

# Bargaining over Voting Rights

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# Motivation (1)

- Dual-class structures are one of the most controversial issues in corporate governance.
- Studies suggesting that dual-class structures decrease firm value:
  - Bebchuk & Kastiel (2019)
  - Gompers et al. (2010)
  - Masulis et al. (2009)
  - Smart et al. (2008)
- Studies suggesting that dual-class structures might benefit shareholders:
  - Bauguess et al. (2012)
  - Dimitrov & Jain (2006)

# Motivation (2)

- One powerful argument is that dual-class structures are voluntary arrangements:
  - Investors are sophisticated parties and are able to price the effects of dual-class structures on firm value
  - Managers have incentives to propose optimal dual-class charters at IPO
  - One size doesn't fit all, therefore each company will choose the optimal voting structure for its specific characteristics
- Policy implication: Regulators and stock exchanges should not interfere with the efficient bargaining process between investors and pre-IPO owners (contractarian theory)

# Scope of the Paper

- How do actual dual-class arrangements look like? Do they adapt to the quirks and vagaries of individual companies?
- Paper tries to answer this question by analyzing comprehensive sample of dual-class charters adopted at IPO by US nonfinancial companies from 1996 to 2018
- Main findings:
  - A lot of of contractual variation
  - But most companies choose similar or identical degree of voting inequality (magnitude and duration)
- Possible explanations:
  - Intrinsic optimality? It seems unlikely
  - Benefits of standardization? It seems unlikely
  - Irrelevance of voting rights? It seems unlikely
  - Fundamental uncertainty -> stickiness of historically determined patterns? More promising

# Literature

- Vast literature on dual-class structure but very little attention paid to contractual variation across dual-class structures
- Two notable and recent exceptions:
  - Bebchuk & Kastiel 2019: It examines 170 dual-class charters (IPOs and midstream amendments) to show that many controllers own or may potentially own only a small % of stock
  - Winden 2018: It examines 139 dual-class charters to suggest that variety of charter provisions allows investors and firms to find optimal balance between controller's vision and investor protection.
- Main contributions:
  - Comprehensive sample of IPO charters
  - Contrasts mere contractual variation with degree of voting inequality
  - Finds predominant pattern in magnitude and duration of voting inequality
  - Systematic analysis of possible theoretical explanations

# A Simple Framework (1)

- Goal of Investors is to maximize firm value  $V$  relative to their investment
- Goal of Founder is to maximize sum of firm value and private benefits  $V + B$
- Voting structure affects both  $V$  and  $B$ 
  - Effect of dual-class structure on firm value may be positive or negative
    - Insulation from short-termist pressures
    - Founder's incentives misaligned with Investors' preferences
    - Founder's diversification -> less risk aversion
    - Founder's bargaining power vis-à-vis buyers
  - Effect of dual-class structure on Founder's private benefits is always positive (but magnitude varies)
    - Different tastes for control, job security, social benefits, slack, tunneling etc.

# A Simple Framework (2)

- Founder chooses a voting structure  $S$  at IPO
- Investors are able to price the effect of  $S$  on  $V$
- Therefore, Founder internalizes the effect of  $S$  on  $V$
- Consequently:
  - Founder will propose voting structure that maximizes  $V + B$
  - Investors will pay a price that accurately reflects  $V$ , therefore their return will not be affected
  - Everybody is happy

# A Simple Framework (3)

## Example

- Mark Zuckerberg must choose between standard single-class structure ( $S_0$ ) and the classic dual-class structure he eventually chose ( $S_1$ )
  - $B_0, B_1$  are the private benefits of Zuckerberg under  $S_0, S_1$
  - $V_0, V_1$  is the firm value of Facebook under  $S_0, S_1$

$$(B_1 - B_0) + (V_1 - V_0) > 0$$

- Parties will choose  $S_1$  over  $S_0$  only if:
  - The dual-class structure increases the value of the firm, or
  - The increase in private benefits exceeds reduction in firm value



# One Size Does Not Fit All

- Supporters of dual-class structures argue that one size does not fit all
  - Voting structure is a function of many characteristics that vary significantly across firms
  - Optimal voting structure varies from firm to firm
  - Founder and Investors are best positioned to identify optimal voting structure for their firm
- But choice is not just between single class and dual class
  - We should observe this “bargaining process” and choice of optimal structure also within the dual-class subset
  - Difference between single-class and dual-class is quantitative, just like one dual-class structure and another
  - We should expect variation across dual-class structures adapting to variation of firm and Founder characteristics

# Dataset

- 211 dual-class IPOs from 1996 to 2018
  - Jay Ritter's dual-class dataset: 683 IPOs
  - Excluded foreign-incorporated companies
  - Limited to NYSE, Nasdaq, Amex
  - Excluded financial, insurance, real estate
  - Excluded LLP, LLC, trusts
  - Excluded Up-C structures
  - Excluded superior voting to public or special investors
  - Excluded temporary dual-class to implement tax exempt spin-off or split-off
- Hand-coded information in prospectuses and proposed charters
- Collected additional information from Thomson Reuters' SDC and Compustat
- Hand-collected information from news sources, institutional websites, and International Directory of Company Histories 1988-2020

# Contractual Variation

- 9 main mechanisms / Several variants for each mechanism
  - Classes of common stock
    - 2 classes (most common)
    - 3 or more
  - Voting ratio (= voting rights per share of high-vote stock relative to low-vote stock)
    - 10 (most common)
    - Several other variants
  - Etc.
- Contractual design = combination of chosen variant for each mechanism (including when mechanism not present)
- Raw heterogeneity = variation in contractual designs

# Contractual Mechanisms (1)

## 1. Classes of common stock

- Facebook (2012): Class A (1 vote), Class B (10 votes)
- Dreamworks (2004): Class A (1 vote), Class B (15 votes), Class C (1 vote)
- Snap (2016): Class A (0 vote), Class B (1 vote), Class C (10 votes)

## 2. Voting Ratio

- Facebook: 10
- Dreamworks: 15
- Snap: infinite

## 3. Minimum equity threshold

- Facebook: None
- LinkedIn: 10%
- Snap: if HV stock < 30% of HV stock at IPO

# Contractual Mechanisms (2)

## 4. Time-based sunsets

- Facebook: None
- Fitbit: 10 years
- Nutanix: 17 years

## 5. Event-based sunset

- Facebook: None
- Classic Communication: If PE fund converts its HV stock
- Unigraphics: 5 years after tax-free spin-off of controlling stake

## 6. Conversion upon death, disability, termination

- Facebook: None
- AppFolio: Individual conversion in case of death or disability
- Under Armour: Sunset in case of death of founder

# Contractual Mechanisms (3)

## 7. High-vote transfer

- Facebook: Only to family members, controlled entities, trusts, nonprofits
- VMWare: Parent company cannot transfer high-vote rights (conversion upon transfer)
- First Data: To anyone

## 8. Voluntary conversion

- Facebook: Yes
- VMWare: Yes
- Gray Television: No

## 9. Special control rights

- Facebook: None
- Big City Radio: HV appoint 75% directors
- Pameco: HV appoint all directors but 2

# Contractual Variants

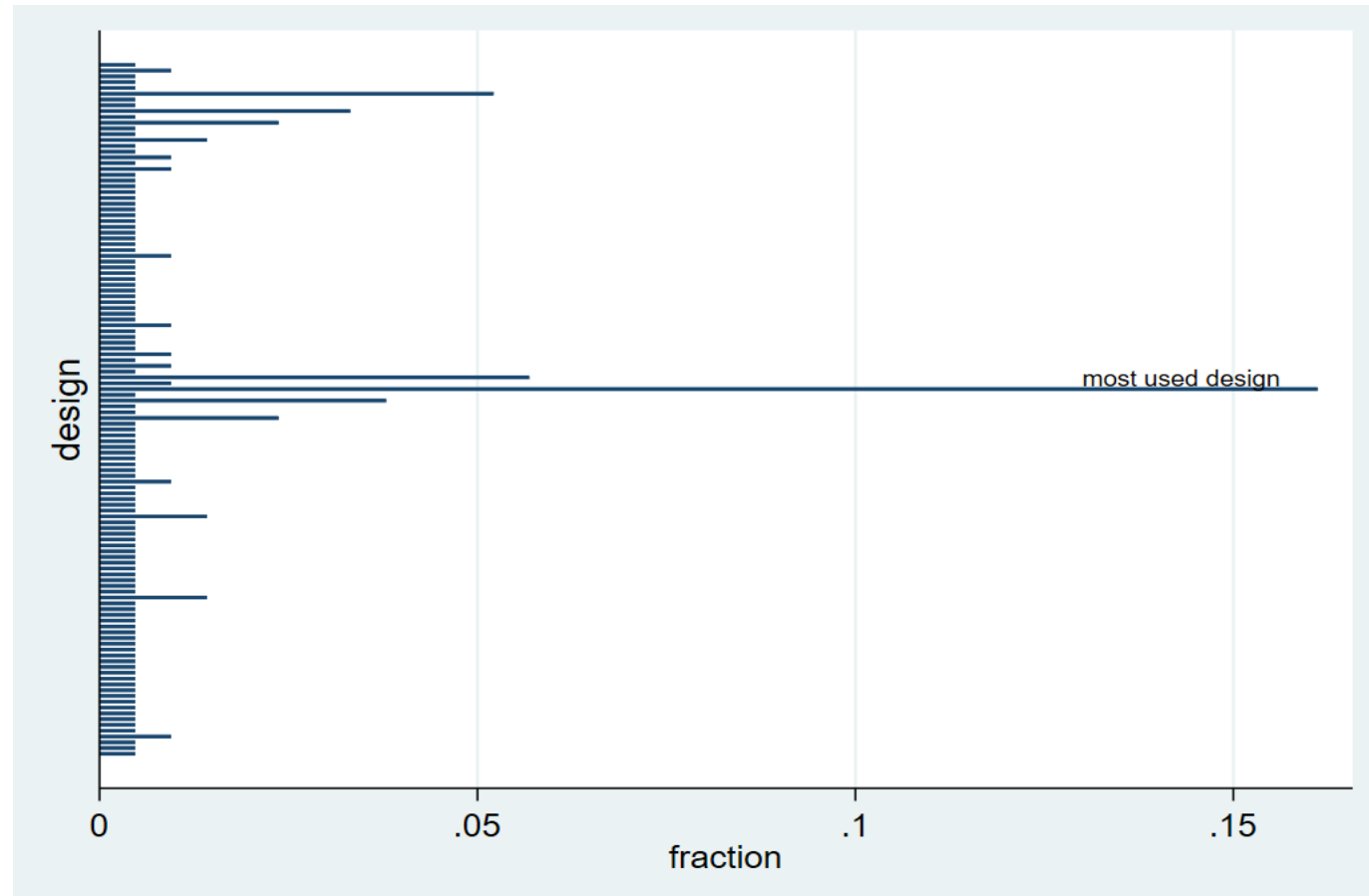
- For each mechanism, there is one prevalent variant

Contractual Feature	Main Versions	%
1. <b>Classes</b>	Two classes	90%
	Three classes	9%
	More than three classes	0.9%
2. <b>Voting ratio</b>	Voting ratio of 10	76.8%
	Voting ratio less than 10	14.2%
	Voting ratio greater than 10	5.7%
	Other	3.3%
3. <b>Minimum equity threshold</b>	No minimum equity sunset	54.5%
	Minimum fraction of common stock	33.7%
	Minimum number of shares	2.8%
	Minimum fraction of total voting rights	3.3%
	Minimum fraction of stock owned at IPO	4.3%
	Other criteria	0.9%
4. <b>Time-based sunset</b>	No time-based sunset	87.2%
	Sunset after 4-20 years from IPO	12.8%

Contractual Feature	Main Versions	%
5. <b>Event-based sunset</b>	No event-based sunset	96.7%
	Sunset upon certain events	3.3%
6. <b>Death</b>	No conversion	74.9%
	Sunset	19.9%
	Individual conversion	5.2%
7. <b>Transfer</b>	Only to family and affiliated entities	52.6%
	Only to affiliated entities	33.2%
	To any buyer	11.8%
	To no buyer	1.4%
8. <b>Voluntary conversion</b>	Allowed	98.1%
	Not allowed	1.9%
9. <b>Special control rights</b>	No special control rights	91.9%
	Special control rights	8.1%

# Raw Heterogeneity

- However, there is very high variability in terms of contractual design



- Most used design: 16.1% IPOs
  - 2 classes of common stock
  - High-vote stock have 10x votes
  - No minimum equity threshold
  - No time-based sunset
  - No event-based sunset
  - No death-based conversion
  - HV power transferable to family
  - Voluntary conversion
  - No special control rights
- But 47.4% IPOs have unique design



# Contractual design $\neq$ Degree of voting inequality (1)

- Mere variation in contractual design does not necessarily capture variation in degree of voting inequality
- Effect of voting inequality on firm value and private benefits:
  - Magnitude of voting inequality = with how few shares the Founder can control the company (minimum controlling fraction of stock)
  - Duration of voting inequality = for how long the Founder can control the company with a minority of shares
- Big differences in contractual design may correspond to small differences in degree of voting inequality and vice versa

# Contractual design $\neq$ Degree of voting inequality (2)

- Magnitude of voting inequality = minimum controlling fraction
  - Contractual potential
  - Assumptions:
    - VC sell
    - Authorized stock is eventually issued
    - Controller(s) divest(s) over time
    - Voluntary conversion before selling
  - Mcf = what is the minimum fraction of stock that allows the controller(s) to keep a majority of voting rights?
- Duration of voting inequality
  - Contractual potential
  - Right to transfer high-vote shares to family or corporate controller = potentially perpetual structure

# Contractual design $\neq$ Degree of voting inequality (3)

- Example #1: Gray Television and Cox Radio, 2 media companies with HQ in Georgia, which went public in 1996 with very similar dual-class designs

	Gray Television	Cox Radio		
<i>Classes of Common Stock</i>	2	2	✓	Very similar contractual design
<i>Voting Ratio</i>	10	10	✓	
<i>Minimum Equity Threshold</i>	No	No	✓	
<i>Time-Based Sunset</i>	No	No	✓	
<i>Event-Based Sunset</i>	No	No	✓	
<i>Conversion upon Death</i>	No	No	✓	
<i>High-Vote Transferability</i>	No	No	✓	
<i>Voluntary Conversion</i>	No	Yes	✗	
<i>Special Control Rights</i>	No	No	✓	
<b>Minimum Controlling Fraction</b>	<b>30%</b>	<b>9.1%</b>		Very different magnitude of voting inequality

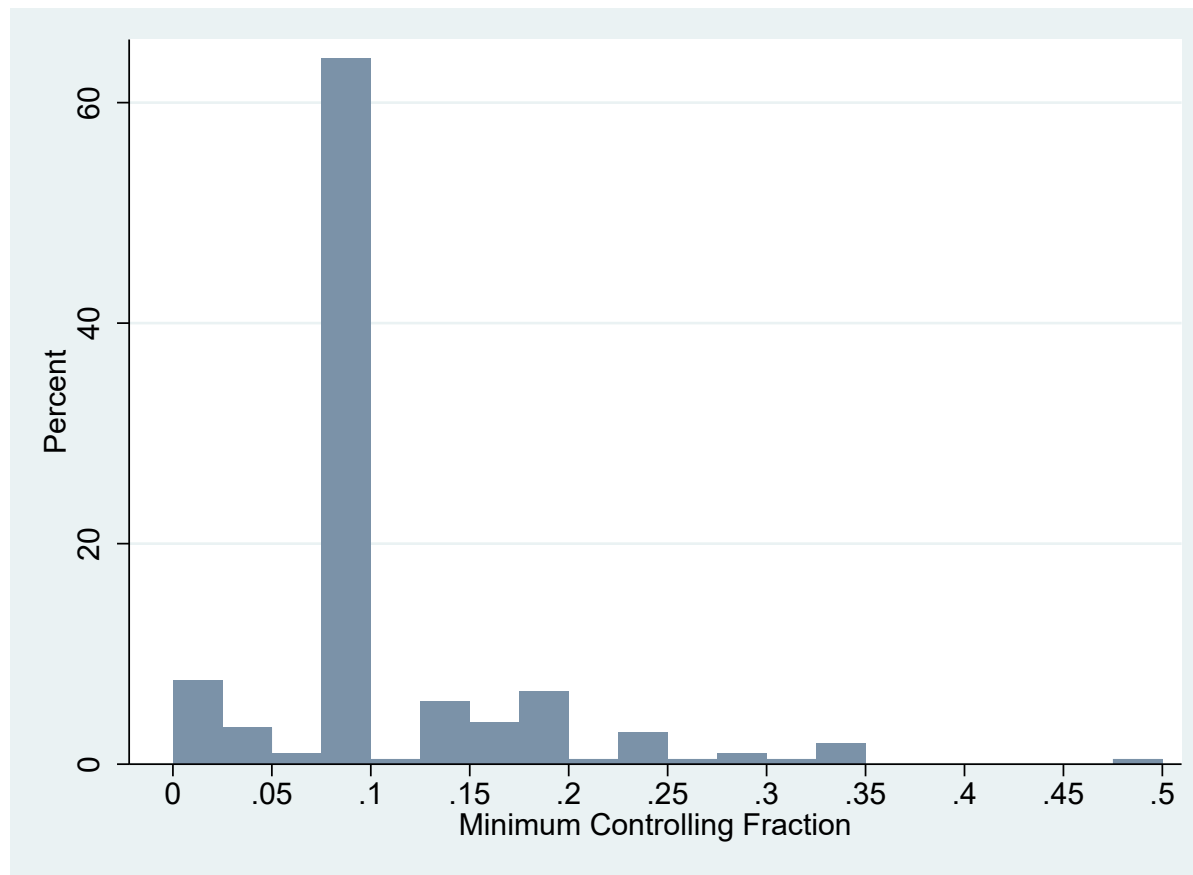
# Contractual design $\neq$ Degree of voting inequality (4)

- Example #2: XM Satellite (1999) and Smartsheet (2018), 2 companies in different sectors, with two very different contractual designs

	XM Satellite	Smartsheet		
<i>Classes of Common Stock</i>	3	2	x	Very different contractual design
<i>Voting Ratio</i>	3	10	x	
<i>Minimum Equity Threshold</i>	No	15%	x	
<i>Time-Based Sunset</i>	No	7 years	x	
<i>Event-Based Sunset</i>	No	No	✓	
<i>Conversion upon Death</i>	No	No	✓	Very similar magnitude of voting inequality
<i>High-Vote Transferability</i>	No	Affiliates	x	
<i>Voluntary Conversion</i>	Yes	Yes	✓	
<i>Special Control Rights</i>	No	No	✓	
<b>Minimum Controlling Fraction</b>	<b>14.8%</b>	<b>15%</b>		

# Magnitude of Voting Inequality

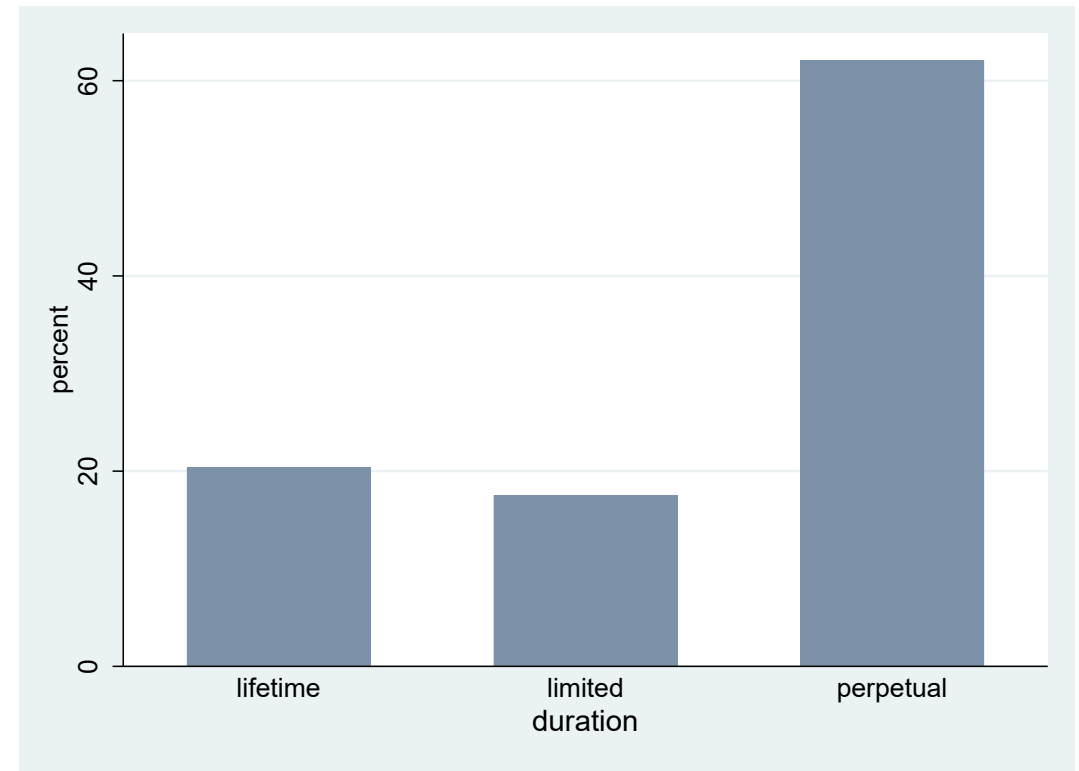
- When I measure the combined effect of charter provisions on the magnitude of voting inequality (minimum controlling fraction) I find that 64% of firms choose identical or very similar levels (9%-10%)



# Duration of Voting Inequality

- 62% of dual-class structure are potentially perpetual; 20% may last for the entire lifetime of founder/controller

Type	Contractual Designs
Perpetual	No time-based sunsets, no conversion upon death, & (a) right to transfer high-vote power to family members or third-party buyers; or (b) corporate controller (excluding private equity with an explicit change-of-control conversion clause)
Lifetime	No time-based sunsets, but (a) conversion upon death or (b) conversion upon transfer to buyers and family members
Limited	Time-based sunset (4-20 years after IPO); or private equity controller with an explicit change-of-control conversion clause



# One Size Fits Most

- If we combine magnitude and duration of voting inequality, 52% of dual-class structures have a minimum controlling fraction between 9% and 10% and a potentially perpetual or lifetime duration
- Why such a high degree of homogeneity? Three “efficient” explanations:
  - Dominant structure (DS) is inherently optimal for most companies
  - DS is suboptimal for many companies, but benefits of standardization outweigh costs of suboptimal choice
  - Investors do not place much value on voting rights, so let Founders choose

# Inherent Optimality (1)

- Finance literature has found some statistical association between certain firm characteristics and the choice of dual-class structure vs single-class structure
- But degree of voting inequality is a spectrum:
  - Difference between 0.5 and 0.4 mcf is not qualitatively different than difference between 0.4 and 0.3 mcf
  - Characteristics that predict dual-class vs single-class should predict variation in degree of voting inequality
  - But dominant dual-class structure prevails in all subsets of companies with little or no statistically significant difference



# Inherent Optimality (2)

- Characteristics of company, CEO or founder/controller that are associated with choice of dual-class vs single-class:
  - Active founder (as a proxy of high psychological benefits of control)
  - Family firm (as a proxy of high psychological benefits of control)
  - Media or high-tech sector (as a proxy of high psychological/social benefits of control)
  - Board size (as a proxy of inefficiencies / high pecuniary private benefits)
  - VC backing (negative coefficient) (as a proxy of lower tolerance for V/B tradeoffs)
  - Size (as a proxy of high private benefits)
- But degree of voting inequality does not seem statistically associated with these characteristics

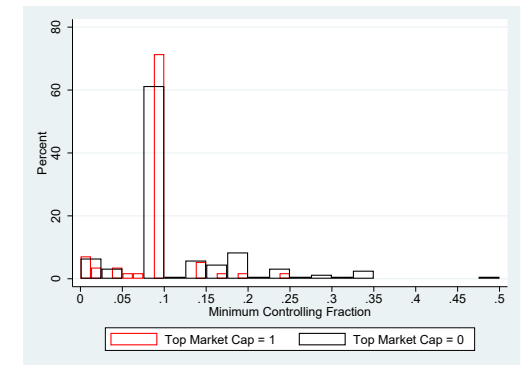
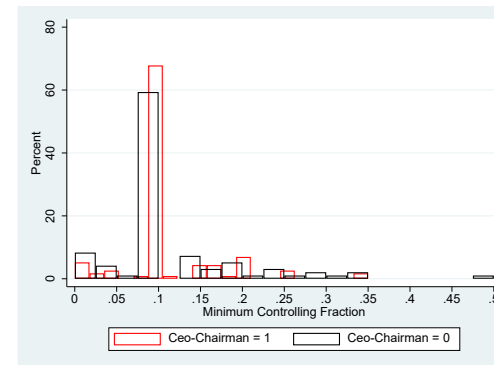
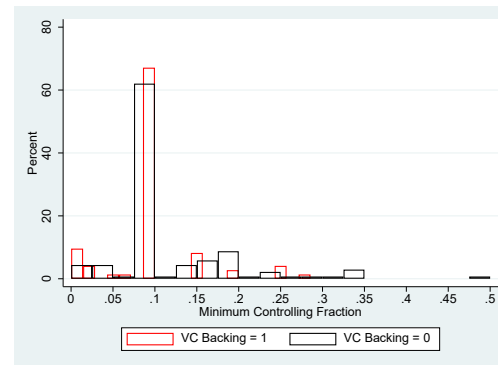
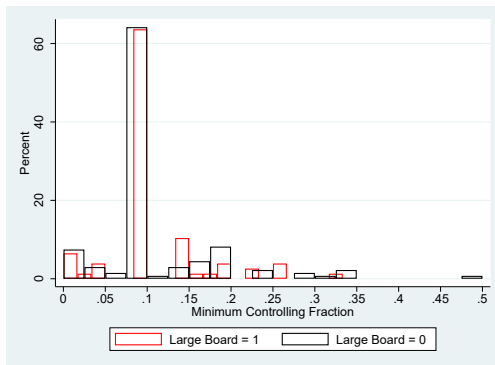
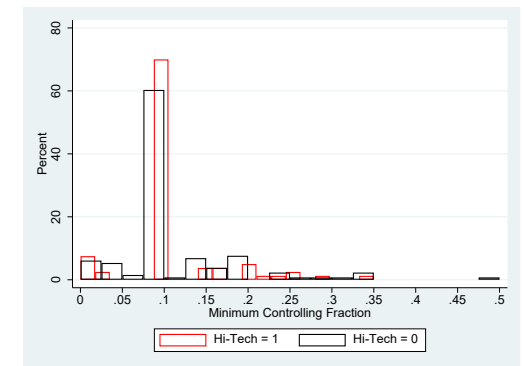
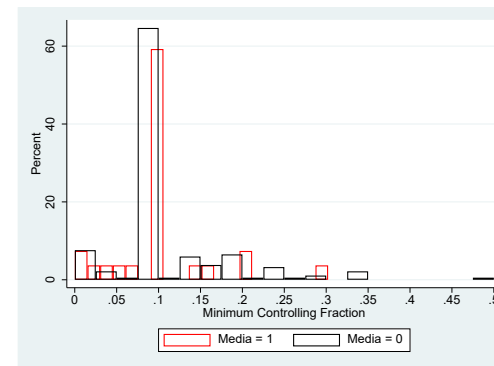
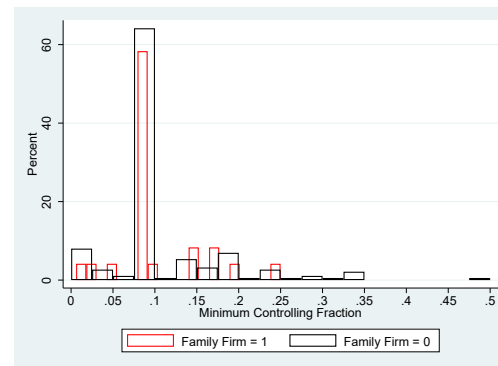
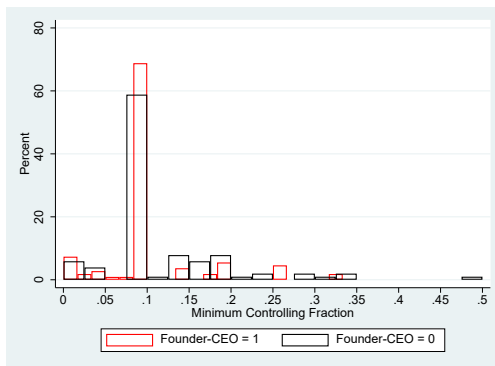
# Inherent Optimality (3)

Firm Characteristics	9%-10% mcf	Mean mcf	Unlimited Duration	Dominant Structure	n
<i>Active Founder</i>					
Yes	67.5%	10.3%	79.8%	52.3%	109
No	58.8%	12.7%	82.3%	52.0%	102
<i>Family Firm</i>					
Yes	62.5%	10.6%	<b>95.8%</b>	62.5%	24
No	64.2%	11.4%	<b>80.7%</b>	50.8%	187
<i>Media Sector</i>					
Yes	59.3%	9.9%	<b>96.3%</b>	59.3%	27
No	64.7%	11.5%	<b>80.4%</b>	51.1%	184
<i>Hi-Tech Sector</i>					
Yes	70.0%	10.8%	76.2%	52.5%	80
No	60.3%	11.6%	86.3%	51.9%	131
<i>&gt;7 Directors</i>					
Yes	63.6%	11.0%	77.9%	53.2%	77
No	64.2%	11.5%	85.1%	51.5%	134
<i>VC Backing</i>					
Yes	67.1%	<b>9.7%</b>	72.6%	46.6%	73
No	62.0%	<b>12.1%</b>	87.6%	54.7%	137
<i>CEO is Chairman</i>					
Yes	67.8%	10.8%	85.2%	56.5%	115
No	59.3%	11.9%	79.2%	46.9%	96
<i>Top Quartile Market Cap</i>					
Yes	71.4%	<b>9.1%</b>	80.3%	60.7%	56
No	61.3%	<b>12.1%</b>	83.2%	49.0%	155

- Prevailing structures are adopted by most firms, regardless of the potentially relevant characteristics
- Differences between groups are small and generally not statistically significant
- In untabulated regression models, these characteristics are not significantly associated with the minimum controlling fraction.

# Inherent Optimality (4)

- Overlaid histograms of distribution of mcf by group (red/ black) shows most companies choose 9%-10% mcf, regardless of potentially relevant characteristics



# Benefits of Standardization (1)

- **Hypothesis:** Prevailing structure is not inherently optimal for many firms, but benefits of standardization outweigh costs of choosing suboptimal structure
- Literature on standard contracts has identified several sources of benefits:
  - Drafting efficiency: Copying existing formulation is (1) easier than formulating a customized new one and (2) reduces number of errors (typos/mechanical mistakes, use of ambiguous language, involuntary violation of legal constraints, etc.)
  - Judicial precedent: Past formulations have been usually litigated and tested before courts
  - Cost of advisors: Standard terms are known to layers, investment bankers, investors, etc. and require less analysis
  - Network externalities: Simultaneous use by many other firms makes it more likely that learning benefits will accrue in the future (for long-term contracts)

# Benefits of Standardization (2)

- But these benefits do not seem applicable to voting inequality:
  - Founder can easily choose and communicate mcf with a number or a combination of two numbers: little drafting efficiency / precedent / ambiguity
    - Mcf is primary driven by voting ratio and minimum equity threshold
- Instead, “qualitative” or potentially ambiguous / complex clauses vary more than quantitative clauses

# Benefits of Standardization (3)

## Example: Right to equal price in M&A (not a voting rule but a common aspect of dual-class structures)

### FACEBOOK § 3.6

Cfr. Appian §1.1, 1.10, & 4: only distribution of company assets to shareholders

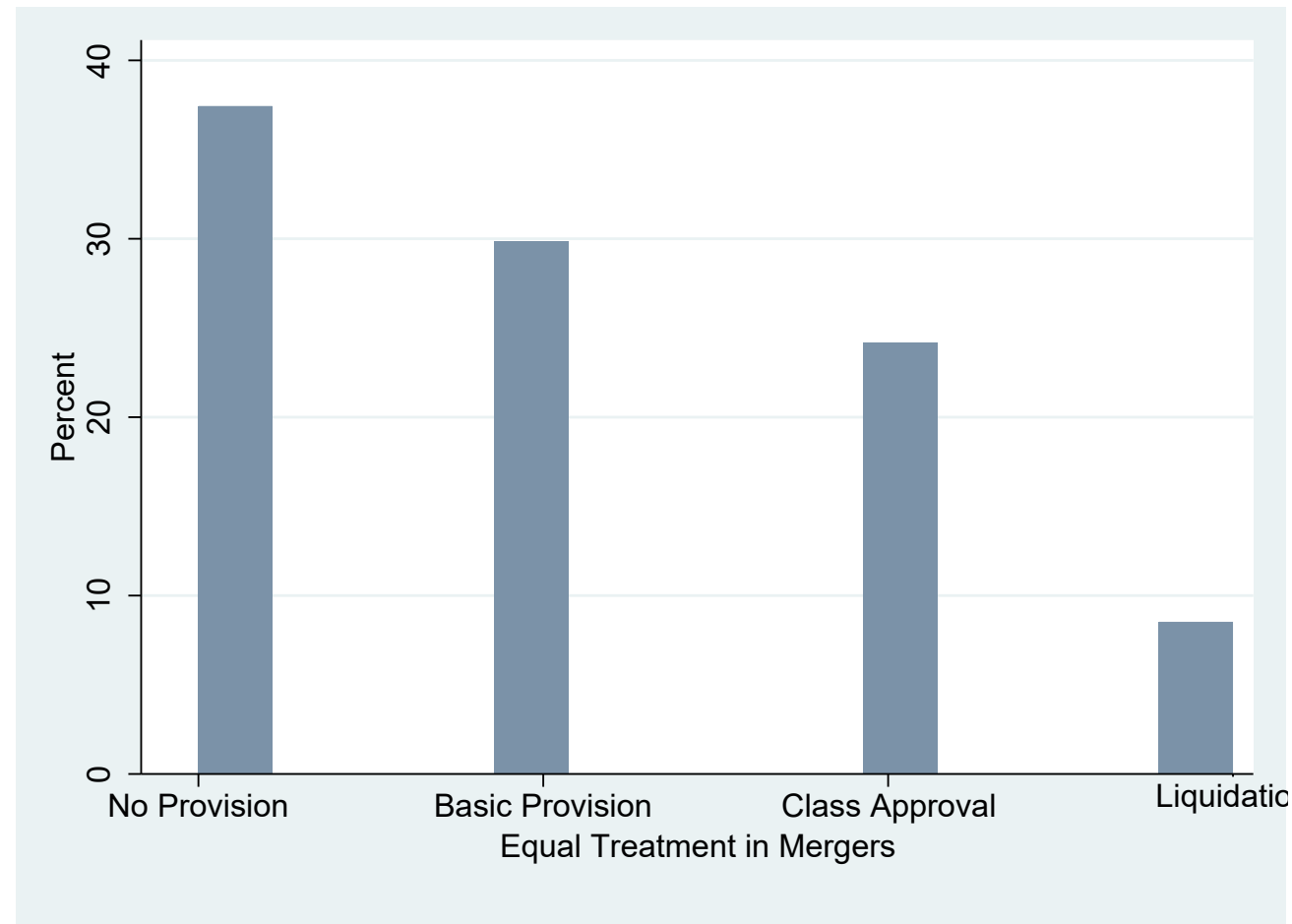
In the case of any **distribution or payment** in respect of the shares of Class A Common Stock or Class B Common Stock upon the consolidation or merger of the Corporation with or into any other entity, or in the case of any other transaction having an effect on stockholders substantially similar to that resulting from a consolidation or merger, such distribution or payment shall be made **ratably on a per share basis** ~~among the holders of the Class A Common Stock and Class B Common Stock~~ as a single class; *provided, however*, that shares of one such class may receive different or disproportionate distributions or payments in connection with such merger, consolidation or other transaction if (i) the only difference in the per share distribution to the holders of the Class A Common Stock and Class B Common Stock is that any securities distributed to the holder of a share Class B Common Stock have ten times the voting power of any securities distributed to the holder of a share of Class A Common Stock, or (ii) such merger, consolidation or other transaction is approved by the affirmative vote (or written consent if action by written consent of stockholders is permitted at such time under this Restated Certificate of Incorporation) of the holders of a majority of the outstanding shares of Class A Common Stock and Class B Common Stock, each voting separately as a class.

Cfr. Google: no right to pro-rata payment

Cfr. Gamestop: no such exception

# Benefits of Standardization (4)

- Substantive features of this clause vary much more than degree of voting inequality:



# Benefits of Standardization (4)

- Qualitative elements (where benefits of standardization are greater) vary a lot :

## FACEBOOK § 3.6

In the case of any distribution or payment in respect of the shares of Class A Common Stock or Class B Common Stock upon the consolidation or merger of the Corporation with or into any other entity, or in the case of any other transaction having an effect on stockholders substantially similar to that resulting from a consolidation or merger, such distribution or payment shall be made ratably on a per share basis among the holders of the Class A Common Stock and Class B Common Stock as a single class; *provided, however*, that shares of one such class may receive different or disproportionate distributions or payments in connection with such merger, consolidation or other transaction if (i) the only difference in the per share distribution to the holders of the Class A Common Stock and Class B Common Stock is that any securities distributed to the holder of a share Class B Common Stock have ten times the voting power of any securities distributed to the holder of a share of Class A Common Stock, or (ii) such merger, consolidation or other transaction is approved by the affirmative vote (or written consent if action by written consent of stockholders is permitted at such time under this Restated Certificate of Incorporation) of the holders of a majority of the outstanding shares of Class A Common Stock and Class B Common Stock, each voting separately as a class.

## ALTAIR § 2(c)

In connection with any Change of Control Transaction, shares of Class A Common Stock and Class B Common Stock shall be treated equally, identically and ratably, on a per share basis, with respect to any consideration into which such shares are converted or any consideration paid or otherwise distributed to stockholders of the Corporation, unless different treatment of the shares of each such class is approved by the affirmative vote of the holders of a majority of the outstanding shares of Class A Common Stock and by the affirmative vote of the holders of a majority of the outstanding shares of Class B Common Stock, each voting separately as a class. Any merger or consolidation of the Corporation with or into any other entity that does not constitute a Change of Control Transaction shall require approval by the affirmative vote of the holders of a majority of the outstanding shares of Class A Common Stock and by the affirmative vote of the holders of a majority of the outstanding shares of Class B Common Stock, each voting separately as a class, unless (i) the shares of Class A Common Stock and Class B Common Stock remain outstanding and no other consideration is received in respect thereof or (ii) such shares are converted on a pro rata basis into shares of the surviving or parent entity in such transaction having identical rights to the shares of Class A Common Stock and Class B Common Stock, respectively.



# Irrelevance of Voting Rights

- **Hypothesis:** Investors attach very little value to voting rights and therefore they tend to follow the Founder's preferences
- This is unlikely to drive the findings:
  - Dual-class structures should be much more frequent
  - Within the dual-class subset, more aggressive structures should be more frequent
    - Instead we see backlash and criticism for aggressive structures
      - Snap: nonvoting stock at IPOs, criticized by CII, press, politicians
      - Facebook: reclassification with nonvoting stock, abandoned after lawsuit

# Uncertainty and Norms (1)

- **Conjecture:** Investors face complex contractual variations and fundamental uncertainty on their long-term effects. Most players just stick to “descriptive norms” which are the product of arbitrary historical patterns
- Regulatory history:
  - 1920s: Lots of dual-class issuances and public opinion backlash -> one share one vote rule
  - 1970s: Companies asking for dual-class structures, Amex allowing dual-class structures
    - Maximum 10:1 voting ratio
    - Low-vote stock entitle to appoint at least 25% of directors
  - 1980s: Many dual-class recapitalizations -> public criticism -> SEC Rule 19c-4 -> DC Circuit invalidation
  - Since then, increasing freedom but most players stick to the 10:1 ratio

# Uncertainty and Norms (2)

- If parties face fundamental uncertainty on how to price variations in voting inequality, they might tend to conform to prevailing norms
  - Founders may have strong uncertainty aversion
  - Agents of all parties might prefer conformism to avoid individual risk (stronger blame if bad outcome is the result of a deviation from the norm)
- Complexity of contractual structure might receive suboptimal scrutiny

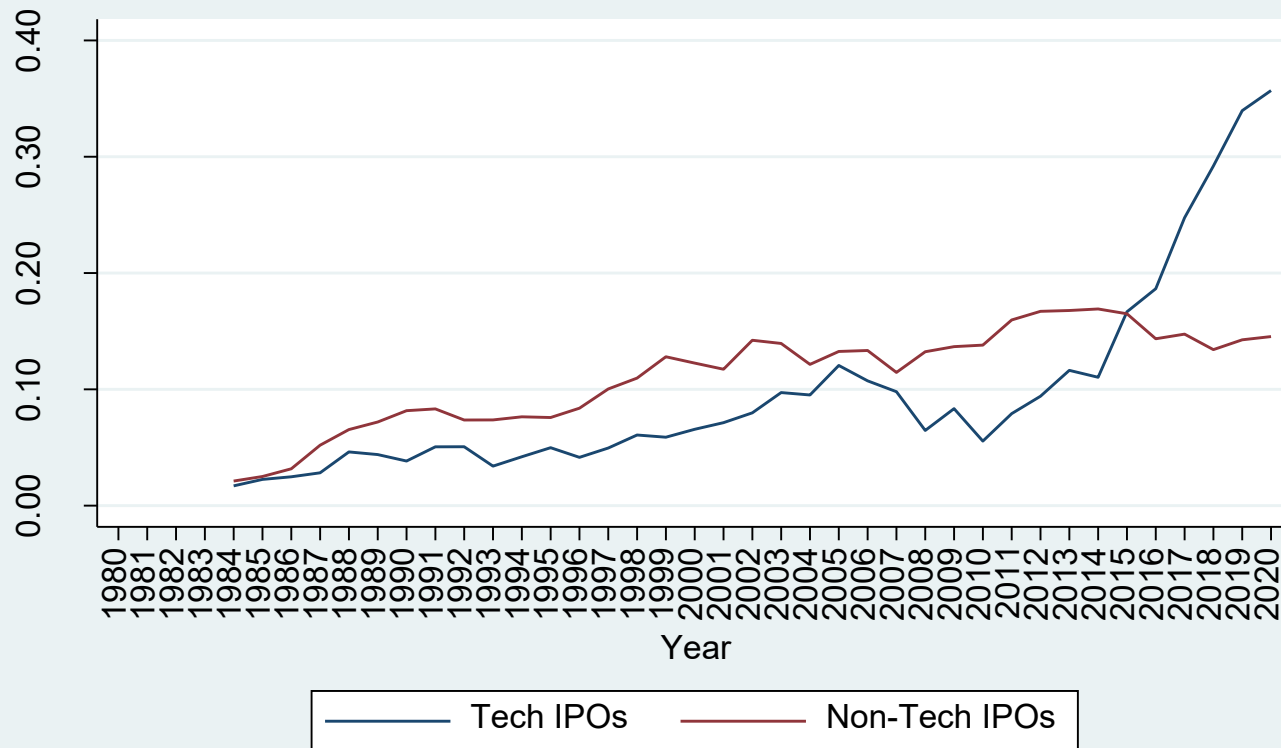
# Uncertainty and Norms (3)

- As recently as 2004, Google founders had to explain to IPO investors why they chose a voting structure that was so unusual (!) for tech companies

While this structure is unusual for technology companies, it is common in the media business and has had a profound importance there. The New York Times Company, the Washington Post Company and Dow Jones, the publisher of *The Wall Street Journal*, all have similar dual class ownership structures. Media observers frequently point out that dual class ownership has allowed these companies to concentrate on their core, long-term interest in serious news coverage, despite fluctuations in quarterly results. The Berkshire Hathaway company has applied the same structure, with similar beneficial effects. From the point of view of long-term success in advancing a company's core values, the structure has clearly been an advantage.

# Uncertainty and Norms (4)

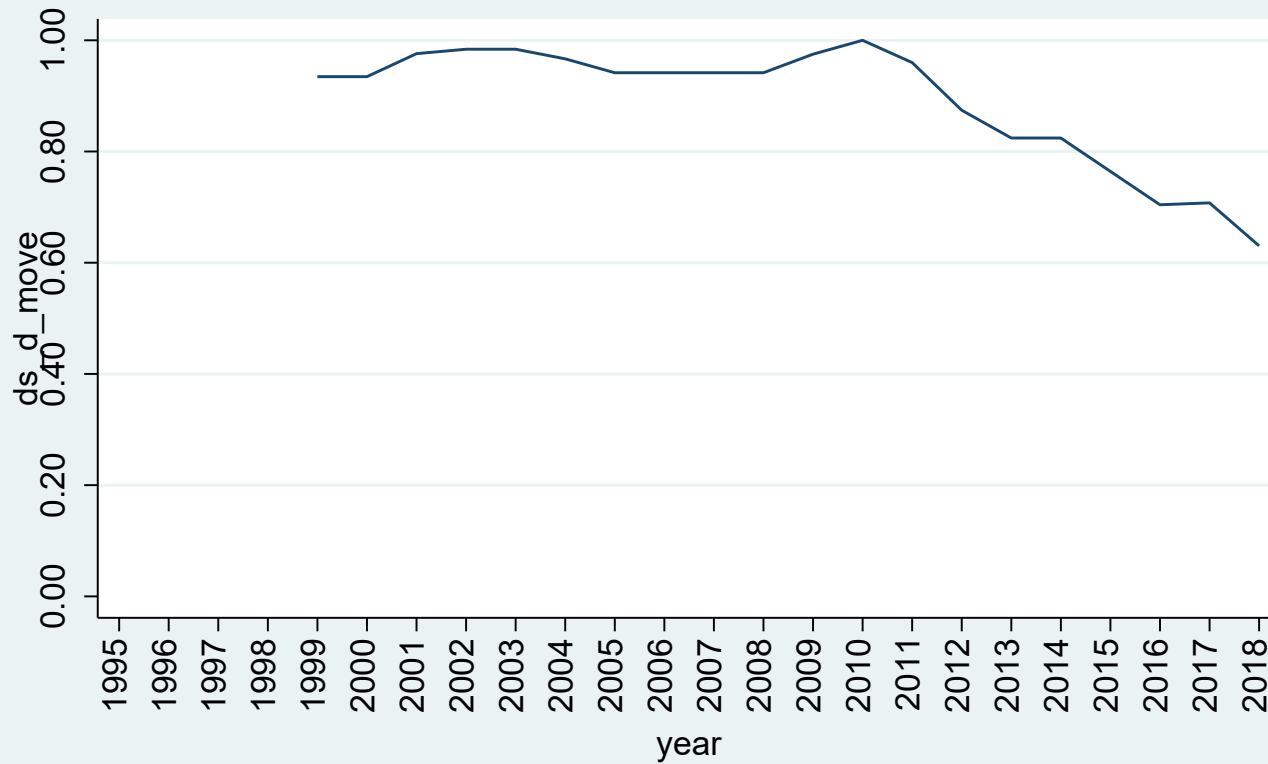
Dual-Class IPOs as % of Total IPOs  
5 Year Moving Average



- Indeed, until recently tech companies were less likely than other companies to adopt a dual-class structure. Then “norms” apparently changed
- By contrast, Snap deviated from the norm by proposing nonvoting stock to IPO investors, but the norm has not changed [no other similar IPO since then]—in fact, there was a public backlash against voting inequality

# Uncertainty and Norms (5)

Perpetual/Lifetime Structures as % of Total Dual-Class IPOs  
5 Year Moving Average



- Another recent trend is the rise of time-limited structures, which used to be pretty rare but they are increasingly popular

# Policy Implications and Future Research

- Complexity of dual-class charters
  - Standardized disclosure for investors
    - Magnitude of voting inequality
      - Absent any charter amendment, with how much equity high-vote shareholders can control the company?
      - Some examples re: appointment of board majority, merger, charter amendments
    - Duration of voting inequality
      - Absent any charter amendment, for how long high-vote shareholders can control the company?
- Less deference to market outcomes
  - Data raise doubts about optimal contracting
    - Regulator doesn't necessarily know better than investors, but assumption that market prices charter variation can be questioned
    - If Investors do not bargain for tailor-made structures, perhaps other macro considerations become more relevant
- How do these norms change and evolve?
  - Future research should study macro trends (also: sociological factors?)