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## COMMENT

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### YOU CAN'T SELL YOUR FIRM AND OWN IT TOO: DISALLOWING DUAL-CLASS STOCK COMPANIES FROM LISTING ON THE SECURITIES EXCHANGES

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## INTRODUCTION

In 2004, Google's initial public offering (IPO) revealed that the company would go public with a dual-class capitalization structure.<sup>1</sup> A dual-class stock company has a capital structure whereby insiders hold common stock with multiple votes per share (typically ten), while the public holds common stock with just one vote per share.<sup>2</sup> This structure was popular in the 1980s as a defensive measure to ensure that a company was protected against hostile takeovers, management would adopt and keep high vote share classes.<sup>3</sup> The NASDAQ Stock Market (NASDAQ) and NYSE MKT LLC<sup>4</sup> have consistently allowed corporations with such structures to list on their exchanges,<sup>5</sup> while the New York Stock Exchange (NYSE) has had different rules over time.<sup>6</sup> In 1988, the Securities and Exchange Commission (SEC) came into the picture and attempted to regulate companies with dual-class stock (and other structures with shareholder voting restrictions) by prohibiting such companies from listing on the stock exchange.<sup>7</sup> However, the Court of Appeals for the District of Columbia subsequently vacated this SEC rule.<sup>8</sup> Today, corporations can list on the NYSE, NASDAQ, or AMEX

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<sup>1</sup> Google Inc., Registration Statement (Form S-1), at iii (Apr. 29, 2004).

<sup>2</sup> Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 687 (1986).

<sup>3</sup> Steven M. Davidoff, *New Share Class Gives Google Founders Tighter Control*, N.Y. TIMES DEALBOOK (Apr. 13, 2012), <http://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control>.

<sup>4</sup> NYSE MKT LLC was originally the American Stock Exchange (AMEX). AMEX was acquired by NYSE Euronext in 2008 and is now rebranded as NYSE MKT LLC. See Press Release, NYSE Euronext, NYSE Euronext to Acquire the American Stock Exchange (Jan. 17, 2008), <http://nyse.com/press/1200568235016.html>; see also Press Release, NYSE Euronext, NYSE Amex LLC to Be Renamed NYSE MKT LLC (May 10, 2012), <http://www.nyse.com/press/1336646911531.html>; Press Release, NYSE Euronext, Rebranding of NYSE Alternext US to NYSE Amex (Mar. 9, 2009), [http://traderupdates.nyse.com/2009/03/rebranding\\_of\\_nyse\\_alternext\\_u.html](http://traderupdates.nyse.com/2009/03/rebranding_of_nyse_alternext_u.html) (explaining that AMEX was renamed NYSE Alternext US LLC after NYSE Euronext's acquisition).

<sup>5</sup> See Seligman, *supra* note 2, at 692 (explaining that while the NASDAQ has considered alternative proposals, it does not currently have an equal voting rights requirement); see also *id.* at 691 (explaining that as long as the common stock is voting, the AMEX may approve its listing even if it only has the right to elect a minority of the board).

<sup>6</sup> See *id.* at 692-93 (discussing the changes to the NYSE rules in the 1980s, and specifically how dual class capitalization became permissible in 1986).

<sup>7</sup> 17 C.F.R. § 240.19c-4(a) (1989) (prohibiting the exchanges from listing, or continuing to list, the securities of any issuer that "issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights" of the issuer's existing stockholders).

<sup>8</sup> See *Bus. Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that the SEC exceeded its authority in promulgating Rule 19c-4).

as long as the dual-class structure was in place at the time of the initial public offering.<sup>9</sup>

Since Google's 2004 IPO, an increasing number of companies have begun to go public with similar capitalization structures.<sup>10</sup> In light of dual-class stock's resurgence, Congress and the stock exchanges should revisit the use of such capitalization structures in the United States. In this Comment, I argue that decoupling voting rights from economic ownership is detrimental to shareholders because it allows companies to avoid the threat of market mechanisms that have traditionally served to keep management in check. In the long term, this decoupling is incompatible with principles of corporate governance, and thus stock exchanges should reevaluate their policy of accepting companies with dual-class stock structures. Part I discusses how the dual-class structure allows management to entrench itself and effectively prevent shareholders from exercising any sort of control over a company they technically own. Part II explains how dual-class stock companies have led to both stock unifications that are detrimental to the general public and controllers extracting benefits for themselves in acquisitions. Finally, Part III discusses how such reforms can be achieved.

## I. WHY DUAL-CLASS STOCK IS DETRIMENTAL TO SHAREHOLDERS

While there are legitimate reasons why dual-class stock can be beneficial for a company and its shareholders, on balance, such structures are undesirable. Management should not be able to enjoy the benefits of controlling a public company while ignoring the voice of its shareholders.

### A. *Dual-Class Stock Companies Have Inadequate Checks on Management*

One of the strongest arguments in support of the dual-class structure is that management can more easily set long-term goals and innovate.<sup>11</sup> The

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<sup>9</sup> See NASDAQ, Inc., NASDAQ Stock Market Rules IM-5640 (2014), available at <http://nasdaq.cchwallstreet.com/NASDAQ/Main> ("Companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this policy."); NYSE Euronext, Inc., NYSE Listed Company Manual § 313.1 (2014) [hereinafter NYSE Manual], available at <http://nysemanual.nyse.com/LCM> (same); NYSE Euronext, Inc., NYSE MKT LLC Company Guide § 122.01 (2014), available at <http://wallstreet.cch.com/AMEX/CompanyGuide> (same).

<sup>10</sup> See, e.g., Facebook, Inc., Registration Statement (Form S-1), at 8 (Feb. 1, 2012); Groupon, Inc., Registration Statement (Form S-1), at 120 (June 2, 2011); LinkedIn Corp., Registration Statement (Form S-1/A), at 116 (Jan. 27, 2011); Zynga Inc., Amended Registration Statement (Form S-1), at 137 (Dec. 9, 2011).

<sup>11</sup> See, e.g., Larry Page & Sergey Brin, *Letter from the Founders*, WALL ST. J. (Apr. 29, 2004), <http://online.wsj.com/news/articles/SB108326432110097510> (explaining that, in implementing its

structure allows “founding entrepreneurs or family members access to the equity markets without diluting control.”<sup>12</sup> For example, at the time Google went public, holders of Class A stock—public shareholders—were entitled to one vote per share;<sup>13</sup> holders of Class B stock—Executive Chairman Eric Schmidt and founders Larry Page and Sergey Brin—were entitled to ten votes per share.<sup>14</sup> This meant that, while the Class B stock comprised only 31.3% of total shares outstanding, Google executives—Schmidt, Page, and Brin—collectively held 66.2% of shareholders’ total voting power.<sup>15</sup> While dual-class proponents may argue that such figures have little effect on governance as long as the company has “terrific management, an engaged board of directors, and a strong governance culture,”<sup>16</sup> this imbalance in voting rights between management and public shareholders eliminates the market checks on managerial misconduct on which shareholders of single-class companies rely.

One of the primary focuses of corporate governance is to monitor possible mismanagement or self-dealing by those in control of the corporation.<sup>17</sup> However, because publicly traded corporations are owned by a large number of widely dispersed shareholders, there is no single shareholder to monitor the corporation. In their oft-cited work, Berle and Means identified this phenomenon as the “[s]eparation of ownership and control.”<sup>18</sup> This collective action problem has led to the traditional conception of corporate governance, whereby the shareholders’ role is to elect the board of directors, which in turn performs the monitoring function and selects the officers (e.g., CEOs and CFOs) who run the corporation.<sup>19</sup>

In a company with dual-class stock, however, the mechanism for board oversight does not function as it should because the CEO—the largest

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dual-class structure, Google “implemented a corporate structure that is designed to protect Google’s ability to innovate”).

<sup>12</sup> Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN’S L. REV. 863, 884 (1994).

<sup>13</sup> Elinor Mills, *Google to Defend Dual-Class Stock Structure*, CNET NEWS (Apr. 12, 2006), [http://news.cnet.com/Google-to-defend-dual-class-stock-structure/2100-1030\\_3-6060691.html](http://news.cnet.com/Google-to-defend-dual-class-stock-structure/2100-1030_3-6060691.html).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> James Kristie, *Dual-Class Stock: Governance at the Edge*, DIRECTORS & BOARDS, Third Quarter 2012, at 40 (summarizing the remarks of David L. Cohen, Executive Vice President of Comcast, a dual-class stock company).

<sup>17</sup> MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 267 (10th ed. 2011).

<sup>18</sup> ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1933).

<sup>19</sup> *See id.* at 86-87.

shareholder—effectively selects the board.<sup>20</sup> If directors can be fired by a single person or family, they will be impeded from exercising the fiduciary duties that they owe to all shareholders.<sup>21</sup> For example, when Google recently approved the issuance of nonvoting stock that further concentrated control in the hands of its founders, the board of directors unanimously approved the measure.<sup>22</sup> Even though the directors met sixteen times to deliberate, “[t]he only likely alternative to voting ‘yes’ would have been to resign and explain why [they] voted ‘no.’ Or they most likely would not have found their names on the board nomination list next year.”<sup>23</sup> When the top directors and the largest shareholders are one and the same, it is unrealistic to expect the board dutifully to make decisions that are beneficial to shareholders as a whole.

Furthermore, when voting rights are not proportional to the economic interests of the shareholders, controllers can easily obtain private benefits while imposing disproportionate costs on the broader shareholder base.<sup>24</sup> However, shareholders are not the only ones disproportionately affected—when these structures lead to less board accountability, the monitoring function of boards will be transferred to third parties (e.g., the courts, the regulators, and the government), and the public will be forced to bear these costs.<sup>25</sup> For example, Reader’s Digest Association (RDA) had a dual-class structure that was controlled by two not-for-profit philanthropic foundations created by its founders.<sup>26</sup> These not-for-profits, driven by a need to fund their own projects, pushed the company toward a policy that eventually led RDA to issue dividends in excess of cash flows.<sup>27</sup> Michael Geltzeiler, who served as the company’s CFO at the time, noted that the interests of the controlling shareholders were not aligned with those of the other shareholders.<sup>28</sup> While investors generally want the board to determine what is in the best interest of all shareholders in order to create the most

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<sup>20</sup> See Kristie, *supra* note 16, at 39 (summarizing the remarks of Geoff Colvin, Senior Editor-at-Large for *Fortune* magazine).

<sup>21</sup> See *id.* at 38 (summarizing the remarks of Ann Yerger, Executive Director of the Council of Institutional Investors).

<sup>22</sup> 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>.

<sup>23</sup> *Id.*

<sup>24</sup> See Kristie, *supra* note 16, at 44 (summarizing the remarks of Vice Chancellor John Noble).

<sup>25</sup> *Id.* at 38 (summarizing the remarks of Charles Elson, Director of the Weinberg Center for Corporate Governance at the University of Delaware).

<sup>26</sup> *Id.* at 42 (summarizing the comments of Michael S. Geltzeiler, Executive Vice President and CFO of NYSE Euronext).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

long-term value, “[t]hat can become more difficult in a dual-class structure if one party views the firm not as the public’s company but as their business, one that they own.”<sup>29</sup>

To further exacerbate the problem of inadequate checks on management, dual-class companies that fall under the definition of a “controlled company” do not have to comply with NYSE governance rules 303A.01, 303A.04, and 303A.05.<sup>30</sup> Rule 303A.01 requires listed companies to have a majority of independent directors on the board,<sup>31</sup> Rule 303A.04 requires listed companies to have nominating and corporate governance committees composed entirely of independent directors,<sup>32</sup> and Rule 303A.05 requires listed companies to have a compensation committee composed entirely of independent directors.<sup>33</sup> Independent directors, a particular focus of corporate-governance reforms post-Enron, ensure that corporate officers do not abuse their authority or shirk their responsibilities.<sup>34</sup> At least in theory, directors’ independence prevents managers from engaging in self-dealing and allows them to objectively oversee managerial decisionmaking.<sup>35</sup> While the exchanges were required to adopt such rules in accordance with the Sarbanes–Oxley Act,<sup>36</sup> companies are exempt from these requirements as long as they qualify as a controlled company—“[a] listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company.”<sup>37</sup> Therefore, even if managers in dual-class stock companies do not have more than a fifty-percent economic interest in the company, by virtue of their voting power, they are entitled to do away with these shareholder safeguards.

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<sup>29</sup> *Id.* at 43.

<sup>30</sup> See NYSE MANUAL, *supra* note 9, § 303A.00 (excepting controlled companies from the requirements of section 303A).

<sup>31</sup> *Id.* § 303A.01.

<sup>32</sup> *Id.* § 303A.04.

<sup>33</sup> *Id.* § 303A.05.

<sup>34</sup> See, e.g., Michael W. Peregrine, *The Independent Director: A Key Sarbanes Legacy*, NYSE, <https://www.boardmember.com/the-independent-director-a-key-sarbanes-legacy.aspx> (last visited Apr. 18, 2014) (noting that Sarbanes–Oxley Act “significantly expanded” the importance of independent directors).

<sup>35</sup> *Id.* (“Effective corporate governance is perceived as a byproduct of attentive, independent board members focused on the best interests of the organization they serve, and its underlying business mission.”).

<sup>36</sup> Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>37</sup> NYSE MANUAL, *supra* note 9, § 303A.00.

### B. Dual-Class Stock Structures Facilitate Managerial Entrenchment

In addition to weakening market mechanisms for management oversight, the dual-class stock structure can also be used to facilitate managerial entrenchment.<sup>38</sup> As Vice Chancellor Noble explains, even though the two structures may seem similar, a company with dual-class stock is different from a company with a large majority shareholder because at least the large shareholder in a single-class company holds a proportionate economic interest.<sup>39</sup> Having a proportionate economic interest is desirable because a market-oriented approach is the optimal way to lower agency costs.<sup>40</sup> For example, if the Efficient Capital Markets Hypothesis<sup>41</sup> holds, a drop in the stock value would signal to shareholders that a company is being poorly managed.<sup>42</sup> Lower share prices may therefore encourage shareholders to mount proxy challenges to replace current management or lead to bids to buy the corporation (which often results in the replacement of the incumbent board of directors). However, in a dual-class company, where the controller's voting power outweighs his economic interest, "[c]oncerns about proxy fights, losing votes at the shareholders' meetings, simply aren't a real consideration."<sup>43</sup> Therefore, by having dual-class shares, management can insulate itself from corporate governance mechanisms, such as the market for corporate control or monitoring by noncontrolling shareholders.<sup>44</sup>

When investors buy common stock in a company with dual-class stock, they are essentially betting on the management of the company to create value,<sup>45</sup> but when the interests of controlling management diverge with shareholder interests, there is not much a shareholder can do. For example, when Groupon's shares fell fifteen percent after its auditor found "material weakness in the company's internal controls," shareholders could not

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<sup>38</sup> See Kristie, *supra* note 16, at 38 (summarizing the remarks of Ann Yerger) ("[D]ual-class stock is created with short-term thinking in mind, because [it] is really about entrenching leaders . . . at the expense of the company's long term.").

<sup>39</sup> Kristie, *supra* note 16, at 44 (summarizing the remarks of Vice Chancellor John Noble).

<sup>40</sup> See generally EISENBERG & COX, *supra* note 17.

<sup>41</sup> The Efficient Capital Markets Hypothesis asserts that investors in the stock market react quickly and efficiently to information, and that only new information will change the value of a company's shares. This hypothesis would suggest that the share price in an efficient market reflects how well a corporation is run. *Id.*

<sup>42</sup> EISENBERG & COX, *supra* note 17, at 59 (citing Richard A. Brealey, Stewart C. Myers, and Franklin Allen, PRINCIPLES OF CORPORATE FINANCE 314, 329-33 (10th ed. 2011)).

<sup>43</sup> Kristie, *supra* note 16, at 44 (summarizing the remarks of Vice Chancellor John Noble).

<sup>44</sup> See Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANTITATIVE ANALYSIS 695, 715 (2003) (analyzing Swedish firms and finding that "firms with [controlling stockholders] are much less likely to be taken over compared to other firms").

<sup>45</sup> See Kristie, *supra* note 16, at 42 (summarizing the remarks of Michael S. Geltzeiler).

demand that the board replace the CFO or CEO (who was a music student just three years prior to assuming his position) since the founders, including the CEO, retained majority voting control.<sup>46</sup> As one commentator put it, once the founders stop being visionaries, or control is passed to another generation of leadership, management “won’t have the kick in the pants that the prospect of pressure from shareholders can provide.”<sup>47</sup> This is why Rupert and James Murdoch, even after being implicated in a criminal investigation for phone-hacking, were able to retain their positions as the heads of News Corp.<sup>48</sup> Despite substantial noncontrolling shares being cast in favor of replacing them on the board of directors, their own votes were enough to secure their positions.<sup>49</sup>

In a dual-class company, shareholder protection is limited to disclosure, common law fiduciary duties imposed on directors, and public pressures such as shaming.<sup>50</sup> Efforts to change the dual-class structure once it is no longer beneficial to shareholders can be futile, because by definition, the shareholders lack the requisite votes to effect such a change. For example, in 1999, when CalPERS attempted to end the dual-class structure at Tyson Foods, its push was “defeated by the Tyson family’s supervote.”<sup>51</sup>

Allowing management to entrench itself is counter to public policy and has been cited as a critical concern in classic corporate law cases such as *Schnell*<sup>52</sup> and *Portnoy*.<sup>53</sup> The fact that dual-class stock structures facilitate managerial entrenchment further suggests that companies with such structures should not be permitted to list on the exchanges.

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<sup>46</sup> Therese Poletti, *IPO Investors: Beware the Dual-Class Stock*, MARKETWATCH (Apr. 5, 2012), [http://articles.marketwatch.com/2012-04-05/commentary/31288299\\_1\\_groupon-stock-brad-keywell-eric-lefkofsky](http://articles.marketwatch.com/2012-04-05/commentary/31288299_1_groupon-stock-brad-keywell-eric-lefkofsky).

<sup>47</sup> Sorkin, *supra* note 22.

<sup>48</sup> See Richard Blackden, *Rupert Murdoch’s Iron Grip on News Corp Dealt a Blow*, 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>.

<sup>49</sup> See *id.*

<sup>50</sup> See Kristie, *supra* note 16, at 44 (summarizing the remarks of Vice Chancellor John Noble).

<sup>51</sup> Bill Mann, *Dual-Class Shares, Second-Class Investors*, MOTLEY FOOL (Apr. 14, 2004), <http://www.fool.com/investing/general/2004/04/14/dualclass-shares-secondclass-investors.aspx>.

<sup>52</sup> See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (finding that management’s attempt to “utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office” was an “inequitable purpose, contrary to established principles of corporate democracy”).

<sup>53</sup> See *Portnoy v. Cryo-Cell Int’l, Inc.*, 940 A.2d 43, 47 (Del. Ch. 2008) (setting aside the results of a contested election after finding that the CEO’s “use . . . of corporate resources and fiduciary authority” was motivated by her desire to keep her corporate office); *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (holding that management’s attempt to “utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office . . . may not be permitted to stand”).

C *Dual-Class Stock Companies Do Not Benefit from  
Institutional Investor Monitoring*

Ownership of a company's stock by institutional investors may push companies to improve their governance mechanisms,<sup>54</sup> thereby benefiting even dispersed shareholders. However, there are signs that many institutional investors are beginning to shift their investments away from companies with dual-class stock. In one study, institutional ownership in dual-class firms was found to be substantially lower than it was in comparable single-class firms.<sup>55</sup> In 2006, Morgan Stanley Investment Management urged the board of the New York Times, a dual-class company controlled primarily by the Ochs-Sulzberger family, to end the company's dual-class structure.<sup>56</sup> In a press release, the investment company noted that, "[w]hile it may have at one time been designed to protect the editorial independence and the integrity of the news franchise, the dual-class voting structure now fosters a lack of accountability to all of the company's shareholders."<sup>57</sup> After its efforts ultimately failed, Morgan Stanley sold its 7.2% stake.<sup>58</sup> Furthermore, in 2012, CalPERS, the largest pension fund in the United States, began to campaign for the removal of dual-class voting structures; it is currently in the process of reevaluating whether to invest in IPOs that use them.<sup>59</sup>

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<sup>54</sup> See, e.g., C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 380 (2010) (finding that "institutional investors are more resourceful and motivated" to achieve favorable litigation outcomes and that "defendant firms with institutional lead plaintiffs experience greater improvement in corporate governance subsequent to the lawsuit filing").

<sup>55</sup> Marcia Millon Cornett & Michael R. Vetsuypens, *Voting Rights and Shareholder Wealth: The Issuance of Limited Voting Common Stock*, 10 MANAGERIAL & DECISION ECON. 175, 186 (1989); Kee H. Chung & Hao Zhang, *Corporate Governance and Institutional Ownership*, 46 J. FIN. & QUANTITATIVE ANALYSIS 247, 270 (2011) (hypothesizing that, in the 1990s, "institutional investors might have voted with their feet by selling shares of firms with poor governance and buying shares of companies with good corporate governance").

<sup>56</sup> *Morgan Stanley Challenges N.Y. Times Ownership Structure*, USA TODAY (Nov. 8, 2006), [http://usatoday30.usatoday.com/money/media/2006-11-08-ny-times-ownership\\_x.htm?csp=34](http://usatoday30.usatoday.com/money/media/2006-11-08-ny-times-ownership_x.htm?csp=34).

<sup>57</sup> Press Release, Morgan Stanley Inv. Mgmt. Ltd., Calls for Elimination of Dual-Class Capital Structure to Enable All Shareholders to Hold Board of Directors and Management Accountable for Company's Performance (Apr. 18, 2006), available at <http://www.businesswire.com/news/home/20060418005896/en/MSIMs-Global-Franchise-Investment-Program-Announces-Withhold>.

<sup>58</sup> See Louis Hau, *Two-Tier Ownership Prevails*, FORBES (Oct. 17, 2007), [http://www.forbes.com/2007/10/17/nyt-morgan-sale-biz-media-cx\\_lh\\_1017biznyt.html](http://www.forbes.com/2007/10/17/nyt-morgan-sale-biz-media-cx_lh_1017biznyt.html).

<sup>59</sup> See Shanny Basar, *CalPERS Sets Sights on Dual-Class Stock Structures*, WALL ST. J. (Aug. 20, 2012), <http://online.wsj.com/article/SB10000872396390443855804577601271252759472.html> (reporting that CalPERS "is threatening to boycott any stock-market listing that allows minority shareholders to control a majority of the votes through multitier share structures").

The departure of large institutional investors from companies with dual-class stock may be especially detrimental since those investors play a large role in overseeing management and overcoming the collective action problem that results from an otherwise dispersed group of shareholders. In the past, shareholders who were dissatisfied with their investment would sell their shares rather than try to influence corporate behavior (the “Wall Street Rule”).<sup>60</sup> However, the modern trend is for these institutional investors to become more active in the corporations whose shares they own.<sup>61</sup> Institutional investors seek to influence corporate decisions by using their voting power, meeting with managers, and exerting pressure for change on independent directors.<sup>62</sup> For example, one study found that institutional investors were instrumental in defending the public’s interest in unifications of dual-class stock; they helped lower the compensation that majority shareholders were able to extract from the company for their vote loss.<sup>63</sup>

#### D. Pricing of Dual-Class Stock

Proponents of the dual-class structure further argue that such structures are not detrimental because only those who invest in dual-class stock companies could potentially be harmed.<sup>64</sup> They assert that, because the dual-class structure is disclosed when a company goes public, the limited rights associated with the stock will be reflected in its IPO price, which will be discounted accordingly.<sup>65</sup> Moreover, proponents argue that investors should price the cost of having fewer voting rights when determining

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<sup>60</sup> See EISENBERG & COX, *supra* note 17, at 304 (“[U]ntil twenty to thirty years ago, the role of shareholders in publicly held corporations was largely one of extreme passivity.”).

<sup>61</sup> See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 828-29 (1992) (discussing the rise in institutional activism, including placing institutional representatives on corporate boards).

<sup>62</sup> See EISENBERG & COX, *supra* note 17, at 304-05 (noting the various forms that shareholder activism can take).

<sup>63</sup> Shmuel Hauser & Beni Lauterbach, *The Value of Voting Rights to Majority Shareholders: Evidence from Dual-Class Stock Unifications*, 17 REV. FIN. STUD. 1167, 1183 (2004); see also *infra* Section II.A.

<sup>64</sup> See Kristie, *supra* note 16, at 37-38 (summarizing the remarks of Charles Elson, Director of the Weinberg Center for Corporate Governance at the University of Delaware).

<sup>65</sup> See Ashton, *supra* note 12, at 868 (explaining that “in an IPO[,] the purchasing shareholder suffers no real economic loss” because “the value of the vote will be discounted and reflected in the price on which the buyer and seller have agreed”). For example, when Google went public with the structure in 2004, it contained an explicit warning in its filing documents regarding the structure. Kristie, *supra* note 16, at 38.

whether or not to buy into the IPO; if they do not like the bargain, they can always choose not to invest.<sup>66</sup>

However, while investors, in theory, can always choose not to participate in an IPO, other factors may induce them to make an otherwise irrational choice. For example, as Institutional Shareholder Services points out, Facebook's recent IPO presented a "Hobson's choice"<sup>67</sup>: investors either had to accept Facebook's governance structure—which included dual-class stock and other provisions that "diminish[ed] shareholder rights and board accountability"—or otherwise miss out on what at the time seemed like "one of the hottest business models of the internet age."<sup>68</sup> The Facebook scenario is not uncommon: Scott Goebel of Fidelity revealed that, while Fidelity generally opposes the adoption of dual-class structures, it "nevertheless regularly invest[s] in dual-class companies" because they might, for example, have compelling businesses.<sup>69</sup> Similarly, when LinkedIn went public with a variety of mechanisms that would leave control largely in the hands of its founder, one observer noted that it was doing so likely because "it [could] get away with it, particularly since [it would] be a hot I.P.O." and institutional investors who typically buy at the IPO stage plan to flip their shares anyway.<sup>70</sup>

Moreover, the proponents' argument that investors are only getting what they voluntarily bargained for is undermined by the possibility that these stocks are not properly discounted at the time of the IPO. While underwriters serve the function of gatekeepers in evaluating whether an IPO is appropriate for the public market, their gatekeeping function has grown weak in recent years.<sup>71</sup> Banks have become "captive[s] of the issuers," and can dilute any reputational losses from underwriting poor stock by sharing the burden with multiple banks.<sup>72</sup>

To make matters worse, underwriters may work with issuers to obscure investors' access to relevant information. For example, eleven days prior to

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<sup>66</sup> *See id.*

<sup>67</sup> INSTITUTIONAL S'HOLDER SERVS., THE TRAGEDY OF THE DUAL CLASS COMMONS 1 (Feb. 13, 2012), available at <http://online.wsj.com/public/resources/documents/facebook0214.pdf>.

<sup>68</sup> *Id.*

<sup>69</sup> *See* Kristie, *supra* note 16, at 39-40 (summarizing the remarks of Scott Goebel, Senior Vice President and General Counsel of Fidelity Management & Research Co.).

<sup>70</sup> Steven M. Davidoff, *Plans for LinkedIn's I.P.O. May Make Few Friends*, N.Y. TIMES DEALBOOK (May 10, 2011), <http://dealbook.nytimes.com/2011/05/10/plans-for-linkedins-i-p-o-may-make-few-friends>.

<sup>71</sup> *See* Steven M. Davidoff, *After Years Without Change, Cracks Appear in I.P.O. Process*, N.Y. TIMES DEALBOOK (June 14, 2011), <http://dealbook.nytimes.com/2011/06/14/after-years-without-change-cracks-appear-in-i-p-o-process>.

<sup>72</sup> *Id.*

the launch of Facebook's IPO, Facebook discovered that its revenue growth was not as high as it expected.<sup>73</sup> To deal with the "nearly unprecedented last-minute correction" in its revenue projections,<sup>74</sup> Facebook and its lead underwriter, Morgan Stanley, decided to do two things: (1) file an amendment to its registration statement; and (2) "call research analysts with much more specific information about the company's weakening projections."<sup>75</sup> This new information regarding revenue growth was embedded on three pages of a 170-page document and was worded in such a way that "[e]ven the most sophisticated retail investors, armed with a software bot that could comb the new [registration statement] for updates, could not have read what research analysts at [various investment banks] would learn later that evening: That Facebook . . . was slashing its annual projections."<sup>76</sup> Facebook's Vice President of Finance also made calls to research desks at Morgan Stanley, JP Morgan, and Goldman Sachs, causing each bank to lower their estimates of Facebook's annual revenue by 3.01% to 3.33%.<sup>77</sup> The upshot of all this was that institutional investors acted on the slashed revenue projections—many made "huge profits betting against the company" while "others avoided major losses by backing out of the IPO just in time"<sup>78</sup>—while individual investors, left in the dark, saw Facebook's value plummet, taking their investments with it.<sup>79</sup>

Given the potentially widened investor base from these "hot" IPOs,<sup>80</sup> one is forced to question whether shareholders and investors truly have the ability to accurately assess the value of a dual-class stock at the time of the IPO. It is likely that many investors make their purchase decisions in order to avoid losing out on a widely hyped opportunity. Simultaneously, companies may be opportunistically exploiting this hot demand to force investors

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<sup>73</sup> Khadeeja Safdar, *Facebook, One Year Later: What Really Happened in the Biggest IPO Flop Ever*, ATLANTIC (May 20, 2013), <http://www.theatlantic.com/business/archive/2013/05/facebook-one-year-later-what-really-happened-in-the-biggest-ipo-flop-ever/275987>

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* (telling the story of one woman who used her late husband's 401(k) retirement account to invest in Facebook stock and lost \$36,000 by the second day of trading); *see also, e.g., In re Facebook, Inc., IPO Sec. & Derivative Litig.*, 288 F.R.D. 26, 30 & n.2 (S.D.N.Y. 2012) (consolidating nearly thirty securities actions against Facebook in connection with its IPO).

<sup>80</sup> *See* Michael Giles, *Facebook IPO Will Bring a Whole New Generation to the Stock Market*, HUFFINGTON POST (Mar. 6, 2012), [http://www.huffingtonpost.com/michael-giles/facebook-ipo\\_b\\_1290659.html](http://www.huffingtonpost.com/michael-giles/facebook-ipo_b_1290659.html) ("[W]ith over 850 million active users around the world, Facebook's IPO will reignite interest in the stock market for young adults who had previously abandoned investing . . . [and] will encourage a whole new generation to start investing for the first time . . .").

to buy shares in a company with a capital structure they might otherwise avoid. Such behavior will harm shareholders in the long run.

E. *Companies Are Turning to the United States for Its Soft Regulation*

Another reason that the exchanges should reevaluate their policy on allowing the listing of dual-class stock companies is the fact that dual-class stock companies are now turning to the United States to launch their IPOs. For example, in 2012, Manchester United, the English soccer team, filed to go public in the United States with a dual-class structure.<sup>81</sup> Its decision was driven by the fact that the London Stock Exchange does not allow dual-class structures, and the Hong Kong Stock Exchange “would not give the team a waiver to allow two classes of shares, with different voting rights.”<sup>82</sup> Moreover, because the team benefited from the Jumpstart Our Business Startups (JOBS) Act,<sup>83</sup> it did not face the same hurdles as many U.S. businesses do when filing for an IPO. The JOBS Act lessens the regulatory and reporting requirements for IPOs of “emerging growth companies,” defined as companies with annual gross revenues of less than one billion dollars during the most recent fiscal year.<sup>84</sup> In addition to allowing for private submission of IPO registration statements,<sup>85</sup> emerging growth companies are exempt from, among other things, the internal controls audit required by Sarbanes–Oxley Section 404(b),<sup>86</sup> and the requirement to hold shareholder advisory votes and disclose information on executive compensation that would otherwise be required of a public company.<sup>87</sup> An emerging growth company can benefit from these loosened restrictions until the first fiscal year in which its revenues exceed one billion dollars, or the first fiscal year after the fifth year following its IPO.<sup>88</sup>

Moreover, because Manchester United also qualified as a “foreign private issuer” under Rule 405 of the Securities Act, it was able to avail itself of additional loosened restrictions.<sup>89</sup> For example, while foreign private

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<sup>81</sup> Steven M. Davidoff, *In Manchester United's I.P.O., a Preference for American Rules*, N.Y. TIMES DEALBOOK (July 10, 2012), <http://dealbook.nytimes.com/2012/07/10/in-manchester-uniteds-i-p-o-a-preference-for-u-s-rules>.

<sup>82</sup> *Id.*

<sup>83</sup> Pub. L. No. 112-106, 126 Stat. 306 (2012).

<sup>84</sup> *Id.* § 101.

<sup>85</sup> *Id.* § 106(a).

<sup>86</sup> *Id.* § 103.

<sup>87</sup> *Id.* § 102(a).

<sup>88</sup> *Id.* § 101.

<sup>89</sup> See 17 C.F.R. § 230.405 (2013) (“Once an issuer qualifies as a foreign private issuer, it will immediately be able to use the forms and rules designated for foreign private issuers until it fails to qualify for this status . . .”).

issuers must still file annual reports with the SEC, they are not required to provide, among other things, quarterly financial information (Form 10-Q for domestic companies) or proxy solicitation materials (Schedule 14A or 14C for domestic companies).<sup>90</sup>

Other companies are following in Manchester United's footsteps. According to *The Wall Street Journal*, eight out of nine Chinese companies that went public in the United States in 2013 adopted a structure whereby "insiders have influence beyond their economic stakes"; in March of 2014, Chinese e-commerce giant Alibaba and China's version of Twitter, Weibo, both announced plans to file for U.S. IPOs.<sup>91</sup> Alibaba was initially set to launch its IPO on the Hong Kong Stock Exchange but changed its mind when the Hong Kong authorities would not allow it to use a structure that allows leading executives to nominate a majority of board directors.<sup>92</sup> On one hand, attracting new companies to list in the United States could bring potential economic benefits. On the other hand, however, we should be wary of the potentially disastrous consequences of welcoming companies that are listing in the United States solely to avoid their home countries' regulations or to avoid having to disclose information to investors.

Other countries have already made the move toward eliminating dual-class structures on exchanges. Countries such as South Korea, India, and Russia now only allow a one-vote, one-share structure.<sup>93</sup> Moreover, in Western European countries where dual-class structures are permitted, certain rules seek to minimize the effect of differential voting rights.<sup>94</sup> For example, in Sweden, the government established a maximum voting disparity of ten to one and implemented protections for noncontrolling shareholders, such as "membership on the board nominations committee for

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<sup>90</sup> See Nilene R. Evans, Thomas A. Humphreys & Neeraj Kumar, *Frequently Asked Questions About Foreign Private Issuers*, MORRISON & FOERSTER LLP 4, 12 (2013), <http://www.mofo.com/files/Uploads/Images/100521FAQForeignPrivate.pdf>.

<sup>91</sup> Liz Hoffman & Telis Demos, *Easier Rules Lure Foreign Firms to List in U.S.*, WALL ST. J. (Mar. 21, 2014), <http://online.wsj.com/news/articles/SB10001424052702304026304579449702968537802> (explaining that "looser corporate-governance standards are luring foreign companies to U.S. markets" and that companies, such as Weibo, will qualify as foreign-private issuers).

<sup>92</sup> Paul J. Davies & Arash Massoudi, *Alibaba Abandons \$60bn Hong Kong Listing*, FIN. TIMES (Sept. 25, 2013), <http://www.ft.com/intl/cms/s/0/525f4bc2-25ae-11e3-ae88-001444feab7de.html#axzz2ynM4VOw8> (noting that corporate governance experts in Hong Kong supported the Exchange's decision and characterized Alibaba's efforts as an attempt to "bully" the Exchange away from the "tradition of one share, one vote").

<sup>93</sup> Simon C.Y. Wong, *Google's Stock-Split Plan Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. BLOG (Apr. 18, 2012), [http://blogs.hbr.org/cs/2012/04/googles\\_stock-split\\_plan\\_would.html](http://blogs.hbr.org/cs/2012/04/googles_stock-split_plan_would.html).

<sup>94</sup> *Id.* ("In recent years, the trend globally has been to eliminate or reduce the severity of multiple share classes in order to loosen the grip of dominant shareholders.")

a firm's top 3-4 shareholders and a 90% shareholder-approval threshold (by economic interests) for any proposal to issue equity to executives and related parties."<sup>95</sup> It is time for the United States to follow these countries in disallowing dual-class structures on the stock exchanges.

#### F. *Dual-Class Stock Structures Are Unnecessary*

Dual-class stock structures exacerbate potential agency problems in companies that have already incorporated sufficient antitakeover mechanisms. For example, LinkedIn drew criticisms that it had the potential to turn into a "corporate governance nightmare" when it went public with a dual-class structure, bylaw notice provisions intended to discourage shareholder activism, and a staggered board.<sup>96</sup> Further, its charter specifies that the staggered board can only be repealed by an eighty-percent shareholder vote—an "almost impossible threshold" given that charter amendments must be proposed by the board, which would have little incentive to amend this rule.<sup>97</sup> Given these antitakeover protections, the dual-class structure, whereby the controlling shareholders have ten-to-one voting power, was unnecessary.<sup>98</sup> In this case, public shareholders had less than one percent of the voting power in LinkedIn after the IPO, while cofounder and Chairman, Reid Hoffman, controlled the company with three venture capital shareholders.<sup>99</sup>

Similarly, Facebook's charter provisions are more than sufficient to protect the company from hostile takeovers without the dual-class structure. Facebook has a staggered board, a "blank check" provision that can be used to put in a poison pill and a provision that prohibits action by shareholder consent without a meeting.<sup>100</sup> In contrast, Facebook CEO Mark Zuckerberg can take action as a shareholder without any stockholder meeting or prior notice,<sup>101</sup> and he can designate his successor in the event he still controls the

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<sup>95</sup> *Id.*

<sup>96</sup> Steven M. Davidoff, *A Deeper Look at LinkedIn's Structure*, N.Y. TIMES DEALBOOK (May 12, 2011), <http://dealbook.nytimes.com/2011/05/12/a-deeper-look-at-linkedins-structure>.

<sup>97</sup> *Id.* Staggered boards are "powerful antitakeover device[s] because it [would take] two years to replace a majority of the board." *Id.*

<sup>98</sup> Steven M. Davidoff, *Plans for LinkedIn's I.P.O. May Make Few Friends*, N.Y. TIMES DEALBOOK (May 10, 2011), <http://dealbook.nytimes.com/2011/05/10/plans-for-linkedins-i-p-o-may-make-few-friends>.

<sup>99</sup> *Id.*

<sup>100</sup> Ronald Barusch, *At Facebook, Governance = Zuckerberg*, WALL ST. J. (Feb. 1, 2012), <http://blogs.wsj.com/deals/2012/02/01/at-facebook-governance-zuckerberg>.

<sup>101</sup> *Id.*

company at the time of his death.<sup>102</sup> Finally, when gaming company Zynga went public, it created an unprecedented three-tier stock structure whereby the CEO would have shares with seventy times the voting power of public investors.<sup>103</sup> All of these companies already have sufficient takeover protection without having to resort to the dual-class stock structure.

*G. Dual-Class Stock Companies Have Continued to  
Decouple Voting and Economic Power*

Companies have now begun to take further advantage of the dual-class structure to increase their control. In 2012, Google's cofounders announced that the company would create a class of nonvoting shares that would be issued as a part of employee stock incentive plans, acquisitions, and other stock sales.<sup>104</sup> The reaction to the announcement was generally unfavorable,<sup>105</sup> yet there is little that shareholders can do to effect change in this policy.<sup>106</sup> This issuance of stock would further concentrate ownership of the company in Executive Chairman Schmidt, and cofounders Page and Brin.<sup>107</sup> Given the wave of dual-class IPOs that followed Google after its IPO in 2004,<sup>108</sup> it may only be a matter of time before other companies also begin to utilize such measures to further cement their control.

## II. UNIFICATIONS AND ACQUISITIONS

Experiences of companies that have had dual-class structures are particularly illustrative of why such structures can be detrimental to shareholders'

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<sup>102</sup> Douglas MacMillan, *Zuckerberg Controlling 57% of Facebook Seen as Risk to Investors*, BLOOMBERG BUSINESSWEEK (Feb. 2, 2012), <http://www.businessweek.com/technology/zuckerberg-controlling-57-of-facebook-seen-as-risk-to-investors-02022012.html>.

<sup>103</sup> *Id.* Zynga's other antitakeover provisions included noncumulative voting rights, which would allow stockholders with a majority of the voting power to elect the Company's entire board of directors. *Id.*

<sup>104</sup> Steven M. Davidoff, *New Share Class Gives Google Founders Tighter Control*, N.Y. TIMES DEALBOOK (Apr. 13, 2012), <http://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control>.

<sup>105</sup> See, e.g., Sorkin, *supra* note 22 ("[T]he entire point of the stock split was to solidify the founders' control of the company by diminishing the future voting power of the shareholders."); Brian Womack, *Google Stock Plan Irks Governance Watchdogs*, BLOOMBERG BUSINESSWEEK (Apr. 13, 2012), <http://www.businessweek.com/news/2012-04-13/google-stock-plan-irks-governance-watchdogs> (noting that Google's stock declined 4.1% following the announcement).

<sup>106</sup> See Womack, *supra* note 105 (suggesting that shareholders have limited power in Google's decisionmaking and proposing that the real solution to their discontent is to sell their shares).

<sup>107</sup> See *id.*

<sup>108</sup> James Surowiecki, *Unequal Shares*, NEW YORKER (May 28, 2012), [http://www.newyorker.com/talk/financial/2012/05/28/120528ta\\_talk\\_surowiecki](http://www.newyorker.com/talk/financial/2012/05/28/120528ta_talk_surowiecki) (recognizing LinkedIn, Groupon, Yelp, and Zynga as examples of technology companies that adopted dual-class structures after Google).

interests. In this Part, I discuss the effect of the dual-class stock structure in two contexts—stock unifications and acquisitions.

### A. Unifications

When companies with dual-class stock fail or are underperforming, investors might call for the company to unify its two classes of stock.<sup>109</sup> In fact, a shareholder proposal for a recapitalization plan that gives one vote per share of all outstanding stock is already on the agenda for Facebook's second annual meeting.<sup>110</sup> Those who support the dual-class stock structure argue that the structure does not have permanent implications on the governance of a firm and can easily be changed; however, when management does in fact decide to end the dual-class stock structure and unify the two classes into one single stock, it can be against the public shareholders' interests, and is often anything but easy.

For example, RDA, which went public in 1990 with dual-class shares, decided to unwind the dual-class structure in 2002.<sup>111</sup> The company initially proposed paying \$100 million to the trust funds that owned the Class B supervoting stock in exchange for converting to the newly issued common stock at one vote per share.<sup>112</sup> This decision was controversial and eventually led to litigation in the Delaware Supreme Court.<sup>113</sup> The Court held that the Special Committee in charge of the recapitalization process only considered the fairness of the payment to RDA as a whole, but not the specific impact on the Class A shareholders who would also hold the single-vote common

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<sup>109</sup> For example, in 2006, Bricklayers & Trowel Trades International Pension Fund informed Google that it would submit a shareholder proposal urging shareholders to adopt a recapitalization plan. Mills, *supra* note 13. Similarly, Comcast faced such calls from investors to eliminate its dual-class stock structure. See *Investor Calls for Ouster of Comcast Chief*, N.Y. TIMES DEALBOOK (Jan. 18, 2008), <http://dealbook.nytimes.com/2008/01/18/investor-calls-for-ouster-of-comcast-chief> (noting shareholder proposals opposing Comcast's supervoting structure which allowed the chief executive's family to have thirty-three-percent voting power with only a one-percent economic stake). For a discussion of the New York Times shareholder proposal to end its dual-class structure, see *supra* notes 56-58 and accompanying text.

<sup>110</sup> Jennifer Van Grove, *At Annual Meeting, Facebook Stockholders to Propose Changes*, CNET NEWS (Mar. 31, 2014), <http://www.cnet.com/news/at-annual-meeting-facebook-stockholders-to-propose-changes/>; see also Pamela Park, *Corporate Governance Watch: Recent No-Action Letters Show Continued Focus on Dual-Class Structures*, BUS. L. CURRENTS, Dec. 30, 2013, available at 2013 WLNR 32554846 (describing shareholder attempts to call for recapitalization plans at various corporations).

<sup>111</sup> Kristie, *supra* note 16, at 42 (summarizing the comments of Michael S. Geltzeiler).

<sup>112</sup> See *Levco Alt. Fund Ltd. v. Reader's Digest Ass'n*, No. 466,2002, 2002 WL 1859064, at \*1 (Del. Aug. 13, 2002).

<sup>113</sup> See *id.*

stock after the recapitalization.<sup>114</sup> As a result of the Court's ruling, the original recapitalization plan was terminated and a new agreement was negotiated.<sup>115</sup> Ultimately, the Class B stockholders received \$100 million in the process, as in the original plan, and Class B stock was exchanged at a ratio of 1.22 shares of Class B stock to one share of common stock.<sup>116</sup>

Similarly, Frank Stronach of Canadian company Magna International was severely criticized for obtaining fifty-two million dollars in consulting fees and six million dollars from stock options in compensation, even though Magna's stock price had fallen thirty percent in the previous year.<sup>117</sup> When Magna eventually decided to end its dual-class structure, Stronach managed to extract nearly one billion dollars (an 1800% premium) from the company in exchange for giving up control.<sup>118</sup>

Finally, when restaurant chain Benihana's dual-class structure led to half a decade of proxy contests and boardroom struggles,<sup>119</sup> the board proposed a restructuring that would collapse both classes of stock into a single class at a one-for-one exchange ratio.<sup>120</sup> The proposal effectively eliminated the market premium of the common stock, which had carried with it voting control, and transferred value from the common shareholders to the Class A common shareholders.<sup>121</sup>

Announcements for unifications are generally met with higher stock prices, signaling that the market believes that such unifications are beneficial to shareholders in the long run. However, as these examples show, in the short term, public shareholders are forced to finance that unification with costly litigation and excessively large premiums.

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<sup>114</sup> *Id.* at \*2-3.

<sup>115</sup> See *Reader's Digest Completes Recapitalization to One Share-One Vote Structure*, PR NEWSWIRE (Dec. 13, 2002), <http://www.thefreelibrary.com/Reader's+Digest+Completes+Recapitalization+to+One+Share-One+Vote...-a0132148779> (discussing the terms of the new October 15th recapitalization agreement).

<sup>116</sup> *Id.*

<sup>117</sup> Michel Magnan & Samer Khalil, *Dual-Class Shares: Governance, Risks, and Rewards*, IVEY BUS. J. (May-June 2007), available at <http://iveybusinessjournal.com/topics/leadership/dual-class-shares-governance-risks-and-rewards>.

<sup>118</sup> *Court Approves Magna Payment to Stronach*, N.Y. TIMES DEALBOOK (Aug. 18, 2010), <http://dealbook.nytimes.com/2010/08/18/magna-payment-to-stronach-approved>; see also INSTITUTIONAL S'HOLDER SERVS., *supra* note 67, at 3.

<sup>119</sup> Benihana's capitalization structure was rather unique because the Class A common shares, with one-tenth vote per share, were mostly owned by the company's directors, executives, and large minority shareholders. INSTITUTIONAL S'HOLDER SERVS., *supra* note 67, at 2. The Common shares, on the other hand, were the "supervoting" shares; they had one vote per share and were publicly traded (although they were mostly owned by the founder's family trust). *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

### B. Mergers and Acquisitions

Controlling shareholders can also realize a significant premium for their shares in the context of mergers and acquisitions. For example, when Affiliated Computer Services was acquired, Darwin Deason, the Chairman, negotiated a \$300 million premium for his Class B shares.<sup>122</sup> The Affiliated Computer Services deal led to the inclusion of “fair-price” clauses in charters of dual-class stock companies, which require all shares to be purchased at an equal price in the case of a takeover.<sup>123</sup>

However, even with such a provision in place, shareholders are still at risk in takeovers. This point was made clear in the 2012 case, *In re Delphi Financial Group Shareholder Litigation*.<sup>124</sup> In *Delphi*, the company’s founder, Robert Rosenkranz, possessed 49.9% of the voting power while holding only 12.9% of the equity.<sup>125</sup> Rosenkranz achieved this by distributing Class A common stock to the public, while retaining the Class B common stock, with ten-to-one voting rights.<sup>126</sup> While a control block is usually entitled to a control premium, Rosenkranz bargained away that premium by inserting a charter provision that prohibited disparate consideration between Class A and Class B stock in the event of a merger.<sup>127</sup>

In 2011, Tokio Marine Holdings (TMH) approached Rosenkranz about the possible purchase of Delphi.<sup>128</sup> Throughout discussions regarding a potential merger, Rosenkranz represented Delphi with assistance from Delphi’s COO and CFO, and Rosenkranz began to consider how he might receive a premium on his Class B shares notwithstanding the charter prohibition on such disparate distributions.<sup>129</sup> In considering TMH’s offers, the Delphi Board created a special committee comprised of only Class A shareholders and a subcommittee that would make decisions with respect to any matters related to Rosenkranz and differential merger consideration.<sup>130</sup>

Even though financial and legal advisors warned that disparate consideration would be “unusual and problematic,” Rosenkranz refused to accept the

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<sup>122</sup> See Steven M. Davidoff, *What A.C.S. Settlement Means for Deal Litigation*, N.Y. TIMES DEALBOOK (Dec. 15, 2009), <http://dealbook.nytimes.com/2009/12/15/what-ac-s-settlement-means-for-deal-litigation>.

<sup>123</sup> Curtis J. Bacon et al., *The Board of Directors and Dual-Class Recapitalizations*, FIN. MGMT., Autumn 1997, at 5, 5.

<sup>124</sup> C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012), available at <http://courts.delaware.gov/opinions/download.aspx?ID=169430>.

<sup>125</sup> *Id.* at 9.

<sup>126</sup> *Id.* at 3.

<sup>127</sup> *Id.* at 9.

<sup>128</sup> *Id.* at 12.

<sup>129</sup> *Id.* at 13-14.

<sup>130</sup> *Id.* at 16-17.

same price as the Class A stockholders.<sup>131</sup> The sub-committee, afraid that Rosenkranz would walk away from the deal, decided to accept his demand for differential consideration.<sup>132</sup> Ultimately, they agreed on \$44.875 for Class A stock and \$53.875 for Class B stock.<sup>133</sup>

Rosenkranz got around the charter provision requiring equal consideration by conditioning his approval of the merger on a charter amendment that would explicitly exclude this merger from the prohibition.<sup>134</sup> The subcommittee found the charter amendment to be in the best interests of the Class A stockholders, as it was the only way to enable the Class A stockholders to obtain a substantial premium on their shares.<sup>135</sup>

Class A stockholders subsequently brought suit, attacking, in part, the negotiations with respect to the differential consideration.<sup>136</sup> They alleged that Rosenkranz breached fiduciary and contractual obligations in seeking the differential in the first instance.<sup>137</sup> The court found that plaintiffs were "reasonably likely to be able to demonstrate at trial that in negotiating for disparate consideration and only agreeing to support the merger if he received it, Rosenkranz violated duties to the stockholders."<sup>138</sup> While the court did not grant the preliminary injunction sought by the shareholders, the court noted that

[w]ith respect to the differential consideration, . . . any recovery in damages will be on top of the amount at which the stockholders are being asked to tender their shares. In light of all the issues raised above, the stockholders have a fair if not perfect ability to decide whether to tender their shares or seek appraisal rights under 8 Del. C. § 262.<sup>139</sup>

*Delphi* clearly illustrates that even with equal price provisions in place, controlling shareholders may force public shareholders to jump through the extra hoop of lengthy litigation in order to ensure enforcement of their rights under the charter. It is doubtful that, at the time an investor purchases the stock of a dual-class company, he is able to properly incorporate the

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<sup>131</sup> *Id.* at 19.

<sup>132</sup> *Id.* at 19-20.

<sup>133</sup> *Id.* at 24.

<sup>134</sup> *Id.* at 25.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 30.

<sup>137</sup> *Id.* at 30-31.

<sup>138</sup> *Id.* at 46. The court reasoned that Rosenkranz could not bargain away his control premium through the corporate charter and then coerce it back after the fact. *Id.* at 43-44.

<sup>139</sup> *Id.* at 54.

cost of such litigation into his evaluation of the stock price. The fact that management wins—both during and after the existence of the dual-class stock structure—further suggests that such companies should not be listed on the nation’s stock exchanges.

### III. CHANGE REQUIRES CONGRESSIONAL ACTION

To change the current rules on the listing of dual-class stock companies, one might expect that the SEC, through its rulemaking powers, would be a good place to start. However, the SEC has tried, unsuccessfully, to regulate the exchanges’ policy in regards to dual-stock companies. In 1988, in response to General Motors’ plan to issue two classes of stock—of which one would have one-half vote per share—the SEC promulgated Rule 19c-4, which barred self-regulatory organizations from listing the stock of a corporation that takes action “with the effect of nullifying, restricting or disparately reducing the per share voting rights of [existing common stockholders].”<sup>140</sup> The D.C. Circuit found that, because the rule regulated *substantive* matters of corporate governance, it exceeded the SEC’s authority under the Securities and Exchange Act of 1934.<sup>141</sup> In light of this decision, any change in policy to disallow companies with dual-class structures from listing on the various U.S. stock exchanges would have to come either as a collective decision from the stock exchanges themselves, or as a congressional mandate.

Realistically, unless the exchanges can come to a mutual agreement to change their rules, only Congress will be able to compel a change in the current policy. Because of difficulties in overcoming collective action problems, any one exchange would likely be unwilling to make the first move in disallowing dual-stock companies from listing on its exchange; for example, once one exchange has implemented such a rule, other exchanges will benefit from their increased appeal to dual-class companies seeking to go public. Moreover, exchanges can alter their policies later on if such rules are implemented voluntarily; a congressional mandate would both overcome such problems and ensure that the exchanges continue to enforce the prohibition on dual-class stock companies.

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<sup>140</sup> Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (internal quotation marks and citations omitted).

<sup>141</sup> *Id.*; see also 15 U.S.C. § 78s (2012) (describing the regulation of self-regulatory organizations).

## CONCLUSION

If we accept the modern theory that the purpose of a corporation is to maximize shareholder wealth, dual-class stock structures simply do not make any sense. Empirical studies have found that when voting and economic rights are not proportionate, corporate funds are more likely to be diverted to private benefits.<sup>142</sup> Excess control rights drive up CEO compensation, incentivize unprofitable empire building, and increase the likelihood that management will make shareholder value-destroying acquisitions.<sup>143</sup>

As one commentator ironically notes, “The advantage of a dual-class share structure is that it protects entrepreneurial management from the demands of ordinary shareholders. The disadvantage of a dual-class share structure is that it protects entrepreneurial management from the demands of shareholders.”<sup>144</sup>

Even if the SEC did not place restrictions on dual-class stock in IPOs because the process was not disenfranchising,<sup>145</sup> the structure implicates serious issues beyond voting rights. Dual-class structures run counter to public policy because they weaken investor protections provided by the market, exempt corporations from disclosure requirements that are otherwise required of single-class corporations, and lead to costly unifications and litigation. Thus, they should be disallowed from listing on the U.S. stock exchanges.

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<sup>142</sup> Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1715 (2009).

<sup>143</sup> *Id.* at 1722.

<sup>144</sup> Andrew Hill, *Enrolment Open for an MBA in Murdoch*, FIN. TIMES (July 18, 2011), <http://www.ft.com/cms/s/0/2fda9e8e-b176-11e0-9444-00144feab49a.html#axzz2IYIKmzDt>.

<sup>145</sup> See Ashton, *supra* note 12, at 876.