

**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*,

ferred stock owned by Benchmark.<sup>4</sup>

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.

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).

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