Dual-Class IPOs: A Solution to Unicorn Governance Failure

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Abstract

The conventional view of dual-class structures assumes that the alternative to a dual-class IPO is a single-class IPO, where shareholders' voting power aligns with their economic interests. However, more often than not, the alternative to a dual-class IPO is for firms to remain private or, at the very least, postpone their IPOs. Dual-class IPOs have become prevalent among startup unicorns in the technology sector, with many of these unicorns being controlled by founders who highly value maintaining control. With the expansion of private markets, these unicorns may opt to stay private if their founders would otherwise have to relinquish control upon going public. From a governance standpoint, the private option may be particularly worrisome. While founder-controlled firms, whether private or public, may grapple with agency problems, governance failures in private unicorns with dominant founders, such as Theranos, WeWork and FTX, have led to a complete collapse of the business model. In comparison, founder-controlled startups that went public with a dual-class structure have arguably performed reasonably well. The explanation I offer in this article is that dual-class structures facilitate the IPO decision by enabling startup founders to take their company public without losing control. The IPO process, with its requirements for detailed disclosures about the firm's business model and financial accounts followed by market scrutiny, effectively screens entrepreneurial startups with a viable business model from those that do not. Thus, the availability of dual-class structures effectively mitigates the tail risk of the agency problem in founder-controlled firms that could result in dramatic losses for investors.

Keywords: dual-class, governance, unicorn, venture capital, IPO, private markets

JEL Classifications: G34, G24, L26

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DUAL-CLASS IPOS: A SOLUTION TO UNICORN GOVERNANCE FAILURE

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Forthcoming in the Handbook on the structure of Private Equity and Venture Capital (edited by Brian Broughman and Elisabeth De Fontenay)

Dual-class stock structures have proliferated in recent years.[1] In 2017-2019, almost 30 percent of IPOs had a dual-class structure, and most of them were founder-controlled technology firms.[2] Their increasing popularity has drawn the ire of proxy advisory firms and academic scholars who view dual-class structures as detrimental to shareholder value and antithetical to good corporate governance.[3] The well-known concern with these structures is that they entail high agency costs. Founders with superior voting rights have control over decision-making while their economic stake is relatively low. Thus, they may have strong incentives to extract private benefits or pursue fanciful projects.

The standard accounts of dual-class structures ignore the full menu of organizational choices that are available to entrepreneurial firms. In particular, the critique of dual-class structures rests on the assumption that the alternative to a dual-class IPO is a single-class IPO in which shareholders' voting power is identical to their economic interests. However, if dual-class structures were not legally permissible, the firms that opt for dual-class structures would not necessarily choose to become public at all. Instead, these firms could opt to remain private indefinitely or, at the very least, postpone the IPO.

The underlying motivation for adopting dual-class structures is that founders place very high value on maintaining control.[4] If they cannot maintain control after the firm becomes public, they may choose not to become public at all and continue to operate as private firms. Indeed, during the same period that dual-class firms have proliferated, there has also been a dramatic increase in the number of startups with over $1 billion valuations, commonly known as unicorns.[5] The

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[1] Dual-class stock structures typically decouple cash-flow and voting rights by allocating superior voting rights to holders of a specified class of stocks as opposed to the traditional one vote, one share model.

[2] Dhruv Aggarwal, Ofer Eldar, Yael V. Hochberg & Lubomir P. Litov, *The Rise of Dual-Class Stock IPOs,* 144, no.1 J. of Fin. Econ. 123 (2022).

[3] For a few examples, *see* Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64, no. 4 The J. of Fin. 1697-1727 (2009); Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23, no. 3 The Rev. of Fin. Stud. 1051-1088 (2010); Lucian A. Bebchuk & Kobi Kastiel. *The Perils of Small-Minority Controllers* 117, Geo. L. J. 1453-1514 (2018).

[4] For the argument that dual-class structure allow firm founders to implement their visions and increase long-term value without worrying unduly about appeasing poorly informed investors, *see* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 Yale L.J. 560-795 (2016).; Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 Stanford L. R. 687-745 (2019).

[5] *See* Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135, no. 1 J. of Fin. Econ. 120-143 (2020); Daria Davydova, Rüdiger Fahlenbrach, Leandro Sanz & René M. Stulz, *The Unicorn Puzzle* (Nat'l Bureau of Econ. Rsch., Working Paper No. 30604, 2022).

proliferation of unicorns underscores that remaining private is a viable and attractive alternative for sizable startups instead of pursuing a public listing.

From a governance perspective, the private option may be particularly concerning. Unicorns with dominant founders have experienced a multitude of scandals in recent years, some of which ended with major losses for investors. Well-known examples include the collapse of WeWork, Theranos and FTX.[6] These companies not only had a toxic work culture or failed to comply with laws and regulations, but more importantly, their whole business model was either fraudulent or could not realistically support the firm valuation. Most of these failures resulted directly from the untrammeled and irresponsible behavior of a dominant founder, and the inability of investors, including reputable VC firms, to monitor their actions in a material way.[7]

In comparison to the dramatic governance failures in large unicorns, dual-class corporations have arguably fared reasonably well. While there is an ongoing debate about the performance of dual-class firms, overall performance appears to have been fairly strong, at least when considering the founder-controlled firms that became public in the 2010s.[8] Moreover, while some of them have experienced a large decline in stock price over time, compliance failures, or other public scandals, none of the failures goes as far as those experienced by unicorns, such as WeWork, Theranos and FTX, that largely amounted to a complete collapse of the business model.

The explanation I offer in this article is that the IPO process is effective in distinguishing founder-controlled firms that have viable business models and valuations from those that do not. Perhaps the largest agency cost associated with founder control is that the founder may exaggerate the growth potential of the firm in order to raise capital at higher valuations. Investors can suffer extreme losses when they discover that the valuation is grossly inflated, or worse, that the business model is fraudulent, and the firm generates no value. By ensuring that the firm has a viable business model and a reasonable valuation, the IPO process mitigates the tail risk of the agency problem in founder-controlled firms that could result in dramatic losses for investors.[9]

To the extent that they facilitate the IPO decision, dual-class structures effectively mitigate the agency costs of founder control. Without the option to create dual-class structures at the IPO, these founder-controlled firms may stay private, and if they do, they will escape the scrutiny of the IPO process. As the recent failures of large unicorns suggest, when founders have complete control over decision-making and the business model is not transparent, even reputable VC firms may fail to monitor startups effectively. In fact, many of the problems with founder-controlled startups came to light at a late stage when the firm was contemplating an IPO. The IPO process, which includes detailed disclosure and financial analysis, can elicit new information on these private firms that may end in the delay of the IPO, adjustments to the valuation, or even the withdrawal of the IPO.

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[6] *See infra* Section I.

[7] For discussion, *see* Renee Jones, *The Unicorn Governance Trap,* 166 U. Pa. L. Rev. 165 (2017).; Elizabeth Pollman, *Private Company Lies,* 109 Geo. L. J. 353 (2020).; Donald Langevoort & Hillary Sale. *Corporate Adolescence: Why Did "We" Not Work?*, 99 Tex. L. Rev. 1347 (2021); Matthew Wansley, *Taming Unicorns*, 97 Ind. L.J. 1203 (2022).

[8] *See infra* Section III.

[9] I emphasize that my argument is not that the overall record of private firms is poor as compared to public firms; rather that they appear to be more susceptible to extreme governance failures.

In this sense, dual-class structures provide a solution to the unicorn governance problem. When there is great availability of private capital or when startups need less capital to run their businesses, founders can delay the IPO or keep their startups private. There is indeed evidence that tech unicorns that invest in intangible assets tend to go public later than other startups of similar age.[10] The VCs who are scrambling to get a piece of a startup with substantial growth potential have little leverage in negotiating for control rights, both in terms of board representation[11] or contractual rights.[12] The governance at unicorn firms often affords very few tools for investors to monitor the operation and even the strategy of the firm.[13]

By acquiescing to the dual-class structure at the IPO, the VCs can get the startup founder to go public at a relatively early stage of the startup life cycle. Indeed, the average age of dual-class firms at the IPO is substantially lower than that of other IPO firms.[14] By prompting startups to go public, VCs can reduce the risk of a major governance failure that they may be unable to prevent in an environment in which they compete for investments. Within this broader perspective that accounts for private markets, the dual-class structure is not a governance failure but rather, a solution to the relative laxity in the governance of entrepreneurial startups that could end up imposing severe losses on private investors.

This account provides an overlooked explanation for why VCs have changed their attitude towards dual-class structures, despite the concerns about agency costs. Historically, VC firms were averse to dual-class structures as part of their efforts to instill accountable governance structures at startups prior to their IPOs.[15] But in recent times, many of them have warmed up to this structure, and some have even lauded them as an ideal structure for founder-controlled technology startups seeking to go public.[16] The reason is that under economic conditions in which founders have the upper hand, VCs are likely to be less concerned about founders' control after the IPO. Instead, their primary concern is that the firm may remain private without any meaningful scrutiny, thereby exacerbating the risk of a major failure.[17] The relatively strong performance of many dual-class

[10] *See* Davydova, Fahlenbrach, Sanz & Stulz, *supra* note 5.

[11] *See* Michael Ewens & Nadya Malenko, *Board Dynamics over the Startup Life Cycle*, Nat'l Bureau of Econ. Rsch., Working Paper No. 27769 (2020).

[12] *See* Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33, no. 12 The Rev. of Fin. Stud. 5463-5509 (2020).; Michael Ewens & Joan Farre-Mensa, *Private or public equity? The Evolving Entrepreneurial Finance Landscape*, 14 Ann. Rev. of Fin. Econ. 271-293 (2022).

[13] *See* Brian Broughman & Matthew Wansley, *Risk-Seeking Governance*, 76 No.5 Vand. L. Rev. 1299 (2023).

[14] Aggarwal, Eldar, Hochberg & Litov, *supra* note 2.

[15] *See* Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46, no. 2 The J. of L. and Econ. 569-598 (2003).; Yael Hochberg, *Venture Capital and Corporate Governance in the Newly Public Firm*, 16 Rev. of Fin. 429–480 (2012).

[16] Scott Kupor, the managing partner of Andreessen Horowitz, stated in 2013, "Dual-class stock is ... well suited for founder-led technology companies ...where economic interests between external shareholders and internal management are aligned." *See* Scott Kupor, *Sorry CalPERS, Dual Class Shares Are A Founder's Best Friend*, Forbes (May 14, 2013,) https://www.forbes.com/sites/ciocentral/2013/05/14/sorry-calpers-dual-class-shares-are-a-founders-best-friend/?sh=1ac94c1812d9.

[17] To be clear, I do not argue that this is the only reason why VC firms have become more receptive to dual-class structures. It may very well be that VC firms have also concluded that maintaining founder control is necessary to enable founders to focus on their long-term vision and protect it from activist shareholders who arguably seek short-term returns. Addressing and assessing this argument is outside the scope of this article.

technology firms further provides assurance that a dual-class structure will not undermine investors' demand for shares at the IPO.

This article is related to two main literatures. The first is the literature that debates whether dual-class structures harm investors. As I discuss below, the empirical evidence suggests that the performance of dual-class firms, especially the entrepreneurial tech firms that emerged in the 2010s, is on par with other public firms. For example, as of late 2023, the investment in firms like Google and Facebook has yielded large returns for investors despite the potential agency costs. While no study can determine conclusively the causal impact of dual-class structures on firm value, the relative success of dual-class firms suggests that the IPO process does a relatively good job at screening founder-controlled startups at the IPO stage. Thus, founder-controlled firms that go public typically possess robust business plans at the IPO, and although their ventures may entail risk, public investors are not lured into grossly speculative or deceptive business models.

The second is the literature on startup governance, particularly exploring the failures of unicorns. It is often argued that unicorns should be forced to become public or at least be subjected to strong disclosure and governance requirements. The idea is that stronger accountability and transparency may mitigate the risk of compliance failures, public scandals and litigation.[18] However, the challenge with this argument is that such failures also occur in public firms, whether they are controlled by founders via a dual-class structure or not.[19] The contribution of this article is to articulate the role that publicness truly plays in mitigating governance failures. While it is possible that publicness reduces the risk of compliance failures and scandals, this appears to be largely a marginal impact of going public. Rather, it is the IPO process with its requirements for detailed disclosures about the firm's business model and financial accounts followed by market scrutiny that is effective in screening the entrepreneurial startups that have good (or at least plausible) ideas from those that don't.[20]

This article proceeds as follows. In the first section, I describe the unicorn governance problem focusing on three well-known cases studies, WeWork, Theranos and FTX. In the second section, I present the theory that when market valuations are high, the ability to adopt a dual-class structure that maintains founder control is necessary for encouraging startups to become public. In the third section, I discuss the empirical evidence on the performance of dual-class firms and argue that there is no convincing evidence that their agency problems result in harm to investors. Finally, in the fourth section, I discuss how the IPO process reduces the risk that founder control will result in a major governance failure and the ensuing extreme losses for investors.

[18] See Jones, *supra* note 7; Wansley, *supra* note 7.

[19] *See* Alexander I. Platt, *Unicorniphobia*, 13 Harv. Bus. L. Rev. 115 (2023). It is noteworthy that in instances of compliance failures or public scandals at startups, VC investors—much like investors in public firms—may effectively exert pressure leading to the departure of the founder from the company; *see* Yifat Aran & Elizabeth Pollman, *Ousted*, U of Penn, Inst for Law & Econ Research Paper No. 23-40, Theoretical Inquiries in Law (Forthcoming, Nov. 3, 2023), https://ssrn.com/abstract=4625990, at 22-24 (describing the ousting of Uber's and Zenefits' founders).

[20] This is consistent with the theory that the purpose of securities regulation is to provide traders with accurate information that will improve their ability to make accurate predictions; *See* Zohar Goshen, & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711-782 (2005).

I. The Unicorn Governance Problem

While the startup industry has generated some of the most successful firms and most consequential technological innovations, it has also produced some recent, epic failures. The stories of several major governance failures in large unicorns have been well documented in the media and legal scholarship. Several cases demonstrate the challenges of dealing with high-powered founders.

The first case is WeWork, a provider of shared office space, which sought to revolutionize the work environment by creating a vibrant community of like-minded professionals.[21] The company is known for having succeeded in raising capital from reputable VC firms, such as Benchmark, despite the fact that Bechmark had historically resisted investing in real estate,[22] and in spite of WeWork's adolescent culture that reportedly involved lavish parties, drug use in work events, and even claims of sexual harassment.[23]

The major problems in WeWork, however, emanated from the mismanagement of its founder, Adam Neumann. Fueled by large injection of capital from Softbank, WeWork expanded rapidly by acquiring and leasing office space at large costs, even as it was failing to service its existing leases by renting out the office space.[24] The company also engaged in a series of self-interested transactions, including personal loans on favorable terms to Neumann and extravagant spending on items such as private jets and luxurious offices.[25] After several late-stage VC financing rounds, the company announced its decision to go public with Neumann having voting control through a dual-class structure.[26] However, when the IPO was announced, investors started questioning WeWork's inflated valuation and business model. When it became clear that the valuation was grossly inflated, and the company's burn rate was very high, WeWork withdrew from the IPO,[27] Adam Neumann was forced to step down and sell his shares,[28] and the company ultimately went bankrupt.[29]

The second case is Theranos, the biotech startup that sought to make blood testing faster and more accessible.[30] The company led by Elisabeth Homes basically made fraudulent claims to investors and customers about its technology. The company promised that the company could run comprehensive diagnostic tests by obtaining a few drops of blood from a finger prick, where in fact, it was simply not capable to perform these tests.[31] The company received investments from VC firms and angel investors despite being very secretive about the technology it claimed to possess, and its failure to comply with the FDA (U.S. Food and Drug Administration) and the

[21] For a detailed account *see* Langevoort & Sale, *supra* note 7.
[22] *Id.,* at 1350.
[23] *Id.,* at 1353, 1355-1356, 1371.
[24] *Id.,* at 1351-1355.
[25] *Id.,* at at 1367-1371.
[26] *See* We Co., Registration Statement Under the Securities Act of 1933 (Form S-1) 200 (Aug. 14, 2019), https://sec.report/Document/0001193125-19-220499/.
[27] Langevoort & Sale, *supra* note 7, at 1355, 1372-1374, 1376.
[28] Aran & Pollman, *supra* note 19, at 16-17.
[29] Alexander Gladstone, Alexander Saeedy, and Konrad Putzier, *WeWork Files for Bankruptcy*, Wall Street Journal, Nov. 7, 2023, https://www.wsj.com/articles/wework-files-for-bankruptcy-5cd362b5.
[30] Wansley, *supra* note 7, at 1216-1219.
[31] *Id.*

Centers for Medicare & Medicaid Services (CMS) requirements.[32] When the fraud came to light through whistleblower revelations and journalistic reports, Holmes faced a criminal trial and was found guilty of wire fraud and conspiracy among other charges.[33]

The third case is FTX, which was one of the largest digital currency exchanges. The company led by Sam Bankman-Fried was involved in a series of financial irregularities and mismanagement of client funds.[34] In its early days, the company grew rapidly through a series of acquisitions and substantial investments from prominent VC firms, including Sequoia.[35] As it turns out, FTX lent customer deposits to Alameda Research, an investment firm also founded by Bankman-Fried, that traded on the FTX exchange and was heavily invested in FTT, coins created by FTX itself.[36] FTX became bankrupt after the value of FTT, which was artificially inflated through Alameda, declined dramatically, customers withdrew their deposits en masse, and it failed to strike a deal to be acquired by its rival Binance.[37] Bankman-Fried faced criminal charges for stealing billions of dollars from customers and was convicted on multiple counts including wire fraud and conspiracy to defraud the United States.[38]

The governance of all these firms suffered essentially from the same basic problem. All these companies were controlled by one dominant founder who had largely full power to decide who would serve on the board. Adam Neumann had super-voting power that granted control of the voting power in WeWork and with it the ability to fire board members.[39] And WeWork's board continuously ignored the lavish spending sprees and approved many self-interested transactions that Neumann had entered into without asking any questions.[40] Elisabeth Holmes had shares with 100 votes each, giving her complete control over company decisions.[41] Theranos' board, which included notable figures such as Henry Kissinger and George Shultz, but no VC representatives, was taken by Holmes and her vision, but seemingly made no inquiries into the business and technology of its products.[42] Finally, despite receiving about $2 billion of investment from VC

[32] *Id.*, at 1216-1217.
[33] *United States v. Elizabeth A. Holmes, et al.* 18-CR-00258-EJD.
[34] *See* Noan Wasserman, *FTX and the Problem of Unchecked Founder Power*, Harv. Bus. Rev. (Dec. 1, 2022), https://hbr.org/2022/12/ftx-and-the-problem-of-unchecked-founder-power.
[35] *Id.*
[36] *See* Paige Tortorelli & Kate Rooney, *Sam Bankman-Fried's Alameda quietly used FTX customer funds for trading, say sources*, CNBC (November 13, 2022, updated on November 14, 2022), https://www.cnbc.com/2022/11/13/sam-bankman-frieds-alameda-used-ftx-customer-funds-for-trading-.html.
[37] *See* Andy Kessler, *Crypto Coffin: FTX's Bankman-Fried Seeks $450 Million Loan After Binance Rescue*, The Wall Street Journal (November 9, 2022), https://www.wsj.com/articles/crypto-coffin-ftx-sam-bankman-fried-market-exchange-loans-binance-bailout-token-alameda-deal-11668030037.
[38] James Fanelli & Corinne Ramey, *Sam Bankman-Fried Is Convicted of Fraud in FTX Collapse*, The Wall Street Journal (November 2, 2023), https://www.wsj.com/finance/currencies/verdict-sam-bankman-fried-trial-ftx-guilty-4a54dbfe.
[39] *See* Langevoort & Sale, *supra* note 7, at 1369-1370.
[40] *Id.* At 1371.
[41] Aran & Pollman, *supra* note 19, at 31.
[42] *See* Lydia Ramsey Pflanzer, *How Elizabeth Holmes Convinced Powerful Men like Henry Kissinger, James Mattis, and George Shultz to Sit on the Board of Theranos*, Business Insider (June 2, 2023), https://www.businessinsider.com/theranos-former-board-members-henry-kissinger-george-shultz-james-mattis-2019-3.

firms, FTX had no board of the directors, and the company was managed by a small group of inexperienced friends led by Bankman-Fried.[43]

Why were these startup unicorns managed with little to no oversight? The main reason is the growth of venture capital funding in the 2010s. Between 2010 and 2019 the amount of VC financing had more than tripled.[44] This growth was likely propelled by various legal and business developments. On the legal side, the JOBS Act of 2012 eased the burden of raising capital by private firms in multiple ways, including increasing the number of shareholders that compels registration as a public company from under 500 to 2000 and exempting capital-raising from accredited investors (financial institutions and wealthy individuals) from the ban on solicitation and advertising.[45] On the business side, new sources of capital such as sovereign wealth funds, hedge funds, and mutual funds started making investments in VC-baked startups.[46]

Greater availability of private capital increases the bargaining power of startup founders in negotiating for greater control rights. Founders tend to value control more than investors because they want to accomplish their vision or alternatively extract private benefits in the form of influence or perks. If they need to compete for private capital, they are likely to cede control to their investors. But when more capital is available and money is chasing deals, the founders have greater bargaining power in choosing their VC investors and negotiating for better terms, including greater control over decision-making.[47] This partly explains the complete control that founders of many startup unicorns have had over their companies.

II. Dual-Class IPO as an Alternative to Staying Private

Founder control not only proliferated in private firms, but also in public firms through dual-class structures. In my work with Aggarwal, Hochberg and Litov, we show that increases in VC financing flows at the industry level predict the likelihood that a firm adopts a dual-class structure with founder control at the IPO.[48] Recall that the growth in private capital increased founders' bargaining power and their ability to maintain control over startups. These founders, who tend to place high value on control, may resist the idea of going public because they are concerned that they will not be able to maintain control. The option to raise capital in private markets coupled with increasing valuations due to "more money chasing deals" may provide better outside options for founders and make it less advantageous for them to go public unless they can maintain control. Dual-class structures permit founders to keep control over the firm even as it becomes public.

[43] Aran & Pollman, *supra* note 19, at 31.
[44] *See* Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34, no. 3 J. of Econ. Perp. 237-261 (2020).
[45] *See* Elizabeth Pollman, *Startup Governance*, 168 U. Pa. L. Rev. 155 (2019).; Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. Rev. 583 (2016).; Usha Rodrigues, *The Once and Future Irrelevance of Section 12(g)*, 2015 U. Ill. L. Rev. 1561 (2015); Michael D. Guttentag, *Patching a Hole in the JOBS Act, How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 Ind. L. Rev. 151 (2013); Donald C. Langevoort & Robert B. Thompson, *Publicness in Contemporary Securities Regulation after the JOBS Act*, 101 Geo. L.J. 337 (2012).
[46] Lerner & Nanda, *supra* note 42, at 244.; Ewens & Farre-Mensa (2020), *supra* note 11.
[47] *See* Goshen & Hamdani, *supra* note 4, at 585-586 (discussing the bargaining between entrepreneurs and investors over control rights).
[48] Aggarwal, Eldar, Hochberg & Litov, *supra* note 2.

We used a simple model to demonstrate this intuition.[49] We assume that the founder values both private benefits from control and cashflow or economic rights from dividends. Therefore, the value of the firm to the founder is $V_E = \overline{A} + B$, where the first term represents the value of operational control over the company, and the second the sum of economic rights from all the outstanding shares. An investor does not value the founder's control over the company as much as the founder does, so the value of the firm to the investor under founder control is $V_I = \underline{A} + B$, where $\underline{A} < \overline{A}$.

We assume that the firm needs to raise I amount of investment (where I is smaller than the firm valuation, i.e., $I < \underline{A} + B$), and the firm may seek to raise this amount from a private investor or in an IPO.[50] To raise funds in the amount I from a private investor, the founder must relinquish voting power, $\underline{v} = \frac{I}{\underline{A}+B}$. The public shareholders are typically passive, and thus, they place greater value on founder control. Thus, $V_{PUB} = \tilde{A} + B$, where $\tilde{A} \in (\underline{A}, \overline{A}]$. In the IPO, the founder will relinquish voting power, $v = \frac{I}{\tilde{A}+B}$. Because $\underline{A} < \tilde{A}$, the founder relinquishes more voting power to private investors than to public shareholders, and thus $\underline{v} < v$.

In order to retain control, the founder may own shares with superior voting rights. Let $\mu \geq 1$ represent the number of votes per share owned by the founder. For example, if the founder owns "Class B" super-voting stock that entitles her to five votes per share, $\mu = 5$. Let $p \in [0, 1]$ represent the probability that the IPO is successful in attracting a sufficient number of investors. In this setting, the founder decides to go public rather than raise funds from private investors if:

$$p \left[\frac{\mu(1-v)}{v+\mu(1-v)}\tilde{A} + (1-v)B\right] > \left(1-\underline{v}\right)\underline{A} + \left(1-\underline{v}\right)B \qquad (1)$$

It is clear from the equation that a higher μ also makes it more likely that the firm will go public. Thus, if public shareholders are willing to buy shares when the founder has superior voting rights, the founder will be more inclined to go public.

When there is high competition among private investors, the valuations by private investors will tend to be higher, and therefore, $\underline{A}$ will be higher. We assume for expositional clarity that $\underline{A} = \tilde{A}$, and therefore, $v = \underline{v}$. The condition in equation (1) simplifies to the following:

$$\frac{\mu p \underline{A}}{\underline{v}+\mu(1-\underline{v})} > \underline{A} + (1-p)B \qquad (2)$$

Suppose that μ = 1. Then, the inequality becomes $p\underline{A} > \underline{A} + B(1-p)$. This means that the firm chooses to remain private because $p \leq 1$. Accordingly, for the firm to do an IPO it must be that $\mu > 1$, as the left-hand side is increasing in μ. Thus, the growth in private capital not only increases founders' power before the IPO, but also after the IPO.

We cannot observe of course whether or not founders would choose to do an IPO if the dual-class option were not available, and they had to share voting power on the same terms as other public investors. However, the liberalization and growth of private market suggest that staying

[49] *Id.*, at 131-132.
[50] For simplicity, we assume that the founder holds the ability to stop or delay the IPO.

private is a real alternative to going public, particularly for large private firms.[51] Even if these firms would ultimately go public, they may delay the IPO simply because the conditions in the private markets are convenient.[52] Thus, it is possible that without the possibility of public firms creating a dual-class structure, there would be fewer IPOs and even more large private firms, that is, the type of firms that gave rise to the dramatic governance failures described above.[53]

Of course, for some startup founders there may be various compelling reasons to go public even without the ability to maintain control. The most common reason is to obtain liquidity by selling their stake in the company. This account does not incorporate the full set of considerations in the decision to go public. It is important to emphasize, however, that the advantage of going public for liquidity purposes has also waned in the time frame that is the focus on this article. It has become common for founders to cash out even before an IPO. For example, Adam Neumann sold stock worth several hundred million dollars in the years before WeWork's failed IPO attempt.[54] At any rate, there are good reasons to believe that maintaining control is of crucial importance to the ambitious and eccentric founders particularly in large tech unicorns. About 50 percent of unicorns opt for a dual-class structure at the IPO stage,[55] suggesting that unicorn founders place high value on control.[56]

Accordingly, a key alternative to a dual-class IPO that we need to consider from a policy perspective is not necessarily a single class IPO, but a private large firm that is controlled by a founder. This choice founder-controlled firms make between a private and a public firm has been mostly overlooked in the literature on dual-class IPOs.

III. The Performance of Dual-Class Firms

As discussed above, a key alternative for dual-class firms is not necessarily to opt for a single class IPO, but rather to remain private. Most of the literature to date, however, has focused almost exclusively on comparing the performance of dual-class firms to other public firms. While the impact of dual-class structures on firm performance has been intensely debated in academic and

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[51] *See* Davydova, Fahlenbrach, Sanz & Stulz, *supra* note 5 (showing that unicorns status enables startups to access more capital and as a result unicorns can stay private longer).

[52] Most unicorns do pursue exit via an IPO, though when market valuations are high and they can raise capital easily in the private markets, they are likely to delay the exit by several years. *See* Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, 39 Yale J. Reg. Bull. 23 (2021).; *See also* the discussion of Facebook's decision to delay its IPO when its private valuation rose to $10 billion; Sebastian Mallaby, The Power Law: Venture Capital and the Making of the New Future, Ch. 12 (2022).

[53] It is worth noting that, even in the absence of dual-class structures, founders may still devise creative strategies to retain control, albeit to a lesser extent. A notable example is Tesla, which employs a super-majority requirement for approving major corporate actions like mergers. This essentially grants its founder, Elon Musk, near-veto power over crucial decisions.
the founder can continue to serve as a CEO and the board of
example by adopting a staggered board structure or by requiring a super majority for important decisions (

[54] Eliot Brown, Maureen Farrell & Anupreeta Das, *WeWork Co-founder Has Cashed out at Least $700 Million via Sales, Loans*, The Wall St. J., July 18, 2019.

[55] *See* Davydova, Fahlenbrach, Sanz & Stulz, supra note 5, at 5.

[56] Founder control appears to be a distinctive characteristic of unicorn companies. In a more extensive study encompassing startups from 1990 to 2012, a period marked by less abundant private capital, only a small percentage of founders succeeded in retaining control of their startups by the time of the IPO; *see* Brian Broughman & Jesse M. Fried, *Do Founders Control Start-up Firms that Go Public?,* 10 Harv. Bus. L. Rev. 49 (2020).

policy forums, the empirical evidence on the performance of dual-class firms is somewhat inconclusive, particularly when considering the recent wave of technology firms.

The early studies mostly found that dual-class structures are negatively correlated with firm value on the basis that they entail greater agency costs than single-class firms. For example, Gompers, Ishii & Metrick find that the wedge between voting rights and cash flow rights was negatively associated with shareholder value (measured as Tobin's Q) in a sample from 1995-2002.[57] Masulis, Wang, and Xie find in a sample from 1995 to 2003 that when the wedge is larger, corporate cash holdings are worth less to outside shareholders, CEOs receive higher compensation, managers are more likely to make value-destroying acquisitions, and capital expenditures contribute less to shareholder value.[58]

These studies suffer from a well-known weakness which is common to many studies in the corporate governance literature.[59] The negative association between dual-class structures and firm performance is based on cross-sectional variation – essentially a comparison of the value of firms with a greater wedge to the value of firms with a lower wedge. Thus, the results may be driven by the selection of lower-valued firms into dual-class structures, potentially to prevent the company from being acquired.

But even if the selection issues are not fatal, it is not clear that these studies tell us much about the adequacy of dual-class structures for founder-controlled entrepreneurial firms in the tech industry. In the early days, a large percentage of dual-class firms were "old media" companies. The classic example was Sumner Redstone who indirectly controlled eighty percent of Viacom's voting shares through a corporation he controlled through a trust, while holding only about ten percent of the equity interest. Redstone continued to maintain control even when his mental and physical health had deteriorated while the company was performing poorly and was in dire need for new leadership.[60] However, even if dual-class exacerbated agency costs in older companies such as Viacom, it may have had a different effect on the more recent innovating dual-class firms.

There are some fundamental differences between the dual-class stock IPOs that were created prior to the mid-2000s and the later periods. As shown in Table 1, the former not only included a large percentage of media companies, but were also much more likely to be controlled by other corporations for strategic reasons,[61] often creating media conglomerates designed to accumulate market and political power.[62] The new dual-class IPOs were much more likely to be younger firms

[57] *See*, e.g., Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 Rev. Fin. Stud. 1051, 1084 (2010).

[58] Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. Fin. 1697, 1698 (2009).

[59] For discussion of the weaknesses of empirical studies of corporate governance, *see* Ofer Eldar, *A Lawyer's Guide to Empirical Corporate Governance*, 27 Stan. J. of L., Bus. & Fin. 1-93 (2022). Another potential problem with the empirical studies is that they use Tobin's Q as a measure of shareholder value; *see* Robert Bartlett & Frank Partnoy, *The Misuse of Tobin's q*, 73 Vand. L. Rev. 353 (2020). For simplicity, I ignore these potential issues in this article.

[60] Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-class Stock*, Va. L. Rev. 585-630 (2017).

[61] For example, McDonalds held a controlling stake via a dual-class structure in Chipotle at the time of Chipotle's IPO as part of its strategy to invest in healthier food.

[62] Interestingly, some media corporations were not "true" dual-class firms in the sense that the firms had specific shareholders with super-voting rights. Rather these firms had a class of equity shares with no voting rights at all allocated

controlled by their founders and more likely to be backed by VC firms. They are also predominantly tech firms defined broadly to include not only companies that manage an internet platform or data storage, but also service providers that use sophisticated software or big data as part of their business.[63] Many of these firms arguably benefit from founders' control because they permit founders to focus on pursuing their vision for increasing the influence of the company and making long-term investment in innovating its products. The newer dual-class firms were also more likely to include limits on the controlling shareholder by adopting a sunset provision that eliminates the dual-class structure on the occurrence of a specified event, such as the death or disability of the founder.[64] Moreover, even if founders have more voting rights than cash flow rights, they are not usually diversified, and their equity stake is seemingly substantial enough to induce them to exert efforts to maximize shareholder value.[65]

Table 1: Old Dual-Class versus New Dual-Class IPOs

IPO year:	1994-2006	2007-2019
Founder Control	0.36	0.61
Corporation Control	0.27	0.17
PE Control	0.11	0.06
Media Ind.	0.22	0.02
Tech (Cloud) Ind.	0.46	0.76
VC-backed	0.23	0.59
Non-US	0.09	0.5
Age	25.2	14.84
IPO Proceeds ($ Mil)	293.01	560.68
Assets ($ Mil)	1240.22	1118.98
R&D/Assets	0.07	0.11
Patents (#)	7.21	7.36
Patents ($ Mil)	51.53	216.27
Sunset	0.64	0.86
N	356	251

This table is based on data from Dhruv Aggarwal, Ofer Eldar, Yael V. Hochberg & Lubomir P. Litov, The Rise of Dual-Class Stock IPOs, 144, no.1 J. of Fin. Econ. 123 (2022). Sunset means a provision that eliminates the dual-class structure on the occurence of a specified event. All other variables are defined in Aggarwal, Eldar, Hochberg & Litov (2022).

to another media company so that this company does not violate the cross-ownership restrictions of the Federal Communication Commission.

63 In Table 1, tech industry refers to "cloud" industries as the term is used in Aggarwal, Eldar, Hochberg & Litov, *supra* note 2. These are industries, such as software, business services and leisure, where firms were more likely to benefit from the advent of the cloud technology in 2006.

64 For more detailed analysis of sunset provisions, see Aggarwal, Eldar, Hochberg & Litov, *supra* note 2, at 146-149.

65 *See* Dhammika Dharmapala & Vikramaditya S. Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities*, J. of Corp. L. Stud. 1 (2023).

A more recent study by Cremers, Lauterbach & Pajuste examines a larger sample from 1980 to 2019 that includes the recent wave of entrepreneurial dual-class stock firms. They find that dual-class firms have higher valuations (measured as Tobin's Q) than a sample of matched single-class firm in the first years after the IPO and a lower valuation in later years.[66] They interpret their findings as evidence that founders' vision or unique skills dissipate over time.

Although the study provides more nuance in understanding dual-class firms, it is unlikely that it captures the impact of dual-class for innovative startups that go public. First, this study compares dual-class stocks to a matched sample based on observable variables (such as size or return on assets prior to the IPO). But it is unlikely that such variables capture the unique business model and vision of many dual-class firms, particularly those led by influential founders. Accordingly, just like the earlier studies, it likely suffers from selection issues.[67] Second, even if selection is not a big concern, the negative association between dual-class IPOs and shareholder value in the later stage of the firm life cycle is entirely driven by performance 8 years after the IPO, and mostly comes from the 13th to the 15th year.[68] Many of the recent tech firms have yet to reach that stage in their life cycles. Accordingly, this study likely does not account for the association between shareholder value and dual-class structures that give control to innovative entrepreneurs. In fact, when evaluating a timeframe of 10 to 12 years from the IPO, the aggregate association between shareholder value and dual-class structures appears to be positive.[69]

Accordingly, no study appears to examine separately the performance of entrepreneurial founder-controlled firms with a dual-class structure that went public since the mid-2000s. The only study that comes close is a recent work by Ahn, Fisch, Patatoukas & Solomon that studies the performance of dual-class firms that that went public no more than 20 years before 2022, thereby focusing primarily on the recent wave of entrepreneurial dual-class firms. They show that an index that tracks these dual-class firms outperformed the market in the period of June 2009 to December 2019.[70] This study leaves room for further inquiry because the authors do not examine the performance of dual-class firms by the type of industry and controller, nor whether the controller is a founder or not. However, because it gives greater weight to the periods when most innovative dual-class firms became public, it suggests that dual-class at innovative firms perform on par with single-class firms, and perhaps even better.

Finally, it is important to emphasize that by averaging shareholder value over both old and new dual-class firms together, the existing studies may not adequately account for the evolution of public markets and corporate governance over time. Describing this evolution is beyond the scope of this chapter. Suffice it to say that the adoption of Sarbanes-Oxley in 2002 likely resulted in greater monitoring schemes, particularly stronger auditing standards, greater disclosure and

[66] Martjin Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* (Rev. Corp. Fin. Stud. 2022).
[67] For example, firms with weaker business models that are less likely to last for a long time adopt dual-class structures to protect insiders from the risk that they will be penalized at a later stage of the firm life cycle.
[68] *See* figure 2 in Cremers, *supra* note 59.
[69] *See id.*
[70] Byung Hyun Ahn, Jill E. Fisch, Panos N. Patatoukas & Steven Davidoff Solomon, *Synthetic Governance*, 2021 Colum. Bus. L. Rev. 476, 482 (2022).

increased director and auditor independence.[71] Moreover, there has been a well-documented increase over time in the ownership of sophisticated institutional investors, and the intervention of hedge fund activists in corporate governance creating greater pressure on public corporations to act in the interest of their shareholders.[72] Even though dual-class firms have controlling shareholders, there are many documented instances where investors were able to pressure under-performing dual-class firms to change their strategy[73] or even force their founders to step down.[74]

Accordingly, it is possible that despite the potential for agency costs, the regulation of public firms coupled with the discipline of capital markets mitigates these costs. This may explain in part why dual-class firms in recent times may have performed reasonably well as compared to other firms. While the focus of this article is the comparison of dual-class firms to startup unicorns, the fact that the market performance of entrepreneurial dual-class firms does not appear to lag behind other public firms, and may even be stronger, indicates that dual-class IPOs may serve as a viable alternative to keeping startups private for the purpose of maximizing firm value.

IV. The Role of the IPO Process in Screening Founder-Controlled Firms

In the previous section I suggested that on average, dual-class founder-controlled firms likely perform reasonably well when compared to single-class firms. But if the main alternative to going public as a dual-class firm is to stay private, we need to compare dual-class firms to private firms. Unicorns in particular would be a reasonable comparison group because they are more likely to match the size and value of public firms, and because they very often adopt dual-class structures when they go public. There is yet no empirical study that compares the average performance of startups that went public with a dual-class structure to the performance of founder-controlled unicorns, in large part because there are challenges with using comparable performance measures. But while average performance is useful evidence, the key question in this article is a qualitative one, whether going public – which the availability of dual-class structures facilitates – can mitigate the extreme governance failures that unicorns endured.

When companies undergo an IPO, they are subjected to thorough legal and business scrutiny. As part of an IPO, the company must undergo a diligence process in which the firm's legal adviser and investment bankers will identify legal and business risk, and the company's financial statements in the previous three years will need to be audited. If the whole business model is fraudulent or based on an entirely frivolous valuation, the pre-IPO process is likely to expose these failures, and the IPO is unlikely to ever occur. It is inconceivable that the diligence and disclosure process followed by analysts' and institutional investors' review as well as media attention would not bring to light extreme failures, such as those created by Theranos and FTX, if these firms were to attempt an IPO. To conduct an IPO, Theranos would have needed to demonstrate the

[71] For summary and discussion of the Sarbanes-Oxley Act, see John C. Coates IV, *The Goals and Promise of the Sarbanes–Oxley Act*, 21 J. Econ. Persp. 91 (2007). For a critique of Sarbanes-Oxley, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2004).
[72] *See* Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 121 Colum. L. Rev. 2563 (2021).
[73] *See* Kastiel, Kobi. *Against All Odds: Hedge Fund Activism in Controlled Companies*, Colum. Bus. L. Rev. 60 (2016) (describing successful activist hedge fund campaigns in dual-class firms).
[74] See Aran & Pollman, *supra* note 19, (describing examples where controlling founders were forced to step down from the CEO role in dual-class firms).

functionality of its products, either by obtaining FDA approval or, at the very least, some form of professional certification. Similarly, FTX would have had to appoint a board, audit its financial statements, and provide an account for its prior transactions with affiliate companies.[75] Therefore, just attempting to go public would have exposed almost automatically the fact that the business models of these companies were fraudulent.

The case of WeWork is even more relevant because its business model was not strictly speaking fraudulent, but simply implausible or negligent based on the then available information. As discussed above, when WeWork was a private company it was growing very rapidly by raising millions of dollars in multiple rounds, and acquiring and leasing new properties, all while making lavish and grandiose expenditures on perks for its employees. But the failure of WeWork should not be attributed so much to the lavish lifestyle of Neumann or his grandiose ambitions.

Rather, the failure boils down to WeWork's highly deficient business model and unrealistic valuation. The business model was based on leasing properties on a long-term basis and renting out these properties using short-term leases at higher prices. Although it raised multiple financing rounds from VC firms and private investors, each time at higher valuations, the costs of buying and leasing new properties and the firm's losses continued to rise. WeWork marketed itself as a high-growth tech firm to justify the high valuations. However, like most real estate firms, WeWork needed large capital investments to grow, had significant operating expenses of maintaining its properties and serving its tenants, and needed to continuously spend large sums on marketing its properties to maintain occupancy rates.[76]

Although WeWork did disclose its high expenses and negative EBITDA even prior to its planned IPO in a bond offerings in 2008, it attempted to mask them by inventing the concept of Community Adjusted EBITDA, which simply ignored the large sales and marketing expenses as if they were a one-time fixed costs of creating the business.[77] The concept of Community Adjusted EBITDA was widely ridiculed in the media and did not make it to the IPO registration statement, which simply reported the growing negative adjusted EBITDA of the firm.[78] The result was limited demand for WeWork IPO shares, a sharp drop in its valuation, and ultimately withdrawal from the IPO.

This case study suggests that the IPO process was effective in bringing into light the flaws in WeWork's business model. These flaws persisted through multiple rounds of private investments, including from long-standing VC firms such as Benchmark and investment banks such as JPMorgan.[79] The exaggerated projections regarding demand for office space and the rising costs

[75] Note that being secretive about a company's technology and strategy or not getting FDA approvals on their own would not bar an IPO. A good example would be Moderna's IPO in 2019 despite its secretive culture and the absent of any marketable products that passed the requisite three phases of clinic trials. *See* Platt, *supra* note 29, at 166-167. However, all this information was disclosed to investors. In contrast, Theranos defrauded its customers by claiming to have technology it did not possess.

[76] Vijay Govindarajan & Anup Srivastava, *No, WeWork Isn't a Tech Company". Here's Why That Matters*, Harv. Bus. Rev., Aug. 21, 2019, https://hbr.org/2019/08/no-wework-isnt-a-tech-company-heres-why-that-matters

[77] Jamie Powell, *The Magic of Adjustments: Ebitla-dee-da*, (April 15, 2008), https://www.ft.com/content/884e7da3-2de7-3c56-bdff-a308152ce086.

[78] *See* We Co., Registration Statement, *supra* note 26.

[79] *See* Langevoort & Sale, *supra* note 7, at 1352, 1372.

over several years did not deter these sophisticated investors. It is unclear whether Neumann, Softbank and other investors were fully informed of the problems, or just hoped to shift the risk to public investors.[80] Either way, the pure hype did not withstand the scrutiny of public markets, because the IPO process required transparency with respect to information that revealed the implausibility of the business model.

So, what does this have to do with dual-class structures? As discussed above, founders may prefer to keep the company private if they cannot maintain control. The availability of the dual-class structure makes the IPO route more attractive for founder-controlled startups. It is likely that Adam Neumann would have been far less inclined to do the IPO if he could not keep his control over the company. Thus, it is possible that if dual-class structures were not permissible, fewer innovative startups would go public. It is the IPO process that ultimately fully exposed the weaknesses in WeWork and Neumann's vision for the company. Without an IPO, the failures in WeWork would probably have continued to grow and perhaps ended in more catastrophic outcomes for investors.

It is possible that without dual-class structures, there would be even more unicorns. While most unicorns may have a solid business, the meltdowns of WeWork, Theranos and FTX indicate that that they are prone to extreme governance failures. When founders have a strong bargaining power, VC firms and other sophisticated investors may have little leverage to monitor the business. It is possible that VC firms condone dual-class structures because they facilitate the exit of founder-controlled startups. The prospect of an IPO requires the startup to improve and solidify its business model so that it supports a valuation that can withstand market scrutiny. Striving for an IPO – which is likely to come earlier if founders can keep their control – creates incentives for startups to become more financially disciplined. The prospect of an IPO is a first-order governance device for enhancing startup performance, and paired with the reasonably strong performance of many dual-class firms, it arguably offsets the potential agency costs of unequal voting power.

V. Potential Limitations to IPO Markets

It is important to emphasize that public markets are not a perfect solution to agency costs and in some respects have limited advantages in mitigating agency costs as compared to private markets.

The first and most obvious limitation is that public markets may experience asset bubbles. Inflated valuations driven by irrational exuberance shared by the market as a whole naturally hamper the ability of the IPO process to scrutinize the fundamentals of entrepreneurial firms. The burst of tech bubble in the early 2000s is a well-known example. But asset bubbles are not frequent events, and therefore do not thwart the core beneficial function of the IPO process.

The second limitation is that the disclosure regime does not necessarily screen or bring to light negative events that are not directly related to the company's business model and financial standing. There are many public firms that have nurtured a toxic working environment, kept quiet sexual harassment scandals, and engaged in activities that violated laws and regulation. Of course,

[80] Some investors, such as T. Rowe, did sell their stake to Softbank prior to the IPO; *see* Langevoort & Sale, *supra* note 7, at 1371.

when these are revealed, there is a negative price reaction, but the SEC disclosure requirements on their own seem to do little in bringing them to light.

Likewise, there have been many revelations about similar bad conduct at private firms. Consider Uber, the ride sharing company founded by Travis Kalanick. The company under Kalanick's reign was involved in a series of scandals and controversies, including allegations of sexual harassment, employees' protests over a toxic working environment, and using a program to deceive law enforcement officials in cities where its service violated regulations.[81] Although Kalanick had control over the firm, following pressure from investors and the media, he agreed to cede his voting power.[82]

The key point however is that the information that ended Kalanick's term came from media accounts and employees' complaints. Moreover, although the negative news affected the company's valuation, Uber did go on to do an IPO. The reason was that its business model was strong. Despite the lack of profitability at the IPO stage, as a platform firm, the operating costs were low, and therefore investor demand remained sufficiently strong for the IPO to proceed despite the bad publicity.[83]

The third limitation is that the IPO market does not guarantee that stock prices will not fall below the IPO valuation when new information comes to light. Some dual-class entrepreneurial firms have seen their shares fall substantially below their IPO price over time. One recent example is Peloton, a company that sells internet connected bicycles with touchscreens that stream fitness classes through a subscription service. The company went public in 2019 with a dual-class structure. Its share price spiked in 2020 during the Covid pandemic with increased demand for remotely connected fitness equipment, but fell when pandemic ended and people went back to physical gyms. Following public pressure from hedge fund activists, the founder voluntarily resigned, but the stock price continued to decline.[84]

It may be argued that Peloton's case is similar to WeWork in that the company's estimates for the demand of its product were exaggerated, and partly driven by the adolescent ambitions of its founder. Peloton suffered in great part from making large investment in its hardware that did not sell as expected.[85] Arguably WeWork is similar in that its costs were going up while its projections for increased demand were too high. The only difference between the two firms may be viewed as one of degree. WeWork as a real estate company had greater ongoing expenses of servicing long-term leases and its forecasts for increased demand were inflated. And this is why Peloton succeeded in making it to the IPO facilitating a lucrative exit for the private investors perhaps at the expense of public ones.

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[81] *See* Jones, *supra* note 7, 179-182.

[82] Aran & Pollman, *supra* note 28, at 23-24. To be sure, the prospect of an IPO played a role in the removal of Kalanick as well. Once the scandals and compliance failures became public, the imperative to prepare for an IPO necessitated the appointment of a new CEO to "clean up" the company's image and address underlying issues. *See* Langevoort & Sale, *supra* note 7, at 1356-1357.

[83] *See* Govindarajan & Srivastava, *supra* note 76.

[84] *See* Aran & Pollman, *supra* note 19, at 18-20.

[85] Gabrielle Fonrouge, *Inside Peloton's Rapid Rise and Bitter Fall — and Its Attempt at a Comeback*, CNBC (February 19, 2023), https://www.cnbc.com/2023/02/19/peloton-rise-fall-attempted-comeback.html.

A better distinction between WeWork and Peloton however is that as of the time of the proposed IPO when all the required information was disclosed in the registration statement, the valuation of WeWork could not plausibly be justified based on the available information, whereas Peloton's valuation roughly reflected the publicly available information at the time. The decline in Peloton's market value was largely due to excessive investments in hardware based on market expectations in the midst of the pandemic when revenues were growing, not information at the time of the IPO. Thus, to the extent that these investments were a mistake when made, they reflect a failure that occurred after the company was already public, and one that public firms may make from time to time.[86] The IPO markets are not supposed to protect firms from all future hurdles and failures, only to ensure that available information is priced efficiently.

VI. Conclusion

The discourse surrounding dual-class structures has often overlooked the crucial role they play in empowering founders to maintain control. Without the ability afforded by dual-class structures, many unicorns might opt to remain private or, at the very least, postpone their IPOs. With the surge in private capital, VC firms found themselves in fierce competition to invest in startups led by visionary founders. However, their ability to scrutinize and oversee these founders was often limited. Consequently, VCs frequently fell short in fulfilling their traditional monitoring role, neglecting to ensure that founders' ambitious initiatives were supported by robust business models capable of sustaining the startups' valuations. While such lapses may turn out to be harmless in most cases, they can lead to catastrophic collapses, exemplified by instances like Theranos, FTX, and WeWork.

This analysis underscores the role of the IPO process in instilling discipline within founder-controlled firms. The scrutiny of capital markets, combined with mandatory disclosure during the IPO stage, effectively filters out founder-controlled startups lacking viable business models. In equilibrium, startups lacking plausible models would opt not to pursue a public offering. The WeWork case may be perceived as an off-equilibrium event wherein founders and investors chose to go public, seemingly expecting that public investors would overlook the facts disclosed in the company's registration statement. The subsequent withdrawal of the IPO and the founder's removal, prompted by weak demand from public investors, further emphasizes the disciplining impact of the IPO process.

I suggested above that this analysis might have normative implications. In the absence of a dual-class structure, it's conceivable that fewer unicorns would have opted for the IPO route. Consequently, without the prospect of an IPO, many unicorn founders might have experienced less oversight, attracting more private investment for potentially implausible or even fraudulent projects. The availability of the IPO option creates incentives for founders to avoid inflating startup

[86] It may further be argued that the excessive investments in hardware were driven by the adolescent ambition of Peloton's founder, and thus the dual-class structure is responsible for the fallout of Peloton. But it is important to recall that as discussed above, dual-class IPOs do not appear to perform poorly on average. Moreover, there are examples of founder-controlled dual-class firms that rebounded when their founders insisted on sticking to their vision despite public criticism and declining stock prices. Meta's stock price plunged in October 2022 after increased spending on virtual reality products but a year later, in October 2023, tripled in value as Zuckerberg insisted on continuing his vision of focusing on virtual reality.

valuations by making unrealistic promises. Paradoxically, the absence of dual-class structures could potentially lead to more pronounced and extreme startup failures.

Accordingly, in the enduring debate surrounding the advantages and drawbacks of dual-class structures, it is crucial to recognize their role in streamlining the IPO process for startup unicorns. When evaluating policies that seek to limit firms' adoption of dual-class structures, the assessment should extend beyond their potential performance as single-class entities. Equally significant is an examination of their performance as private firms, taking into account the elevated risk of an extreme governance failure.

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