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THE DUAL CLASS VOTING STRUCTURE, ASSOCIATED AGENCY ISSUES, AND A PATH FORWARD

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INTRODUCTION

Corporations have long since become the dominant form of business organization in the United States,[1] and the ensuing funding of these corporate entities with capital from the public has resulted in a general divergence of ownership from control. This divergence in turn has given rise to spirited debate about the existence and impact of various types of agency problems associated with corporate ownership structures.[2] Managers are not the residual claimants of the corporations that they control and oversee and, therefore, do not fully internalize the wealth effects of their decisions. Thus, there is a powerful incentive in place to take actions that lead to private extraction of benefits at the expense of the corporation's shareholders.

Broadly speaking, corporations have three different types of ownership structures: dispersed ownership (DO), controlled structures (CS), and controlling-minority structures (CMS). Dual class corporations, the subject of this Note, fall under the category of controlling-minority structures, where a shareholder or small group of shareholders exercises control while retaining only a minor percentage of the ownership equity.[3] Dual class corporations, although in existence in the

1. *See generally* U.S. CENSUS BUREAU, Statistical Abstract of the United States: 2012 Section 15: Business Enterprise (2011), https://www.census.gov/library/publications/2011/compendia/statab/131ed/business-enterprise.html. Eighty-one percent of business receipts collected by the Census came from corporations, compared with fifteen percent from partnerships and only four percent from sole proprietorships. *Id.*

2. *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

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

United States since the 1920s, came into vogue once again during the hostile takeover wave of the 1980s due to the defensive strength that they offer against hostile acquisitions.[4] They continued to maintain prominence during the surge of high-profile technology initial public offerings over subsequent decades.[5] Proponents of the dual class structure argue that it allows founders and management to focus on a long-term vision for the company and not be subject to the near-term vicissitudes of market and investor opinion. However, critics contend that it is simply an excuse for founders and management to entrench themselves in power and escape accountability to shareholders.[6] Critics have also alleged that the dual class structure, by further decoupling economic ownership and voting control, diminishes investor monitoring effectiveness and further exacerbates the basic agency problems that exist in the publicly funded corporation business form.

This Note first seeks to review the basic monitoring and agency issues associated with the dual class form, deliver a recommendation on whether American stock exchanges or regulatory entities should ban dual class structures, and offer a path forward to decrease and minimize existing problems. In Part I, I discuss the corporation control structure. After considering agency issues associated with the public corporation business form generally in Section I.A, I introduce the three different types of corporate ownership forms and examine the basic kinds of agency problems and protections that arise in each in Section I.B. Part II delves into an analysis of dual class and other CMS structures. Section II.A provides an overview of the dual class structure, including a historical background and the basic characteristics of the dual class structures found in

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4. Stephen I. Glover & Aarthy S. Thamodaran, *Debating the Pros and Cons of Dual Class Capital Structures*, INSIGHTS: THE CORPORATE LAW & SECURITIES LAW ADVISOR, Mar. 2013, at 12.

5. Dual class companies accounted for 20 out of 170 initial public offerings between January 2010 and March 2012, many of which were technology start-ups, such as Zynga and LinkedIn. *See* Joe Mont, *Dual-Class Shares Get Double Teamed by Critics*, COMPLIANCE WEEK: THE FILING CABINET (Oct. 2, 2012), https://www.complianceweek.com/blogs/the-filing-cabinet/dual-class-shares-get-double-teamed-by-critics#.VSQB9hPF-5I.

6. *Compare* Google, Inc., Registration Statement (Form S-1) (Apr. 29, 2004), *with* Andrew Ross Sorkin, *Stock Split for Google That Cements Control at the Top*, N.Y. TIMES DEALBOOK (Apr. 16, 2012, 9:14 PM), http://www.nytimes.com/pages/business/dealbook/index.html.

the market today. Section II.B evaluates the arguments of proponents and critics of dual class structures and, in particular, focuses on the agency arguments that detractors have advanced against the dual class structure. Section II.C presents a survey of the empirical study literature surrounding dual class CMS structures. Section III.A offers a recommendation on the key question of whether dual class structures should be allowed on American stock exchanges, and in Section III.B, I advance several methods by which agency problems in dual class structures can be reduced and curtailed.

I.
THE CORPORATION CONTROL STRUCTURE AND BASIC AGENCY ISSUES

A. *The Corporate Ownership Form*

Corporations have become the dominant business entity structure in the United States. In 2008, they generated eighty-one percent of the business revenue in the country, as compared with partnerships at fifteen percent and sole proprietorships at four percent.[7] Throughout history, sole proprietorships were the prevailing form of business enterprise until the modern era, when they were overtaken in popularity by the corporation.[8] Corporations allow founders to scale their businesses to a size and complexity that is impossible with the sole proprietorship. In particular, the ability to raise capital through public stock markets is a unique feature of the modern corporation. As a result, the rise of corporations created new agency issues not previously seen in their sole proprietorship counterparts. As Eugene F. Fama and Michael C. Jensen describe in their seminal article, "Separation of Ownership and Control," agency problems arise and need to be controlled "when the decision managers who initiate and imple-

7. U.S. CENSUS BUREAU, *supra* note 1, at 491.

8. It is important to note here that the *number* of sole proprietorships in the United States is still far greater than the number of C- or S-class corporations; as the Tax Foundation estimates, there are 23 million sole proprietorships as compared to 1.7 million C-corporations. *See* Scott Hodge, *The U.S. Has More Individually Owned Businesses Than Corporations*, THE TAX POLICY BLOG (Jan. 13, 2014), http://taxfoundation.org/blog/us-has-more-individually-owned-businesses-corporations. However, as shown by the 2012 Statistical Abstract, the revenue of each sole proprietorship is extremely small relative to what an average C-class corporation generates.

ment important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions."[9] Fama and Jensen believe that, in these types of organizations, decision management will be separated from decision control and all optimally performing companies—those companies that effectively manage agency costs—will have appropriate monitoring controls in place.[10] It is worth noting, however, that it is not possible nor even desirable to attempt to eliminate agency costs altogether; eliminating public stock markets or management control would dramatically reduce agency costs, yet would also result in a significant loss of efficiency and wealth. Investors must accept that, as a result of separation of ownership and control, agency costs will exist. The successful players will be the ones that best monitor and manage these costs in the quest to optimize performance and wealth.[11]

These types of corporations typically have different organizational checks and balances in place to make sure that agency costs are mitigated and lessened. For example, a formalized decision hierarchy allows for superiors to ratify and monitor the decisions of their subordinates.[12] At the top of the hierarchy, upper-level management will in turn be monitored and supervised by an experienced and knowledgeable board of directors, which oversees important decisions and actions with some members who are independent and external.[13] In checking and aligning managers' motivations with the interests of the corporation, the board of directors may create incentive compensation plans to reward managers based on positive company performance.

Furthermore, there are various market-imposed checks for publicly traded corporations. The stock market is one such monitoring mechanism. If shareholders are unhappy with the actions taken by management and believe that such actions are against their best interests, a stock sell-off serves as a strong

9. Fama & Jensen, *supra* note 2, at 304.

10. *Id.* at 323.

11. I am grateful to Professor William Allen of New York University School of Law for this insight.

12. Fama & Jensen, *supra* note 2, at 323.

13. *Id.*

indicator to management of shareholder disapproval.[14] Naturally, if shareholders voice their disapproval by selling shares and the stock price drops significantly, the threat of a hostile takeover will become more significant and serve as a powerful incentive for management to correct its malfeasance.[15]

B. *The Dispersed Ownership, Controlled Structures, and Controlling-Minority Structures Corporate Ownership Forms*

There are three basic types of control dynamics that corporations exhibit: dispersed ownership (DO), controlled structures (CS), and controlling-minority structures (CMS).[16] The typical publicly traded corporation operates under a DO structure, where the corporation's stock and voting control is dispersed among many thousands, if not millions, of shareholders, none of whom have enough shares to exert control over the affairs of the company. CS firms are firms in which one shareholder or an allied group of shareholders owns enough of the company's shares to exert influence and control over the corporation. Finally, CMS corporations are those in which a shareholder controls the firm while holding only a fraction of the equity. Dual class structure firms, which are the focus of this Note, fall under this third category.

Generally speaking, CMS firms do not have the same checks and balances to limit agency costs as DO and CS structures.[17] Although the classic problem outlined in Fama and Jensen's article exists in DO structures—namely, that managers will not have to fully internalize the wealth effects of their decisions—managers have little voting control and can be easily displaced or challenged by the board of directors, proxy fights, activist investors, or hostile bidders. The controllers of CMS firms do not face this threat; due to the entrenching effects of the CMS structure, managers cannot be easily dis-

14. *See, e.g.*, Martin Peers & Keach Hagey, *Fox Withdraws Time Warner Bid*, WALL ST. J. (Aug. 5, 2014) http://www.wsj.com/articles/fox-withdraws-time-warner-bid-1407269617. A potential blockbuster merger between 21st Century Fox and Time Warner was abandoned largely due to the precipitous price drop in Fox's stock, signaling strong shareholder disapproval of the combination.

15. Fama & Jensen, *supra* note 2, at 313.

16. *See generally* Bebchuck, Kraakman & Triantis, *supra* note 3.

17. *Id.* at 301.

placed (if at all).[18] In CS organizations, despite the fact that the controller is entrenched and dictates the course of the company, it will largely internalize the wealth effects of its decisions due to its large economic stake. Presumably, this helps to restrain the holder of the control bloc from taking actions detrimental to shareholders' best interests.[19] CMS controllers do not have this check either, as they have a similarly dominant level of voting control with comparatively low cash-flow rights.[20]

We can see, therefore, an initial reason for alarm with CMS firms. The traditional methods that many corporations employ to reduce agency costs, such as board of director influence, market and hostile takeover checks, and shareholder activism, cannot be utilized very successfully in CMS corporations, theoretically paving the way for much higher levels of agency abuse. Indeed, one study has indicated that controlling and founding families often employ the CMS structure to entrench themselves and derive large private benefits.[21] There are opposing views, of course,[22] but for now it can be properly stated that the potential agency dynamics arising in CMS firms are at least significantly different from their DO and CS counterparts.

II.
The Controlling-Minority Structure and Dual Class Structure

A. *Overview*

Typically, shareholder voting rights and economic rights are perfectly aligned. One share of common stock normally entitles the shareholder to one share of the cash-flow and dividend rights, and one vote in the control of the corporation.

18. *Id.*
19. *Id.*
20. *Id.*
21. Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. Fin. & Quantitative Analysis 695, 714 (2003).
22. *See, e.g.*, Armando Gomes, *Going Public Without Governance: Managerial Reputation Effects*, 55 J. Fin. 615 (2000) (asserting that a manager's reputation for proper shareholder treatment and the hope for higher stock prices can provide a powerful incentive, even in the complete absence of strong governance policies, for controllers in CMS firms to act in the best interests of minority shareholders).

Dual class structures decouple cash-flow and voting rights, allowing shareholders of the superior voting stock to hold several votes per share of stock as opposed to the traditional one vote, one share model.[23] Dual class structures first came into existence and use in the 1920s as a method for managers to raise capital from the public while maintaining strategic control of their firms.[24] The advent of the dual class structure sparked fierce debate about the impact it would have on shareholder rights, and criticism of the structure culminated in a ban on dual class structures by the New York Stock Exchange (NYSE) in 1940.[25]

After a relatively quiet four decades following the NYSE ban, dual class voting structures came back into vogue during the hostile takeover battles of the 1980s.[26] Dual class voting structures offer a strong takeover defense since the superior voting class of stock is usually held by a single individual or a small group and not publicly traded. As a result, no matter how much of the publicly traded inferior voting stock a hostile raider might acquire, it will almost always be outvoted by the private holders of the superior voting stock. Thus, the hostile takeover is effectively thwarted before it even begins. Furthermore, many dual class corporations avoid the potential defector problem by declaring in the corporate charter that superior voting shares are automatically converted to inferior voting shares if transferred to another party, making it impossible for a hostile acquirer to woo superior voting shareholders

23. In the United States, dual class firms typically have two classes of stock, and the most common vote to share ratio seen in superior-voting shares is ten-to-one; this ratio is present in the superior-voting shares of companies such as Facebook and LinkedIn. *See* Myles Udland, *Facebook Has a New Class Structure and Mark Zuckerberg is Still in Control*, BUS. INSIDER (Apr. 27, 2016, 4:34 PM), http://www.businessinsider.com/facebook-new-stock-structure-2016-4; Steven Davidoff Solomon, *A Deeper Look at LinkedIn's Structure*, N.Y. TIMES (May 12, 2011, 4:01 PM), http://dealbook. nytimes.com/2011/05/12/a-deeper-look-at-linkedins-structure/. Many companies choose to deviate from this default, like Zynga, which has three classes of stock, one of which is reserved to the founder and carries a ratio of seventy-to-one votes per share. See Gary Rivlin, *Zynga's IPO Gives Founder Mark Pincus a Stock Class All His Own*, DAILY BEAST (Dec. 14, 2011, 6:18 PM), http://www.thedailybeast.com/articles/2011/12/14/zynga-s-ipo-gives-founder-mark-pincus-a-stock-class-all-his-own.html.

24. *See* Glover & Thamodaran, *supra* note 4, at 2.

25. *Id.*

26. *Id.*

with a premium offer.[27] Although the NYSE ban on dual class structures was still in effect at the beginning of the 1980s, companies seeking to implement the structure would simply list on the NASDAQ stock exchange instead, prompting the NYSE to eventually withdraw its ban in order to stay competitive.[28]

The Securities and Exchange Commission (SEC), alarmed at the proliferation of dual class structures during the 1980s, promulgated Rule 19c-4 in 1988. In effect, Rule 19c-4 sought to prohibit the listing of a corporation's stock on a national security exchange if it had taken any action to nullify or restrict the voting rights of existing shareholders.[29] Although this was not a strict ban on dual class structures or a mandate for a universal one share, one vote policy, the rule sought to impose various restrictions on the issuance of dual class common stock. This regulation was extremely short-lived, however, and was struck down by the D.C. Circuit as an overreach of the SEC's rulemaking authority.[30] Thereafter, any restriction on dual class voting structures depended on the rulemaking power of the individual exchanges (although states do have the authority to regulate dual class structures, in almost all cases they have declined to do so).[31] The exchanges implemented a compromise solution: IPOs for companies with existing dual class structures would be permitted, whereas companies that were already listed would be prohibited from restructuring the stock into a dual class system.[32] This compromise remains in force today.[33]

Presently, approximately five to ten percent of listed companies, as measured either by number of companies or market

27. *See, e.g.*, UNITED PARCEL SERVICES, INC., RESTATED CERTIFICATE OF INCORPORATION 5 (2010) (holding that Class A shares will automatically convert to Class B shares if given to an individual who is not a "permitted transferee").

28. Glover & Thamodaran, *supra* note 4, at 2.

29. For a detailed discussion of Rule 19c-4, its fate in the D.C. Circuit Court, and subsequent regulation of dual class structures on the national security exchanges, see Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L. REV. 565 (1991).

30. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

31. Bainbridge, *supra* note 29, at 625.

32. Glover & Thamodaran, *supra* note 4, at 2.

33. *Id.*

capitalization, employ a dual class structure.[34] This number has been increasing steadily since the 1980s.[35] The most common arrangement in the United States among dual class corporations is a ten-to-one votes to share ratio for the superior voting stock, while the inferior class has one vote per share.[36] On average, this results in insiders controlling approximately sixty percent of the voting rights with only forty percent of the cash-flow rights.

Internationally, the use of dual class structures varies considerably. In Canada and the European Union, for instance, the percentage of firms employing a dual class structure is at or above 20%, considerably higher than the proportion on American exchanges.[37] In other areas, like Israel, Hong Kong, and Singapore, dual class structures are banned outright, although in Hong Kong regulators seem to be back-pedaling on this policy after several high-profile companies, including Alibaba, chose to list elsewhere due to their preference for the dual class structure.[38] Companies in international markets such as Hong Kong make ample use of alternative CMS structures (for example, pyramids and cross-holding), so the banning of dual class structures seems to only open the door for

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34. Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies* 5 (Eur. Corp. Governance Inst., Working Paper No. 209, 2008), http://ssrn.com/abstract_id=1080361.

35. *See* Paul Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 Rev. Fin. Stud. 1051 (2007). Gompers et al. report that from 1994 to 2001, their sample size of dual class firms increased from 100 to 215, reflecting the popularity of the dual class structure among the technology firms of the late 1990s. A report by the Investor Responsibility Research Center and Institutional Shareholder Services found that from 2002 to 2012, the number of dual class firms in the S&P 1500 Composite Index rose from sixty-eight to seventy-nine, reflecting growth at a slower rate over the last decade, at least when looking at larger cap firms. IRRC Inst. & ISS, Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review 3 (2012). In sum, Thomas Chemmanur and Yawen Jiao estimate that almost twice as many listed companies employ a dual class structure now than in the 1980s. Thomas J. Chemmanur & Yawen Jiao, *Dual Class IPOs: A Theoretical Analysis* 1 n.1 (Eur. Corp. Governance Inst., Working Paper No. 129, 2006), http://ssrn.com/abstract_id=925236.

36. Gompers, Ishii & Metrick, *supra* note 35, at 1053.

37. Chemmanur & Jiao, *supra* note 35, at 1 n.1.

38. *See Out of Control*, The Economist (Sept. 20 2014), http://www.economist.com/news/finance-and-economics/21618889-more-worlds-big-stock markets-are-allowing-firms-alibaba-sideline.

other more elaborate and unregulated mechanisms of maintaining family or founder control.[39] This may indicate that CMS structures are regarded as the most efficient corporate governance structure in at least some instances across various markets. Alternatively, if we adopt a darker view, the situation may demonstrate that if management wants to expropriate value from firms, it will find a way to do so despite the banning of dual class structures.

B. *Arguments For and Against the Dual Class Structure and Agency Issues Asserted by Critics*

The rationale for implementing a dual class structure is much the same today as it was in the 1920s: it is an excellent way to raise capital from the public while maintaining the long-term vision and control of the founder.[40] When one looks at the high-profile IPOs of recent years, a clear trend of high-growth technology start-ups with strong founder personalities is evident. Facebook with Mark Zuckerberg, Alibaba with Jack Ma, and LinkedIn with Reid Hoffman are just a few examples. There is certainly some *a priori* force to this argument; if a founder is not subject to the "fluctuating attitudes of the capital markets," as Joseph Tsai of Alibaba labeled short-term market and investor pressure, she can focus more on long-term value maximization for shareholders.[41] Particularly in technol-

39. Prominent examples of family pyramid structures in Asia include the Li Ka-Shing group in Hong Kong and the Gondrej family in India. *See* Bebchuk, Kraakman & Triantis, *supra* note 3, at 299.

40. *See, e.g.*, Google, Inc., *supra* note 6, at iii. Larry Page candidly disclosed to potential investors that, "[i]n the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. This [dual class] structure will also make it easier for our management team to follow the long-term, innovative approach emphasized earlier . . . . New investors will fully share in Google's long-term growth but will have less influence over its strategic decisions than they would at most public companies."

41. This quote comes from a blog post by Joe Tsai on Alizila, a news and commentary blog funded by the Alibaba Group. Joe Tsai, *Alibaba Offers an Alternative View of Good Corporate Governance*, ALIZILA (Sept. 26, 2013, 10:59 PM), http://www2.alizila.com/alibaba-offers-alternative-view-good-corporate-governance. Tsai's post is a vigorous defense of Alibaba's use of an elaborate type of dual class structure, and it was a direct criticism of the Hong Kong Exchange's failure to allow Alibaba to list due to its ban on dual class structures. Tsai concludes the post by stating, "[w]e understand Hong Kong may not want to change its tradition for one company, but we firmly

ogy sector firms where the importance of innovation across product cycles is paramount, a myopic focus on next quarter's bottom line without proper investment in continuing projects could plausibly have deleterious consequences on long-term shareholder value and company health.[42] Dual class structures exist in other, non-technology driven firms as well, one of the most historic cases being the New York Times, which is controlled by the Sulzberger family. Despite the punishing last two decades for all newspaper companies, the Sulzbergers have been able to fend off corporate raiders and hedge funds, and focus on long-term journalistic integrity over all else solely because they have been able to maintain control through the dual class structure of New York Times stock.[43] The example is particularly poignant given the sale of other prominent and historic newspapers during recent years, such as the Wall Street Journal and the Boston Globe. Finally, proponents of the dual class system point to instances like Berkshire Hathaway, which is often viewed as the gold standard in corporate governance and shareholder transparency, to argue that a multiclass share structure does not by itself lead to subpar corporate governance.[44]

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believe that Hong Kong must consider what is needed in order to adapt to future trends and changes. The question Hong Kong must address is whether it is ready to look forward as the rest of the world passes it by." *Id.*

42. Scott Kupor, *Sorry CalPERS, Dual Class Shares Are a Founder's Best Friend*, FORBES (May 14, 2013, 10:01 AM), http://www.forbes.com/sites /ciocentral/2013/05/14/sorry-calpers-dual-class-shares-are-a-founders-best-friend (writing that the ability to successfully navigate and innovate across longer-term product cycles determines the success or failure of technology companies, and that dual class share structures are well suited to this purpose).

43. *See generally* Joe Nocera, *How Punch Protected* The Times, N. Y. TIMES (Oct. 1, 2012), http://www.nytimes.com/2012/10/02/opinion/nocera-how-punch-protected-the-times.html. Upon the passing of Arthur Sulzberger, who listed the New York Times Company in 1969, long-time New York Times columnist Joe Nocera wrote an encomium praising Arthur's decision to list the newspaper company with a dual class structure. *Id.*

44. It is possible that advocates of Warren Buffet's management of Berkshire Hathaway are conflating superior financial performance with superior corporate governance, an assumption that does not necessarily hold true. There have also been complaints recently of increasing opacity at the conglomerate. Lynnley Browning, *Warren Buffet's Transparency Problem*, NEWSWEEK (Feb. 24, 2015), http://www.newsweek.com/2015/03/06 /berkshire-hathaways-transparency-problem-309127.html.

Naturally, critics of the dual class structure vigorously contest the premise that founders need to maintain control in order to ensure long-term corporate success. To them, the idea of a founder entrenching herself in control in order to valiantly maintain a future vision for the company is a quixotic notion fed to public investors that allows an escape from shareholder accountability.[45] Of course, this principal argument has remained mostly intact from the 1920s, when the first critics of the newly introduced dual class structure emerged.[46] Detractors of the dual class structure counter such sterling examples of dual class governance, like Berkshire Hathaway, with more nefarious examples of managerial avarice enabled by entrenchment through the dual class system, like Lord Conrad Black, former CEO of Hollinger International, who served a felony sentence for fraud.[47] If the dual class structure does not lead to illegal extraction of benefits, as it did with Hollinger International, critics worry that it will cause stock underperformance, and point to recent listing examples such as Zynga.[48] As discussed in Section II.C, however, both advocates and critics seem to bring endlessly voluminous and contra-

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45. *See, e.g.*, Andrew Ross Sorkin, *Stock Split for Google That Cements Control at the Top*, N.Y. TIMES DEALBOOK (Apr. 16, 2012), http://dealbook .nytimes .com//2012/04/16/stock-split-for-google-that-cements-control-at-the-top/. Sorkin was highly critical of Google's issuance of a third class of stock in 2012 as a follow-up to its dual class listing in 2004. This piece in DealBook was particularly unforgiving towards the "visionary founder" argument, as Sorkin writes, "[j]ust think about other once highflying technology companies that turned sour. Yahoo. Or Research in Motion. Its founders were once lionized as visionaries—until they weren't. The problem is that Google will succeed until it doesn't. And when it falters, it won't have the kick in the pants that the prospect of pressure from shareholders can provide." *Id.*

46. The most prominent dual class critic in the 1920s was Harvard University Professor William Ripley, who was very likely the first individual to foresee and articulate the conflicts of interest and agency issues that were manifest in multiclass stock structures. Bainbridge, *supra* note 29, at 569. Professor Ripley asserted that the dual class structure was the "crowning infamy" of corporate regulation developments in the 1920s, which he viewed as empowering management at the expense of shareholder rights. *See generally* WILLIAM RIPLEY, MAIN STREET AND WALL STREET (1927).

47. Chemmanur & Jiao, *supra* note 35, at 2.

48. Since its initial public offering in December 2011, Zynga shares are down 71% as of March 1, 2017, compared with a 123% gain in the NASDAQ composite over the same period. This information may be found on Google Finance.

dicting empirical data to bear in order to advance their claims to no clear resolution.

The strongest arguments against the dual class structure invoke agency theory and the inherent conflict of interest that managers face with disproportionate voting right to ownership rights. As discussed in Section I.B, dual class and other CMS firms seem particularly susceptible to agency problems, more so than their DO and CS counterparts. Critics who allege heightened agency costs associated with dual class firms posit a two-part argument: first, there is decreased monitoring at these companies, and second, this decreased monitoring and oversight *a fortiori* signifies increasing agency problems and residual loss for shareholders.[49] I now examine each of these arguments in turn and conclude Section II.B with potential counterweights for the agency problems raised.

1. *Theories of Decreased Monitoring and Oversight*

A fall in share price and corresponding increase in the threat of a hostile takeover can serve as powerful motivators for corporate managers to change behavior that shareholders see as antithetical to their interests.[50] However, the controlling management in dual class firms will not face this pressure due to its entrenchment via control of the superior voting stock.[51] Together with the ability to resist hostile bids, management will also be less receptive toward friendly offers than its counterparts at DO firms. Even if a favorable friendly offer is made, the majority of the gains would go to other shareholders, whereas entrenched management can extract one hundred

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49. Jensen and Meckling put forward perhaps the most frequently cited definition of agency costs as the sum of: (1) monitoring expenditures by the principal, (2) bonding expenditures by the agent, and (3) residual loss, or the divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). This Note does not seek to explicitly discuss the potential higher agency costs of dual class structure firms under the agency costs = monitoring + bonding + residual loss equation, but briefly it can be mentioned that critics' agency arguments essentially imply that the *decreased* monitoring present in dual class firms is more than offset by the *increased* residual loss. As a result, overall agency costs will increase.

50. *See* Fama & Jensen, *supra* note 2, at 313.

51. *See* Bebchuck, Kraakman & Triantis, *supra* note 3, at 301.

percent of the private benefits of control should the status quo be maintained.[52] Counterarguments have been advanced against this theory of decreased monitoring. Armando Gomes, for example, argues that controlling shareholders will work to increase their reputation for positive treatment of minority shareholders because, otherwise, upon going public, knowledgeable investors and analysts will discount the stock according to greater perceived extraction of private benefits.[53] Secondly, not all hostile takeovers or aggressive bidders are good for shareholders, whether they are controlling or minority shareholders. The management of a dual class firm may have implemented the structure to fend off these unwanted advantages rather than to ignore fruitful and beneficial takeover offers.[54] On balance, however, an explicit reason many founders have advanced to implement the dual class structure is the ability to ignore short-term market fluctuations, which is tantamount to founders asserting that they are throwing off the yolk of shareholder monitoring.

A stronger critique related to reduced monitoring at dual class firms alleges that board of director independence and supervision suffer at these companies.[55] For instance, one study found that approximately seventy percent of dual class firms had an independent board versus eighty percent for single class firms, where an independent board is defined as one

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52. *See* Cronqvist & Nilsson, *supra* note 21, at 699. One may ask whether a controlling chief executive could in fact extract a larger piece of the pie by demanding a premium for his controlling shares. This may be possible absent minority shareholder protections in the corporate charter, but many dual class companies have provisions stating that there may be no premium for super-voting shares in a merger. *See, e.g.,* Google, Inc., FOURTH AMENDED AND RESTATED CERTIFICATE OF INCORPORATION 3 (June 22, 2012). When dual class companies do have these anti-premium provisions, the Delaware Court of Chancery has stepped in to enforce them. *In re* Delphi Financial Group Shareholder Litigation, C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012).

53. *See* Gomes, *supra* note 22, at 616.

54. *See* Cronqvist & Nilsson, *supra* note 21, at 700.

55. A counterargument to allegations of decreased board independence at dual class firms is that investors care about positive financial performance, not good governance. Despite the *ipse dixit* of dual class critics claiming that reduced board independence should concern investors, some studies have found no correlation between board independence and financial performance. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long Term Firm Performance,* 27 J. CORP. L. 231 (2001).

in which at least half of the directors are independent.[56] There is an excellent explanation for this disparity given current stock exchange rules. The NYSE and NASDAQ both contain controlled-company exemptions from many of their board independence requirements.[57] In both exchanges, controlled companies in which greater than fifty percent of the voting power is held by a single individual or group are exempt from the requirements of having a majority of independent directors on the board, maintaining an independent director nomination committee, and creating an independent compensation committee. The end result, critics allege, is a rubberstamp board that is beholden to the chief executive. One notable example is the unanimous board approval of Google's recent controversial decision to issue nonvoting shares through a stock split.[58] Google's situation is relatively innocuous, however, when compared to more egregious examples of founding families dominating the board through dual class entrenchment such as News Corp. In 2012 at the News Corp annual meeting, approximately two-thirds of independent investors voted to install an outside chairman; yet, the resolution still failed due to the Murdoch family's control of the superior voting stock.[59] As much as founders like Rupert Murdoch may insist that their interests are perfectly aligned with those of the shareholders, it can be hard for critics to take such claims seriously when corporations view corporate governance proposals with such disdain.

Finally, institutional investors exercise less oversight and ownership in companies with dual class structures, potentially

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56. John S. Howe & Chris Tamm, *Corporate Governance of Dual-Class Firms*, in 14 INTERNATIONAL CORPORATE GOVERNANCE, ADVANCES IN FINANCIAL ECONOMICS, 1, 13 (Kose John & Anil K. Makhija eds., 2011). However, the authors note the interesting counterbalance statistic that dual class firms are more likely to have different individuals holding the CEO and Chairman of the Board titles than single class firms. *Id.*

57. *See* NEW YORK STOCK EXCHANGE, NYSE MANUAL 303A.00 1; NASDAQ, NASDAQ STOCK MARKET RULE 5615 1, 6.

58. *See* Sorkin, *supra* note 45. Sorkin continues to make the assertion that, "[t]he only likely alternative to voting 'yes' would have been to resign and explain why [they] voted 'no'."

59. Katherine Rushton & Richard Blackden, *Rupert Murdoch's Iron Grip on News Corp Dealt a Blow*, THE TELEGRAPH (Oct. 17, 2012), http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/media/9613863/Rupert-Murdochs-iron-grip-on-News-Corp-dealt-a-blow.html.

eliminating one of the most significant forms of monitoring to which most corporations are subjected. Institutional investors provide the best answer to the collective action problem that dispersed shareholders in most corporations face; by pooling their relatively larger holdings together and voting as a block, institutional investors play a very important role in overseeing management.[60] Research shows that higher institutional ownership levels also correlate positively with higher pay-for-performance sensitivity and negatively with the level of management compensation, therefore serving as an important check on a major corporate agency problem.[61] Due to the lack of any real pressure that institutional investors can exert over the management of a dual class firm, critics allege that the percentage of shares owned by institutional investors in dual class firms has decreased. One study estimates institutional ownership of publicly traded dual class stock at 34.7% as compared to 37.5% of single class stock.[62]

Institutional investors have not been silent about their alleged disenfranchisement. In 2012, amidst high-profile dual class IPOs such as Facebook and Manchester United, CalPERS, the largest public pension fund in the United States, launched a major publicity campaign to remove dual class structures and threatened to boycott any future dual class listings.[63] The Council of Institutional Investors (CII), an association that represents pension funds, endowments, and foundations with combined assets of $3 trillion, consistently lobbies the NYSE, NASDAQ, and international stock exchanges to return to a one share, one vote model.[64] It is unclear, however, that such

60. Tian Wen, Comment, *You Can't Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges*, 162 U. PA. L. REV. 1495, 1504 (2014).

61. Jay Hartzell & Laura Starks, *Institutional Investors and Executive Compensation*, 6 J. FIN. 2351, 2351 (2003).

62. Howe & Tamm, *supra* note 56, at 13. The significance of this lowered ownership percentage is debatable; however, as even John S. Howe and Chris Tamm acknowledge, this decrease is only statistically significant at the ten percent level. *Id.*

63. Shanny Basar, *CalPERS Sets Sights on Dual-Class Stock Structures*, WALL ST. J.: MKTS. (Aug. 20, 2012, 12:16 PM), http://www.wsj.com/articles/SB10000872396390443855804577601271252759472.

64. *See, e.g.*, Letter from Jeff Mahoney, Gen. Counsel, Council of Inst. Inv., to John Carey, Vice President, NYSE (Mar. 27, 2014), http://www.cii.org/files/issues_vand_advocacy/correspondence/2014/03_27_14_CII_let

lobbying has had any effect, as the CII has sent several querulous letters over the past few years that have not seemed to yield any real results.[65] Institutional Shareholder Services (ISS), another corporate governance advocate for "asset owners, hedge funds, and asset service providers,"[66] also vigorously denounces dual class share structures and other management entrenchment mechanisms. For example, ISS labelled Facebook's structure upon its IPO as "a governance profile with a defense against everything except hubris."[67]

Defenders of the dual class structure should raise an obvious question to these allegations of reduced institutional influence and presence: though they may help temper and reduce agency costs in theory, do institutional or activist investors actually drive up shareholder value at the firms that they seek to reform? In other words, we must ask whether shareholder activism is an efficient and effective form of monitoring in the first place. The answer is not simple, as studies tend to show conflicting or ambiguous results. This is particularly true of data regarding the so-called "CalPERS Effect," the measured impact of prominent institutional investor CalPERS on the firms that it targets, which are known as the "Failing Fifty."[68] One recent study finds that the companies pursued by CalPERS show an excess return of 2.9% per year for five years from the "initiative date," or the date of CalPERS' first letter, compared with an excess return of negative 30.9% per year for the five years prior.[69] However, these findings probably overstate the efficacy of CalPERS' targeting for two main reasons.

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ter_to_NYSE_one_share_one_vote.pdf. In this letter, the CII was strongly urging the NYSE to reject the listing of Alibaba, which opted to list on the NYSE due to its allowance of dual class structure listings.

65. *CII Correspondence & Testimony*, COUNCIL OF INST. INV., http://www.cii.org/correspondence (last updated Oct. 31, 2016).

66. *About ISS*, INST. SHAREHOLDER SERVICES, INC., http://www.issgovernance.com/about/about-iss/.

67. ISS, THE TRAGEDY OF THE DUAL CLASS COMMONS 1 (Feb. 13, 2012). As noted previously, even if one could allege poor corporate governance at Facebook due to the dual class share structure, financial performance is perhaps uncorrelated. At the time of this writing, Facebook's stock price is up over 200% from the time of its IPO, outperforming the NASDAQ handily.

68. Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 232 (1996).

69. Stephen L. Nesbitt, *The "CalPERS Effect" on Targeted Company Share Prices*, NACD DIRECTORSHIP, May 2001, at 1.

First, this study does not address the fact that much of the 2.9% average excess return is due to the stocks' performance from years three to five. If CalPERS were to actually account for the dramatic turnaround that the study's authors describe, one would expect the impact to occur much sooner. Secondly, for a span of five years, it is really quite difficult to say that a relatively low abnormal return is statistically significant since stock price fluctuation is a rather noisy statistical indicator and could reflect any variety of contributing factors of which the CalPERS Effect is just one.[70] Other studies conclude with similar unclear results; for example, Michael Smith finds an increase in shareholder wealth due to the CalPERS Effect but only when it is successful in its organizational change efforts.[71] Additionally, this study found no statistically significant change in operating performance for targeted firms.[72] Mixed results such as these certainly blunt the force of the argument that institutional investors have a reduced monitoring role at dual class firms.

Following analysis of the specific claims that the dual class structure results in weakened takeover and market checks, diminished board independence and effectiveness, and reduced institutional investor oversight, there does seem to be cause for concern about decreased monitoring and the board of directors' role in dual class corporations. Those boards have been shown to be statistically less independent and consequentially more deferential to management. Not as evident, however, is any connection or causation between reduced board independence and poor financial performance. Contentions about lack of a proper market check and decreased institutional investor oversight are still on less solid ground, and it is unclear what, if any, negative impact actually results from reduced monitoring through these avenues.

2. *Agency Costs and Extraction of Private Benefits*

Regarding agency problems and the residual loss that follows, several studies have alleged that minority shareholders in CMS and dual class firms endure a variety of agency costs, in-

70. Interview with Professor David Yermack of New York University Stern Business School.

71. Smith, *supra* note 68, at 243.

72. *Id.* at 248.

cluding poorer use of cash reserves, increased CEO compensation, questionable acquisition and project investment decisions, and a greater reluctance to allow a transfer of control.[73] Many of these agency issues are not unique to dual class firms of course; Jensen offers the hypothesis that, when confronted with free cash flow, management often makes poor acquisition decisions, grows firms beyond their optimal size, and invests in negative net present value projects.[74] More recently, other commentators have pushed the case that such agency problems are even greater at CMS and dual class firms than at their DO counterparts.[75]

However, as I will argue in the next Section, despite such strong evidence suggesting that there is an expropriation of benefits from minority shareholders to the advantage of the controlling shareholders, these rationales may overstate the danger of agency problems in dual class firms, like founder reputation and future cost of raising capital.

3. *Counterweights to Offset Decreased Monitoring and Increased Agency Costs*[76]

Critics asserting increased agency costs and wealth expropriation in dual class firms rely on an unstated assumption: the controlling shareholders in these firms do not own a significant percentage of the lower voting stock or a higher percentage of the stock than is necessary to maintain control. If this assumption were not true, controlling shareholders would be

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73. *See* Cronqvist & Nilsson, *supra* note 21; Masulis, Wang & Xie, *supra* note 34. Both sources are well-written works that dive into the mathematical and statistical methods used to find the correlation between dual class or CMS structures and these agency costs. Perhaps two findings are most interesting. In the Masulis paper, the authors find that not only are agency costs positively correlated with the use of the dual class structure but they rise in step with the concentration of voting power in the founder's hands. In the Cronqvist article, the authors determine that, among the Swedish sample of firms studied, families are much more likely to employ CMS structures, and these family CMS firms are "associated with the largest discount on firm value."

74. *See generally* Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

75. *See* Cronqvist & Nilsson, *supra* note 21.

76. I am grateful to Professor William Allen of New York University School of Law for assistance with many of the concepts expounded in this Section.

expropriating a larger-than-required amount of wealth from themselves, and would be reducing the value of their shares, thus defeating the plausibility of increased agency costs and minority shareholder expropriation. This is because, in most cases, the value of the shares to the founder or controlling shareholder will be orders of magnitude greater than the value of any extraction, such as excess CEO pay, that the controller could procure. Furthermore, such malicious expropriation would likely be punished by the capital markets in future equity offerings, raising the future cost of equity and thereby further diminishing the value of the controlling shareholder's ownership.[77]

Clas Bergström and Kristian Rydqvist challenge the assumption that controlling shareholders only own the superior voting stock necessary for control of the company, thus allowing them to extract private benefits of control at limited cost to themselves. Bergström and Rydqvist label this assumption the "expropriation hypothesis." Their findings show that, in most firms, the controlling shareholder owns more than the minimum fifty percent equity required for control. Additionally, the largest shareholder coalition frequently invests in significant amounts of inferior voting shares that, while adding little voting power, can appreciate in value over time given successful management of the firm.[78] By way of a more modern example, as of December 31, 2014, Mark Zuckerberg owned approximately four million class A shares in Facebook, which at the time had a market valuation just north of $300 million.[79] Admittedly, this is a much smaller stake than represented by his superior voting Class B shares; however, it is nonetheless a significant amount of ownership in a class of stock that Zuckerberg did not need to own in order to maintain control of Facebook and extract private benefits.

Even if one accepts the cynical hypothesis that controlling shareholders only maintain ownership of the superior voting shares necessary in order to extract ownership benefits, there

77. Clas Bergström & Kristian Rydqvist, *Ownership of Equity in Dual-Class Firms*, 14 J. BANKING & FIN. 255, 258 (1990).

78. *Id.* at 267.

79. *See* Facebook, Inc., Schedule 13G (Dec. 31, 2014). As of the filing, Mark Zuckerberg owned 3,999,241 Class A shares valued at approximately $305 million. In the Facebook corporate ownership structure, Class A shares are publicly traded and have inferior-voting rights to Class B shares.

are other pressures that may constrain them from minority shareholder exploitation. A founder's reputation for proper treatment of minority shareholders and the hope of higher stock prices can provide powerful incentives, despite the complete absence of strong governance policies, for controlling shareholders in dual class firms to act responsibly and not expropriate benefits.[80] Indeed, Jensen and William H. Meckling assert that minority shareholders are rational, and that they can anticipate such behavior and adjust the subscription or purchase price accordingly.[81]

One could also choose to take a more benign view of the reason for instituting a dual class structure in a firm. Perhaps, as Larry Page noted in the 2004 Google Registration Statement, the founders actually want to protect their long-term vision for the company and have no interest in attempting to expropriate shareholders.[82] Of course, whether such intentions lead to strong long-term stock performance is another question, but adopting these sentiments at face value would at the very least rule out the possibility of malicious appropriation. Dual class structures may therefore be a legitimate way of giving founders the best of both worlds—capital from the public markets and the ability to focus on the future of a private company, allowing the business to excel more than if it were purely one or the other. Moreover, the dual class structure may even be necessary for societal wealth maximization; gifted entrepreneurs like Larry Page or Mark Zuckerberg, without the ability to implement a dual class governance structure, may prefer to restrict the growth of their firms rather than risk raising additional capital and face the possibility of losing control. Such an argument is not so far-fetched when one remembers the example of Steve Jobs, who was famously ousted at Apple soon after its IPO. Thus, the dual class structure can help resolve the "brilliant entrepreneur problem" and actually generate value for society by allowing innovative firms and their founders to scale up by tapping into public capital markets without risking ouster of the individuals who made them innovative in the first place. This could also provide a benign rationale for the restriction on transfer of high-voting shares men-

80. Gomes, *supra* note 22, at 616.
81. Jensen & Meckling, *supra* note 49, at 313.
82. *See, e.g.*, Google, Inc., *supra* note 6, at i.

tioned in Section II.A. The market may recognize that high-voting shares serve the purpose of protecting visionary founders, but such shares no longer serve that purpose once transferred to another party.

Other counterweights to excessive founder overreach are the legal constraints imposed by courts. In general, controlling shareholders have a duty of loyalty to minority shareholders and cannot self-deal against the interest of the corporation.[83] Furthermore, there have been some cases where the Delaware courts have moved to protect the holders of inferior voting shares in dual class companies. In *In re Delphi Financial Group,* the Delaware Court of Chancery sided with minority shareholders and stated that the controlling shareholder in a dual class company breached his fiduciary duties by seeking and obtaining a control premium for his shares when the certificate of incorporation specifically stated that both classes of stock must be treated equally in a merger.[84] In *Levco Alternative Fund v. Reader's Digest*, Chancellor William B. Chandler III enjoined the recapitalization of the dual class company because the court found that the independent committee in charge of the recapitalization breached its fiduciary duties by not evaluating the fairness to non-voting shareholders of a payment to voting shareholders.[85] These legal protections could be labeled as fairly weak; in *In re Delphi*, shareholders only prevailed because there was a relevant protection included in the certificate of incorporation, and in *Levco*, Chancellor Chandler's ruling implies that, as long as a controlling shareholder passes the barrier of entire fairness, the action will not be struck down. However, the willingness that Delaware courts have shown to protect minority shareholders from gross overreach by the majority shareholder should come as a reassuring trend.

Finally, as the minority shareholders in *In re Delphi* successfully utilized to their advantage, investors can demand corporate charter protections from founders who decide to utilize

83. *See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971) (finding that contracting overly favorably with another entity in which the controlling stock holder has an interest is self-dealing and an unfair transaction).

84. *In re* Delphi Financial Group Shareholder Litigation, C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012).

85. Levco Alternative Fund Ltd. v. Reader's Digest Ass'n., Inc., 803 A.2d 428 (Del. 2002).

the dual class structure. Mechanisms such as sunset provisions, bars on transfer of voting power, and restrictions on premiums for high-voting shares in the event of a change of control can all provide powerful checks on executive and founder power.[86] As I recommend in Section II.B, these voluntary provisions on the part of dual class firms can shore up confidence in the governance of such firms. Investors could then choose to invest in companies with strong self-governance mechanisms or penalize firms without such controls with a lower share valuation.

C. *Empirical Evidence on the Performance of Dual Class Firms*

To say that the evidence is conflicted on whether dual class firms outperform their single class counterparts is an understatement. A broad glance at high-profile technology IPOs of recent years such as Facebook, LinkedIn, and Zynga reveals large discrepancies in performance, from stellar returns beating the market by multiples (in the case of LinkedIn) to abysmal, company-threatening performance (in the case of Zynga). Due to such large differences in post-IPO performance and the general "noisiness" of using stock price as a reliable proxy for the evaluation of any one, isolated contributing variable, it is extremely difficult to generate a reliable conclusion or prediction of the impact of dual or single class structures on market performance. The literature and studies composed to date reflect this confusion and ambiguity.

A recent study conducted by the Investor Responsibility Research Center (IRRC) and ISS determined that the returns in multiclass companies behave precisely the opposite of how founders in these firms predict. Multiclass firms were found to outperform their single class peers over a one-year horizon, but underperform over a longer time period.[87] Moreover, the study found that the share price volatility of multiclass firms was much higher than for single class firms.[88] Unfortunately, this particular study likely suffers from some bias on the part

86. For examples of such provisions, see the charters of Facebook (sunset provisions), UPS (no transfer of superior-voting power), and Google (restriction against premium for sale of high-vote shares in a merger), available through Delaware's Secretary of State.

87. *See* IRRC INST. & ISS, *supra* note 35, at 3.

88. *Id.*

of the authors; both the IRRC and ISS are prominent critics of the dual class structure and frequently lobby to have the NYSE and NASDAQ remove listings of dual class firms. Nonetheless, the groups are not alone in their findings, and there are multiple other studies that also arrive at the conclusion that dual class firms underperform in a variety of metrics.[89]

However, for each study that seems to find that multiclass firms underperform, there is another study with the exact opposite conclusion. Ekkehart Bohmer, Gary C. Sanger, and Sanjay B. Varshney[90] ascertained that dual-class firm IPOs outperform single-class firm IPOs in stock market returns and accounting performance measures. Valentin Dimitrov and Prem C. Jain[91] found that firms undergoing dual-class share recapitalizations exhibit long-term positive abnormal stock returns and operating performance. Thomas J. Chemmanur and Yawen Jiao[92] concluded that, among firms with a high incumbent management reputation, an IPO with dual class structure and long-term focus will maximize shareholder value.

Hence, both proponents and critics of the dual class share system have studies and empirical data to support their positions, and both can justify their viewpoints depending on the study, methodology, and sample of companies that is selected. For a neutral observer, it is very difficult to draw any sort of conclusion about the impact of single or multiclass share structure on stock and operational performance of firms given the conflicting literature currently available. Furthermore, it is challenging to control for the impact that share structure has on these performance metrics against other variables since, as mentioned before, share price and financial performance can be noisy indicators. Every company, and every founder, is different, and where one multiclass company may succeed with a

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89. *See, e.g.*, Ashrafee Hossain, *Dual v. Single Class Firms: An Acquisition Perspective*, 14 J. ACCT. & FIN. 9 (2014) (finding that long-term post-acquisition operating performance of single class firms are significantly higher and experience higher abnormal returns around acquisition announcements).

90. Ekkehart Boehmer, Gary C. Sanger & Sanjay B. Varshney, *Managerial Bonding and Stock Liquidity: An Analysis of Dual-Class Firms*, 28 J. ECON. & FIN. 117, 117–18 (2004).

91. Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns,* 12 J. CORP. FIN. 342 (2006).

92. Chemmanur & Jiao, *supra* note 35.

visionary founder, another may fail for reasons entirely unrelated to the multiple classes of stock. As it stands, we simply do not have sufficient information to posit a determinative answer to the question of whether and how multiclass governance structures systematically affect financial performance.

III.
A Path Forward for Dual Class Structures

A. *Recommendation on Inclusion of Multiclass Structures on American Stock Exchanges*

Given ambiguous evidence on the impact of multiclass share structures on the financial and operating performance of firms, American stock exchanges will, in all likelihood, continue allowing multiclass firms to publicly list their shares. There are multiple reasons for this conclusion, such as the strong trend towards use of the multiclass share structure domestically and abroad, the lack of enforceability for regulations on share structures, and adequate existing protections for investors who otherwise desire the ability to invest in multiclass firms.

As the ISS and IRRC note, in recent years, there has been an increasing trend domestically toward use of a dual or multiclass share structure.[93] In particular, technology companies like Square, Alibaba, and Facebook have leveraged the use of the dual class share structure. It is doubtful that a restriction on the listing of multiple classes of shares would encourage such companies to adopt a single class structure; instead, similar to the flight away from the NYSE in 1940 after it banned the dual class structure, companies would simply list on other exchanges, even if they had to go abroad.[94] Manchester United, the quintessential British football club, opted to avoid listing on its natural home, the London Stock Exchange, due to such a prohibition.[95] Following grumbling about the loss of

93. *See* IRRC Inst. & ISS, *supra* note 35, at 3.

94. The recent case of Alibaba is instructive, as the company opted to list on the NYSE instead of the Hong Kong Stock Exchange due to Hong Kong's ban on multiclass structures. *See* The Economist, *supra* note 38.

95. Manchester United proved to be extremely opportunistic in order to take advantage of disparities in listing regulations. After forgoing the London Stock Exchange due to its ban on dual class share structures and initially moving the IPO to Singapore, it also abandoned Singapore when it

massive amounts of business, some exchanges, including the Hong Kong Stock Exchange—albeit unsuccessfully— have shown signs of backtracking on the ban on dual class structures.[96] Therefore, banning dual class shares seems to amount to a collective action problem; even if the NYSE or NASDAQ would prefer to not list dual class shares, they will continue to do so as long as companies can simply list their dual class shares on another exchange. An effective ban would require all major international exchanges to come to an enforceable agreement to ban multiclass share firms. Given the amount of money that they have generated for exchanges like the NYSE, particularly through poaching dual class IPOs such as AliBaba and Manchester United, this is unlikely to happen.

The lack of regulatory methods to force American exchanges to ban dual class shares is also a critical reason why such a ban could not work. As previously noted, the SEC had attempted to regulate and discourage the listing of dual class shares through Rule 19c-4, promulgated in 1988. The D.C. Circuit invalidated this rule in 1990 and found that the SEC had exceeded the statutory authority delegated to it by Congress. Professor Stephen Bainbridge of the UCLA School of Law and other knowledgeable commentators have agreed with the decision, and there have been no significant efforts by the SEC to regulate dual class firm structures in the following years.[97] It seems that, for the time being, the only legal protections offered against dual class firms guard minority shareholders against founder overreach through cases such as *In re Delphi* and *Levco*.

Finally, asking the exchanges to ban dual class share structures to protect investors begs the question: do investors actually need additional protection? Although the ISS labels the

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became clear that the country's regulators were dragging their feet to approve the IPO. Manchester United finally landed on the same safe ground for dual class listings that so many other companies have found, the New York Stock Exchange. *See* Steven Davidoff Solomon, *In Manchester United's I.P.O., a Preference for American Rules*, N.Y. TIMES DEALBOOK (Jul. 10, 2012, 2:32 PM), http://dealbook.nytimes.com/2012/07/10/in-manchester-united-s-i-p-o-a-preference-for-u-s-rules/?_r=0.

96. *See* Jennifer Hughes & Josh Noble, *Hong Kong Exchange Gives up on Dual-Class Share Plan*, FIN. TIMES (Oct. 5, 2015), http://www.ft.com/intl/cms/s/0/0bc597ee-6b42-11e5-aca9-d87542bf8673.html#axzz47WfbHVJ0.

97. *See* Bainbridge, *supra* note 29, at 567.

listing of dual class shares as a sort of Hobson's choice where investors must either accept governance structures which diminish shareholder rights or risk missing out on the hottest business models of the day, this argument is disingenuous.[98] Investors cannot liken missing out on a hot IPO to having a gun to their head forcing them to purchase shares; indeed, institutional and sophisticated investors like those that the ISS represents should be the very ones that do not buy into the mania and frenzy of high-profile IPOs if they judge something is amiss with the underlying company's governance model. Secondly, as this Note discusses in Section II.C, there is a wealth of data and studies available on the effects of a dual class structure on corporate governance and performance. Under an efficient markets hypothesis, all of this information should be accounted for when investors decide the price at which they seek to purchase a stock. If indeed a dual class structure is less desirable, that does not inevitably lead to the conclusion that we must ban the structure but rather that the stock price should receive a corresponding discount in the market. Finally, if an investor feels that management is extracting private benefits from its shares at the expense of holders of inferior voting shares, the ultimate market check is still available: it may sell their shares at any time.

B. *A Path Forward*

Given that it is both impractical and perhaps undesirable to attempt a ban on dual class shares, how can the exchanges and investors proceed in an optimal fashion? By revoking board independence exceptions, creating and enforcing corporate charter requirements, and continuing to ensure adequate information through disclosures, investors will feel protected and secure in the brave new world of dual class share listings.

The most obvious and commonsense reform that both the NYSE and NASDAQ can make in order to bolster corporate governance at dual class firms is to eliminate the controlled company exemptions that exist on both exchanges. On the NYSE, for example, a listed company where greater than fifty percent of the voting power is held by an individual is exempt from the requirements of an independent board, an

98. *See* ISS, *supra* note 67, at 1.

independent compensation committee, and any sort of nomination or corporate governance committee.[99] The NASDAQ joins the NYSE in all of these exemptions with the exception of waiving the need for a corporate governance committee.[100] It is difficult to fathom why controlled companies, which arguably would have the greatest need for independent board supervision in order to protect minority shareholders, are exempt from these requirements. No such explanation can be found in either the NYSE or NASDAQ rules. Eliminating these exemptions would go far in assuring investors that, once their capital has been invested in a CS firm, it will be protected by a board that is independent from the founders. As discussed by Sanjai Bhagat and Bernard Black,[101] stronger independent board oversight may not lead directly to stronger financial performance, but it will in any case help counter the arguments of corporate governance critics.

The second recommendation of this Note is that the exchanges require basic protections be built into the charters of companies that choose to list with a dual class structure. As noted in Section II.B.3, many companies have voluntarily adopted measures such as sunset provisions that phase out dual class shares over time. These measures can lead to a more optimal balance between the need to protect a founder's long-term vision and the need to assure investors of proper long-term corporate governance. Advocates of the dual class structure may contend that a CMS structure is necessary to protect a founder's long-term focus, but that argument holds true mainly while the company in question is in a high-growth and more volatile stage. After ten or twenty years, if a company survives intact, it is likely to be a stable company that does not require protection for a founder's vision. The argument for dual class shares is significantly undermined when one considers a longer time horizon, and consequently sunset provisions are an excellent solution to balance the competing needs of

99. *See* New York Stock Exchange, NYSE Manual Section 3: Corporate Responsibility. . The rules implicated here are 303A.01 (the exemption from needing a majority of independent directors), 303A.04 (exemption from needing a nominating and corporate governance committee), and 303A.05 (exemption from needing an independent compensation committee).

100. *See* NASDAQ, *supra* note 57.

101. *See* Bhagat & Black, *supra* note 55, at 233.

founders, who tend to think long-term, and investors, who generally want optimal short- and medium-term stock performance. By requiring this and other protections, such as restrictions on transfer of voting power and preventing premiums for the sale of high-voting shares, the NYSE and NASDAQ can go a long way toward keeping dual class shares but limiting the harm that investors fear, or keeping the baby while throwing out the bathwater.

One may rightly ask why exchanges should require even these relatively minimal protections: why not allow the markets to continue evolving such provisions organically and appropriately price the resulting governance structures? Although this is a compelling point that, at the very least, questions the validity of imposing uniform charter protections on a diverse array of companies, mandated basic charter protections serve two beneficial purposes. First, they would impose a uniformity that is currently lacking with the present patchwork of charter protections. It is much more difficult for investors to appropriately correct the market price of a particular structure when it is entirely unique with no analog for comparison. Instead, if a basic floor is set on all dual class listings, investors will have a more robust data set upon which to rely and a better chance of accurately pricing listings without having to compare the usefulness of, for example, a fifteen-year sunset provision with a high-voting share transfer restriction. Secondly, implementing this recommendation would also enable a discussion toward finding a reasonable baseline boundary of protection for minority voting shareholders. Dual class companies that choose to go above and beyond this baseline may be rewarded with a higher listing price should the market feel that it is warranted. Additionally, the feeling of having a Hobson's choice dilemma will be alleviated somewhat since investors will know that there is at least some sort of governance concession that dual class companies have agreed upon as useful to the investor and not harmful to the company or founder.

Finally, the efficient markets hypothesis and investor protection only work when the relevant information is disclosed and easy to find. Therefore, the exchanges and the SEC, to the extent they are able, should continue to make corporate governance structures easy to identify and evaluate. In fact, this is one area in which having dual class firms is actually significantly more desirable than other CMS types, such as pyramid

or cross-holding structures, which are infinitely more complicated and essentially impossible to fully comprehend due to their intricacies.[102] Currently, the exchanges require that any firm relying on a controlled company exemption disclose this fact on its annual proxy statement, but the rules should require a clear disclosure of any firm utilizing a dual class structure whether or not it relies on this exemption. Although some firms like Google have laudably been crystal clear in their proxy statements about governance structure, such disclosure should be required of all CMS firms. If disclosure is adequate, proper protections are built into company charters, and board independence exemptions are eliminated, sophisticated investors and the public should be able to inform and protect themselves against any abuse or overreach from owners of superior voting shares.

Conclusion

Banning dual class share structures from the NYSE and NASDAQ is even less practical now than it was when the NYSE first implemented its ill-advised prohibition in 1940. Where there is a will to implement a CMS governance structure, there is a way, whether by listing a dual class share structure in a foreign jurisdiction or creating elaborate pyramid and cross-holding structures. Even if it were a practical possibility, the evidence is conflicted as to whether or not dual class structures detrimentally impact corporate governance and, *a fortiori*, financial performance. Overly bleak and cynical views of the greedy controller expropriating shareholder value have also not generally been corroborated convincingly by the existing literature.

We must therefore come to terms with the brave new world of dual class structures since they are here to stay. Through increased independent board oversight, basic corporate charter protections, and adequate disclosures, investors

102. Telecom Italia is a prime example of a pyramid structure, whereas Samsung utilizes a cross-holding structure, both of which significantly obfuscate where the capital and power lies within each corporate structure. *See generally* Simon Mundy, *South Korea: Sparks Fly over the Chaebol*, Fin. Times (Nov. 2, 2014), https://www.ft.com/content/9d84d488-5f90-11e4-8c27-00144feabdc0 (discussing the intricate and complicated structure of South Korea's chaebol business groups).

can feel sufficiently secure in their investments. We can make peace with a corporate governance structure that, when used properly, can reasonably contribute to an efficient and wealth-optimizing society.