. 19, 1999, at B6. At the time, some people viewed billion-dollar funds as a symbol of elite status. See, e.g., Lawrence Aragon, *Benchmark Forms Billionaire Boys Club*, RED HERRING, Sept. 15, 1999. Three years later, however, Benchmark decided to allow investors in the fund to opt out of capital calls because Benchmark lacked adequate investment opportunities. See Ann Grimes, *Venture Capital Had a Meager Year*, WALL ST. J., Jan. 2, 2003, at R4.

3. No. CIV.A.19719, 2002 WL 1732423 (Del. Ch. July 15, 2002).

ferred stock owned by Benchmark.<sup>4</sup> The case ultimately was decided on the basis of the arcane doctrine of independent legal significance, which is described below.<sup>5</sup> The court did not mention the contractual duty of good faith, and this Article explores the intersection of this duty and the doctrine of independent legal significance in the context of venture capital contracts.

The proposed merger at issue in *Benchmark* had been originated by Juniper Financial Corporation, a credit card issuer based in Delaware, and Canadian Imperial Bank of Commerce (CIBC), Juniper's largest investor.<sup>6</sup> The primary purpose of the merger, described in more detail below,<sup>7</sup> was to amend Juniper's certificate of incorporation, creating a new series of preferred stock with priority over the preferred stock owned by Benchmark.<sup>8</sup> CIBC intended to purchase shares of the new series of preferred stock, and Benchmark—a minority investor in Juniper—wanted to prevent the transaction.<sup>9</sup>

Until the late 1800s, most corporation statutes in the United States required the unanimous consent of stockholders to authorize a merger.<sup>10</sup> While protective of minority stockholders, this rule had a disabling effect on many corporations and gave minority stockholders enormous clout by permitting holdups.<sup>11</sup> Gradually, state legislatures changed the voting rules for mergers, initially requiring a supermajority vote and later allowing for majority rule.<sup>12</sup> Thus the modern rule for voting on mergers attempts to balance the legitimate interests of the majority stockholders in flexible administration of the firm against the legitimate interests of the minority stockholders in protecting their

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4. *Id.* The Delaware Supreme Court subsequently affirmed “on the basis of and for the reasons assigned by the Court of Chancery in its opinion.” *Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp.*, 822 A.2d 396 (Del. 2003).

5. *See infra* Part II.

6. *Benchmark*, 2002 WL 1732423, at \*1.

7. *See infra* Part I.

8. *Benchmark*, 2002 WL 1732423, at \*1; *see also* DEL. CODE ANN. tit. 8, § 251(e) (2003) (“In the case of a merger, the certificate of incorporation of the surviving corporation shall automatically be amended to the extent, if any, that changes in the certificate of incorporation are set forth in the agreement of merger.”).

9. *Benchmark*, 2002 WL 1732423, at \*1-2.

10. Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 12 (1995).

11. *Id.* at 13 (“Any one shareholder could hold up a beneficial change or force the enterprise to reassemble the financial investors in a new venture with the attendant costs that would drain money from the evolving business.”).

12. William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69 (1980).

investment.<sup>13</sup> Absent contractual override, these voting rules would enable Juniper and CIBC to pursue the merger transaction without interference from Benchmark because CIBC controlled a majority of the votes.<sup>14</sup>

Presumably recognizing its vulnerability under the applicable legal rules, Benchmark bargained for additional protection against preference stripping.<sup>15</sup> This bargained-for protection took the form of a contract provision prohibiting corporate actions that “materially adversely change the rights, preferences and privileges” of the Series A or Series B Preferred Stock.<sup>16</sup> Unfortunately for Benchmark, this protective provision did not perform up to expectations. Benchmark argued that this provision allowed them to thwart *any* transaction that impaired their stock, including the proposed merger.<sup>17</sup> In response, Juniper and CIBC observed that the language of the contract was similar (though not identical) to the language of § 242(b) of the Delaware General Corporation Law, which describes the procedure for amending the charter outside the context of a merger. Juniper and CIBC argued that the similarity between the contract and the statute suggested that the drafters of the contract intended to allow Benchmark to veto charter amendments but not mergers.<sup>18</sup> The court agreed:

Where the drafters have tracked the statutory language relating to charter amendments in 8 Del. C. § 242(b), courts have been reluctant to expand those restrictions to encompass the separate process of merger as set forth in 8 Del. C. § 251, unless the drafters have made clear the intention to grant a class vote in the context of a merger.<sup>19</sup>

In short, the court held that (1) the harm to Benchmark was caused by the merger, not by a charter amendment, and (2) Bench-

13. In addition to the right to vote, minority stockholders have the right to receive an appraisal of the value of their shares. DEL. CODE ANN. tit. 8, § 262 (2003).

14. CIBC and Benchmark both held shares of preferred stock in Juniper. In this instance, both CIBC and Benchmark were entitled to vote by virtue of voting rights specified in Juniper’s corporate charter. *Benchmark*, 2002 WL 1732423, at \*3; *see also* DEL. CODE ANN. tit. 8, § 251 (requiring a majority vote of “the outstanding stock of the corporation entitled to vote” on the merger).

15. *Benchmark*, 2002 WL 1732423, at \*3-\*4 (Benchmark sought to ensure that Juniper did not issue any additional equity security that would be senior to the shares owned by Benchmark.).

16. *Id.* at \*4.

17. *Id.* at \*2, \*5.

18. *Id.* at \*6.

19. *Id.* at \*7.

mark had no separate voting rights—either by statute or by contract—with respect to the merger.<sup>20</sup> This result reflects the workings of the doctrine of independent legal significance, which holds that a transaction structured in compliance with one section of the Delaware corporation statute is valid, even if it leads to a substantive result that would not be allowed by another section of the statute.<sup>21</sup> More particularly in the context of *Benchmark*, the merger provision of the Delaware statute is independent of the provision on charter amendments.

When law students and nonlawyers first encounter cases like *Benchmark*, they are often struck by the apparent unfairness of the result. To the extent that the parties negotiated *Benchmark*'s status, they explicitly prohibited this sort of preference stripping.<sup>22</sup> Unfortunately for *Benchmark*, the contract was incomplete. It prohibited preference stripping using language that failed to identify mergers as the potential mechanism.<sup>23</sup> Had the parties focused on this gap in the contractual protections, would they would have filled the gap with a provision that protected *Benchmark*? The answer to that question is difficult to know. Nevertheless, the Delaware court appears to be elevating form over substance in a most dramatic way.

Most lawyers, by contrast to law students and non-lawyers, readily accept the formalism of *Benchmark*.<sup>24</sup> Lawyers may debate the wisdom of the doctrine of independent legal significance, but those debates are rarely cast in terms of fairness. As long as the rules of the game are stated openly, lawyers are not too concerned by decisions that enforce those rules strictly. Indeed, given the long line of precedents dealing with exactly this sort of preference stripping, lawyers might go so far as to assume—contrary to non-lawyers—that the parties to any contract failing to provide for a veto in the event of a charter amendment via merger must have intended implicitly to allow

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20. *Id.* at \*9-\*10.

21. *See, e.g., Orzeck v. Englehart*, 195 A.2d 375 (Del. 1963) (“[A]ction taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.”).

22. *See Benchmark*, 2002 WL 1732423, at \*1, \*4.

23. *Id.* at \*9.

24. While law students are often taught to view formalism as a sin, it plays an important role in contemporary law. And while formalism can be difficult to define, the doctrine of independent legal significance would seem to qualify under any conception of that word. *See* Paul N. Cox, *An Interpretation and Partial Defense of Legal Formalism*, 36 IND. L. REV. 57, 68 (2003) (citing the doctrine as an example of the proposition that “a rule’s addressee may with impunity circumvent the rule though strict compliance with it, as by engaging in the evil, or a substantially similar evil, targeted by a rule while nevertheless simultaneously adhering to the rule”).

such a merger.

But there is the rub: To the extent that there is concern about the intent of the parties, one must recognize that such intent is not always readily discernable from the terms of a contract or other communications. As observed recently by Robert Scott, “All contracts are incomplete.”<sup>25</sup> Indeed, people often act in offensive ways that are not expressly regulated by any legal commands. In resolving contract disputes, courts rely on the duty of good faith to fill in the gaps in incomplete contracts.<sup>26</sup>

This Article begins in Part I with a brief description of the *Benchmark* case. Part II describes the origins and development of the doctrine of independent legal significance and illustrates its role as a doctrine of judicial abstention. Part III examines the method used by Delaware courts to interpret the terms of preferred stock agreements. The interpretive rule of strict construction described in this part combines with the doctrine of independent legal significance to make a formidable hurdle for holders of preferred stock. Part IV explores the contract doctrine of good faith, with special attention to the common law of Delaware, and shows its importance as a doctrine of judicial intervention. Part V employs comparative institutional analysis<sup>27</sup> and the incomplete contracting theory to examine the appropriate role for courts in disputes like *Benchmark*.

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25. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1641 (2003).

26. See, e.g., *Market St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991) (“The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule.”).

27. See NEIL K. KOMESAR, *LAW'S LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS* (2001) [hereinafter KOMESAR, *LAW'S LIMITS*].