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The Perils of Small-Minority Controllers

Law Working Paper N° 434/2018
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The Perils of Small-Minority Controllers

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Abstract

This Article contributes to the longstanding and heated debate over dual-class companies by placing a spotlight on a significant set of dual-class companies whose structures raise especially severe governance concerns: those with controllers holding a small minority of the company's equity capital. Such small-minority controllers dominate some of the country's largest companies, and we show that their numbers can be expected to grow. We begin by analyzing the perils of small-minority controllers, explaining how they generate considerable governance costs and risks and showing how these costs can be expected to escalate as the controller's stake decreases. We then identify the mechanisms that enable such controllers to retain their power despite holding a small or even tiny minority of the company's equity capital. Using a hand-collected dataset of the governance documents of these companies, we present novel empirical evidence of the current incidence and potential growth of small-minority and tiny-minority controllers. Among other things, we show that governance arrangements at over 80% of dual-class companies enable the controllers to reduce their equity stake to below 10% and still retain a lock on control, and that a sizable fraction of such companies enable retaining control with even less than a 5% stake. Finally, we examine the considerable policy implications that arise from recognizing the perils of small-minority controllers. We first discuss the disclosures necessary to make transparent to investors the extent to which governance arrangements enable controllers to reduce their stake without forgoing control. We then identify and examine measures that public officials or institutional investors could take to (i) ensure that controllers maintain a minimum fraction of equity capital, (ii) provide public investors with extra protections in the presence of small-minority controllers, or (iii) screen midstream changes that can introduce or increase the costs of small-minority controllers.

Keywords: Corporate governance, agency problems, dual-class, controlling shareholders, small-minority controllers, tiny-minority controllers, wedge, nonvoting stock, IPO

JEL Classification: G32, G34, K22

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THE PERILS OF SMALL-MINORITY CONTROLLERS

Lucian A. Bebchuk[*] *and Kobi Kastiel*[**]

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[*] James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, Harvard Law School. © 2019, Lucian A. Bebchuk & Kobi Kastiel.

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This Article is the second part of a larger project on the problems of dual-class structures. The first part was published as Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017). Our work on this Article benefited from discussions with and comments of Julian Franks, Jesse Fried, Assaf Hamdani, Sharon Hannes, Alon Harel, Scott Hirst, Ehud Kamar, Lewis Kaplow, Reinier Kraakman, Yoram Margaliot, Ariel Porat, Mark Roe, Roy Shapira, Avi Tabach, Roberto Tallarita, and participants at two Harvard Law School seminars, the TAU/NYU Corporate Law Conference, the Global Corporate Governance Colloquia, the CII spring meeting, the ALEA annual meeting, and the ECGI/Bar Ilan conference. David Azimov, Ehud Efraim, Eric Goodwin, David Mao, Pierre Saddi, Gregory Shill, and Nadav Tiomkin provided valuable research assistance. We are especially grateful to Aluma Zernik for her valuable suggestions and help throughout our work on this Article.

For full disclosure, we note that Lucian Bebchuk served as an expert and submitted an expert report in litigation concerning the Facebook reclassification noted in this Article (*In re* Facebook, Inc. Class C Reclassification Litig., C.A. No. 12286-VCL, 2016 Del. Ch. LEXIS 193 (Del. Ch. Dec. 12, 2016)), and that Kobi Kastiel provided research services in connection with this expert report.

Abstract

This Article contributes to the longstanding and heated debate over dual-class companies by placing a spotlight on a significant set of dual-class companies whose structures raise especially severe governance concerns: those with controllers holding a small minority of the company's equity capital. Such small-minority controllers dominate some of the country's largest companies, and we show that their numbers can be expected to grow.

We begin by analyzing the perils of small-minority controllers, explaining how they generate considerable governance costs and risks and showing how these costs can be expected to escalate as the controller's stake decreases. We then identify the mechanisms that enable such controllers to retain their power despite holding a small or even tiny minority of the company's equity capital. Using a hand-collected dataset of the governance documents of these companies, we present novel empirical evidence of the current incidence and potential growth of small-minority and tiny-minority controllers. Among other things, we show that governance arrangements at over 80% of dual-class companies enable the controllers to reduce their equity stake to below 10% and still retain a lock on control, and that a sizable fraction of such companies enable retaining control with even less than a 5% stake.

Finally, we examine the considerable policy implications that arise from recognizing the perils of small-minority controllers. We first discuss the disclosures necessary to make transparent to investors the extent to which governance arrangements enable controllers to reduce their stake without forgoing control. We then identify and examine measures that public officials or institutional investors could take to (i) ensure that controllers maintain a minimum fraction of equity capital, (ii) provide public investors with extra protections in the presence of small-minority controllers, or (iii) screen midstream changes that can introduce or increase the costs of small-minority controllers.

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INTRODUCTION

Snap, the owner of the disappearing-message application Snapchat, went public in March 2017 at a valuation exceeding $20 billion with a multiple-class structure that creates significant risks.[1] Following the initial public offering (IPO), Snap's young cofounders, Evan Spiegel and Bobby Murphy, owned a substantial fraction of Snap's equity capital—about 18% each. Our analysis of Snap's IPO structure, however, indicates that it would enable the cofounders to unload the overwhelming majority of their shares—reducing their economic stakes to 1.4% of the company's equity capital each, or 2.8% together—while still retaining control.[2] Snap's offering documents do not disclose this significant detail nor discuss the considerable governance risks that it generates.[3]

Facebook, Snap's larger and older rival, went public in 2012 with a dual-class structure that placed some limits on the ability of its founder, Mark Zuckerberg, to reduce his fraction of equity capital without relinquishing control.[4] In April 2016, however, Facebook passed a reclassification plan, approved by Zuckerberg's majority voting power, that would have enabled Zuckerberg to sell two-thirds of his Facebook shares—reducing his stake of equity capital to about 4% or possibly less—without losing his controlling voting power.[5] Eventually, in September 2017, in the face of a shareholder

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[1] Leslie Picker & Anita Balakrishnan, *Snap Soars Nearly 50% After Trading Begins*, CNBC (Mar. 2, 2017, 10:49 AM), https://www.cnbc.com/2017/03/01/snapchat-ipo-pricing.html [https://perma.cc/9CAA-N424].

[2] For information on Snap's IPO structure, the company's cofounders equity position after the IPO, and their ability to unwind it, see *infra* notes 66, 96–102, 115–17 and accompanying text.

[3] Similarly, our analysis of Dropbox's IPO documents reveals the considerable risk that the company's cofounders, Andrew Houston and Arash Ferdowsi, would be able to hold lifetime control even if they retain only a tiny minority of the company's equity capital. Although the IPO documents do not make this risk transparent to investors, a close analysis shows that the IPO structure contains some of the governance mechanisms that we identify below as facilitating extreme separation between voting power and equity ownership. For the preliminary IPO documents of Dropbox, see Dropbox, Inc., Registration Statement (Form S-1) (Feb. 23, 2018).

[4] The statements of this paragraph are based on an analysis of the data in Facebook's 2012 IPO prospectus and 2016 disclosures. *See* Facebook, Inc., Current Report (Form 8-K) (June 20, 2016); Facebook, Inc., Definitive Proxy Statement (Form DEF 14A) 37–40, 55–74 (June 2, 2016); Facebook, Inc., Amendment No. 8 to Registration Statement (Form S-1) 141 (May 16, 2012).

[5] This calculation is based on the beneficial ownership information set forth in Facebook's 2016 Definitive Proxy Statement. Facebook, Inc., Definitive Proxy Statement, *supra* note 3, at 37–40. Without the reclassification, Zuckerberg would have to retain at least 12.8% of Facebook's cash-flow rights in order to retain majority voting power. Following the reclassification, this figure would be reduced by two-thirds, to approximately 4.3%.

suit, Facebook announced its decision not to proceed with the reclassification plan for the time being.[6] Zuckerberg currently continues to face certain limits on his freedom to unload shares without losing his control.

In this Article, we seek to place a spotlight on dual-class structures that enable controllers to have a lock on control (that is, the ownership of more than 50% of the voting power or a majority control of the board) with only a small fraction of the company's equity capital. We argue that such structures can be expected to generate considerable governance risks and costs, and that they therefore deserve the close attention of public officials and institutional investors. We also show that these governance risks and costs rise steeply as a controller's stake declines.

Furthermore, using a hand-collected dataset of governance provisions in dual-class companies, we provide the first empirical evidence on (i) the incidence of various mechanisms that facilitate the retention of control with only a small equity stake, (ii) the incidence of small-minority controllers, and perhaps most importantly, (iii) the potential incidence of small-minority controllers that existing governance arrangements permit. Using these arrangements, our empirical analysis indicates that over 80% of dual-class controllers can retain a lock on control with less than a 10% equity stake, and a sizable fraction of those controllers can even still retain control with less than a 5% equity stake.

Finally, we analyze the considerable implications for both public officials (including regulators and courts) and institutional investors resulting from the perils of small-minority controllers. To that end, we examine both potential regulatory interventions and private-ordering responses.

The use of dual-class structures is the subject of heated debate.[7] Companies have increasingly gone public with dual-class structures, including well-known names such as Alphabet (formerly Google), Berkshire Hathaway, Facebook, Ford, News Corp, Nike, and Viacom.[8] At the same

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[6] *See* Facebook, Inc., Current Report (Form 8-K) 3 (Sept. 21, 2017). For the lawsuit filed in connection with the Facebook reclassification, see *In re* Facebook, Inc. Class C Reclassification Litig., C.A. No. 12286-VCL, 2016 Del. Ch. LEXIS 193 (Del. Ch. Dec. 12, 2016).

[7] *See infra* Section I.A.

[8] *See* EDWARD KAMONJOH, INV'R RESPONSIBILITY RESEARCH CTR. INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A FOLLOW-UP REVIEW OF PERFORMANCE & RISK 84–90 (2016), https://www.weinberg.udel.edu/IIRCiResearchDocuments/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf. In 2015, Google announced a corporate reorganization that created a holding company, Alphabet Inc., with Google as a subsidiary. Jillian D'Onfro, *Google Is Now Alphabet*, BUS. INSIDER (Oct. 2, 2015, 10:56 AM), http://www.businessinsider.com/google-officially-becomes-alphabet-today-2015-10 [https://perma.cc/G259-L9EU]. Because the Google name is still commonly used, that name will be used in this Article.

time, leading institutional investors and market participants have increasingly expressed strong opposition to dual-class structures.[9] In this longstanding debate, both proponents and opponents have tended, until recently, to lump all dual-class structures into one category.[10]

By contrast, when we started our work on dual-class companies a few years ago, we sought to reorient the debate by stressing certain key differences among dual-class structures. Although we are skeptical of the efficiency of all dual-class structures, even at the IPO stage, we recognize that individuals may reasonably disagree on this subject. Therefore, our strategy has been to identify subsets of dual-class structures that should be viewed as especially problematic even by those who strongly believe in the potential benefits of a dual-class structure in some IPOs.

In an earlier article, *The Untenable Case for Perpetual Dual-Class Stock*, we focused on the perniciousness of longstanding dual-class structures.[11] We demonstrated that the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to recede while the potential costs tend to rise as time passes from the IPO.[12] Furthermore, we showed that "controllers have perverse incentives to retain dual-class structures," even when those structures become inefficient over time.[13] Accordingly, we explained that longstanding dual-class structures are especially problematic, and the case against perpetual dual-class stock is compelling.[14]

Our earlier work provided a theoretical framework for subsequent empirical studies on the topic, which tested and confirmed our economic prediction that the costs of indefinite dual-class structures rise, and their benefits decline, the longer they extend past the IPO.[15] This earlier work also

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[9] *See infra* note 25.

[10] *See infra* Section I.A.

[11] *See generally* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

[12] *Id.* at 630.

[13] *Id.*

[14] *Id.*

[15] *See, e.g.*, Lindsay Baran, Arno Forst & M. Tony Via, Dual Class Share Structure and Innovation (Dec. 21, 2018) (unpublished manuscript) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3183517 [https://perma.cc/S6Y3-JERA]; Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* (Eur. Corp. Governance Inst., Working Paper No. 550, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895 [https://perma.cc/D3PJ-CAYR]; Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Voting* (Eur. Corp. Governance Inst., Working Paper No. 590, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3145209 [https://perma.cc/5L9C-MG5G]; Robert J. Jackson Jr., Comm'r, U.S. Sec. & Exch. Comm'n, Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018),

contributed to the submission of a rulemaking petition by the Council of Institutional Investors (CII) calling on U.S. stock exchanges to mandate time-based sunsets as a condition for listing dual-class structures.[16] Additionally, SEC Commissioner Robert Jackson Jr. and a group of leading issuers and investors, including the investment manager BlackRock, expressed their support for the time-based sunsets we advocated.[17]

In this Article, we focus on the ownership-stake dimension and the perniciousness of structures with small-minority controllers. Dual-class structures enable a shareholder to retain a lock on control with less than a majority ownership stake. Thus, such structures commonly create what the literature refers to as a "controlling-minority shareholder," a term introduced in an early work that one of us coauthored with Reinier Kraakman and George Triantis.[18] In this Article, we focus on the subset of controlling minority shareholders whose stake is not merely a minority stake, but rather a "small-minority" stake (defined as less than 15% of equity capital), a "very-small-minority" stake (less than 10%), or even a "tiny-minority" stake (less than 5%). Controllers holding such stakes pose increased governance risks relative to other controlling minority shareholders.

The analysis of this Article is organized as follows. Part I begins by discussing how we aim to reorient and contribute to the longstanding, heated

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https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty [https://perma.cc/WKN9-6ZZR].

[16] *See* Petition from Council of Institutional Inv'rs to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf. A sunset provision is a governance mechanism that automatically dismantles the dual-class structure when some conditions are satisfied. A sunset provision with a time limitation is triggered at a predetermined date, say, ten years after the IPO. When the clause is activated, the shares with the superior voting rights automatically convert into ordinary shares, and the company's second class is eliminated.

[17] For Commissioner Jackson's statement, see *supra* note 15. For Blackrock's support of time-based sunsets, see Open Letter from Barbara Novick, Vice Chairman, BlackRock, Inc., to Baer Pettit, President, MSCI, Inc. (May 3, 2018), https://corpgov.law.harvard.edu/2018/05/03/open-letter-regarding-consultation-on-the-treatment-of-unequal-voting-structures-in-the-msci-equity-indexes/ [https://perma.cc/47MU-FP6A] ("[W]e believe that [dual-class] structures should have a specific and limited duration."). The 2018 version of the Commonsense Corporate Governance Principles, issued by a group of leading issuers and investors, also expressed support for sunsets. *See* Open Letter: Commonsense Principles of Corporate Governance (2018), http://www.governanceprinciples.org/wp-content/uploads/2018/10/2016-Open-Letter-Principles.pdf.

[18] *See* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 297 (Randall K. Morck ed., 2000).

debate over dual-class structures. We then explain why structures with small-minority controllers can be expected to produce considerable governance risks and costs. In companies that are widely held, the market for corporate control and the threat of replacement incentivize corporate insiders to serve the interests of public investors. In companies with a majority owner, the disciplinary force of the control market does not operate. However, the controller's ownership stake forces her to bear the majority of the economic effect of her choices on total market capitalization, providing strong ownership incentives that align the controller's interests with those of public investors. By contrast, a company with a small-minority controller lacks both the discipline of the control market and the incentives generated by having to bear the majority of any effect on total market capitalization.

We illustrate how small-minority controllers can be expected to distort corporate decisionmaking, including decisions regarding the allocation of opportunities and talents, strategy and company scale, related-party transactions, responses to acquisition offers, and whether to remain as CEO. In these contexts, small-minority controllers can be expected to make value-reducing choices. These agency distortions and costs steeply escalate as the controller's equity stake declines. Finally, we discuss a body of empirical evidence that supports our conclusions regarding the expected costs of small-minority controllers and the relationship of these costs to the controller's ownership stake.

Part II identifies and explains the operation of mechanisms that enable controlling shareholders despite owning only a small minority of the company's equity capital. Furthermore, using a hand-collected dataset of governance arrangements in dual-class companies, we provide empirical evidence about the incidence and use of these mechanisms. The mechanisms that Part II analyzes include (i) "hardwiring" provisions granting the controller the ability to elect a majority of board members or to cast a fixed fraction of votes, regardless of how small the controller's equity stake might become, (ii) a large difference in voting power between high-vote and low-vote shares, (iii) nonvoting shares, which represent an extreme case of infinitely high ratio between the voting power of high-vote and low-vote shares, (iv) arrangements aimed at limiting the dilution in the controller's majority voting power upon sale of stock by the controller, and (v) arrangements aimed at limiting the dilution in the controller's majority voting power upon sale of high-vote shares held by third parties.

Part II also analyzes midstream changes to existing governance arrangements of a company, such as nonvoting stock reclassifications, that can be used to enhance the controller's ability to unload shares without relinquishing control. Google, for example, recently adopted such a nonvoting stock reclassification, paving the way for its cofounders to issue

additional shares while remaining firmly in control.[19] We show that the future use of such nonvoting stock reclassification could enable controllers to reduce their ownership stakes to negligible levels without weakening their grip on control.

Part III uses our hand-collected dataset of governance provisions in dual-class structures to present novel empirical evidence of the incidence of small-minority, very-small-minority, and tiny-minority controllers. Importantly, we analyze not only current equity stakes but also the extent to which controllers would be able to reduce their equity stakes in the future without relinquishing control. Because existing governance provisions enable future increases in the separation between control and ownership stake, we also analyze the minimum equity stake that the controller at each company would need to hold to retain control.

Through analysis of this empirical evidence, we find that, in more than 30% of cases, the governance provisions in place would enable the controller to become a "tiny-minority controller" by reducing her share of the equity capital to less than 5% while still retaining control. Furthermore, in over 80% of cases, the governance provisions in place would enable the controller to become a "very-small-minority controller" by reducing her share of the equity capital to less than 10% while still retaining control. Finally, in more than 90% of cases, the governance provisions in place would enable the controller to become a "small-minority controller" by reducing her share of the equity capital to less than 15% while still retaining control.

Part IV discusses the implications of our analysis for future policymaking and capital market practices. To begin with, public officials and institutional investors should recognize the substantial governance risks associated with small-minority controllers. The extent to which governance arrangements can be used to expand the "wedge"—the gap between the controller's fraction of voting rights and fraction of equity capital—is seldom transparent to investors. Thus, disclosure rules should require companies to provide such information. In assessing the extent to which dual-class companies pose governance risks, public officials and institutional investors should pay close attention to the existing and potential size of the wedge.

Furthermore, we identify and discuss arrangements that could be used to address the current and future presence of small-minority controllers. Institutional investors could press for or encourage the introduction of such measures, and public officials could consider using their legal and regulatory tools to ensure a uniform adoption of such measures. We discuss three types of arrangements: (i) those aimed at limiting the extent to which controllers can lower their ownership stake without weakening their lock on control, (ii)

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[19] *See infra* notes 112–13 and accompanying text.

those aimed at providing additional protections to public investors in situations where small-minority controllers would remain in control, and (iii) those aimed at preventing midstream changes, such as nonvoting stock reclassifications, that would introduce new governance costs or exacerbate the existing governance costs of small-minority controllers.

Before proceeding, we should note that some corporate law scholars oppose limits on the structures that companies going public may offer to investors.[20] The debate on contractual freedom in corporate law is longstanding and raises general questions that go beyond the scope of this Article.[21] Although we subscribe to the view that it is desirable to place some constraints on IPO choices as existing corporate and securities law do, this Article does not seek to repeat the arguments for this view or otherwise to contribute to the debate on contractual freedom.[22] However, because we recognize that some readers may well support, in principle, allowing companies to go public with any structures they choose, we wish to stress that our analysis should be of interest even to such readers.

The main contribution of our Article is an understanding of the governance risks posed by small-minority controllers. To the extent that such risks are significant, all readers should recognize the benefits to public officials and institutional investors of understanding these risks. Obtaining such an understanding is essential for facilitating the introduction of private-ordering arrangements that would serve the interests of public investors, for judicial application of an appropriate level of scrutiny to controller actions, and for the development of disclosures that would provide adequate transparency of the risks posed to public investors and help IPO investors to price these arrangements accurately.

We believe that, to aid in their assessment of public companies, public officials and institutional investors would benefit from a recognition of the perils of small-minority controllers, the mechanisms that enable them to retain control, and the potential measures for responding to these perils. In a series of recent posts examining the governance arrangements of Dell, Lyft

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[20] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1420 (1989).

[21] For a well-known collection of articles expressing different views on the subject, see generally Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

[22] One of us sought to contribute to this debate and to support this view in an earlier work. *See generally* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989) (arguing that the contractual view of the corporate structure presents important reasons to limit corporations from opting out of corporate law rules); Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (discussing the various aspects of the debate regarding corporations' ability to opt out of corporate law rules).

and Pinterest, three companies that recently joined the public markets with dual-class structures and initial market capitalization exceeding $10 billion, we apply the methodology and concepts introduced in this Article to analyze the extent to which these governance arrangements enable the presence or future emergence of small-minority controllers.[23] We hope that our analysis will also prove useful to future examinations of dual-class structures by others.

I. PLACING A SPOTLIGHT ON SMALL-MINORITY CONTROLLERS

This Part places a spotlight on dual-class companies with small-minority controllers. Section I.A begins by discussing how we aim to reorient the longstanding debate over dual-class structures by stressing certain key differences among these structures. Section I.B explains why structures with small-minority controllers can be expected to produce considerable governance risks and costs. Section I.C illustrates how the decisions made by small-minority controllers can be expected to distort a wide range of corporate choices. Section I.D discusses a body of empirical evidence that supports our conclusions regarding the expected costs of small-minority controllers and the relationship of these costs to the controller's ownership stake. Finally, Section I.E explains how these agency distortions and costs can be expected to steeply escalate as the controller's equity stake declines.

A. The Heterogeneity of Dual-Class Structures

In the longstanding debate over dual-class stock, both opponents and supporters have tended to lump together all dual-class structures. In this section, we seek to reorient the debate and identify an important subset of dual-class structures that pose much more severe governance problems than other such structures.

Since Google went public with dual-class stock in 2004, IPOs have increasingly featured dual-class stock: 19% of the companies listed on U.S.

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[23] Lucian Bebchuk & Kobi Kastiel, *The Perils of Dell's Low-Voting Stock*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 16, 2018), https://corpgov.law.harvard.edu/2018/11/16/the-perils-of-dells-low-voting-stock/; Lucian Bebchuk & Kobi Kastiel, *The Perils of Lyft's Dual-Class Structure*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 3, 2019), https://corpgov.law.harvard.edu/2019/04/03/the-perils-of-lyfts-dual-class-structure/; Lucian Bebchuk & Kobi Kastiel, *The Perils of Pinterest's Dual-Class Structure*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 10, 2019), https://corpgov.law.harvard.edu/2019/04/10/the-perils-of-pinterests-dual-class-structure/.

exchanges in 2017 used a dual-class structure, compared to just 1% in 2005.[24] This growing use of dual-class structures has rekindled the longstanding debate about the desirability of these structures. We reviewed this heated debate in our earlier work and showed that it is still ongoing.[25] On one side of the debate stand those who believe that dual-class structures should be permitted because they enable talented founders with superior skills to lead a company without being subject to short-term market pressures.[26] On the other side stand some leading institutional investors, their advisors, and prominent governance-thought leaders. They all have expressed strong opposition to the use of dual-class structures because they "pose a serious risk to a company's public shareholders."[27]

However, prior to the circulation of our earlier work on the case against longstanding dual-class structures, this heated debate had primarily focused on whether it is desirable for companies to go public with any such dual-class structure. Market participants on both sides of the debate often lumped together the different categories of dual-class structures. By doing so, they failed to recognize a distinct subset of dual-class companies that are likely to

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[24] *See* KAMONJOH, *supra* note 8, at 84–90. The use of a dual-class IPO is even more prevalent among large IPOs. A comprehensive annual report by the law firm Shearman & Sterling LLP analyzed the IPOs of companies with a market capitalization of at least $100 million. The study found that 29% of the sixty-two such IPOs in 2015 had a multi-class structure; 19% of the thirty-two IPOs in 2016 had a multi-class structure; and 39% of the fifty-nine IPOs in 2017 had a multi-class structure. SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE & EXECUTIVE COMPENSATION SURVEY 2018, at 53 (2018), http://digital.shearman.com/i/1019978-2018-corporate-governance-survey/0? [https://perma.cc/6MSL-45TJ]. It is likely that at least some companies do not have a founder at the helm at the IPO stage, and thus have little incentive (if any) to retain dual-class structures. After excluding these widely held companies from the universe of IPOs in consideration, the percentage of dual-class IPOs is likely to be higher.

[25] *See* Bebchuk & Kastiel, *supra* note 11, at 596–601.

[26] *See, e.g.*, David J. Berger, *Dual-Class Stock and Private Ordering: A System That Works*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 24, 2017), https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/ [https://perma.cc/2LXL-TJY5]; Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 136–39 (1987) (raising the claim that dual-class stock facilitates long-term planning); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 566–67 (2016) (arguing that it could be value enhancing to provide a talented founder with a lock on control, as it enables that founder to freely implement her strategy and utilize her skills to produce superior returns). For a discussion of these benefits and their limitations, see Bebchuk & Kastiel, *supra* note 11, at 609–13.

[27] *See, e.g.*, Kimberly Gladman, *The Dangers of Dual Share Classes*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 21, 2012), https://corpgov.law.harvard.edu/2012/05/21/the-dangers-of-dual-share-classes/ [https://perma.cc/J2ZC-L6PP]. For a review of the strong opposition to dual-class structures, see Bebchuk & Kastiel, *supra* note 11, at 596–99.

generate some of the most severe governance problems—those with small-minority controllers.

For example, Institutional Shareholder Services (ISS), the leading proxy advisory firm, operates a well-known corporate governance rating system that, despite its comprehensiveness, contains only a single item—a checkbox—for dual-class structures, noting their existence or absence.[28] This binary scoring system does not measure the degree of separation between a controller's equity capital and voting rights.[29] Similarly, in 2017, a group of prominent institutional investors adopted a stewardship code, which stipulates that "[s]hareholders should be entitled to voting rights in proportion to their economic interest."[30] This shareholder initiative, however, does not distinguish dual-class companies with small-minority controllers from other versions of the structure, even though dual-class companies with small-minority controllers raise the most severe governance concerns.

As we noted in the Introduction, we recognize that the desirability of dual-class IPOs is a question on which reasonable individuals may disagree. Therefore, our approach has been to identify certain limitations on dual-class structures that could provide the basis for a broad consensus. This strategy is based on the understanding that even in jurisdictions such as the United States that enable the use of dual-class shares, there is still an important place for a policy debate about the need to limit the use of certain types of dual-class structures, the rationale behind these limitations, and their legal design. Our earlier work placed a spotlight on the problem of longstanding structures, and we are pleased that this work has contributed to the subsequent growth of investors' support of time-based sunsets.

In addition to recognizing the problem with a longstanding dual-class structure, we believe that all market participants should recognize that an assessment of the viability of, and risks posed by, dual-class structures heavily depends on the size of the equity interest held by the controller. As

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[28] The ISS rating system, currently named "ISS Governance QuickScore 3.0," is a scoring system (from 1 to 10) designed to help institutional investors identify governance risks posed by portfolio companies. *See* INST. S'HOLDER SERVS., QUICKSCORE 3.0: FACTORS BY REGION (Oct. 23, 2014), http://www.issgovernance.com/file/products/qs3-appendix-final.pdf. The system rates over 200 governance factors. *Id.*

[29] We examined ISS reports on a number of companies with extreme separation of cash-flow rights and votes, including CBS and Martha Stewart Living Omnimedia, and did not find any reference to the size of the wedge. *See* STEPHEN FARR, ISS PROXY ADVISORY SERVS., CBS CORPORATION 3 (2011) (analyzing governance risk indicators with no mention of the wedge); ALLEN SMITH, ISS PROXY ADVISORY SERVS., MARTHA STEWART LIVING OMNIMEDIA, INC. 3 (2012) (same).

[30] Inv'r Stewardship Grp., *Corporate Governance and Stewardship Principles*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 7, 2017), https://corpgov.law.harvard.edu/2017/02/07/corporate-governance-and-stewardship-principles/ [https://perma.cc/3KU9-BEUN].

we explain in the next section, this factor can be expected to have a significant impact on the financial incentives of the controllers and, in turn, on the magnitude of agency costs that the dual-class structure potentially generates.

B. The Costs of Small-Minority Controllers

1. Combining Entrenchment with Weak Ownership Incentives

The goal of this section is to highlight the severe governance issues that plague dual-class companies with small-minority controllers. To that end, it is worthwhile to compare such companies to two other common structures: (i) widely held companies, which are characterized by diverse ownership of shares without a single controlling shareholder, and (ii) controlled companies with majority owners whose equity stake—and thus, economic interest—in the company reflects their status as majority owners. Each of these structures has a mechanism that protects public investors by aligning their interests with those of corporate decisionmakers.

In a widely held company, a manager owns a small fraction of cash-flow rights and thus has limited financial incentives to maximize company value. However, this manager is not entrenched and can be removed at any time if she underperforms or otherwise acts against the interests of other public investors.[31] Therefore, the market for corporate control both limits the extent to which a manager can underperform and serves a disciplinary function that reduces agency costs. Indeed, empirical evidence indicates that the threat of removal provides managers with incentives to perform.[32]

Conversely, whereas a majority owner cannot be replaced and would not be disciplined by the market for corporate control, her large equity stake in

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[31] For a theoretical analysis of this point, see generally Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (systematically critiquing the argument that insulated boards serve the long-term interests of a publicly traded company and its shareholders), and Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013) (using empirical evidence to argue that companies with "effective" staggered boards that rejected bids made their shareholders worse off, without sufficient countervailing benefits).

[32] *See, e.g.*, Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. ACCT. & ECON. 94, 113 (2008) (showing that dual-class companies trade at lower prices than do single-class companies, both at the IPO date and for at least the subsequent five years, and attributing this to the inability of outsiders to replace incumbents in dual-class companies). For studies showing that proximity to director elections has a significant positive impact on CEO turnover-performance sensitivity, see, for example, Paul E. Fischer et al., *Investor Perceptions of Board Performance: Evidence from Uncontested Director Elections*, 48 J. ACCT. & ECON. 172, 180–82 (2009), and Vyacheslav Fos, Kai Li & Margarita Tsoutsoura, *Do Director Elections Matter?* 31 REV. FIN. STUD. 1499, 1501 (2017).

the controlled company provides powerful financial incentives to maximize company value. A majority owner bears most of the costs of her actions and captures most of the benefits.[33]

A dual-class structure with a small-minority controller, however, lacks both mechanisms. In both widely held companies and those with small-minority controller structures, corporate decisionmakers have a small minority of the company's equity stake and therefore lack powerful financial ownership-based incentives. However, unlike CEOs of widely held companies, small-minority controllers are insulated from market disciplinary forces and thus lack incentives generated by the threat of replacement, which would mitigate the risk that they will act in ways that are contrary to the interests of other public investors.

Similarly, in both majority-owned companies and small-minority controller structures, corporate decisionmakers face no discipline from the threat of replacement and the market for corporate control. However, unlike in majority-owned companies, small-minority controllers lack the powerful incentives generated by a large equity stake.[34]

In sum, dual-class structures with small-minority controllers generate significant governance risks because they feature a unique absence of incentive alignment. These controllers own a small fraction of the company's equity capital and thus bear only a small (and sometimes extremely small) share of the losses that their actions may inflict on the company's value. Yet they exercise effective control over decisionmaking and can capture the full private benefits of that control. This means that they may tolerate underperformance by the company where their private incentives offset any cost to their small shareholdings. At the same time, they are fully insulated from market disciplinary forces, and no threat of removal exists to help ensure they will not act against the interests of other public investors. This combination of entrenchment and weak ownership incentives could well lead to a wide range of distorted choices, which we discuss in detail in section C of this Part.[35]

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[33] For a discussion of controllers' incentives to monitor management, see, for example, Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281–82 (2009), and Zohar Goshen, *Controlling Corporate Agency Costs: A United States–Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 100–01 (1998).

[34] *See* LUCIAN BEBCHUK, COMM. ON INCREASING COMPETITIVENESS IN THE ECON., CORPORATE PYRAMIDS IN THE ISRAELI ECONOMY: PROBLEMS AND POLICIES 7–8 (2012) (on file with authors) (describing the incentive and entrenchment problems created by the use of control-enhancing mechanisms).

[35] One could argue that majority controllers may be too risk averse, owing to their large equity stake, while small-minority controllers may have greater incentives to take more risks; in that sense, minority controllers' interests could be more aligned with those of

2. The Severe Distortions of Small Equity Stakes

Corporate governance research pays close attention to agency problems that arise when controllers have incentives to act in ways that are not optimal for the company and other shareholders.[36] This section focuses on the well-accepted relationship between the fraction of equity capital held by the controller and the severity of the controller's agency problems—that is, the smaller the equity fraction, the more distorted the incentives and the greater the increase in expected costs.

To illustrate how the distortion in a controller's incentives depends on the controller's fraction of equity capital, consider the following examples. Imagine a dual-class company with a controller who holds 25% of the company's equity capital. Further suppose that the value of the company is V, and that the controller may bring about a corporate action that would result in a financial loss of ΔV to the public company but a gain in private benefits of $100 million to the controller. In this scenario, the controller would prefer to avoid the value-reducing action only if the decrease in ΔV exceeds $400 million and, accordingly, if the controller's pro rata share of that financial loss, which is 25% of ΔV, exceeds $100 million.

Now suppose that the same controller reduces her fraction of cash-flow rights to 5% while retaining control over the company through the use of one of the separation mechanisms discussed in Part II. If the controller takes the same inefficient corporate action, the controller's pro rata share of the financial loss would now be only 5% of ΔV, but such controller would still receive $100 million in private benefits. Therefore, the controller would now prefer to avoid the value-reducing action only if 5% of ΔV exceeds $100 million—that is, only if the decrease in ΔV exceeds $2 billion. Thus, in the range of situations in which ΔV is between $400 million and $2 billion, the 25% controller would prefer to avoid the value-reducing action, but the 5% controller would not. Accordingly, the range of value-reducing choices that would serve the controller's private interests would be considerably larger for the 5% controller than for the 25% controller.

This problem can be stated in a more general fashion. Suppose a controller owns a fraction, α, of the company's equity capital and the market

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diversified public shareholders. These potential advantages, however, have to be offset against the costs of entrenchment and weak ownership incentives that are created by this structure. As demonstrated in Section I.D, our economic analysis of the costs generated by small-minority controllers is supported by a significant body of empirical work that documents the association of an enlarged wedge with lower value and higher agency costs.

[36] *See* Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 56, 66 (2008) (stating that "many papers are primarily concerned with the magnitude of the difference, or wedge, between votes and cash flow rights").

capitalization of the controlled company is V. Suppose further the controller is considering an action that would decrease the value of the public company by a large amount, ΔV, but would provide private financial benefits in the amount of B to the controller. In this case, taking the value-reducing action would serve the interests of the controller if and only if

$$\alpha \Delta V < B,$$

which would be the case if and only if

$$\Delta V < B / \alpha.$$

The above equations define the range of circumstances in which the controller's private interests would favor taking an action that is inefficient for the company as a whole. The equation implies that this range of circumstances expands—and the expected severity of distortion increases—when the controller's fraction of equity capital (α) is smaller. As α declines, expected costs to the company and other shareholders increase in two ways: first, the growth of the wedge increases the likelihood that the controller will favor value-reducing choices; and second, if a value-reducing choice is favored, the total expected reduction in value from that choice will be higher.[37]

C. Dimensions

The general structure of the economic problem analyzed above is relevant to a wide array of corporate situations and choices faced by a controller. It applies to any situation in which a controller faces a choice that affects both the value of the controlled company and the controller's private interests.[38] To highlight the importance of this problem, we analyze a number of situations that might arise when an enlarged wedge affects the controller's interests. The examples below are intended only to illustrate the problem and not to provide an exhaustive account of all the situations in which the problem may arise. For illustrative purposes, consider the same hypothetical reduction

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[37] In our example, we assume that there is no fluctuation in the value of the company (aside from the inefficient action that could decrease that value by ΔV). Of course, if the company's value increases (irrespective of the controller's potential actions), one could think of a situation in which the reduced incentives due to the decline in the controller's equity stake would be partially offset by the nominal increase in the company's value.

[38] Legal rules may preclude some value-reducing actions. However, because legal rules leave insiders with significant discretion, they cannot be expected to eliminate all agency problems, which is why insiders' incentives are important. This is especially relevant to business decisions, such as the allocation of opportunities and talents, the choice of CEO or corporate strategy, and decisions as to whether to expand the corporation or accept an acquisition offer, which are subject to the deferential business judgment rule.

in a controller's fraction of cash-flow rights in a dual-class company from 25% to 5%, and its consequences on six types of choices faced by the controller.

1. Self-dealing

Suppose that a controller could engage in a self-dealing transaction in which the company buys an asset from an entity that is wholly owned by the controller. Further suppose that the transaction would reduce the wealth of the dual-class company by ΔV but would provide the controller with a private benefit of B. Finally, suppose that $\Delta V > B$, so that it would be inefficient for the company to engage in this self-dealing transaction.[39]

In this case, with 25% of the cash-flow rights, the controller would engage in the self-dealing transaction if and only if B is larger than 25% of ΔV. By contrast, with only 5% of the cash-flow rights, the controller would benefit from the self-dealing transaction if and only if B is larger than 5% of ΔV. Thus, in the range of situations in which $(5\% * \Delta V) < B < (25\% * \Delta V)$, the controller would be better off engaging in inefficient self-dealing if such controller has only 5% of the cash-flow rights but not if it has 25% of those cash-flow rights. Thus, the reduction in cash-flow rights would be expected to increase the range of value-reducing choices with respect to allocation decisions that would serve the controller's private interests.

2. Allocating Opportunities and Talents

Suppose that a controller encounters some opportunities for making new investments or attracting new talent and can direct those opportunities either to the controlled dual-class company or to another entity that is wholly owned by the controller, but not to both. Further suppose that allocating the opportunities to the dual-class company would provide that company with a gain of ΔV. By contrast, allocating the opportunities to the wholly owned entity would provide the controller with a private benefit of B and would prevent the dual-class company from gaining the value ΔV. Finally, suppose that $\Delta V > B$. Following the same reasoning as above, it can be shown that in the range of situations in which $(5\% * \Delta V) < B < (25\% * \Delta V)$, allocating the opportunity to the wholly owned entity would benefit the controller if it has only 5% of the cash-flow rights but not 25% of them.

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[39] For concrete examples and an analysis of the different types of self-dealing transactions, see Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1 (2011), and see generally Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000) (presenting cases of tunneling in civil law countries).

3. Remaining the CEO

Suppose that a controller serves as the company's CEO and that holding the position of CEO provides her with a private benefit of *B*. Suppose further that the controller has ceased to be a good choice for this role and that replacing her with a professional manager would increase the company's value by ΔV, while depriving the controller of her private benefit, *B*.[40] Using the same logic as above, it can be shown that in the range of situations in which $(5\% * \Delta V) < B < (25\% * \Delta V)$, maintaining an executive position would make the controller better off if she has only 5% of the cash-flow rights but not if she has 25% of those rights.

4. Choosing Corporate Strategies

Suppose that a controller faces a choice between pursuing two strategies, one of which would reduce the controlled company's value by ΔV. Suppose, however, that pursuing this strategy would provide the controller with a private benefit, *B*, because it would either enhance the controller's legacy or reputation or would move the world in a direction that the controller favors.[41] As with the decisions discussed above, it can be shown that in the range of situations in which $(5\% * \Delta V) < B < (25\% * \Delta V)$, pursuing the value-reducing strategy would make the controller better off in the 5% scenario but not in the 25% scenario.

5. Empire Building

A well-known agency problem concerns the interests of controllers in excessive expansion, when expansion would be expected to increase the controllers' private benefits.[42] Suppose that a controller could make a series

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[40] *See, e.g.*, Troy Wolverton, *The Era of the All-Powerful Tech CEO Has Only Just Begun, Even Though Facebook and Snap Show Why That's a Bad Thing*, BUS. INSIDER (Feb. 18, 2019, 9:00 AM), https://www.businessinsider.com/dual-class-stock-structures-facebook-lyft-snap-2019-2 [https://perma.cc/MRA7-S3P6] (noting that, despite shareholder opposition and poor company performance in recent years, Zuckerberg decided to keep running Facebook, and that his control over the majority voting power allowed his decision to stand—no matter the cost to shareholders).

[41] *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1667–68 (2006) (discussing how controlling shareholders' decisions to acquire a media or entertainment company may be motivated by the desire to increase their consumption of nonpecuniary private benefits rather than to maximize company value).

[42] For well-known studies that analyze empire building and management's tendency to avoid distributing cash or assets to shareholders, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 903–04 (2005), Sanford J.

of acquisitions that would substantially increase the size of the controlled company while reducing the wealth of the company's pre-acquisition shareholders by ΔV. Suppose further that by increasing the company's size and importance, the acquisitions would increase controller's influence, power, and stature, thereby providing the controller with a private benefit, *B*. Following the same reasoning as above, it can be shown that, in the range of situations in which $(5\% * \Delta V) < B < (25\% * \Delta V)$, making the value-reducing acquisitions would benefit the controller in the 5% scenario but not in the 25% scenario.

6. Blocking Efficient Sales

Commonly, the controller must decide whether to accept a value-enhancing offer to acquire the company—perhaps because the prospective acquirer recognizes that the company has been inefficiently managed owing to the above distortions. To illustrate, suppose that control over a dual-class company provides the controller with a private benefit, *B*. Further suppose that in an acquisition of that company, the controller would receive its pro rata share of the acquisition price but lose all its private benefits of control.[43] The controller will accede to the offer only if the increase in value of her stake exceeds the loss of her private benefits. Thus, the reduction in cash-flow rights from 25% to 5% would *quintuple* the necessary premium to induce the controller to accept a value-enhancing acquisition offer.

To be clear, the analysis presented in this section does not suggest that a reduction in the fraction of equity capital held by the controller would *always* lead the controller to prefer choices that would increase her own private benefit but reduce the value of the company for public investors. The important takeaway is that the enlargement in the wedge increases the structural bias in favor of such choices, and thereby exacerbates agency

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Grossman & Oliver D. Hart, *Corporate Financial Structure and Managerial Incentives*, *in* THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107 (John J. McCall ed., 1982), and Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986).

[43] Our analysis assumes that the acquisition price will be distributed pro rata. Of course, the controller might be willing to sell the whole company if such controller could obtain a larger per-share price than other public investors. However, courts have placed limits on the ability of a controller to sell the controlled company to a third party in exchange for a benefit not shared by other shareholders. *See, e.g.*, *In re* Tele-Commc'ns, Inc. S'holders Litig., No. Civ.A. 16470, 2005 WL 3642727, at *7 (Del. Ch. Dec. 21, 2005); *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 178 (Del. Ch. 2005). Although such limits might well be justified, this may cause the controller to often prefer to retain a dual-class structure even if it becomes inefficient. At any rate, our analysis is based on—and takes as given—the existing set of rules that impose limits on controllers' ability to receive a significant side payment from a third party in order to induce a sale of the company.

problems and distortions. In particular, the reduction in cash-flow rights would be expected to considerably expand the range of situations in which value-reducing choices would benefit the controller.

D. Empirical Evidence

Our economic analysis is supported by a significant body of empirical work. Empirical studies consistently document the association of an enlarged wedge with lower company value and higher agency costs. To begin, a study by Paul Gompers, Joy Ishii, and Andrew Metrick used hand-collected data on U.S. dual-class companies between 1995 and 2002 to analyze the relationship between cash-flow rights and company valuation.[44] The authors found "strong evidence that firm value is increasing in insiders' cash-flow rights and decreasing in insider voting rights."[45] They explain that "[t]he strongest results come from the separation sample, where insiders have voting control but less than 50% of the cash-flow rights. For these firms, all the evidence supports the positive effect of cash flow on valuation."[46]

Furthermore, a study by Ronald Masulis, Cong Wang, and Fei Xie examined how the divergence between insider voting rights and equity capital at dual-class companies affects various agency problems.[47] Using the same sample as Gompers, Ishii, and Metrick, these authors found that "as this divergence widens, corporate cash holdings are worth less to outside shareholders, CEOs receive higher levels of compensation, managers make shareholder value-destroying acquisitions more often, and capital expenditures contribute less to shareholder value."[48] They conclude, "[t]hese findings support the agency hypothesis that managers with greater excess control rights over cash flow rights are more prone to pursue private benefits at shareholders' expense, and help explain why firm value is decreasing in insider excess control rights."[49]

In a third study, Matthew T. Billett, Paul Hribar, and Yixin Liu examined a sample of 111 U.S. dual-class companies from 1990 to 2005 and reported that "the credit ratings worsen, and the cost of debt and overall cost of capital

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[44] Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1052–55, 1067 (2010) (as measured by the standard valuation metric of industry-adjusted Tobin's *Q*).

[45] *Id.* at 1051.

[46] *Id.* at 1084–85.

[47] Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1697 (2009).

[48] *Id.* at 1697 & n.*. For companies where insiders own at least 50% of the voting rights, the authors find that the coefficients of all key explanatory variables "are all larger in magnitude and statistically more significant than [those] in the full sample." *Id.* at 1716–17.

[49] *Id.* at 1697.

increase in the separation between managerial voting rights and cash-flow rights."[50] The authors also found that "leverage increases in voting rights and declines in cash-flow rights," and conclude that "the value gain from properly aligning the interests of managers and shareholders may be larger than previously thought."[51]

The negative economic effects of an enlarged wedge are also supported by studies on dual-class companies outside the United States. These studies report that as the wedge between a controller's cash-flow rights and voting rights widens, company value declines;[52] the likelihood of takeover substantially decreases because controlling shareholders "hang on to the control too long";[53] the dividend payout ratio decreases;[54] and the cost of debt financing, the likelihood of stock price crashes, and investment in projects with negative present value all increase.[55] Another study found that a high separation of ownership and control is negatively correlated with the likelihood of announcing a corporate acquisition, and with abnormal returns around such an announcement.[56] Other evidence shows that the amount of

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[50] Matthew T. Billett, Paul Hribar & Yixin Liu, Shareholder-Manager Alignment and the Cost of Debt (Jan. 2015) (unpublished manuscript) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=958991 [https://perma.cc/KWB9-ZZXW].

[51] *Id.* at 3–4 (emphasis omitted).

[52] Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANTITATIVE ANALYSIS 695, 709 (2003) (reporting a "strong negative relation between controlling owner vote ownership and firm value" as measured by Tobin's *Q*).

[53] *Id.* at 697 (finding that "firms with family [controlling minority shareholders] are about 50% less likely to be taken over compared to other firms").

[54] Mikko Zerni, Juha-Pekka Kallunki & Henrik Nilsson, *The Entrenchment Problem, Corporate Governance Mechanisms, and Firm Value*, 27 CONTEMP. ACCT. RES. 1169, 1201 (2010) (using a sample of Swedish companies and finding that "both the stock market valuation of free cash flow and the dividend payout ratio of a firm increase with major shareholders and board members' ownership of cash-flow rights").

[55] *See* Sabri Boubaker, Hatem Mansali & Hatem Rjiba, *Large Controlling Shareholders and Stock Price Synchronicity*, 40 J. BANKING & FIN. 80, 81, 88–89 (2014) (using a sample of French-listed companies and finding that a one-standard-deviation increase in the wedge is associated with a 3.14% increase in stock price crash risk); Chen Lin et al., *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FIN. ECON. 1, 2, 10 (2011) (using a sample of East Asian and Western European companies and finding that an increase of one standard deviation in the wedge increased the average loan spread from 14% to 18%); Zerni et al., *supra* note 54, at 1172 (reporting that, "when corporate insider incentives are better aligned with those of outside shareholders, the funds of a firm are more likely to be distributed as dividends to shareholders rather than (over)invested in projects with less-than-zero present value").

[56] François Belot, Excess Control Rights and Corporate Acquisitions 3–4 (Sept. 2014) (unpublished manuscript) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695061 [https://perma.cc/8ZAR-YLP8] (examining corporate acquisitions by dual-class companies using a sample of French-

industry- and market-level information incorporated into stock prices decreases as the wedge widens, which is consistent with the prediction that the "control-ownership wedge gives controlling shareholders incentives to limit the flow of firm-specific information to the market to keep any opportunistic behavior outside the glare of external scrutiny."[57]

The effect of enlarging the wedge between voting power and cash-flow rights has also been empirically investigated in the context of additional control-enhancing mechanisms, such as pyramidal structures, which are prevalent in many countries around the world and, like dual-class structures, produce such a wedge.[58] A significant body of evidence indicates that companies in pyramidal structures with a larger wedge between voting power and cash-flow rights are associated with more severe reductions in value[59] and with larger agency problems.[60]

E. How Costs Escalate When Equity Stakes Decrease

We have demonstrated thus far that as the equity stake decreases, the expected governance costs are likely to increase. It is important to emphasize, however, that such an increase is not linear; rather, as explained below, the costs grow at an increasing rate as the controller's cash-flow rights become smaller. Thus, when the controller's equity stake decreases from 10% to 5%,

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listed companies and finding that "[a] one standard deviation increase in the wedge between control and cash flow rights from the mean is associated with a 1.40% reduction in the likelihood of acquiring" and that "a one standard deviation increase in the proxy for excess control is associated with a 0.40% decrease in abnormal returns around the announcement of the transaction").

[57] Boubaker, *supra* note 55, at 93.

[58] Corporate pyramidal structures provide another mechanism that separates cash-flow rights and voting power and thereby enables a party to control corporate assets while contributing only a minority of the underlying equity capital. For an economic analysis of the relationship between dual-class structures and corporate pyramids, see Bebchuk et al., *supra* note 18, at 297–99.

[59] *See, e.g.*, Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002) (studying eight East Asian countries); Sung Wook Joh, *Corporate Governance and Firm Profitability: Evidence from Korea Before the Economic Crisis*, 68 J. FIN. ECON. 287 (2003) (using data from Korea); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159 (2003) (studying eighteen emerging markets).

[60] *See, e.g.*, Yves Bozec & Claude Laurin, *Large Shareholder Entrenchment and Performance: Empirical Evidence from Canada*, 35 J. BUS. FIN. & ACCT. 25 (2008) (evidence from Canada); Guohua Jiang, Charles M.C. Lee & Heng Yue, *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (2010) (evidence from China); Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment?: Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857 (2005) (evidence from Taiwan).

it creates a much bigger increase in expected governance costs than would a decrease from 30% to 25%.

Consider a 30% controller and a 10% controller, each of whom reduces her equity stake by 5%. In the case of the 30% controller, the decrease of her equity stake to 25% would increase the range of situations in which said controller would prefer to avoid a value-increasing action in order to retain private benefits of $100 million to cases in which ΔV is between $333.3 million to $400 million (a total range of $66.6 million).[61] In contrast, in the case of the 10% controller, exactly the same percentage-point decrease in equity stake—from 10% to 5%—would increase the range of distortions to cases in which ΔV is between $1 billion to $2 billion (a total range of $1 billion).[62]

To illustrate this pattern, it is instructive to consider the context in which an offer to acquire the company is rejected. Suppose that a controller decreases its equity stake from 10% to 5%. In absolute levels, the reduction in cash-flow rights is just 5%. However, this reduction would halve the controller's economic interest in the company, and thus double the premium that would be necessary to induce the controller to accept a value-enhancing acquisition offer. In this way, the 5% reduction in cash-flow rights would greatly expand the range of potentially value-increasing offers that the controller would have an incentive to reject.

This analysis is consistent with the empirical evidence we presented in the previous section, which shows that the decrease in the controller's equity stake is associated with lower value and higher agency costs. In particular, Gompers, Ishii, and Metrick show that the relationship between the controller's cash-flow rights and company value (as measured by Tobin's *Q*) is a nonlinear one, with the costs growing at an increasing rate as ownership stake declines.[63] This evidence reinforces the concerns we raise in this Article about controllers who have especially small equity stakes.

Our analysis is relevant to any given level of controllers' skills. Thus, even controllers with superior skills or talents are likely to make more value-decreasing choices as their equity stake decreases. At some point, the benefits attributed to their superior skills will be outweighed by the costs associated with entrenched leadership. Therefore, even those who believe it could be value-enhancing to provide a talented controller with a lock on control[64] should oppose the use of dual-class structures without any limitation on the

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[61] We obtained these figures by using the general formula presented *supra* Section I.B.2:

100 [B] / 0.3 [α] = 333.3 [ΔV]; 100 / 0.25 = 400.

[62] 100 / 0.1 = 1,000; 100 / 0.05 = 2,000.

[63] Gompers et al., *supra* note 44, at 1073–78.

[64] *See, e.g.*, Goshen & Hamdani, *supra* note 26.

ability of the controller to unwind her equity position without relinquishing control.

II. THE MECHANISMS OF EXTREME SEPARATION

This Part identifies and analyzes the main governance arrangements that are used to enable controllers of dual-class companies to retain control with a small or even a tiny fraction of the company's equity capital. An understanding of these mechanisms is necessary to identify the extent to which governance arrangements in place enable the controller to substantially reduce her equity stake without relinquishing control. In sections II.A through II.F, we analyze six types of mechanisms that operate to enable controllers to do just this.[65] In section II.G, we show that although some dual-class companies have adopted ownership-based sunset provisions, in practice, these provisions do not place substantial limits on controllers' ability to unload shares while maintaining control.[66]

In addition to identifying and analyzing these mechanisms, we provide in this Part novel empirical evidence of the incidence of each mechanism in existing dual-class companies as well as in recent dual-class IPOs. To this end, we collected the governance provisions of two sets of companies.[67]

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[65] We do not attempt in this Part to provide an exhaustive list of all separation mechanisms, but rather to present the main avenues that have thus far been used to create extreme separation. Undoubtedly, with the assistance of creative legal counsel, controllers may be able to develop additional mechanisms in the future. For instance, prior to the Dropbox IPO, the company cofounders received "Co-Founder Grants," and were able to "vote these shares immediately upon grant and prior to their vesting." *See* Dropbox, Inc., Registration Statement, *supra* note 3, at 38. Enabling Dropbox's cofounders to vote this large number of shares immediately and prior to their vesting is another separation mechanism.

[66] An ownership-based sunset converts the high-vote shares held by the controllers of a dual-class company into common stock when they represent less than a certain predetermined percentage of the total number of all common shares outstanding or of all high-vote shares outstanding. *See, e.g.*, Snap Inc., Registration Statement (Form S-1) 157 (Feb. 2, 2017) (providing that the high-vote shares held by each founder will convert to low-vote shares when the founder's holdings drop below a certain threshold (30%) of high-vote shares that the founder held at the IPO).

[67] Data on ownership rights, voting rights, and contractual arrangements to nominate directors were hand collected and analyzed from proxy statements and annual reports filed on the SEC's EDGAR system.

Consistent with prior research in the field, we have excluded REITs (Real Estate Investment Trusts), LLPs (Limited Liability Partnerships), LLCs (Limited Liability Companies), ADRs (American Depositary Receipts), Closed-End Funds, and financial companies from both datasets. *See, e.g.*, Gompers et al., *supra* note 44, at 1055–56. In particular, we excluded companies with the following industry codes: 6021, 6022, 6029, 6141, 6163, 6211, 6282, 6311, 6331, 6411, 6512, 6531, and 6798. We have also excluded companies with time-phased voting, as this control-enhancing mechanism is different from dual-class structure. Time-phased voting is an arrangement in which long-term shareholders

The first set, "the Dual-Class Dataset," includes all controlled dual-class companies in the Russell 3000 as of 2017 (122 companies).[68] Although a dominant shareholder could exercise effective control over a company by holding less than 50% of the voting rights,[69] we have included in this sample only companies whose controllers have a lock on control by either (i) holding 50% or more of the voting rights or (ii) being entitled to elect a majority of the board of directors. The second set, "Dual-Class IPOs Dataset," includes dual-class IPOs during the period between 2013 and 2017 (forty-eight companies).[70] In this Part, we include information from the Dual-Class IPOs Dataset in order to examine the frequency of mechanisms of extreme separation in recent IPOs.

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receive more votes per share than short-term shareholders. *See, e.g.*, Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 547 (2016).

[68] *See* COUNCIL OF INSTITUTIONAL INV'RS, DUAL CLASS COMPANIES LIST (2017), https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf (providing list of dual-class controlled companies as of March 2017). The Russell 3000 Index is a capitalization-weighted stock market index maintained by FTSE Russell. FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES 6 (2018), https://www.ftse.com/products/downloads/Russell-US-indexes.pdf?354.

[69] *See, e.g.*, *In re* Zhongpin Inc. Stockholders Litig., C.A. No. 7393-VCN, 2014 WL 6735457, at *8–9 (Nov. 26, 2014) (determining that a 17% stockholder could be deemed a controller). A Delaware court has held that "there is no absolute percentage of voting power that is required in order for there to be a finding that a controlling stockholder exists." *In re* PNB Holding Co. S'holders Litig., No. Civ.A. 28-N, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006). Instead, Delaware courts consider whether the dominant stockholder "exercises 'such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control.'" *In re* Morton's Rest. Grp., Inc. S'holders Litig., 74 A.3d 656, 665 (Del. Ch. 2013) (quoting *In re* PNB, 2006 WL 2403999, at *9) (alteration in original)*; see also In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 553 (Del. Ch. 2003) (considering "whether the stockholder, as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes").

[70] We derived the list of dual-class IPOs from Compustat, a database of financial, statistical, and market information published by Standard and Poor's. *See* S&P GLOBAL MARKET INTELLIGENCE, COMPUSTAT DATA FROM S&P GLOBAL MARKET INTELLIGENCE (2017), https://www.spglobal.com/marketintelligence/en/documents/compustat-brochure_digital.pdf. For the research platform we used to access the Compustat database, see WHARTON RESEARCH DATA SERVICES, http://wrds.wharton.upenn.edu/ [https://perma.cc/KLL2-XBF6] (last visited Apr. 5, 2019). We eliminated from our sample companies in which the dominant shareholder held the low-vote shares or is entitled to elect only a minority of the board. We included in this dataset all dual-class IPOs regardless of whether their controllers had a lock on control at the time of the IPO. This is because the voting power of certain controllers may increase after the IPO, once other holders of high-vote shares sell their shares and those shares are automatically converted into low-vote shares. *See infra* Section II.E.2.

A. Hardwiring for Votes or Directors

Controllers of dual-class companies can include provisions in the company's governance documents to secure preferential governance rights for themselves. These provisions sever the relationship between governance rights and equity ownership: so long as the controller holds the shares with preferential rights, that controller holds the right to a fixed percentage of votes or a fixed number of board seats, regardless of her percentage of equity capital.

First, controllers may "hardwire" a fixed percentage of voting rights to themselves, which we refer to as "hardwiring for votes." Mechanically, these provisions allocate more votes to the control class (or fewer to the public shares) as the controller's equity stake decreases. Absent a sunset provision that automatically dismantles the dual-class structure when some conditions are satisfied, a controller will retain the same voting percentage no matter how negligible her equity stake becomes.

To illustrate, consider Ford Motor Company: Ford's charter provides the members of the controlling family with the right to exercise 40% of the company's voting power, regardless of the size of its equity stake.[71] This governance mechanism ensures that the family will maintain effective control over the company even if it substantially decreases its equity stake over time. Therefore, although the equity stake of the Ford controlling family has fallen significantly over the years—from 12% in 1956 to 1.78% in early 2015—the family members have constantly held 40% of the company's voting power.[72]

Another prominent example is Comcast, one of the country's largest providers of cable services.[73] Following its initial public offering in 1972, the company's capital structure provided the founding Roberts family with three votes per share and public shareholders with one vote per share.[74] Over time, the controlling family preserved its controlling stake through a series of amendments to Comcast's governing documents, which gradually increased

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[71] Ford Motor Co., Definitive Proxy Statement (Schedule 14A) 75 (Mar. 31, 2017) (stating that the public shareholders hold common stock with "60% of the voting power" and that class B shareholders, the Ford family members, "have the remaining 40% of the voting power"). To maintain the hardwiring for votes, the number of votes allocated to the controlling family is calculated each year in accordance with the company charter. *Id.* at 80. As of 2017, each share with superior voting rights held by the controlling family was entitled to 36.8 votes. *Id.*

[72] For the charter provision stipulating that the Ford family members have 40% of the voting power, see *id.* For the information used to calculate the equity stake of the Ford family, see FORD MOTOR CO., ANNUAL REPORT 30 (1956) (on file with authors), and Ford Motor Co., Definitive Proxy Statement (Schedule 14A) 17–18 (Mar. 27, 2015).

[73] *See Our History*, COMCAST BUS., http://business.comcast.com/about-us/our-history [https://perma.cc/X7N9-YPER] (last visited Apr. 8, 2019).

[74] *See* COMCAST CORP., PROSPECTUS 17, 24 (1978) (on file with authors).

the family's voting power.[75] In 2001, Comcast's articles of incorporation were amended to include a new voting rights formula that gave the Roberts family a one-third voting interest in the company that could not be diluted.[76] As a result of this formula, public shareholders have been entitled to just 0.0599 votes per share, whereas the Roberts family is entitled to fifteen votes per share—over 200 times as many votes as other public investors.[77] This hardwiring provision has enabled the family to retain effective control even as its equity stake has shrunk from 45% in 1978 to less than 1% today.[78]

Second, controllers can also include provisions in governance documents that permit the controlling class to elect a majority of the board members. A typical example of this mechanism, which we refer to as "hardwiring for directors," stipulates that holders of each class of shares—the public investors and the controller—should vote separately as a single class on the election of directors. The controller is entitled to elect a majority of the board members, and the public shareholders elect the remaining minority directors.[79] Proportional voting for directors ensures that a controlling shareholder will always exercise control over the board, even after the controller substantially reduces its equity investment. The New York Times Company, for example, incorporated into its governing documents a provision that enables the controlling family to elect 70% of the board members even though it holds less than 11% of the company's equity capital.[80]

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[75] The votes-per-share entitlement of the class of shares held by the Roberts family increased to seven in 1982 and then to fifteen in 1984. *See* COMCAST CORP., CERTIFICATE OF AMENDMENT (July 22, 1982) (on file with the Department of State of the Commonwealth of Pennsylvania); COMCAST CORP., CERTIFICATE OF AMENDMENT 84541493 (Aug. 28, 1984) (on file with the Department of State of the Commonwealth of Pennsylvania).

[76] *See* Comcast Corp., Definitive Proxy Statement (Form DEF 14A) 6 (Apr. 28, 2017) (stating that the shares beneficially owned by Mr. Brian L. Roberts represent 33.33% of the combined voting power of the company). The formula operates by holding the shares with superior voting power—those held by the Roberts family—constant at fifteen votes per share and adjusting the votes-per-share entitlement of public shareholders so that the Roberts family will have at all times a one-third voting interest. *Id.* at 5.

[77] *Id.*

[78] Comcast Corp., Definitive Proxy Statement, *supra* note 76, at 7; Comcast Corp., Proxy Statement 1–2 (1978) (on file with authors).

[79] One could also imagine a governance arrangement that enables a controller to elect all of the company's directors. However, such an arrangement was precluded by the listing standards of the American Stock Exchange (AMEX), a major exchange that permitted the use of dual-class stock in the 1970s and 1980s. *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 704 n.90 (1986).

[80] *See* N.Y. TIMES CO., CERTIFICATE OF INCORPORATION art. 4(II) (2007) ("The holders of the Class A Common Stock [the class held by the public] shall be entitled to one vote for each share thereof held by them in the election of 30% of the Board of Directors . . . and the holders of the Class B Common Stock [the class held by the controller] shall be

Our data show that hardwiring into governance documents is an important separation mechanism that currently exists in a non-negligible number of companies in the Dual-Class Dataset. Of these companies, 25% grant their controlling shareholders the ability to exercise control by hardwiring such control into governance documents.[81] Furthermore, 10.4% of the companies in the Dual-Class IPOs Dataset went public with such a mechanism.[82]

B. Large Ratio of High/Low Votes

Another mechanism enabling the creation of extreme separation is the initial allocation of extensive voting power to the class of shares held by the controller. An overwhelming majority of dual-class companies use this high/low vote mechanism, with most setting the ratio at 10:1 or higher.[83] A dual-class structure with a 10:1 ratio allows the controller to hold an equity stake as low as 9.1% without losing full control over the company, becoming a very-small-minority controller.

The following numeric example can illustrates this point. Suppose a company has 1,000 shares: 91 high-vote shares (10 votes per share) that are held by a controller and 909 ordinary shares (1 vote per share) that are held by public investors. In this example, the controller would control 910 votes (91 * 10), and public investors would hold 909 votes (909 * 1). Therefore, the controller would be able to exercise full control as long as it holds 9.1% (91 ÷ 1,000) of the equity capital.

The high/low vote ratio adopted at the IPO determines the extent to which a controlling shareholder could reduce its equity stake over time without losing majority control. If, instead of a 10:1 ratio, issuers adopt a ratio of 5:1, 4:1, 3:1, or 2:1, a controller would need to hold at least 18.2%, 20%, 25%, or 33.3%, respectively, of the company's equity capital to maintain majority control. However, unlike certain other jurisdictions, U.S. exchanges impose no limits on the ratio of high/low votes, and issuers are allowed to allocate as

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entitled to one vote for each share held by them . . . ."); N.Y. Times Co., Definitive Proxy Statement (Schedule 14A) 7–8 (Mar. 22, 2016).

[81] The vast majority (twenty-nine) of the thirty-one companies with hardwiring provisions established hardwiring for directors. There are seven additional companies that provided hardwiring solely for the election of minority directors, while the rest of the directors are elected by both classes. In this case, the hardwiring does not serve as a control-enhancing mechanism, so we did not include these companies in our calculations.

[82] The certificates of incorporation of two of the five companies that went public with such a mechanism provide that the number of directors that a controller can elect does not remain constant, but rather declines when the controller's equity stake decreases below certain thresholds.

[83] *See infra* note 88 and accompanying text.

many votes as they desire to the class with the superior voting rights.[84] Indeed, some companies choose to adopt a ratio that is higher than 10:1. The recent IPOs of Lyft and Pinterest, for example, used a 20:1 ratio.[85]

To illustrate the consequences of using a high ratio, consider Zynga, Inc., which went public in 2012 with three classes of common stock.[86] Zynga Class C common shares are exclusively held by Zynga's founder, Mark Pincus, and are entitled to seventy votes per share.[87] Zynga Class B common shares are held by other pre-IPO shareholders and are entitled to seven votes per share, and Zynga Class A common shares are entitled to one vote per share.[88] Creating a class with a favorable voting power of 70:7:1 at the IPO stage allows Zynga's founder to concentrate control in his hands for a longer period. In particular, the ratios prescribed in this triple-class structure enable Pincus to control 63.5% of Zynga's voting rights while holding only 10% of the company's equity capital.[89] Moreover, as long as Pincus has 1.5% of Zynga's equity capital, he will have more votes than public investors in the aggregate.[90]

Zynga also adopted a sunset provision stipulating that the company's triple-class structure will be dismantled when the number of outstanding shares of Class B and Class C common stock represent less than 10% of the aggregate *voting power* of the company's capital stock.[91] This is a fig leaf, because Pincus could unwind his stake to as low as 0.15% of total equity without triggering the sunset clause.[92]

Our hand-collected data shows that the allocation of extensive voting power to the shares held by the controller is another important mechanism for facilitating extreme separation. Of all the companies in the Dual-Class Dataset, 43% use a 10:1 ratio; 8% of the companies use a higher ratio; an additional 19% of cases use no voting stock -- a mechanism that we discuss in greater detail in the next section and that is equivalent to an "infinite ratio;" and 25% of those companies have provisions under which control is

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[84] For a discussion of the use of limits that other jurisdictions impose on using high/low vote ratios, see *infra* notes 169–71 and accompanying text.

[85] *See supra* note 23.

[86] *See* Zynga Inc., Amendment No. 9 to Registration Statement (Form S-1) (Dec. 15, 2011) [hereinafter Amendment No. 9].

[87] *Id.* at 28.

[88] *Id.*

[89] Zynga Inc., Definitive Proxy Statement (Schedule 14A) 41 (Apr. 28, 2016).

[90] The percentage of equity capital required to maintain majority control is calculated in the following way: 1 / 1 + 70 = 0.014.

[91] Zynga Inc., Amendment No. 9, *supra* note 86, at 139.

[92] This calculation was made following the methodology described *infra* Section IV.B. and is based on the beneficial ownership data of Mark Pincus retrieved from Zynga's Definitive Proxy Statement. *See* Zynga Inc., Definitive Proxy Statement, *supra* note 89, at 41.

hardwired. In only 5% of the cases did dual-class companies have a ratio that was lower than 10:1 and no hardwiring mechanism.[93] Similarly, 97% of the companies in our Dual-Class IPOs Dataset, which did not use nonvoting shares or hardwiring, went public with a ratio that is equal to or larger than 10:1.[94] As we demonstrated in the beginning of this section, absent a sunset provision, a controller of a dual-class company with a 10:1 ratio (or higher) can hold as little as 9.1% (or lower) without losing majority control.

C. Nonvoting Stock

A controlling shareholder can also take a dual-class company public with a capital structure that authorizes the issuance of nonvoting shares. Nonvoting shares can be viewed as a subset of the high/low vote structure where the ratio is infinite. Alternatively, they can be viewed as equivalent to hardwiring for 100% of the votes.

When the dual-class structure concentrates all the high-vote shares in the hands of the controller and provides no voting power to other public shareholders, the controller retains control no matter how negligible her equity stake is compared to that of the public shareholders. When there are other pre-IPO shareholders who hold high-vote shares, the extent to which the controller can lower her fraction of equity capital without relinquishing control depends on two factors: (i) the number of high-vote shares held by the other pre-IPO investors and the pace at which such investors sell those shares relative to the controller, and (ii) the number of authorized nonvoting shares that are approved at the IPO stage and could ultimately be issued as dividends over time.[95]

To illustrate this point, imagine a dual-class company, "ABC Corp.," which goes public with a structure that concentrates all the high-vote shares in the hands of the controller and certain pre-IPO shareholders and provides no voting power to other public shareholders. Assume that, given the initial distribution of voting rights between the controller and the other pre-IPO shareholders, the controller will lose her lock on control when said controller holds less than 10% of the company's equity capital. ABC Corp. could issue authorized nonvoting shares as stock dividends, and the controller would be able to sell them on the market and reduce her fraction of cash-flow rights without affecting her fraction of votes.

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[93] In hardwired companies, the controllers could exercise majority control over the board, regardless of the voting ratio between the high- and low-vote share (which is often 1:1 in these companies).

[94] In the vast majority of these IPOs, issuers used a 10:1 ratio.

[95] If the company's governance structure includes an ownership-based sunset provision, that provision could also limit the controller's ability to unload its equity stake.

Table 1 below demonstrates how the percentage of shares that a controller would be able to sell is a function of the number of authorized shares to be issued as dividends at a later stage. Consider first a dividend ratio of 1:1—that is, one nonvoting share issued as a stock dividend for each of the company's outstanding shares. In such a case, the controller would be able to sell half her shares, reducing her equity stake from 10% to 5%.

Table 1: Dividend Ratio and Controller's Equity Stake After the Sale of the Dividend

Dividend Ratio	% of Shares that a Controller Could Sell	Controller's Total Equity Stake after the Sale (%)
1:1	50.0	5.00
2:1	66.6	3.33
3:1	75.0	2.50
4:1	80.0	2.00
5:1	83.0	1.70
6:1	85.7	1.43
7:1	87.5	1.25
8:1	88.9	1.11
9:1	90.0	1.00
10:1	90.9	0.91

If ABC Corp. authorizes a sufficiently large number of nonvoting shares at the IPO stage, there is no practical limit on the extent to which its controller could reduce her fraction of equity stake without any diminution of her voting power. Suppose that the ratio between the authorized but unissued nonvoting shares and the company's issued shares is 50:1 after the IPO. If ABC Corp. later distributes all these authorized nonvoting shares as dividends, its controller would be able to sell up to 98% of her equity capital and retain as little as 0.2% of the company's equity capital without losing any of her voting power.

To see how this theoretical analysis applies in reality, consider the example of Snap, which sold only nonvoting shares at its IPO.[96] By doing so, Snap adopted an unusual triple-class share structure: its founders, Evan Spiegel and Bobby Murphy, retain super-voting shares (ten votes per share); other pre-IPO investors' shares have a lesser voting power (one vote per share); and IPO investors hold zero votes.[97]

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[96] Snap Inc., Registration Statement, *supra* note 66, at 153–55.
[97] *Id.*

Immediately after the IPO, Spiegel and Murphy controlled 89% of the company voting power while holding approximately 36% of the company's equity capital.[98] The triple-class capital structure enables them to maintain a lock on control even if they dilute their ownership stake significantly over time. Moreover, because Snap issued a dividend of one nonvoting share to all its equity holders prior to filing for the IPO, each cofounder could liquidate half of his holdings without diminishing his voting control.[99]

Finally, the company also authorized three billion nonvoting shares at the IPO (only 519,013,572 of which were issued prior to the IPO's filing).[100] In the future, Snap can issue pro rata dividends from some of the remaining authorized nonvoting shares, which Spiegel and Murphy may unload into the public market without any diminution of their voting power.[101] Our calculation indicates that, if the company uses this avenue to the fullest extent possible, each cofounder would be able to sell 92.2% of his equity stake—lowering it to about 1.4% of the company's equity capital, and 2.8% together—without losing their majority voting power.[102]

Our hand-collected data of governance provisions in dual-class companies indicates that nonvoting shares are currently in place at 19% of companies in the Dual-Class Dataset.[103] This percentage, however, includes not only companies that adopted nonvoting shares at the IPO stage but also those that introduced them through a midstream reclassification, discussed further in section F of this Part. Additionally, 12.5% of the companies in the Dual-Class IPOs Dataset went public with a dual-class structure that includes nonvoting shares.[104]

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[98] This calculation is based on the beneficial ownership information from Snap's registration statement. *See* Snap Inc., Amendment No. 3 to Registration Statement (Form S-1) 155–59 (Feb. 27, 2017).

[99] *Id.* at 161.

[100] *Id.* at 155, 160.

[101] Section 3(7) of Snap's certificate of incorporation obligates the company to hold in reserve a sufficient number of authorized nonvoting shares to honor its conversion rights. The company has outstanding 279,516,853 shares of Class B stock and 215,887,848 shares of Class C stock, which could be converted into nonvoting shares. *Id.* at 8. Additionally, the company has around 650 million shares of nonvoting shares reserved under existing option plans and commitments. *Id.* at 9–11. We therefore assume that the actual amount of authorized nonvoting shares that the company could issue in the future is around 1.2 billion.

[102] This estimation is based on the assumption that Snap will issue 1.2 billion authorized nonvoting shares, and that each cofounder would avoid triggering a sunset provision that Snap adopted at the IPO.

[103] This percentage does include companies with hardwiring for directors. See infra note 93.

[104] However, the majority of these companies (four out of six) had a class of nonvoting shares that were authorized but not issued at the time of the IPO.

D. Dealing with Sales of Controller Shares

Controllers of dual-class companies often have incentives to sell their high-vote shares to diversify their portfolios and reduce idiosyncratic risk.[105] However, any sale of high-vote shares would decrease their total voting power. This section discusses two mechanisms that mitigate this decrease and, in some circumstances, even increase the separation between voting rights and cash-flow rights: voluntary conversion clauses and the distribution of low-vote shares as dividends.

1. Voluntary Conversion

The organizational documents of dual-class companies often include a provision that permits the holders of high-vote shares to convert them into low-vote shares upon their transfer to a third party.[106] This clause has an entrenchment effect when the controller sells its shares on the market: the conversion of the high-vote shares into low-vote shares reduces the pace at which the controller's voting power is diluted.

To illustrate, suppose that at the IPO stage a dual-class company has 100 shares: 40 high-vote shares held by the controller and entitling this controller to 10 votes per share, and an additional 60 ordinary shares, held by shareholders other than the controller, entitling their holders to one vote per share. At that point, the controller holds 87% of the company's voting power (400 out of 460 votes) and 40% of the company's equity (40 out of 100 shares). In the years following the IPO, the controller reduces its equity position to 20% by selling the high-vote shares on the market. What happens to its voting power?

The answer depends on whether the company's charter includes a conversion provision. In the absence of this provision, the controller's voting power will be reduced to 43.5% of the votes because the secondary market purchasers will hold ten-vote shares. If, however, the company's charter includes a conversion provision, the high-vote shares lose their superior voting power upon a sale to a third party. In this case, after the sale, the dual-class company would have 20 high-vote shares and 80 ordinary shares, so the controller would still hold 71.4% of the company's voting power (200 out of 280 votes), even though such controller now owns only 20% of the

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[105] Idiosyncratic risk is a risk endemic to a particular stock and not a whole investment portfolio. That risk can be mitigated through diversification in an investment portfolio. For a discussion of a controller's need to reduce idiosyncratic risk, see, for example, George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 749 (1987), and Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 812 (1987).

[106] *See, e.g.*, Snap Inc., Registration Statement, *supra* note 66, at 157.

company's equity (20 out of 100 shares). Although the sale would reduce the controller's *total* voting power, the conversion clause mitigates this decrease and allows the controller to retain majority control even after reducing her equity stake by half.[107]

Data we hand-collected indicates that this mechanism is quite common among dual-class companies. In particular, such a mechanism is in place at 92% of the companies in the Dual-Class Dataset. Furthermore, 90% of the companies in the Dual-Class IPOs Dataset went public with such a mechanism.

2. Dividends in Low-Vote Shares

Another mechanism that mitigates the decrease in the controller's voting power is the authorization of a large number of low-vote shares at the IPO stage and their issuance to all shareholders as a dividend at a later stage. Once these shares are issued on a pro rata basis after the IPO, the controller can sell them on the market, instead of selling her high-vote shares, and thus slow down the pace at which her voting stake is diluted.[108] This separation mechanism is similar to the one described for nonvoting shares in section II.C. Here again, when the number of authorized but unissued shares increases, the controller is better able to reduce her fraction of equity stake through the distribution and sale of low-vote shares with a minimal impact on her voting power.

To illustrate the effect of this mechanism, consider the same scenario as in section II.D.1 above, in which the controller owns 40% of the company's equity (40 out of 100 shares) and 87% of the company's voting power (400 out of 460 votes) through the holding of high-vote shares. In the years following the IPO, the controller decides to reduce her equity stake by half. To do so while still maintaining majority control, the controller could distribute low-vote shares as dividends to all shareholders and then sell those low-vote shares on the market. After the dividends, the controller's voting power would be 78.6% (440 out of 560 votes), and selling her 40 new low-vote shares would only reduce her voting power to 71.4% (400 out of 560 votes), compared to 43.5% if such controller had sold half her high-vote

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[107] This provision also increases the wedge between voting rights and cash-flow rights—from 47% before the sale (87% - 40%) to 51.4% after (71.4% - 20%).

[108] For example, Match Group went public in 2015 with a triple-class structure that included a class with ten votes per share, a class with one vote per share, and a class of nonvoting shares that were authorized but not issued at the time of the IPO. *See* Match Grp., Inc., Amendment No. 4 to Registration Statement (Form S-1) 9 (Nov. 17, 2015).

shares.[109] In this way, the controller is able to retain majority control while unwinding half of her equity.

Low-vote share dividends could be particularly useful when there are other pre-IPO shareholders who avoid selling their high-vote shares. In such a scenario, any sale of high-vote shares by the controller would change the proportional holding of high-vote shares to the controller's detriment (regardless of whether the automatic conversion provision is triggered). A controlling shareholder could prevent that change by issuing low-vote shares as dividends.

What happens when there are not enough authorized low-vote shares? In that case, the company would have to authorize and issue additional ones. It could also create a new class of nonvoting shares through a midstream change to the governing documents. This mechanism and the special problem it creates will be discussed in section F of this Part.

E. Dealing with High-Vote Shares Not Held by the Controller

When a corporation adopts a dual-class structure at the IPO stage, it often grants high-vote shares to certain pre-IPO investors other than the founder, such as venture capital funds or employees. This section discusses two contractual arrangements with these pre-IPO investors that controlling founders use to maintain a high degree of separation. The first separation mechanism—post-IPO voting agreements—applies as long as pre-IPO investors still hold the high-vote shares. The second mechanism—automatic conversion into low-vote shares—is triggered in the event that these shares are sold by any of the pre-IPO investors.

1. Post-IPO Voting Agreements

Voting agreements are often used to allocate control rights among investors prior to the IPO. Occasionally, the agreements survive the IPO. In the typical scenario, certain pre-IPO shareholders who hold high-vote shares commit to vote them as directed by the controller. These shares amplify the controller's voting power even though that controller does not own their underlying economic rights. Thus, as long as the voting agreement remains in place and the covered shareholders hold the stock, the agreement will further increase the wedge between the controller's equity stake and her voting rights. Our Dual-Class Dataset includes ten companies (8%) that have

[109] Following the distribution of the dividend, there will be 200 shares (40 high-vote shares and 160 low-vote shares), the controller will have 440 votes (400 + 40), and other shareholders will have 120 votes (60 + 60).

a voting agreement in place.[110] Additionally, 23% of the companies in our Dual-Class IPOs Dataset went public with a voting agreement that survived the IPO.

For example, when Facebook went public in 2012, Mark Zuckerberg entered into voting agreements with certain pre-IPO shareholders, pursuant to which these shareholders agreed to vote all of their shares as he directed, except under limited circumstances.[111] Following the IPO, Zuckerberg's shares entitled him to 30.9% of Facebook's voting rights, and he controlled a majority of the voting power only by virtue of his proxy rights over shares with an additional 27.6% of the votes.[112]

Moreover, although pre-IPO shareholders are often free to sell their shares subject to the voting agreement after the IPO, such sales would not necessarily undermine the controller's majority voting power. If, as is now common, the company has an automatic conversion provision (discussed below), a sale of shares by a pre-IPO shareholder will trigger conversion into low-vote shares and cement the controlling shareholder's control.

2. Automatic Conversion

High-vote shares held by pre-IPO shareholders often have automatic conversion provisions, which automatically convert high-vote shares into low-vote shares upon their transfer to a third party. This mechanism would seem to benefit public investors because it ensures that only the pre-IPO shareholders who played an important role in the company's business development exercise the shares' superior voting power.

The automatic conversion mechanism, however, has an entrenchment effect, which is triggered when certain holders of high-vote shares—such as the venture capital fund—sell their shares on the market more quickly after the IPO than does the original founder. This will often be the case given that controllers have incentives to maintain control, and the venture capital

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[110] Voting agreements are likely to be less common in mature dual-class companies because pre-IPO investors, such as venture capital funds, often liquidate their positions in the years following the IPO. *See infra* note 111 and accompanying text.

[111] Facebook, Inc., Prospectus (Form 424B4) 150 (May 17, 2012). Under one of the voting agreements, shareholders agreed to vote all of their shares as directed by Zuckerberg on all matters to be voted upon by shareholders; another of these voting agreements excludes issuances of capital stock "in excess of 20%" of then outstanding Facebook stock, and "matters which would disproportionately, materially and adversely affect" a shareholder who is party to the voting agreement. *Id.* For another example, see TMS Int'l Corp., Amendment No. 8 to Registration Statement (Form S-1) 36–37 (Apr. 8, 2011). In this case, the investor stockholder agreement increased the post-IPO voting power of the controller by 11%. *Id.*

[112] Facebook, Inc., Prospectus, *supra* note 111, at 141.

business model usually requires funds to liquidate their positions several years after an IPO.[113]

Suppose that at the IPO stage, a dual-class company with an automatic conversation clause has 100 shares: 20 high-vote shares entitling their holders to 10 votes per share, and 80 ordinary shares entitling their holders to 1 vote per share. Suppose further that the company has two pre-IPO shareholders, a founder and a venture capital fund, each of whom holds 10 high-vote shares. At that point, the founder maintains 35.7% of the company's voting power (100 out of 280 votes) and 10% of the company's equity (10 out of 100 shares).

After the IPO, the venture capital fund liquidates its entire position, selling its 10 high-vote shares on the market. By operation of the conversion clause, these high-vote shares become low-vote shares, leaving the company with only 10 high-vote shares (held by the founder) and 90 low-vote shares (the original 80 plus the 10 formerly high-vote shares held by the venture capital fund). The conversion shrinks the total number of votes to 190, meaning that the founder's voting power leaps to majority control—53% (100 out of 190 votes)—even though his equity stake remains unchanged at 10%.

In the above example, we assumed that the founder maintained the same equity stake after the IPO. However, an automatic conversion clause could also substantially increase the founder's voting power even when the founder unloads a significant fraction of his equity stake after the IPO. Consider the example of Google. The cumulative voting power of its founders, Larry Page and Sergey Brin, has increased significantly since the company's IPO: from 38.5% of the company's total voting rights in 2004 to more than 54% in 2015.[114] During the same period, Page and Brin reduced their share of equity capital from 28% to 12.9%.[115] This unusual ownership pattern was facilitated by an automatic conversion mechanism that was repeatedly triggered by sales of high-vote shares to third parties.[116] Because venture capital funds sold their high-vote shares faster after the IPO than Google's founders did, the founders were able to substantially increase their cumulative voting power despite the sizable decrease in their equity interest.

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[113] *See, e.g.*, Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1071 (2003) (discussing the limited duration of venture capital investments in portfolio companies).

[114] Google Inc., Amendment No. 5 to Registration Statement (Form S-1) 98 (Nov. 23, 2004) [hereinafter Google Registration Statement]; Google Inc., Definitive Proxy Statement (Schedule 14A) 22 (Apr. 23, 2015) [hereinafter Google Definitive Proxy Statement].

[115] Google Definitive Proxy Statement, *supra* note 114, at 22; Google Registration Statement, *supra* note 114, at 98.

[116] *See* Google Registration Statement, *supra* note 114, at 102 (describing the conversion mechanism of Google's shares).

Snap also adopted an automatic conversion clause at its IPO. When each of Snap's cofounders sells his Class C shares (which entitle the holder to ten votes per share), those shares will convert into Class B shares (which will only entitle the holder to one vote).[117] Furthermore, when holders of Class B shares (including venture capital funds and other pre-IPO holders) sell their Class B shares, those shares will also convert into nonvoting shares.[118]

To illustrate the point, suppose that over the course of the decade following Snap's IPO, cofounders Spiegel and Murphy reduce their equity stake to around 2.8% each but avoid triggering the sunset provision. In such a scenario, their combined voting power will decline from 89% to around 60.5%. Now, let us further suppose that Murphy decides to liquidate the rest of his equity position. Because of the automatic conversion mechanism, Spiegel will still control 41.5% of Snap's votes, despite owning only 2.8% of the company. But even this understates the degree of separation between cash-flow rights and voting rights in this case. If venture capital funds that hold only 30% of the Class B shares sell their shares on the market, Spiegel would control the majority of the company's voting rights with the same 2.8% equity stake.[119]

The automatic conversion provisions adopted by Google and Snap are far from unusual. Data we hand-collected show that they are quite common among dual-class companies, existing in more than 65% of those in the Dual-Class Dataset. Interestingly, we also find that in the overwhelming majority of these cases (96%), the governing documents exempt transfers of shares to the controller's family members, estate, or trust from the automatic conversation mechanism. In the absence of a sunset arrangement, this waiver ensures that the founding family will retain the controlling stake in perpetuity. Additionally, 81% of the companies in the Dual-Class IPOs Dataset went public with an automatic conversion provision, with the majority of these cases (90%) exempting transfers of shares to the controller's family members, estate, or trust.

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[117] Snap Inc., Registration Statement, *supra* note 66, at 7, 157.

[118] *Id.*

[119] We retrieved the beneficial ownership information from Snap's registration statement. *Id.* at 154–57. We first assume that no Class B holders transfer their Class B shares during the ten-year period after the IPO and that the remaining cofounder avoids triggering the sunset provision by retaining 30% of his Class C shares. In that case, the remaining founder will still be able to control 41.5% of Snap's votes. We then relax the unrealistic assumption that all Class B holders will continue to hold their shares during this ten-year period and show that if even 30% of them sell their shares, the remaining founder will still control the majority of the company's voting rights.

F. Midstream Changes

The separation mechanisms described in the preceding sections were incorporated into the governing documents of corporations at the IPO stage, but such mechanisms can also be introduced midstream. Because governance terms are usually grounded in the charter, a midstream charter amendment would require shareholder approval. However, when the charter amendments do not require a separate vote of the low-vote class, the controlling shareholder would be able to use her majority voting power unilaterally to approve this midstream change. This raises the possibility of introducing midstream governance arrangements that enable further reduction in controller cash-flow rights below what could be generated by the mechanisms that were already present at the IPO stage.

There are significant governance changes that do not require a separate class vote that the controller could introduce midstream, including the creation of additional classes of low-vote shares or the adoption of an automatic conversion provision.[120] However, the type of midstream change that has received the most attention in recent years is the introduction of nonvoting shares in dual-class companies that went public without such shares. Prominent companies, including Google and Under Armour, have adopted such a reclassification.[121] Although these reclassifications were subject to shareholder suits, those suits were settled before going to trial, and the reclassifications took effect.[122] Facebook and IAC/InterActiveCorp also announced plans for such a reclassification but abandoned these plans in the

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[120] Under Delaware law, a controller must engage in a conflicted transaction for the "entire fairness" framework of review to apply (rather than the more deferential business judgment rule). *See In re* Crimson Expl. Inc. Stockholder Litig., No. 8541–VCP, 2014 WL 5449419, at *12 (Del. Ch. Oct. 24, 2014). Even then, a separate class vote is not mandatory, but Delaware courts have encouraged controllers to obtain such a vote by holding that transactions not enjoying such approval would be subject to strict scrutiny. *See infra* note 203 and accompanying text.

[121] In 2012, Google announced a reclassification plan. *See* Google Inc., Definitive Proxy Statement (Schedule 14A) 56–87 (May 9, 2012). The plan's centerpiece was the distribution of a new, nonvoting class of shares as a dividend to the company's existing shareholders. *See id.* at 56. These nonvoting shares were meant to supplement Google's existing two classes of stock, which had a high/low vote share ratio of 10:1. *See id.* at 79. In June 2012, the board and the company's shareholders approved the plan, using the majority voting power held by Google's cofounders. Google Inc., Current Report (Form 8-K) 2–4 (June 21, 2012). For a description of Under Armour's reclassification, see Under Armour, Inc., Definitive Proxy Statement (Schedule 14A) 5–35 (July 13, 2015).

[122] *See In Re* Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045 (Del. Ch. Oct. 28, 2013) (approving settlement); Under Armour, Inc., Current Report (Form 8-K) 2 (Oct. 5, 2015).

face of shareholder suits.[123] Recently, the Delaware Court of Chancery approved a similar reclassification at NRG Yield, declining to apply a strict standard of review in part because a majority of the company's public investors had approved the transaction.[124] However, courts have yet to decide the permissibility and appropriate level of judicial scrutiny of midstream reclassifications that are not approved by a separate vote of the company's public investors.

When the controller issues a new class of nonvoting shares midstream and distributes those shares as a dividend to all shareholders, the controller is able to sell those shares and reduce her fraction of cash-flow rights without affecting her fraction of votes or needing the approval of other public investors. As we highlighted in section II.C, the number of authorized nonvoting shares and the stock dividend ratio are important factors that determine the extent to which the controller can reduce her equity stake without diminishing her voting power. A reclassification with a 1:1 dividend ratio, similar to that used in the Google and Under Armor reclassifications, would enable the controller to unload half her equity stake. As the ratio increases, the controller would be able to unload a larger fraction of her equity stake without relinquishing control.[125]

Midstream reclassifications pose governance risks beyond those present in the separation mechanisms discussed earlier in this Part. These additional risks should concern even those who, in principle, support allowing companies to go public with any structure they choose. When a company goes public with a separation mechanism, supporters of this view posit that public investors are able to form reasonable expectations as to the extent that the controller could decouple control from her ownership stake, and that the company's IPO price reflects these expectations.[126] By changing the governance bargain struck at the IPO, midstream reclassifications would thus extract value from public investors.

Moreover, a controller who chooses to conduct a midstream issuance of nonvoting shares could do so in a substantially unilateral way. Although a

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[123] *See* Facebook, Inc., Current Report (Form 8-K) 3 (Sep. 21, 2017); IAC/InterActiveCorp, Current Report (Form 8-K) 2 (June 21, 2017); *see also* Blair Nicholas & Mark Lebovitch, *CalPERS v. IAC: Clear Win for Investors Protecting Shareholder Voting Rights*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 18, 2017), https://corpgov.law.harvard.edu/2017/07/18/calpers-v-iac-clear-win-for-investors-protecting-shareholder-voting-rights/ [https://perma.cc/A9QX-TJRF]; *supra* note 6.

[124] IRA Tr. FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB, 2017 WL 6335912, at *9–11 (Del. Ch. Dec. 11, 2017) (holding that the business judgment rule applied because reclassification followed the dual procedural protections of Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014), including obtaining "majority-of-the-minority" approval).

[125] *See supra* Table 1.

[126] *See, e.g.*, sources cited *supra* notes 20–21, 26.

proposal to reclassify the capital structure requires shareholder approval, the controller's majority voting power would allow such a proposal to pass. In Google's reclassification, a majority of the company's public investors unaffiliated with the controllers voted against the reclassification proposals, but this vote had no effect on the result because the controllers' vote was sufficient to pass the midstream reclassification.[127] Allowing this type of reclassification to be adopted midstream, without the approval of public investors unaffiliated with the controller, raises the concern that the controller is using her majority voting power to enrich herself at the expense of public investors.

G. The Unfulfilled Promise of Existing Sunset Provisions

As discussed above, certain companies have adopted sunset provisions that lead to the elimination of the dual-class structure if the controller's ownership falls below a specified threshold. As we will explain in Part IV, appropriately designed sunset provisions can limit the extent to which cash-flow rights can be separated from voting rights and to which dual-class structures can give control rights to small-minority controllers. However, the empirical analysis that we conducted of actual market practices indicates that the current use of sunset provisions provides a weak and often nonexistent constraint on the mechanisms of extreme separation discussed in this Article.

For example, Snap incorporated such a provision into its governance documents at the IPO stage.[128] This sunset clause received attention in the various media articles covering the Snap IPO and was highlighted in the company's offering documents.[129] Careful examination reveals that the sunset provision places minimal limits on the ability of the company's cofounders to become tiny-minority controllers in the future and to retain

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[127] *See* Google Inc., Current Report, *supra* note 121, at 4. Over 85% of Google's public shareholders unaffiliated with Brin and Page voted against the issuance of nonvoting shares. *See id*.

[128] Snap Inc., Registration Statement, *supra* note 66, at 157 (providing that the high-vote shares held by each founder will convert to low-vote shares when the founder's holdings drop below a certain threshold (30%) of high-vote shares that the founder held at the IPO).

[129] *See, e.g.*, Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, WALL ST. J. (Jan. 16, 2017, 8:24 PM), http://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034 [https://perma.cc/GF8Z-BPJS] ("The [company] setup includes some features meant to protect public investors."); Stephen Grocer, *Snap's IPO Filing: Everything You Need to Know*, WALL ST. J. (Feb. 2, 2017, 4:37 PM), https://blogs.wsj.com/moneybeat/2017/02/02/snaps-ipo-filing-everything-you-need-to-know/ [https://perma.cc/Q89E-PQ9W]; Snap Inc., Registration Statement, *supra* note 66, at 5, 157.

control while reducing their equity stake to as low as 1.4% each.[130] Because the provision is tied only to the number of *high-vote* shares held by the founders at the IPO, it will not be triggered by the founders' sale of their *nonvoting* shares.

To further examine this issue, we hand-collected the corporate charters of all companies in the Dual-Class Dataset to identify all the cases in which sunset provisions were used. Altogether we examined 122 companies, 69 of which (about 57%) do not have any ownership-based sunset provisions, and thus have no limitations on the mechanisms of extreme separation. Of the 53 that do have ownership-based sunset provisions, 41 (77%) set the threshold at or under 10% of outstanding equity. This threshold, which enables a very-small-minority controller to remain in perpetuity, still permits a substantial amount of incentive distortion.

We also noticed that when a dual-class company has hardwiring for director election, it is often the case that the sunset clause applies only to the hardwiring for director election but not to the elimination of the dual-class itself. Therefore, even if the company triggers the sunset provision, it just eliminates the controller's special rights for director elections but not the company's differential voting rights.[131]

Finally, a closer look at the data reveals a strong correlation between the high/low vote ratio and the ownership threshold triggering the sunset clause adopted at the IPO. For instance, controllers of dual-class companies with a 10:1 high/low vote ratio, which permits majority control with 9.1% of the company's equity capital, also tend to use sunset provisions with a lower ownership threshold (usually no more than 10%). In these companies, the sunset provisions would come into effect only when the controllers were already about to lose majority control: the clause is little more than a fig leaf. In fact, this correlation often negates the impact of a sunset provision.[132]

To be clear, sunset provisions are not inherently incapable of placing effective limits on the creation of extreme separation. As we will discuss in

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[130] *See supra* note 102 and accompanying text.

[131] Based on our analysis of corporate governance documents, companies that have incorporated this type of sunset into their governance documents include Bio-Rad Laboratories, Dell Technologies, Haverty Furniture Companies, Ingles Markets, NIKE, Ralph Lauren, Telephone and Data Systems, United States Cellular, and Watsco.

[132] Our review of the Dual-Class IPOs Dataset yielded similar results. We found that 60% adopted a sunset provision with an ownership threshold at the IPO stage, and the vast majority of these provisions (twenty-five of twenty-nine companies) had a minimum ownership threshold at or under 10%. Our analysis excludes time-based sunset provisions not based on the controller's equity stake. For an analysis of time-based sunsets, see generally Bebchuk & Kastiel, *supra* note 11; Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 2018 COLUM. BUS. L. REV. 852.

Part IV, investors may consider pushing for stronger and more meaningful sunset provisions than the ones that have been adopted by controllers. However, on the basis of our empirical analysis, we conclude that the current use of sunset provisions does not adequately limit the mechanisms of extreme separation.

III. THE PREVALENCE OF EXTREME SEPARATION

This Part provides evidence of the incidence of dual-class companies with extreme separation in the U.S. economy. We show that the problem is not merely theoretical. Section A introduces a typology of four controllers: minority, small-minority, very-small-minority, and tiny-minority controllers. This typology is based on certain thresholds—50%, 15%, 10%, and 5%—of the company's equity capital held by these controllers. Section B then provides evidence on the current incidence of these four types of controllers.

The analysis of Section B provides the first empirical evidence on this subject. The dual-class study by Gompers, Ishii, and Metrick reports the average stake held by controllers in the study's sample.[133] However, our analysis focuses on the distribution of controllers' equity stakes, which shows significant variation among controllers, and we thus are able to identify the incidence of small-minority controllers. Furthermore, we analyze and report the minimum stakes that controllers can retain without relinquishing control, given the existing governance provisions. We thus provide the first empirical evidence on the potential evolution of controller stakes that existing governance arrangements facilitate—and the scale of governance risks that these arrangements pose.

A. A Typology of Minority Controllers

As we demonstrated in Part I, the distortion of a controller's incentives and the generated agency costs become increasingly more severe as the controller's equity stake declines. Therefore, in assessing the governance risks and problems of a dual-class company, it is important to examine the controller's equity stake as well as the expected evolution of this stake—including the extent to which it could decline in the future without the controller relinquishing control.

In our empirical analysis below, we examine controller equity stakes depending on whether they equal or fall below one or more thresholds—50%, 15%, 10%, and 5%—of the company's equity capital. Based on these thresholds, we refer below to four types of controllers. In addition to the term

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[133] Gompers et al., *supra* note 44, at 1053.

"controlling-minority shareholder" already used in the literature,[134] we define below three additional types: small-minority controllers, very-small-minority controllers, and tiny-minority controllers.

1. Controlling-Minority Shareholders

Following the literature, we refer to any controller that owns less than 50% of the company's equity capital, but maintains a lock on control, as a controlling minority shareholder. Dual-class structures enable a controller to have a lock on control with such minority ownership. Our focus in this Article, however, is not on controllers that merely hold a minority stake, but rather on ones that hold a much smaller stake.

2. Small-Minority Controllers

We define a small-minority controller as one that owns 15% or less of the company's equity capital but maintains a lock on control. In the absence of a dual-class structure, such a shareholder would fail to have a dominant position, not to speak of a lock on control. In a one-share-one-vote company, Delaware's antitakeover statute regards 15% as the threshold at which a blockholder could have sufficient influence on corporate decisionmaking to trigger the application of the statute.[135] We also note that even under the most extreme supermajority requirements used in practice, owners of 15% or less of the company's equity capital do not have a veto even over decisions that require such supermajority approval.[136]

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[134] *See* Bebchuk et al., *supra* note 18, at 297.

[135] DEL. CODE ANN. tit. 8, § 203(c)(5) (2017). The Delaware business combination statute prevents a bidder from engaging in a wide range of transactions with an acquired company for three years after the bidder acquires a "controlling stake" that is equal to at least 15% of the target's shares. *Id.* § 203(a), (c); s*ee also* Guhan Subramanian, Steven Herscovici & Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1998–2008*, 65 BUS. LAW. 685, 686 (2010) (noting that Delaware antitakeover law covers "more than half of all U.S. corporations and an even larger fraction of U.S. stock market capitalization").

[136] Data collected from SharkRepellent's dataset shows that companies with a supermajority requirement for charter amendments rarely use a threshold above 80% of all outstanding shares. As of February 2017, only 2% of all companies with supermajority provisions (1,439 companies) had a higher threshold. For access to the dataset, see SHARKREPELLENT.NET, FACTSET RESEARCH SYSTEMS, INC., https://www.sharkrepellent.net [https://perma.cc/KQC2-7UHM] (last visited Mar. 14, 2019). Therefore, in the absence of a dual-class structure, small-minority controllers would not even have a veto power over charter amendments that require supermajority approval.

3. Very-Small-Minority Controllers

We define a very-small-minority controller as one that owns 10% or less of the company's equity capital but maintains a lock on control. We note that in companies without a dual-class structure, securities laws regard owners of a below-10% block as having insufficient influence to trigger the disclosure obligations and the duty to return short-swing profits that Section 16 insiders have.[137]

4. Tiny-Minority Controllers

We define a tiny-minority controller as one that owns 5% or less of the company's equity capital. In the absence of a dual-class structure, securities laws regard the presence of a below-5% blockholder as sufficiently insignificant so as not to require the blockholder to disclose her presence and position to the market.[138] Below-5% shareholders are viewed as sufficiently inconsequential to avoid triggering a reporting requirement under Schedule 13D or even Schedule 13G.[139]

B. Current and Potential Minority Controllers

In this Section we provide evidence of the incidence of dual-class companies with extreme separation. First, for each dual-class company in the Dual-Class Dataset, we collected data that enabled us to calculate the fraction of equity capital currently held by its controller. The data we collected included information on the number of classes of issued and outstanding shares, the rights allocated to each class (including both voting rights and special rights to elect a fixed number of directors), the number of outstanding shares of each class, and the number of shares of each class held by the controlling shareholder. When a company has two or more cofounders or a number of shareholders who have a family relationship, we assumed (unless

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[137] *See* Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p(a) (2012). This section requires the reporting of beneficial ownership by the officers, directors or shareholders (Section 16 insiders) who possess shares directly or indirectly resulting in beneficial ownership over 10% of the company's common stock or other class of equity. *Id.*

[138] *See, e.g.*, Regulation S-K, 17 C.F.R. § 229.407(c)(2)(ix) (2018) (requiring disclosure of the beneficial ownership of officers, directors, and any beneficial owner of more than 5% of a class of the registrant's voting securities); 17 C.F.R. § 240.14a-101 (2018) (same).

[139] 17 C.F.R. §§ 240.13d-101, -102 (2018) (providing that active and passive beneficial owners of more than 5% of any voting class of a publicly traded equity security must file a Schedule 13D or 13G, respectively, disclosing their interests).

otherwise specified in the proxy statement) that these shareholders exercise control in concert.[140]

Next, we estimated the extent to which controllers can unwind their equity position in the future without relinquishing their lock on control. To that end, we hand-collected information on the existence of mandatory conversion provisions that are exercised upon the sale of shares, voluntary conversion provisions that are exercised at the discretion of the high-vote holder, and the ratio of conversion (if different from 1:1). We also collected information on whether a sale of the controller's shares would trigger a sunset clause with a minimal ownership requirement (that is, a provision that automatically eliminates the dual-class structure if the controller goes below a certain percentage ownership threshold). If such a sunset existed, we reviewed its triggering terms and examined whether the triggering of the sunset would lead to the dismantling of the dual-class structure or merely to the elimination of a special right to elect a fixed number of directors.

In calculating the minimum equity capital that a controller must hold in order to retain at least 50% of the voting rights, we proceeded as follows. First, we conducted this analysis assuming that the controller would not try to change the governance arrangements midstream but rather would take full advantage of the arrangements currently in place. To that end, we assumed that the controller would first sell as many low-vote shares as she could, and then as many high-vote shares as she could, without losing majority control. If, at some point, the sale of low- or high-vote shares would cause the controller to lose majority control, we assumed that the controller would stop the selling process and maintain the necessary number of shares needed to retain control.

Second, we assumed that venture capital funds and other pre-IPO shareholders would sell their shares at a faster rate than the controller, as often happens.[141] Third, we examined whether a sale of the controller's shares

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[140] Despite the dispersion of ownership interests among a number of affiliated holders, we assumed that there is a unified decisionmaker that approximates the situation in all the cases in our dataset. In one line of these cases, the control is transferred to heirs of the founder, one of whom exercises actual day-to-day control whereas the others receive the cash-flow benefits. We recognize that, in this scenario, the other heirs may not have the same interest in the private benefits of control as the family member who exercises the actual control. At the same time, these heirs are unlikely to exercise the same intensity of oversight as an unaffiliated third party with a large equity stake. Another line of cases involves cofounders who hold executive positions in the controlled company. In this situation, the cofounders could make retention or expansion choices that would increase the private benefits of *both* of them.

[141] *See supra* Section II.E.2. We found that in approximately 80% of the companies in our Dual-Class Sample, the controller holds over 90% of the high-vote shares, on average. In an additional 9%, the control holds, on average, over 80% of the high-vote shares. These data reinforce our assumption that other holders of the high-vote shares sell their shares at a faster rate than the controller.

would trigger a sunset clause with a minimal ownership requirement. If such a sunset clause existed, we examined the specific sunset terms (which can vary from company to company). We assumed that the controller would avoid triggering the sunset if such action would lead to the elimination of its majority control.

Finally, when a controlling shareholder exercised full control over the election of the company's directors, or when a dual-class company has an outstanding class of nonvoting stock, we assumed, in the absence of a sunset provision, that a controlling shareholder has the right to unwind almost all of her equity position without losing control. Here again, if such a sunset clause existed, we assumed that the controller would stop selling shares to avoid triggering a sunset clause that would cause her to lose her special election rights. The calculation of these percentages required significant work for the following reasons.

To begin with, as stressed later in section IV.B, the information necessary for our analysis is usually not transparent. Companies with a dual-class structure are required to disclose only the number of high/low vote shares held by the controller.[142] However, such disclosure is often not straightforward because companies have significant leeway in detailing shares held by family members, trusts, and other stakeholders affiliated with the controller. Moreover, companies are not required to disclose the controller's combined equity stake or any information on the extent to which the controller could use the various arrangements in the company's governance documents to unload shares without relinquishing control.[143]

Second, the sale of high-vote shares, by either the controller or other high-vote holders, usually triggers a mandatory or voluntary conversion provision. Therefore, to calculate estimated equity stake of the controller, we had to examine the changes to the total outstanding number of shares of each class upon a sale of the high-vote share. Because companies in our sample had different conversion provisions, this analysis had to be conducted separately for each company.[144]

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[142] Securities laws require that an issuer explicitly and precisely disclose the "total number of shares beneficially owned" by 5% holders and "the percentage of class so owned." 17 C.F.R. § 229.403(a) (2018).

[143] For the only relevant disclosure requirement, see *id.*

[144] In companies with automatic conversion provisions, we assumed that the high-vote shares would be automatically converted into low-vote shares upon their sale to a third party, raising the total number of outstanding high-vote shares and reducing the total number of low-vote shares. If a company had only a voluntary conversion provision, we assumed that the controlling shareholder would always convert the high-vote shares into low-vote shares before their sale in order to reduce the potential dilution of her voting stake. *See supra* Section II.D.1. To determine what other high-vote holders would do upon a sale, we had to examine whether the additional class of high-vote share was publicly traded. If the class of high-vote share was not publicly traded, we assumed that the other high-vote holders would

Third, as noted above, the calculation of the effective threshold required a cross-reference between a number of simultaneous conditions: the number of shares the controller would have to maintain in order to preserve majority voting control after taking into account the potential effects of the conversion mechanisms (as described in the previous paragraph), the number of shares the controller would need to maintain to preserve voting control of the board (depending on whether there was a unique voting structure for board election), and the number of shares the controller would need to maintain to avoid triggering a sunset, if that sunset would lead to loss of control.

Fourth, some companies had more than two outstanding classes of shares. For these companies, the same steps described in the previous paragraph were still undertaken, depending on the conversion rights between the three (or more) classes of shares and more complex sunset conditions.

Table 2 below, which shows the results of our empirical analysis, reports the current incidence of controlling minority shareholders, as well as small-, very-small-, and tiny-minority controllers within the Dual-Class Dataset of 122 companies. It also reports the potential incidence of these groups under a scenario in which controllers take full advantage of existing governance provisions to reduce their equity stake to the lowest level that would be consistent with retaining a lock on control.

Table 2: Types of Controllers of Dual-class Companies in the Russell 3000

	Incidence at Present, %	Potential Incidence, %
Controlling Minority Shareholders	83.6	100.0
Small-Minority Controllers	18.9	91.8
Very-Small-Minority Controllers	9.8	81.2
Tiny-Minority Controllers	1.6	30.3

choose to convert their shares before selling. However, if the class of high-vote shares was publicly traded, we assumed that the other holders would not convert. In companies with no conversion mechanism, we assumed that the sale of high-vote shares, either by the controller or other high-vote holders, would lead to these shares being held by non-controller, high-vote holders.

1. Controlling Minority Shareholders

As expected, an overwhelming majority (83.6%) of dual-class companies currently have—and all of them could have in the future—a controlling minority shareholder with less than 50% of the company's equity capital. The contribution of our empirical analysis is in documenting the large fraction of dual-class companies that already have, or could have in the future in accordance with governance provisions already in place, a controller with a small-minority stake, a very-small-minority stake, or even a tiny-minority stake.

2. Small-Minority Controllers

As the Table reports, 91.8% of the companies in our sample either already have or could have, based on the governance provisions already in place, a small-minority controller with a 15%-block or less. Moreover, 18.9% of dual-class companies already have a small-minority controller, and an additional 72.9% could have one if the controller continues to unload shares without relinquishing control to the fullest extent made possible by existing governance arrangements.

3. Very-Small-Minority Controllers

Furthermore, as the Table indicates, 81.2% of the studied companies either already have, or could have based on the governance provisions already in place, a very-small-minority controller with a 10% block or less. Of the dual-class companies examined, 9.8% already have a very-small-minority controller, and an additional 71.4% could have one if the controller lowers her equity ownership to the minimum stake sufficient to maintain a lock on control.

4. Tiny-Minority Controllers

Finally, and most strikingly, 30.3% of the companies studied either already have, or could have, a tiny-minority controller with a 5% stake or less. Already, 1.6% of dual-class companies have a tiny-minority controller, but an additional 28.7% could have a tiny-minority controller if their controllers take advantage of governance provisions already in place to unwind their equity positions to the fullest extent possible without relinquishing control.

Our analysis so far has taken as given the number of outstanding shares of each class as well as the number of low-vote shares issued to the controller.

However, as we explained in section II.D.2, another mechanism that could mitigate the decrease in the controller's voting power is the issuance of a large number of low-vote shares at the IPO stage and their issuance to all shareholders as a dividend at a later stage. Once these shares are issued on a pro rata basis after the IPO, the controller could sell them on the market instead of selling her high-vote shares and could thus slow down the pace at which her voting stake is diluted.

We therefore also examined to what extent the issuance of additional authorized-but-unissued shares would impact the expected incidences of controlling minority shareholders, small-minority shareholders, very-small-minority shareholders, and tiny-minority shareholders. We assumed that the company would issue as dividends as many low-vote shares as possible in order to enable the controller to preserve majority control. However, when a company has a conversion provision, we assumed that it would have to maintain enough authorized-but-unissued low-vote shares to enable the future conversion of outstanding high-vote shares. As expected, after taking into account the controller's ability to issue additional authorized low-vote shares, we documented an additional increase in the potential incidence of small-minority shareholders (93.5%), very-small-minority shareholders (82.8%), and tiny-minority shareholders (33.6%).

Finally, we should stress that our analysis took as given the governance provisions in place and abstracted from the possibility that the controller would seek to increase her freedom to unload shares without relinquishing control by bringing about a midstream change, such as a nonvoting stock reclassification. As explained in section II.F, some dual-class companies, including Google, went through such a reclassification. A nonvoting stock reclassification that authorizes a sufficiently large number of nonvoting shares would enable the controller to lower her equity stake to as low a level as the controller desires without relinquishing control. Thus, to the extent that courts allow such reclassifications without a vote of approval from disinterested public investors, they would enable all controllers to become tiny-minority controllers if those controllers so choose.

We recognize that there are other considerations that may cause small-minority controllers to avoid unwinding their equity positions to the fullest extent possible. For example, once such a controller unloads a significant fraction of her equity position and most of her wealth is no longer tied to the dual-class company, the marginal benefit from selling additional shares and becoming more diversified declines.[145] Furthermore, when the diversification

[145] Financial economists have documented that moving from a portfolio heavily invested in one stock to a portfolio based on a number of stocks considerably reduces risk. *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 174–75 (12th ed. 2017). They have also found that one can get most of the

benefits decline, tax considerations could also prevent the controller's sale of additional shares. This is because such sales would create capital gains liabilities, and the small-minority controller could defer these tax liabilities by postponing additional sales.[146]

Despite the decreasing diversification benefits, in some cases, the controllers might still be interested in unloading their shares to the fullest extent possible. For example, if the controllers have significant liquidity needs, they would sell their shares to the fullest extent possible. Similarly, if they create a foundation and want to spend most of their wealth on charitable causes, they might again be interested in selling their shares to the fullest extent possible. Indeed, Facebook's reclassification plan was aimed at weakening some of the limits imposed at the IPO stage on Mark Zuckerberg's freedom to unload shares without losing his control. Had the plan been adopted, he would have been able to reduce his stake of equity capital to about 4%, and possibly less, without losing his controlling voting power.[147]

In any event, having information on the extent to which controllers are able to unwind their equity positions without losing majority control is important for assessing the governance risks a dual-class company may face in the future. For this reason, we seek to estimate this level in this section and, in section IV.B, to encourage the adoption of a requirement that companies make this level transparent to public investors.

The analysis of the hand-collected dataset of governance provisions in dual-class companies that we compiled for this Article provides empirical evidence of the practical significance of small-minority controllers. These governance provisions enable the emergence of small-minority controllers, very-small-minority controllers, and even tiny-minority controllers in a sizable fraction of dual-class companies. The problem of such controllers, therefore, deserves the urgent attention of public officials and institutional investors.

IV. POLICY IMPLICATIONS

In this Part, we identify and analyze the main policy implications for (i) all public officials who make or apply laws, rules, and regulations, including legislators, regulators, and judges (whether on the state or federal level), and (ii) institutional investors that play a key role in the U.S. capital market. Section A begins by noting how important it is that these public officials and

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diversification benefit with relatively few stocks, and thus once a controller unloads a significant fraction of her equity position, the marginal benefit from selling additional shares is expected to decline. *See id.* at 175.

[146] In the United States, individuals pay federal income tax on the net total of all their capital gains upon the disposition of shares. *See* 26 U.S.C. § 1(h) (2012).

[147] *See supra* note 5.

institutional investors recognize the governance risks that small-minority controllers pose. Going forward, any examination of dual-class companies should be informed by the recognition of these risks. Understanding these risks could also assist institutional investors in assessing the public companies in which they invest.

Building on the lessons of our empirical analysis, section B explains that in companies with small-minority controllers, the existing controller's equity stake, and the extent to which this stake could decline without the controller relinquishing the lock on control, are often not made transparent to investors. Accordingly, we propose two disclosure requirements that would provide investors with adequate information on the subject.

Section C identifies and discusses alternative measures that could be used to limit the extent to which controllers can lower their fraction of equity capital and still retain control. Even those who are reluctant to adopt such limitations via regulation may consider private ordering and investor actions to that end. Section D explains that even if public officials and institutional investors take as given the growing incidence of small-minority controllers and do not seek to restrict their diminishing stake, they may consider other legal governance and judicial steps that small-minority-controlled companies could adopt to protect public investors from controllers' opportunism.

Finally, section E analyzes how public officials and institutional investors should approach midstream changes that enable controllers to substantially reduce their equity stake while retaining a lock on control. In particular, it discusses how making any such changes conditional on a vote of approval from disinterested public investors could preclude changes that would divert value from public investors to small-minority controllers.

A. Recognizing the Problem

Although public officials and institutional investors often lump together all dual-class structures, our analysis shows that there is a subset of dual-class companies—those with small-minority controllers—that generates severe governance concerns and risks. Furthermore, our analysis in Part III demonstrates that such governance risks are either already present or could emerge down the road in most dual-class companies. Thus, the first clear takeaway is that going forward, both public officials and institutional investors should recognize and pay special attention to the perils of small-minority controllers.

With respect to public officials, recognition of the problem may lead them to proceed in one or more of the directions that we analyze in this Part. They may consider enhancing disclosure requirements to make the governance risks posed by small-minority controllers adequately transparent. They may

also consider adopting alternative measures for constraining, or at least discouraging, structures with small-minority controllers, as well as taking additional steps to protect public investors when such controllers are present. Finally, they should pay close attention to the midstream reclassification problem that we have analyzed. Although we suggest four main directions that public officials may pursue, recognizing the significance of the problem might lead them to identify other directions that are worth exploring as well.

With respect to institutional investors, those that seek to understand and limit the governance costs and risks they face must also recognize the problem of small-minority controllers to appreciate the governance problems that dual-class structures pose for them. This recognition might lead institutional investors to back public officials' adoption of the kind of arrangements discussed in the next four sections. Alternatively, as we discuss below, institutional investors may seek to move in such a direction by private ordering and investor initiative.

Finally, putting aside efforts to constrain and reduce the problems resulting from small-minority controllers, institutional investors should modify their allocation and investment decisions in accordance with the governance risks posed by small-minority controllers and the likelihood that such controllers will arise in a company given its governance arrangements. Investors will benefit—and the allocation of capital in the economy will be improved—if investors learn to appreciate which companies pose greater or smaller governance risks. Recall that the prominent proxy advisory firm ISS lumps together all dual-class structures when it provides public investors with assessments of the governance risks posed by these companies.[148] If ISS were to recognize the special problems posed by small-minority controllers, it could provide nuanced information and separately flag dual-class structures that have small-minority controllers so that public investors might adequately assess them.

B. Improving Disclosures

As we explained in Part I, the expected agency problem significantly depends on the controller's fraction of equity capital. Therefore, to assess the governance risks that dual-class structures pose, public investors would benefit from knowing (i) the controller's equity stake, and (ii) the extent to which the company's governance arrangements enable the controller to reduce its stake in the future without relinquishing control of the company. As we argue below, disclosure mandates should be amended to require companies to make this information transparent to investors.

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[148] *See supra* notes 28–29 and accompanying text.

Disclosure mandates often require companies to supply information that would benefit many investors, rather than requiring each investor to bear the costs of obtaining such information independently. For example, in the context of executive compensation, U.S. securities laws mandate a unified disclosure in a single location—the Summary Compensation Table—to provide a comprehensive overview of a company's executive pay practices.[149] One could argue that there is no need to provide such information because large investors with resources could collect and analyze it by themselves. The SEC, however, has concluded that it is valuable to make this information transparent to investors. This disclosure mandate is based on the recognition that it is costlier for each shareholder to individually calculate executive compensation than for the company to publish a uniform disclosure available to each shareholder. Because companies already have the information needed to quantify executive compensation, it is more efficient for each company to provide that information to its shareholders in a unified fashion.[150] The standardized compensation tables have also made the camouflaging of the costs of executive compensation more difficult.[151]

Indeed, in our empirical analysis for this Article, we have found that determining the current and future levels of a controller's equity stake requires significant research and calculation because this information does not appear in the standard datasets. Moreover, as discussed below, in some cases, there are special governance arrangements that are not even accessible to outside investors. Thus, public officials should require companies to supply information on the current and expected levels of a controller's stake to investors.

We note that the SEC's Investor Advisory Committee recently issued a discussion draft on dual-class stock that cites an earlier version of this Article and endorses our proposal below for enhancing disclosure.[152] In our view, the

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[149] *See* 17 C.F.R. § 229.402(c) (2018); Executive Compensation, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answers-execomphtm.html [https://perma.cc/NT99-MVH6] (last modified Oct. 21, 2014).

[150] For an economic justification of mandatory disclosure grounded in the notion that companies are the lowest cost obtainers of most information relevant to securities valuation, see, for example, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048–49 (1995). *See also* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 853 (2005); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 111–12 (2007).

[151] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 67 (2004).

[152] INV'R ADVISORY COMM., DISCUSSION DRAFT RE: DUAL CLASS AND OTHER ENTRENCHING GOVERNANCE STRUCTURES IN PUBLIC COMPANIES (Dec. 12, 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/discussion-draft-dual-class-recommendation-iac-120717.pdf.

SEC would do well to follow this committee's advice and adopt our proposal for enhanced disclosure. Making this information available to investors will foster transparency and facilitate informed investment decisionmaking, while minimizing the costs each investor would have to bear in order to obtain such information independently.

1. The Controller's Current Stake

Securities laws require that an issuer explicitly and precisely disclose the "total number of shares beneficially owned" by 5%-holders and "the percentage of class so owned."[153] However, to the extent that a controller owns the shares through private entities (such as trusts) in which other parties have ownership rights, the controller is not required to provide additional information on its total ownership incentives.[154] Additionally, even when the proxy statement contains all the information necessary for calculating a controller's combined ownership and voting rights, it is not always made available to investors in a transparent way, and certain companies avoid reporting it in the customary ownership table.[155]

For instance, Nike discloses that its controllers have the right to nominate the majority of the board, but it does not disclose the total *ownership interest* of the controllers, information that must be hand calculated by investors.[156] Moreover, in 2015, Nike's founder and controller, Philip Knight, transferred the majority of his shares, which included the right to elect 75% of the Nike board, to a limited liability company named Swoosh, LLC, which is currently managed by four members, including Knight and his son.[157] However, the proxy statement does not clearly identify the Knight family's effective ownership interest in Swoosh, LLC nor the degree to which that company preserves the family's economic interest in Nike.[158]

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[153] 17 C.F.R. § 229.403(a) (2018).

[154] Consider a situation in which a controller owns 50% of a private entity that has 50% ownership in a public company. The ownership stake of the private entity (50%) will be disclosed in the disclosure document, but the total ownership stake of the controller in the public company (25%) does not have to be disclosed.

[155] In some instances, the combined voting or ownership rights are noted only in text, not in tabular form; in other instances, the information is not spelled out in the proxy statement and therefore must be hand-collected. For a similar criticism, see Kobi Kastiel, *Executive Compensation in Controlled Companies*, 90 IND. L.J. 1131, 1174 (2015).

[156] *See* NIKE, Inc., Definitive Proxy Statement (Schedule 14A) 13 (July 25, 2016).

[157] *See id.* at 1, 13; *NIKE, Inc. and Phil Knight Announce Ownership and Governance Actions*, NIKE NEWS (June 30, 2015), http://news.nike.com/news/nike-inc-and-phil-knight-announce-ownership-and-governance-actions [https://perma.cc/5F5F-35RW].

[158] Nike's proxy statement only indicates that on June 30, 2016, a wholly owned subsidiary of Travis A. Knight 2009 Irrevocable Trust II acquired all of the voting units in Swoosh, LLC, and that "Mr. Knight disclaims beneficial ownership of the Companies'

Second, in carrying out our empirical analysis, we encountered situations in which different family members were holding shares through various trusts and private entities; there is often some overlap between the equity holdings of these family members, which in turn generates the concern that some of the equity interests held by the controlling family were counted twice. In such situations, however, the company disclosure might not disclose the precise *combined* ownership stake of the controlling family in the customary ownership table.

For example, Movado, the watchmaker, disclosed in its customary ownership table that one member of the controlling family, Alexander Grinberg, controls 50.14% of the company voting power, and that another member, Efraim Grinberg, controls 69.51% of the voting power.[159] To avoid an overestimation of the controlling family's stake, one needs to closely review the detailed, and often technical, language of the footnotes to customary ownership table, make inferences from these footnotes as to what percentage of equity stake is double-counted in the table, and hand calculate the precise ownership stake manually. This could be a daunting task, not only for lay investors, but also for more sophisticated players. Indeed, in its report on dual-class companies, the Investor Responsibility Research Center Institute noted that the Grinberg family controls a majority of the voting rights, without detailing its exact combined voting stake.[160]

To address the above problems, companies should be required to disclose in their annual proxy materials the percentage of equity stake and voting rights their controllers have in these companies. The information presented in the beneficial ownership table should also eliminate potential double-counting of controllers' shares. To the extent that investors own the shares through private entities, arrangements that affect the calculation of a controller's total ownership stake in the controlled company should also be disclosed. This would enable investors to better assess any agency problems resulting from the wedge between the controller's equity stake and her voting power. It would also facilitate research on these and related topics, which would in turn further contribute to investors' understanding of the desirability of these structures.

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securities held . . . by the Trust." *See* NIKE, Inc., Definitive Proxy Statement, *supra* note 156, at 13.

[159] *See* Movado Grp., Inc., Definitive Proxy Statement (Form DEF 14A) 5 (May 9, 2017).

[160] *See* KAMONJOH, *supra* note 8, at 87.

2. The Risk of Future Reduction

To identify the minimum equity stake a controller must hold while maintaining control, one must analyze the capital structure and governance provisions of a dual-class company and the interaction between them. Companies are currently not required to provide any information in this regard, and in the course of our empirical analysis, we spent a significant amount of time in each case identifying the minimum equity stake that a controller must hold in order to retain control.

For example, Snap disclosed in its IPO registration statement the ownership interest of its cofounders, but it failed to disclose the minimum equity stake that its cofounders could own without relinquishing control.[161] We had to perform this calculation, taking into account the capital structure and governance arrangements that the company adopted at the IPO stage, and including such factors as: the number of authorized nonvoting shares, the equity ownership of other pre-IPO investors, and the potential effects of the sunset clause and the automatic conversion provision. Our analysis concluded that each cofounder could reduce his equity stake to 1.4%, which would result in both of them holding 2.8% of Snap's equity capital, without relinquishing control.[162] To the best of our knowledge, this information was not transparent to public investors, and the vast majority of the media articles that covered the Snap IPO failed to note the extremely low minimum equity stake that would be sufficient to retain control.[163]

A clear disclosure of the minimum equity stake required for the controller to maintain control would enable investors to better evaluate the governance risks that a dual-class structure could generate. Assessing this risk requires an understanding of not only the current level of the controller's equity stake, but also the magnitude of the risk that the wedge between her equity and voting rights will increase in the future. We note that in the context of executive compensation, companies are already required to provide investors with information about the future value that relevant compensation variables may take.[164] Given the significance of potential increases in the wedge

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[161] *See* Snap Inc., Registration Statement, *supra* note 66, at 151.

[162] *See supra* note 102 and accompanying text.

[163] *See, e.g.*, Michael J. de la Merced, *Snap Aims for Valuation of More Than $20 Billion in I.P.O.*, N.Y. TIMES (Feb. 16, 2017), https://www.nytimes.com/2017/02/16/business/dealbook/snap-aims-for-valuation-of-more-than-20-billion-in-offering.html [https://nyti.ms/2lb9A3s]; Dominic Rushe, *Snapchat to Make High-Profile Stock Debut After Revealing IPO Plans*, GUARDIAN (Feb. 2, 2017, 5:54 PM), https://www.theguardian.com/technology/2017/feb/02/snapchat-ipo-goes-public-evan-spiegel-owner-tech [https://perma.cc/77LN-8X9F]; Farrell, *supra* note 129.

[164] For example, the disclosure of present value of option awards or accumulated pension benefits require certain valuation assumptions. *See* FW COOK, SEC STAFF UPDATES

without a relinquishment of control, companies should disclose to their investors the minimum equity stake that is consistent with their controllers retaining control.

C. Limiting the Wedge

The analysis of this Article has highlighted the costs that small-minority controllers can be expected to generate, and it has shown that those costs are expected to escalate as the controller's equity stake declines. Recognizing this problem should lead public officials and institutional investors to consider ways of precluding, or at least discouraging, dual-class structures with small-minority controllers. In this section, we discuss several avenues in which this could be done, examining regulatory legal interventions and private ordering efforts by institutional investors.

1. Ownership-based Sunset Provisions

One way to limit the problem of small-minority controllers is to have an arrangement that would require sunsetting the dual-class structure if the controller's equity stake falls below a specified minimum threshold. Once triggered, the sunset clause would automatically convert high-vote shares to single-vote shares.[165] As explained below, this could be done through either regulation or private ordering.

An ownership-based sunset clause directly addresses the concern of dual-class structures with extreme separation by forcing a controlling shareholder to retain a certain percentage of the company's equity capital. The rationale underlying such sunset clauses is that a controller with a sizable equity holding is likely to better internalize and act in furtherance of the interests of the company's public shareholders. Some might worry that there are circumstances in which it would be desirable to enable the controller to reduce its equity stake without compromising the company's dual-class structure.[166] In such cases, the sunset arrangement could be refined to allow the dual-class structure to remain in place if approved by a majority of public investors unaffiliated with the controller.

INTERPRETIVE GUIDANCE ON EXECUTIVE AND DIRECTOR COMPENSATION DISCLOSURE RULES 1 (Nov. 1, 2016), https://www.fwcook.com/content/documents/publications/11-01-2016__ORIGINALLY_01-29-07__-_SEC_Staff_Updates_Interpretive_Guidance_on_Executive_and_Director_Compensation_Disclosure_Rules.pdf.

[165] AMC, LinkedIn, and Zynga are among the companies that adopted an ownership-percentage sunset clause when they went public. *See* HONG KONG EXCHS. & CLEARING LTD., CONCEPT PAPER: WEIGHTED VOTING RIGHTS 46–48 (2014).

[166] *See, e.g.*, Berger, *supra* note 26; Goshen & Hamdani, *supra* note 26, at 566–67.

The use of a sunset provision with an ownership threshold is not new to U.S. equity markets. From the mid-1970s to the mid-1980s, the American Stock Exchange (AMEX), now known as NYSE American, had an arrangement that permitted dual-class capitalization but subjected it to certain limitations,[167] including decreasing the voting of high-vote shares if the percentage of such shares fell below a certain percentage of total capitalization.[168] AMEX later dropped this arrangement, and other exchanges do not have such an arrangement. Our analysis of the perils of small-minority controllers suggests that regulators should now seriously consider adopting an AMEX-like requirement.

An ownership-based sunset clause could also be introduced through private ordering. Companies going public with a dual-class structure can include such a governance arrangement in their charters, as various such companies have already done.[169] However, for such governance arrangements to be effective in addressing the problem, the devil is in the details. As we explained in section II.G, most dual-class companies still do not have a sunset provision, and for those that do, the specified threshold is typically low enough to permit small-minority controllers. In our view, to the extent to which public officials do not adopt effective and meaningful sunset requirements, institutional investors should seek to encourage companies going public with dual-class structures to adopt these provisions.

2. Limiting High/Low Vote Ratio

As our analysis of the mechanisms of extreme separation has shown, the high/low vote ratio plays an important role in determining the extent to which a controller can reduce her equity stake while maintaining a lock on control. Therefore, public officials and institutional investors who are concerned about the governance costs of small-minority controllers should pay close attention to the high/low vote ratios used by dual-class companies.

The high/low vote ratio could be limited by regulation or the exchange-listing standard. For example, AMEX's old statement policy subjected dual-class listings to a maximum 10:1 high/low vote ratio.[170] Similar rules exist in other countries. For Italian private companies, the maximum high/low vote

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167 *See* Seligman, *supra* note 79, at 704 n.90.

168 *See id.* ("The Exchange will generally require that the 'super' class lose certain of its attributes should the number of such shares fall below a certain percentage of the total capitalization.").

169 *See supra* Section II.G.

170 Seligman, *supra* note 79, at 704 n.90 ("There may not be a voting ratio greater than 10 to 1 in favor of the 'super' voting class on all matters other than the election of directors.").

ratio is 3:1.[171] In Poland, before enacting a prohibition on the use of high-vote shares, the maximum high/low vote ratio was 5:1.[172] And in Denmark, Hungary, Sweden, and Switzerland, the ratio is 10:1, as it was per AMEX policy.[173] However, the present listing standards of U.S. exchanges impose no limits on the use of the high/low vote ratio. The exchanges could well have economic incentives to list companies that use high ratios, but, given concerns about small-minority controllers, regulators may consider requiring exchanges to have some meaningful cap on their high/low vote ratios.

Absent regulatory or exchange requirements, institutional investors should pay close attention, not only to whether companies have a dual-class structure, but also to the vote ratio employed. A high vote ratio plants the seeds for the emergence of extreme separation between cash-flow rights and voting rights, and therefore exposes public investors to substantial governance risks. We note that ISS operates a corporate-governance-rating system that examines only the existence or absence of a dual-class structure.[174] In our view, any assessment of governance risks that is provided to institutional investors should also give significant weight to the high/low vote ratio.

3. Limits to the Issuance of Nonvoting Shares

As explained earlier, introducing nonvoting stock represents an "infinite" ratio of high/low voting shares. As our analysis shows, when assessing the potential for extreme separation, what matters is not only the mere existence of a class of nonvoting stock, but also the number of authorized-but-unissued nonvoting shares. Recall that in our analysis of Snap, it was the large number of authorized-but-*unissued* nonvoting shares—rather than the number of issued nonvoting shares—that provided the basis for our conclusion that Snap's cofounders would be able to retain majority control in the future while unloading the vast majority of their shares and retaining only a tiny equity

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[171] Art. 2351 C.c., *translated in* THE ITALIAN CIVIL CODE AND COMPLEMENTARY LEGISLATION 508 (Sussana Beltramo trans., 2012).

[172] *See* SHEARMAN & STERLING, PROPORTIONALITY BETWEEN OWNERSHIP AND CONTROL IN EU LISTED COMPANIES: COMPARATIVE LEGAL STUDY: EXHIBIT C (PART II): LEGAL STUDY FOR EACH JURISDICTION 165 (2007), http://www.ecgi.org/osov/documents/study-exhibit_c_part2_en.pdf [hereinafter COMPARATIVE LEGAL STUDY, PART II].

[173] For a description of the governing arrangements in these countries, see INST. S'HOLDER SERVS. ET AL., REPORT ON THE PROPORTIONALITY PRINCIPLE IN THE EUROPEAN UNION 26 (2007), http://www.ecgi.org/osov/documents/final_report_en.pdf (Denmark, Hungary and Sweden), and Daniel Schoch, Marc Schamaun & Annina Müller, *Switzerland*, *in* GETTING THE DEAL THROUGH: CORPORATE GOVERNANCE 2016, at 160, 161 (Holly J. Gregory ed., 2016) (on file with authors) (Switzerland).

[174] *See supra* notes 28–29 and accompanying text.

stake.[175] Therefore, public officials and institutional investors who are concerned about the governance costs of small-minority controllers should pay close attention to both the number of nonvoting shares that have already been issued and the number that would remain in the company coffer and could be used for future dividend distributions in a way that could significantly reduce the controller's equity stake.

Numerous jurisdictions around the world outright prohibit the use of nonvoting shares. For instance, corporations in Denmark, the Netherlands, and Sweden cannot issue nonvoting shares.[176] Some other jurisdictions allow the use of nonvoting shares but limit them to a fraction of the company's equity capital: 25% in France;[177] 33% in Austria, Belgium, and Estonia;[178] 40% in Greece;[179] and 50% in Germany, Hungary, Italy, Japan, Luxembourg, and Spain.[180]

In the United States, current regulation and exchange requirements place no limits on the use of nonvoting shares. This state of affairs enables companies to adopt structures in which nonvoting stock forms the overwhelming majority of equity capital. For example, Snap's initial charter authorizes a large number of nonvoting shares which, once fully issued, would result in nonvoting stock constituting about 90% of the company's equity capital.[181] Public officials overseeing the U.S. capital markets should consider whether the benefits of this expansive freedom to use nonvoting stock actually outweigh the substantial governance risks it generates.

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[175] *See supra* Section II.C.

[176] *See* SHEARMAN & STERLING ET AL., PROPORTIONALITY BETWEEN OWNERSHIP AND CONTROL IN EU LISTED COMPANIES: COMPARATIVE LEGAL STUDY: EXHIBIT C (PART I): LEGAL STUDY FOR EACH JURISDICTION 65 (2007), http://www.ecgi.org/osov/documents/study-exhibit_c_part1_en.pdf [hereinafter COMPARATIVE LEGAL STUDY, PART I] (Denmark); COMPARATIVE LEGAL STUDY, PART II, *supra* note 172, at 118–19, 235 (the Netherlands and Sweden).

[177] COMPARATIVE LEGAL STUDY, PART I, *supra* note 176, at 249.

[178] Eva Fischer, *Austria*, *in* GETTING THE DEAL THROUGH, *supra* note 173, at 12 (Austria); COMPARATIVE LEGAL STUDY, PART I, *supra* note 176, at 6, 137 (Belgium and Estonia).

[179] COMPARATIVE LEGAL STUDY, PART I, *supra* note 176, at 173.

[180] *See* Art. 2351 C.c., *translated in* THE ITALIAN CIVIL CODE AND COMPLEMENTARY LEGISLATION 59 (Sussana Beltramo trans., 2012) (Italy); COMPARATIVE LEGAL STUDY, PART I, *supra* note 176, at 99, 201 (Germany and Spain); COMPARATIVE LEGAL STUDY, PART II, *supra* note 172, at 12, 48, 338 (Luxembourg, Hungary, and Japan). Some of the above-mentioned jurisdictions only allow the use of nonvoting preferred shares, which have no voting power but are protected by enjoying preferential dividend rights.

[181] At the time of the IPO, Snap issued three billion nonvoting shares. *See* Snap Inc., Registration Statement, *supra* note 66, at 153–54. If these authorized nonvoting shares are issued to fullest extent possible, they will constitute over 90% of company's equity capital. *See supra* notes 96–102 and accompanying text.

Some institutional investors have sought to limit the use of nonvoting shares via private ordering. As part of this effort, one of the world's largest index providers, Standard & Poor's (S&P), has recently announced its plans to exclude companies with multiple-class share structures from its index.[182] However, the change to the S&P 1500 Composite will not affect existing index constituents and, at this stage, it is not clear whether and to what extent it will discourage companies from going public with dual-class structures.[183]

In sum, nonvoting shares can be a powerful tool for creating an extreme separation between cash-flow rights and voting rights. Our analysis suggests that because this extreme separation generates substantial governance risks and costs to public investors, public officials and institutional investors should consider measures aimed at discouraging the use of nonvoting stock to enable the creation of small-minority controllers.

D. Additional Investor Protections in Companies with Small-Minority Controllers

In the preceding section, we discussed measures that public officials and institutional investors could adopt to reduce the current and potential occurrence of companies with small-minority controllers. Should they decide not to pursue such measures or to pursue them in a limited fashion, a significant incidence of small-minority controllers would still exist. Furthermore, even if public officials and institutional investors were to succeed in limiting the creation of new public companies with small-minority controllers, these structures could remain in companies that went public in the past. Thus, we now examine corporate governance measures for protecting public investors in situations where small-minority controllers would remain in control.

The design of corporate law rules takes into account the potential for certain agency problems. For example, when a company has a controlling shareholder, corporate law provides special rules to address concerns about that controller using her power to divert value from public investors.[184]

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[182] Joseph A. Hall & Michael Kaplan, *Snap Decision: Leading Index Providers Nix Multi-Class Shares*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 2, 2017), https://corpgov.law.harvard.edu/2017/08/02/snap-decision-leading-index-providers-nix-multi-class-shares/ [https://perma.cc/YQ2Z-2FUL].

[183] *See id.*; *see also The Continuing Support for Dual-Class Stock by Companies and Investors*, WILSON SONSINI GOODRICH & ROSATI (Oct. 17, 2017), https://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-dual-class-stock-1017.htm [https://perma.cc/NVG7-23JN] ("[M]ulti-class stock structures will continue to be adopted by emerging growth companies.").

[184] *See infra* notes 186–188, 202–205 and accompanying text (discussing Delaware courts' approach to controllers' related-party transactions).

Because we have shown that the presence of a small-minority controller generates severe governance costs and risks, this insight should inform the design of rules and arrangements that govern decisionmaking in companies with small-minority controllers.

The recognition of the potential for governance risks generated by small-minority controllers should encourage public officials (including both regulators and courts) and institutional investors to address this problem. Below we highlight several avenues through which public officials and institutional investors could seek to provide public investors with additional protections from small-minority controllers. These additional protections include: (i) strengthening limits on conflicted decisions by small-minority controllers, (ii) having a majority of independent directors on the boards of companies with small-minority controllers, and (iii) granting public investors in a company with small-minority controllers the right to elect—or at least approve—the selection of some independent directors. Our analysis is not intended to be exhaustive, but rather to show that there are governance tools and protections available to serve this purpose.

1. Strengthening Limits on Conflicted Decisions

Corporate law has long recognized the problems that arise from the potential opportunism of controlling shareholders, and it provides an elaborate set of rules and doctrines to limit these problems. For example, both in the United States and around the world, there are special rules that limit potential value diversion as a result of related-party transactions between the controlled company and entities affiliated with the controller.[185] Because we have shown that agency problems and distortions are likely to be more severe when the controller has a small stake in the controlled companies, the protection of public investors in such situations calls for heightened rules and doctrines.

a. Judicial Scrutiny.

Enhanced judicial scrutiny of conflicted transactions involving small-minority controllers could provide one way to mitigate this increase in the severity of agency problems and distortions. For example, courts that examine self-dealing transactions should consider applying heightened scrutiny when the controller is a small-, very-small-, or tiny-minority controller. We note that in *In re Ezcorp*, a self-dealing case, Vice Chancellor Laster observed that the controller held 100% of the voting power but owned

[185] For a detailed analysis of the corporate governance problems in controlled companies and the importance of related-party transactions, see Bebchuk & Hamdani, *supra* note 33, at 1304–06.

only a 5.5% economic stake owing to the existence of a dual-class structure.[186] That extreme separation, according to the court, created a strong incentive for the controller to obtain returns through nonratable direct transfers, and thus played a role in the court's decision to subject the related-party agreements between the controller and the company to the "entire fairness" framework of review (rather than to the more deferential business judgment rule).[187] Our analysis suggests that courts should attach weight to the size of the controller's stake and apply heightened scrutiny when that stake is smaller.[188]

b. Limiting the Voting Rights of the Controller.

Another way to limit the agency costs of small-minority controllers is to allow such controllers to continue determining the identity of the board, but to limit their ability to use their voting power to adopt measures that could divert value from public investors. For example, in Switzerland, disproportionate voting rights do not apply to considerations of any resolution concerning the instigation of a special audit or the initiation of a liability action.[189] Similar restrictions on the exercise of a controlling shareholder's superior voting power in conflicted transactions exist in several other countries.[190] Such an approach, if adopted by U.S. regulators, would allow a small-minority controller to determine the company's strategic and managerial direction but, given the substantial agency distortion, would limit

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[186] *See In re* Ezcorp Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245, at *2 (Del. Ch. Jan. 25, 2016).

[187] *See id.* at *2, 11. ("As an equity owner, the controller participates in the resulting benefits (and losses) in proportion to its equity stake, effectively gaining or losing on a *pro rata* basis with other stockholders. . . . [I]n a related-party transaction, the controller receives 100% of the benefit while only funding the payment to the extent of its equity stake. The balance of the payment is funded by the unaffiliated equity holders. The economic incentive to tunnel varies inversely with the controller's equity stake.").

[188] We recognize that enhanced judicial scrutiny could only mitigate some, but not all, of the distortions and costs generated by small-minority controllers. For example, when courts place limits on the ability of a small-minority controller to conduct related-party transactions, these limits could mitigate concerns from excess value diversion by the controller; at the same time, they could cause the small-minority controller to refrain from certain efficient transactions just because they will be subject to stricter judicial review.

[189] Schoch et al., *supra* note 173, at 161.

[190] In some European countries, corporate law prohibits a controlling shareholder from voting on certain resolutions that could provide the controller with non-pro rata benefits. *See* Zoltán Kató & Gyula Körösy, *Hungary*, *in* GETTING THE DEAL THROUGH, *supra* note 173, at 44–45 (Hungary); Nataša Lalović Marić, Iskra Lazić & Bojana Noskov, *Serbia*, *in* GETTING THE DEAL THROUGH, *supra* note 173, at 139 (Serbia); Pelin Baysal, Görkem Bilgin & Bensu Aydın, *Turkey*, *in* GETTING THE DEAL THROUGH, *supra* note 173, at 167 (Turkey).

the controller's power to pass measures that could adversely affect public investors' interests without their support.

Finally, we note that limitations on conflicted decisions could also be introduced through private ordering. Thus, institutional investors might try to encourage companies going public with dual-class structures to adopt provisions that would provide additional protections in the event that a small-minority controller emerges. For example, a charter provision could limit the ability of such a controller to use its disproportionate voting power to unilaterally determine the vote of certain matters, such as charter amendments affecting the interests of public investors.

2. Requiring Majority of Independent Directors

Another protective arrangement to consider is having a majority of independent directors on the boards of companies with small-minority controllers. The Sarbanes–Oxley Act of 2002 and the applicable stock exchange listing standards require that boards of widely held companies have a majority of independent directors.[191] However, the listing standards exempt all controlled companies, regardless of the equity stake of their controllers, from director independence requirements.[192]

Our analysis suggests that exchanges should instead consider limiting this exception to companies where controllers have a sufficiently large equity stake. Because the financial incentives of small-minority controllers are less likely to be aligned with those of other public shareholders, the presence of independent directors is more crucial in dual-class companies with extreme separation than in other controlled companies.

Moreover, even without action by the exchanges or other regulators, requirements for a majority of independent directors could be adopted through private ordering. Thus, in assessing companies going public with a dual-class structure that could give rise to small-minority controllers, institutional investors should try to press such companies to introduce charter provisions that ensure a majority of independent directors.

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[191] *See* 15 U.S.C. § 7211(e)(3) (2012); *Developments in the Law: Corporations and Society*, 117 HARV. L. REV. 2169, 2187 (2004) ("The revised listing standards of both the NYSE and NASDAQ . . . require (with a few exceptions) that listed-company boards have a majority of independent directors . . . .").

[192] *See SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence*, FINDLAW, https://corporate.findlaw.com/finance/sec-approves-nyse-and-nasdaq-proposals-relating-to-director.html [https://perma.cc/Y65S-N8XB] (last visited Feb. 1, 2018).

3. Enhanced Director Independence

Another way to protect public investors in companies with small-minority controllers is to provide them with influence over the election of some independent directors. Under the existing arrangements, even when the controller has a small-, very-small- or a tiny-minority stake, that controller has the power to appoint or terminate all independent directors.[193] As was highlighted in a recent article coauthored by one of us and Professor Assaf Hamdani, the controller's power to appoint and elect independent directors provides these directors with incentives to favor the controller, and weakens their incentives to thoroughly screen conflicted decisions and rigorously guard the interests of public investors.[194]

To provide improved incentives, public investors in a company with small-minority controllers could be given the right to elect, or at least to approve, the selection of some independent directors, who would then be responsible for approving conflicted decisions. Having such enhanced independent directors would not take away from the controller's ability to set the company's strategic and managerial directions. Rather, it would ensure that decisions in conflicted situations would be made only if approved by independent directors that have heightened incentives to serve the interests of public investors.[195]

In those dual-class companies that went public between the mid-1970s and mid-1980s at AMEX, this arrangement has functioned well in practice, requiring these companies to grant public shareholders the right to elect at least 25% of the board of directors.[196] Such arrangements still exist in some mature dual-class companies[197] but are rare in companies with small-minority controllers that did not go public at AMEX.[198] Even if the presence of small-minority controllers were to be accepted, it would still be desirable to introduce enhanced-independent directors in all companies with such controllers. Regulators could adopt such a mandate; courts could encourage it by imposing enhanced scrutiny for conflicted decisions not approved by enhanced-independent directors; and institutional investors should look for

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[193] This is because our definition of controlled dual-class companies includes only companies in which the controllers have 50% or more of the voting rights, or the ability to elect the majority of the directors.

[194] *See* Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1274 (2017).

[195] For a detailed analysis of the potential benefits of this arrangement, see *id.*

196 *See* Seligman, *supra* note 79, at 704 & n.90 (describing the AMEX policy statement that detailed the company's prelisting understandings with Wang Laboratories).

[197] *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 126.

[198] *See id.* at 126–27.

arrangements that provide for enhanced-independent directors when deciding whether to invest in such companies.

In sum, taking as a given that companies with small-minority controllers will continue to exist, public officials and institutional investors approaching such companies should be informed by a comprehensive understanding of the special governance problems that they pose, and the need to provide their public investors with additional protections to address those problems. We have identified some key measures that could be considered for this purpose, and our analysis could provide a basis for identifying and developing additional measures.

E. Screening Midstream Changes

Thus far, we have focused on what arrangements dual-class companies should adopt when they go public. We have discussed arrangements that would limit or discourage the ability of a controller to retain control while holding only a small equity stake, as well as arrangements that would provide public investors with additional protections from a small-minority controller. However, although IPO arrangements are important, we now turn to the problem of midstream charter changes. In a dual-class company with a majority controller, the controller may at a later stage use her voting power to amend some governance arrangements that were adopted at the IPO.

In this section, we examine how public officials and institutional investors should seek to address midstream governance changes. Such changes could take different forms. The controller might make changes that would enable her to retain control with a smaller fraction of the equity capital than would have otherwise been possible. For example, a charter amendment that authorizes the issuance of a sufficiently large number of low-vote shares or nonvoting shares would enable the controller to reduce the minimum equity stake necessary to retain control to as low a level as the controller desires.[199] Another midstream governance change might introduce a conversion clause that would mitigate the expected decrease of the controller's total voting power upon a sale of shares by the controller or other pre-IPO shareholders.[200]

Of course, these charter amendments require a vote of shareholder approval. However, a controller who controls the majority of votes could pass a charter amendment against the wishes of public investors. This introduces the concern of "opportunistic" midstream changes that would serve the controller's private interests even if they would likely have a significant, adverse effect on public investors. For example, a nonvoting share

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[199] *See supra* Sections II.D.2, II.G.

[200] *See supra* Sections II.D.1, II.E.2.

reclassification would serve the controller's private interests by enabling the controller to obtain the liquidity and diversification benefits that come from unloading shares without bearing the costs of losing control. At the same time however, because such a change would reduce the controller's equity stake, it would be expected to increase agency distortions and costs.

One way to guard against midstream governance changes would be to preclude the controller from making any changes in the IPO structure. However, such a rigid approach might impose undesirable costs because it would also preclude the possibility of governance changes necessary to address changing circumstances that benefit both the controller and public investors. Therefore, it would be desirable to have an adequate screening mechanism to preclude opportunistic, value-decreasing changes, while still enabling efficient changes that would serve the interests of both the controller and public investors.

Another way to address midstream governance changes is to subject them to a vote of approval by public shareholders unaffiliated with the controller.[201] Such a requirement would prevent changes that public investors view as opportunistic and against their interests. At the same time, however, because public investors would be expected to vote in favor of midstream charter amendments that would serve both their interests and the interests of the controller, such an approval requirement should not preclude beneficial changes.

Requiring a vote of approval from public investors for midstream governance changes in controlled dual-class companies would be an effective way to deal with the problem of such changes. In our view, the significant problem with recent dual-class nonvoting stock reclassifications, such as the one adopted by Google and the one attempted by Facebook, is that the controllers passed the proposed charter amendments using their own voting power without making the proposals contingent on the approval of disinterested public investors.

One way to introduce an approval vote by disinterested public investors is through judicial intervention. In freeze-out transactions, such votes of approval became common after the Delaware courts held that it would subject a freeze-out to an exacting "entire fairness" standard of review unless the freeze-out proposal was made conditional on receiving the approval of public

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[201] Public officials could also impose a flat prohibition against midstream reclassifications, as AMEX's prior policy did. *See* Seligman, *supra* note 79, at 704 n.90 ("No additional stock (whether designated as common or preferred) may be created which can in any way diminish voting power granted to the holders of the limited voting class."). However, such a prohibition could be opposed on the grounds that it might block efficient midstream reclassifications.

investors (among other requirements).[202] Such a special approval mechanism is used to eliminate freeze-outs that are motivated by the controllers' private interests and are value-reducing for public investors.[203] Similarly, in our context, a court could—and, in our view, should—adopt a similar approach with respect to midstream charter amendments.

In the well-known *Williams v. Geier* case, the Delaware Supreme Court provided a business judgment deferential review to the decision of a controller to pass a charter amendment that was expected to entrench the controlling family.[204] In a recent case involving a midstream reclassification aimed at preserving the voting power of the controller, Chancellor Bouchard thought to limit the scope of *Williams* (though without expressly rebutting it).[205] In our view, it would be desirable for the Delaware Supreme Court to overrule *Williams* in general, or at least in the case of multiple-class share reclassifications. Concerns about opportunistic midstream changes by small-minority controllers fully warrant such an approach by the court.

Finally, a requirement for approval of midstream charter changes in dual-class companies could be introduced through private ordering. The IPO charter of companies going public with a dual-class structure could contain provisions that require majority approval from public investors for any specified charter amendments that could adversely affect the interests of public investors.

CONCLUSION

This Article has placed a spotlight on the perils of small-minority controllers. Such controllers pose substantial governance risks, generate considerable governance costs, and deserve the close attention of public officials and investors.

This Article has provided a systematic analysis of the drivers, incidence, costs, and policy implications of small-minority controllers. We have analyzed the considerable agency costs and distortions of small-minority controllers, how they can be expected to rise steeply as the controller's equity stake declines, and the mechanisms that enable small-minority shareholders

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[202] The Delaware courts have encouraged controllers to obtain the approval of unaffiliated shareholders to the terms of a freeze-out merger by holding that transactions not enjoying such approval would be subject to strict scrutiny. *See, e.g.*, Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

203 *See* Guhan Subramanian, *Post*-Siliconix *Freeze-Outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 1, 14 (2007) (finding that minority shareholders receive lower cumulative abnormal returns in tender-offer freeze-outs not subject to the entire fairness standard than in statutory merger freeze-outs).

[204] 671 A.2d 1368, 1371 (Del. 1996).

[205] *See* IRA Tr. FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB, 2017 WL 6335912, at *8 (Del. Ch. Dec. 11, 2017).

to retain a lock on control. Based on a hand-collected dataset of governance provisions, we provide novel empirical evidence of the current and potential incidence of small-minority controllers. Our finding that the governance provisions of over 80% of dual-class companies would enable the controller to retain control with an equity stake below 10% and, in a sizable fraction of these cases, with even below a 5% stake, highlights the significance of the issue and the concerns it raises.

Finally, we have examined the significant policy implications that small-minority controllers pose for public officials and institutional investors. We hope that our analysis will be useful to them, helping them to recognize and address the pernicious problems produced by small-minority controllers.

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