A PRIVATE ORDERING DEFENSE OF A COMPANY'S RIGHT TO USE DUAL CLASS SHARE STRUCTURES IN IPOS

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ABSTRACT

The shareholder empowerment movement (movement) has renewed its efforts to eliminate, restrict or at the very least discourage the use of dual class share structures in initial public offerings (IPOs). These renewed efforts were triggered by the recent Snap Inc. IPO that utilized non-voting stock. Such advocacy, if successful, would not be trivial, as many of our most valuable and dynamic companies, including Alphabet (Google) and Facebook, have gone public by offering shares with unequal voting rights.

Unless there are significant sunset provisions, a dual class share structure allows insiders to maintain voting control over a company even when, over time, there is both an ebbing of superior leadership skills and a significant decline in the insiders' ownership of the company's common stock. Yet, investors are willing to take that risk even to the point of investing in dual class shares where the shares have no voting rights and barely any sunset provisions, such as in the recent Snap Inc. IPO. Why they are willing to do so is a result of the wealth maximizing efficiency that results from the private ordering of corporate governance arrangements and the understanding that agency costs are not the only costs of governance that need to be minimized.

In this essay, Zohar Goshen and Richard Squire's newly proposed "principal-cost theory," "each firm's optimal governance structure minimizes the sum of principal costs, produced when investors exercise control, and agent costs, produced when managers exercise control," is used to argue that the use of dual class shares in IPOs is a value enhancing result of private ordering, making the movement's renewed advocacy unwarranted.

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INTRODUCTION

The shareholder empowerment movement (movement),[1] driven primarily by public pension funds and union related funds with over $3 billion in assets, has renewed its efforts to eliminate, restrict or at least discourage the use of dual class share structures (multiple classes of common stock with unequal voting rights) in initial public offerings (IPOs). These renewed efforts were triggered by the recent Snap Inc. IPO that utilized non-voting stock. Such advocacy, if successful, would not be trivial, as many of our most valuable and dynamic companies[2] have gone public by offering shares with unequal voting rights.

Besides Snap Inc., companies with dual class shares include Alphabet Inc. (Google), LinkedIn (acquired by Microsoft for $26 billion in 2016), Comcast, Zoetis, Inc., Nike, Inc., Facebook, Inc., and Alibaba Group Holding Limited. Three of these companies, Alphabet, Facebook, and Alibaba, rank in the top ten in the world based on the market value of their common stock. Berkshire Hathaway Inc., a company that also uses a dual class share structure, ranks in the top ten, but it only started using the structure in 1996, long after Warren Buffet bought control of the company in 1962.[3] As reported by Lucian Bebchuk and Kobi Kastiel, public companies with dual class shares had an aggregate market value of over $3 trillion as of July 2016.[4] However, based on current stock prices, the aggregate market value is most likely closer to $4 trillion.

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[1] While it is beyond the scope of this essay to delve into the motivations of those who lead the institutions that make up the shareholder empowerment movement, suffice it to say that the movement advocates for the shifting of corporate decision-making authority to shareholders, and thus away from the most informed loci of corporate authority, boards of directors and executive management, without regard to the impact on the decision making of public companies. Shareholder empowerment, not shareholder wealth maximization, is the objective of the movement. Consistent with this argument, numerous research studies have confirmed that their activism is indifferent to shareholder wealth maximization. *See* Tracie Woidtke, *Public Pension Fund Activism and Firm Value: An Empirical Analysis* (Manhattan Institute, Legal Policy Report 20, September 2015), *available at* http://www.manhattan-institute.org/pdf/lpr_20.pdf. (Woidtke finds that "ownership by public pension funds engaged in social-issue shareholder-proposal activism is negatively related to firm value."); Jonathan B. Cohn, Stuart L. Gillan and Jay C. Hartzell, *On Enhancing Shareholder Control: A (Dodd- Frank Assessment of Proxy Access)*, forthcoming, 71 J. FIN 1623-1668 (Issue 4, August 2016) (suggesting that unions and public pension funds participating in proxy access could lead to decreases in shareholder value); John G. Matsusaka et al., *Opportunistic Proposals by Union Shareholders* (Marshall School of Business, University of Southern California, Research Paper No. CLASS15-25), May 2016, *available at* http://ssrn.com /abstract=2666064 http://dx.doi.org/10.2139/ssrn.2666064 (The authors found that shareholder proposals were being used as "bargaining chips in contract negotiations."); Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUDIES 187, 189 (2012) (finding that "[w]hen a firm's unionized employees are no longer represented by the AFL-CIO, the AFL-CIO's pension funds become significantly less opposed to the firm's directors in subsequent board elections"); Tara Bhandari, Peter Iliev and Jonathan Kalodimos, *Governance Changes through Shareholder Initiatives: The Case of Proxy Access*, (January 17, 2017) (They report that "proponents are just as likely to target firms that were expected to benefit the least from proxy access as those that were expected to benefit the most."), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2635695.

[2] For purposes of this article, a *public company* can be defined as a for-profit corporation that is publicly traded on a national exchange or over the counter.

[3] Berkshire Hathaway, Inc. Prospectus, Class B Common Stock, (filed May 9, 1996), available at https://www.sec.gov/Archives/edgar/data/109694/0000898430-96-001695.txt.

[4] Lucian A. Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock* (April 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630.

As part of the movement's renewed advocacy against dual class shares, the Council of Institutional Investors (CII), the trade organization that represents the movement, has asked the S&P Dow Jones Indices, MSCI Inc. and FTSE Russell to exclude Snap Inc. and other companies with non-voting stock from their indexes[5] unless they include extremely restrictive provisions such as maximum sunset provisions of three to five years.[6] Moreover, consistent with the CII's general policy, the letters to these index providers also advocated for a forced conversion to one share one vote of all existing dual class share structures unless the majority of the non-super-voting common shares vote in favor of extending the dual class structures for a maximum of five years.[7]

So far, the movement's advocacy has been a success. The FTSE Russell has announced that it would bar companies from inclusion in its benchmark indexes unless more than 5% of the voting rights are in the hands of public shareholders ("unrestricted (free-float) shareholders");[8] the S&P Dow Jones Indices has decided to exclude all *new* dual class share offerings, including Snap's, from the S&P Composite 1500 and its components, the S&P 500, S&P MidCap 400 and S&P SmallCap 600;[9] and while the **MSCI Inc.** decision is still pending, it is expected to put into place restrictions consistent with the other two index providers.[10] These are not trivial exclusions. For example, some $8.7 trillion in assets are benchmarked or indexed to the S&P 500.[11] If we accept the rule of thumb that inclusion in these indices increases a company's stock price by an average of 4%,[12] then billions of dollars of investor value must have been foregone because of these exclusions, negatively impacting all types of investors, including investors who had invested in actively managed mutual funds that were holding such equity securities.

The movement's advocacy is not confined to those IPOs with dual class shares listed on the U.S. stock exchanges. It is also attempted to persuade the Singapore and Hong Kong stock exchanges,

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[5] Hazel Bradford, *Snap IPO igniting furor; institutions not pleased: Absence of voting rights has shareholders ready to fight 'line in the sand*, Pensions & Investments (March 20, 2017), http://www.pionline.com/article/20170320/PRINT/303209977/snap-ipo-igniting-furor-institutions-not-pleased.

[6] *See* S&P Survey, S&P Dow Jones Indices consultation with members of the investment community on the eligibility of non-voting share classes in S&P DJI indices (April 27, 2017), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2017/20170426%20CII%20comment%20S&P%20no%20vote%20share.pdf; Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to MSCI Equity Index Committee (March 29, 2017), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_MSCI_letter_request_for_consultation.pdf; Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to FTSE Russell Governance Board (March 24, 2017), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_24_17_letter_ftse.pdf.

[7] *Id.*

[8] FTSE Russell Voting Rights Consultation – Next Steps (July 2017), available at: http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

[9] S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rights (July 31, 2017), available at: https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true.

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[11] S&P Dow Jones Indices, *S&P Dow Jones Indices Releases Annual Survey of Assets*, (June 29, 2017) (The results are based on a survey using data as of December 31, 2016.), http://www.prnewswire.com/news-releases/sp-dow-jones-indices-releases-annual-survey-of-assets-300481674.html.

[12] Maria Kasch and Asani Sarkar, *Is There an S&P 500 Index Effect?*, Table 1, Federal Reserve Bank of New York Staff Reports, no. 484 (2014), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2171235. *See also*, Adam Levy, *Why Excluding Snap From the S&P 500 Is a Big Deal*, The Motley Fool (March 9, 2017) (When Alphabet (Google) was added to the S&P 500, it received an immediate 7% bump in its share price. Facebook received a 4% boost when it was added.), https://www.fool.com/investing/2017/03/09/why-excluding-snap-from-the-sp-500-is-a-big-deal.aspx.

respectively, not to allow the listing of dual class share structures.[13] Here, the movement's advocacy has not been as successful. The Singapore Stock Exchange has announced that it will allow companies with dual-class share structures to list their shares as long as they already have primary listings on "developed market" exchanges, such as the New York Stock Exchange or NASDAQ.[14] The Hong Kong Stock Exchange has made a proposal to list dual class shares but has yet to make a decision on whether to implement its proposal.[15]

In addition, the Securities & Exchange Commission's Investment Advisory Committee, whose chair and co-chair at the time just happened to represent institutions who are the leaders in the shareholder empowerment movement, the CFA Institute[16] and the California State Teachers' Retirement System respectively, quickly put the Snap Inc. IPO and dual class share structures in general, on the agenda for its March 9, 2017 meeting.[17] Finally, it is also expected that the CII will again try and persuade the stock exchanges to prohibit the listing of companies with dual class share structures.[18]

The movement's vigorous response to Snap Inc.'s hugely successful IPO was unsurprising. The CII, since its founding in 1985, has promoted as one of its bedrock principles, a "one share, one vote" policy.[19] This policy may be referred to as "shareholder democracy" and should not be confused with political democracy where each person gets one vote.[20] In shareholder democracy voting power is assigned according to property ownership, i.e., how many shares the person or entity owns.[21]

Dual class share structures clearly violate the CII's policy of shareholder democracy and are an obvious threat to the power of the movement. That is, the more public companies that utilize a dual class

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[13] Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to CEO Loh Boon Chye and Chief Regulatory Officer Tan Boon Gin, Singapore Exchange Limited (March 29, 2017) (advocating for keeping dual class shares off the exchange), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_letter_to_SGX.pdf; Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to Hong Kong Exchanges and Clearing Limited (August 4, 2017) (advocating for keeping companies with non-conforming governance arrangements off the exchange), http://www.cii.org/files/issues_and_advocacy/correspondence/8-4-17%20CII%20response%20to%20HK%20Concept%20Paper.pdf.

[14] SGX, *SGX clarifies that existing secondary listing framework allows dual class share companies* (Press Release; July 28, 2017), available at http://www.sgx.com/wps/wcm/connect/sgx_en/home/higlights/news_releases/sgx_clarifies_that_existing_secondary_listing_framework_allows_dual_class_share_companies

[15] The Stock Exchange of Hong Kong Limited, *Concept Paper, New Board* (June 2017), available at https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017061.pdf.

[16] *See* Mary Leung, *Snapchat IPO: What's Wrong with This Picture?*, CFA Institute Market Integrity Insights blog (April 18, 2017), https://blogs.cfainstitute.org/marketintegrity/2017/04/18/snapchat-ipo-whats-wrong-with-this-picture/ (Expounding on the CFA Institute's one-share, one-vote policy and supporting the efforts of CalPERS on this issue. CalPERS is a leader in the shareholder empowerment movement.).

[17] Bradford, *supra* note 5.

[18] Gibson Dunn & Crutcher LLP, *Non-Voting Shares Make Their Public Debut and Generate Some Governance Concerns, but How Will Courts View the Structure When First Presented?*, Securities Regulation and Corporate Governance (March 12, 2017), available at http://www.securitiesregulationmonitor.com/Lists/Posts/Post.aspx?ID=288.

[19] Anne Sherry, *Snap IPO has Investor Advisory Committee debating no-vote offerings*, Jim Hamilton's World of Securities Regulation (March 13, 2017), http://jimhamiltonblog.blogspot.com/2017/03/snap-ipo-has-investor-advisory.html.

[20] Daniel Fischel uses the term "corporate democracy" instead of shareholder democracy. However, the terms are meant to be interchangeable. *See* Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHICAGO L. REV. 119, 141 (1987).

[21] *Id.*

share structure, the more controlled companies that exist and the less power the movement has. In 2012,[22] 2014,[23] and now in 2017,[24] the CII has tried to use its economic and political influence to get rid of dual class share structures.

Most importantly, the movement's advocacy comes into strong conflict with what many believe to be the great strength of our system of corporate governance, the private ordering of governance arrangements with dual class share structures being an optimal result of that ordering:

> One of America's greatest strengths is that we are a magnet for entrepreneurship and innovation. Central to cultivating this strength is establishing multiple paths entrepreneurs can take to public markets. Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual class structures allow investors to invest side-by-side with innovators and high growth companies, enjoying the financial benefits of these companies' success.[25]

This Article concurs with the above statement, a statement provided by the Nasdaq, Inc. By utilizing Zohar Goshen and Richard Squire's newly proposed "principal-cost theory," "each firm's optimal governance structure minimizes the sum of principal costs, produced when investors exercise control, and agent costs, produced when managers exercise control,"[26] this Article argues that the use of the dual class share structure in IPOs is a value enhancing result of the bargaining that takes place in the private ordering of corporate governance arrangements, making the movement's renewed advocacy unwarranted.

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[22] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Mr. Edward S. Knight, Executive Vice President, General Counsel & Chief Regulatory Officer, NASDAQ OMX Group (October 2, 2012) ("The Council of Institutional Investors ("Council") hereby asks you to propose a rule for approval by the United States ("U.S.") Securities and Exchange Commission under which (1) companies that seek an initial listing on the NASDAQ Stock Market or the BX Venture Market (collectively, "NASDAQ") will be ineligible for a listing if they have two or more classes of common stock with unequal voting rights, and (2) companies newly listed on NASDAQ in the future will be prohibited from issuing multi-class stock with unequal voting rights subsequent to their initial listing. Of note, the Council is not, at this time, requesting a proposed rule change that would impact currently listed companies with multi-class stock structures."), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_02_12_cii_letter_to_nasdaq_dual_class_stock.pdf. *See also*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Ms. Claudia Crowley, CEO & Chief Regulatory Officer, NYSE Regulation (October 2, 2012), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_2_12_cii_letter_to_nyse_dual_class_stock.pdf.

[23] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Mr. Edward S. Knight, Executive Vice President, General Counsel & Chief Regulatory Officer, NASDAQ OMX Group (March 27, 2014) (trying to discourage the NASDAQ from listing Alibaba's dual class shares), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_nasdaq_one_share_one_vote.pdf; *See also* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Mr. John Carey, Vice President–Legal, NYSE Regulation, Inc., NYSE Euronext (March 27, 2014), available at http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_NYSE_one_share_one_vote.pdf.

[24] *See supra* note 6.

[25] Nasdaq, Inc., *The Promise of Market Reform* at 16 (2017), http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf.

[26] Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767. 767 (2017).

This Article proceeds as follows: Part I discusses the characteristics of dual class share structures and provides a short regulatory history. Part II utilizes Zohar Goshen and Richard Squire's "principal-cost theory" within a private ordering framework to explain how the dual class share structure and its requirement for common stock with unequal voting rights can result in an optimal corporate governance arrangement.

PART I: DUAL CLASS SHARE STRUCTURES, THEIR CHARACTERISTICS AND HISTORY

Dual class share structures allow for a "wedge" to be created between a company's cash flows and voting rights such that voting control, and thereby control of the company and its Board, can be maintained by insiders, such as the founders, without having to own a majority of the company's common stock outstanding.[27] That is, by holding onto the bulk of their super-voting shares, insiders have the option of selling off or donating a large bulk of their non-super-voting shares without losing voting control of the company.[28]

Typically, a company that utilizes a dual class share structure in an IPO will issue a class of common stock to the public that carry one vote per share (ordinary shares), while reserving a separate class, a super-voting class, that provide insiders with at least 10 votes per share. (Snap's IPO was an exception to the rule as it utilized three classes of stock, reserving super-voting shares for the founders and ordinary shares for early investors and only offering non-voting stock to the public.[29]) However, both types of shares will typically have equal rights to the cash flows of the company. Sometimes, such as with Nike, Inc., the super-voting class will elect the majority of directors and the class sold to the public will elect the minority of directors.[30] Depending on the "sunset provisions" (triggers that terminate the super-voting characteristics of these shares such as upon the death of the founder or when the founder stops taking an active role in the company) found in the super-voting shares, or lack thereof, this control can potentially last for the lives of the founders and then be passed on to their descendants.

In the United States, dual class shares have been around since at least 1898 and have been tolerated to a greater or lesser extent by the major exchanges since at least the 1920s.[31] For example, in 1926 the New York Stock Exchange (NYSE) implemented an unannounced ban on non-voting stock[32] and then formally announced a one share, one vote listing standard in 1940,[33] a policy that lasted until 1984.[34] The unannounced ban was a result of the activism of a leading corporate governance scholar of his time,

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[27] Gabriela M. Engler Pinto, *Why They Persist? An Analysis of Dual Class Structures and the Unification Process in the U.S. and Brazil*, 10 REVISTA DIREITO GV 23, 25 (2014). *See also*, Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1084 (2010) (On average, the authors found that insiders of dual class firms held 60% of the voting power, with the vast majority of this power coming from super-voting shares, and 40% of the cash flow rights.).
[28] *See* Gompers et al., *supra* note 27.
[29] *See* Part II.B.
[30] Nike, Inc. Proxy Statement (DEF 14A), at 6 (July 25, 2016), available at https://www.sec.gov/Archives/edgar/data/320187/000032018716000339/nke-2016xdef14a.htm.
[31] Pinto, *supra* note 27, at 5.
[32] *Id.*
[33] Kaitlin Descovich, Melanie A. Conroy, Cathy Dixon and Ellen Odoner, Weil, Gotshal & Manges LLP, *Voting Rights Gone in a Snap – Unequal Voting Rights Back in the Spotlight*, Governance & Securities Alert (April 3, 2016), available at, http://www.weil.com/~/media/publications/alerts/2017/pcag-alert.pdf.
[34] *Id.*

William Ripley, a Harvard professor of political economy. Ripley was an early champion of the idea of one share one, vote who found support from both the press and then President Calvin Coolidge[35] in his condemnation of the issuance of non-voting shares by high profile companies such as Dodge Brothers, Industrial Rayon Corporation, A&W Root Beer, and Fox Theaters.[36]

Over time, there were exceptions to the NYSE's one share, one vote listing standard, such as when Ford Motor Co. listed dual class shares on the NYSE.[37] While the shares sold by the Ford Foundation did have voting rights, shares which were converted from non-voting to voting to qualify for NYSE listing, these rights were inferior to those found in the super-voting shares retained by the Ford family.[38] Incidentally, the sale to the public of the Ford ordinary shares was an unqualified success, requiring significant rationing of these shares to clients of retail brokerage houses.[39]

In 1988, the SEC issued the short-lived Rule 19c-4. The rule barred U.S. stock exchanges (self regulatory organizations) from listing the stock of any issuer that took any action "with the effect of nullifying, restricting or disparately reducing the per share voting rights of existing common stockholders."[40] However, shortly after the rule was implemented, the United States Court of Appeals for the District of Columbia Circuit unanimously ruled that the SEC had exceeded its delegated authority in issuing the rule. Specifically, the Court of Appeals found that "the Exchange Act [Securities Exchange Act of 1934] cannot be understood to include regulation of an issue that is so far beyond matters of *disclosure* (such as those disclosures required under § 14 of the Exchange Act), and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states."[41] Moreover, "[w]ith its step beyond control of voting procedure and into the distribution of voting power, the Commission would assume an authority that the Exchange Act's proponents disclaimed any intent to grant."[42] However, it is within the authority of the SEC to require stock exchanges to seek its approval prior to implementing new stock exchange rules as long as the criteria used in the approval process is consistent with the "furtherance of the purposes" of the Exchange Act.[43]

Interestingly, unlike the NYSE, the Nasdaq and the American Stock Exchange (AMEX) have always allowed for dual class shares, even though the AMEX did implement a ban on non-voting stock in 1972.[44] In 1994, with the approval of the SEC, all three exchanges adopted a uniform policy allowing companies to list IPOs with dual class share structures.[45] However, consistent with vacated Rule 19c-4, the policy,

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[35] Peter N. Flocos, *Toward a Liability Rule Approach to the "One Share, One Vote" Controversy: An Eitaph for the SEC's Rule 19c-4?*, 138 U. Penn. L. Rev. 1761, 1762 (1990).
[36] Stephen I. Glover and Aarthy S. Thamodaran, *Debating the Pros and Cons of Dual Class Capital Structures*, 27 INSIGHTS: CORP. & SEC. L. ADVISOR. 1, at 2 (2013).
[37] Jim Henry, *Henry Ford never wanted his company to go public*, Automotive News (June 16, 2003), available at http://www.autonews.com/article/20030616/SUB/306160730/henry-ford-never-wanted-his-company-to-go-public.
[38] *Id.*
[39] *Id.*
[40] Exchange Act Release No. 25891 (July 7, 1988).
[41] The Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406, 407-08 (D.C. Cir. 1990) ("Because the rule directly controls the substantive allocation of powers among classes of shareholders, we find it in excess of the Commission's authority under § 19 of the Securities Exchange Act of 1934,…. ").
[42] *Id.* at 411.
[43] *Id.* at 410.
[44] Pinto, *supra* not 27, at 5.
[45] Rule 313.00(A) and (B), NYSE Listing Company Manual, *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp_1_4_13_1&CiRestrict

except for a small exception implemented by the AMEX,[46] an institution which has since been absorbed by the NYSE, barred companies from reducing the voting rights of existing common stockholders.[47]

It may be somewhat surprising that on an annual basis only a relatively small number of companies go public with a dual class share structure. In the U.S., only a relatively small number of IPOs have utilized dual class shares: 27 of 174 in 2015[48] and 36 of 292 in 2014.[49] Over half of the IPOs using dual class structures were in the technology sector.[50] Also, the current trend is for dual class share structures to be associated with IPOs with the largest market values, such as the recent Snap Inc. IPO, which valued the company at approximately $24 billion.[51]

In Europe, the listing of dual class shares is quite prevalent.[52] Stock exchanges in Canada, Denmark, Finland, France, Germany, Italy, Norway, Sweden, and Switzerland permit the listing of dual class shares.[53] However, the Hong Kong, London and Singapore stock exchanges still do not allow for dual class shares even though Singapore is currently in the process of determining whether such shares should be listed.

In sum, the dual class share structure continues to endure globally. Nevertheless, even after 100 years of use, it has yet to gain universal acceptance, especially by activists who see common stock ownership as a means to implement shareholder democracy, not shareholder wealth maximization.

PART II: DUAL CLASS SHARE STRUCTURES AS THE VALUE MAXIMIZING RESULT OF PRIVATE ORDERING

An IPO allows a company to achieve the objectives of accessing a huge new investor base, the public equity markets, and providing enhanced liquidity for the company's shares. Having a company's stock publicly traded also provides important signals, through changes and trends in the price of the stock, to the Board and executive management on how well the company is doing and its prospects. In addition, an IPO that utilizes a dual class share structure allows for the continuation of the governance arrangements that existed prior to the IPO. These governance arrangements and how it impacts the rights of those who invest in the ordinary shares of a company are described quite nicely by Larry Page in Alphabet's (Google's) 2004 registration statement:

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ion=voting+AND+rights&manual=%2FLCM%2FSections%2Flcm-sections%2F; Rule 5640, Voting Rights, Nasdaq Stock Market Listing Rules, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.

[46] Pinto, *supra* note 27, at 6.

[47] *Id.*

[48] Ross Kerber, *U.S. investor group urges halt to dual-class structures in IPOs*, Reuters (March 23, 2016), www.reuters.com /article/us-usa-ipo-votingrights-idUSKCN0WP1Q0.

[49] *Id.*

[50] Gilbert E. Matthews, Valuation of Shares of Companies with a Dual Class Structure, American Society of Appraisers Advanced Business Valuation Conference (September 14, 2016), available at http://www.appraisers.org/docs/default-source/event_doc/2016_bv_presentation_matthews.pdf?sfvrsn=2.

[51] Lauren Hirsch, *Snap's shares pop after year's biggest IPO*, Reuters (March 2, 2017), http://www.reuters.com/article/us-snap-ipo-idUSKBN1690I7.

[52] Bebchuk and Kastiel, *supra* note 4.

[53] *Id.*

In 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 structure will also make it easier for our management team to follow the long term, innovative approach emphasized earlier….

The main effect of this structure is *likely to leave our team, especially Sergey* [Brin] *and me, with significant control over the company's decisions and fate,* as Google shares change hands. *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.*

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

Academic studies have shown that from a purely economic point of view, dual class structures have not harmed the share price of companies. The shares of each of our classes have identical economic rights and differ only as to voting rights.[54]

This statement makes several key points regarding the use of dual class shares. First, Alphabet (Google) will be almost invulnerable to takeovers and the potential efficiency benefits that such takeovers may provide unless the holders of the super-voting stock approve a takeover.[55] According to Henry Manne, "the control of corporations may constitute a valuable asset" in and of itself, an asset that "exists independent of any interest in either economics of scale or monopoly profits," if the acquirer takes control with the expectation of correcting managerial inefficiencies.[56] According to Daniel Fischel, "the cost of dual class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced."[57]

Second, Alphabet (Google) will be invulnerable to the actions of activist hedge funds, such as a threatened or actual proxy contest to replace Board members, to persuade the Board to either make significant strategic changes or prepare to sell out.[58] Again, without these activities, efficiencies may be lost. Using Henry Manne's writings on the market for corporate control as a foundation, Bernard Sharfman has argued that hedge fund activism may also constitute "a valuable asset in and of itself if the purpose of such activism is to correct such [managerial] inefficiencies."[59] Moreover, while hedge fund

[54] Google, Inc. Registration Statement (S-1), at 11-12 (April 29, 2004), available at https://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm.

[55] Gompers, Ishii & Metrick, *supra* note 27 (Based on the sample used in the study, the average age of companies with dual class share structures in 2001 was 12.87 years while the average age for single-class companies was 9.60 years. In the opinion of the authors, the most likely explanation for this difference was a resistance to being acquired on the part of the dual class companies.).

[56] Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[57] Fischel, supra note 20, at 140.

[58] However, as the Forest City Realty Trust, Inc.'s mid-stream conversion from a dual class share structure to all ordinary shares demonstrates, activist hedge funds may still have influence if the controlling shareholders and the Board are willing to listen. *See infra*, text associated with notes 140-143.

[59] Bernard S. Sharfman, *A Theory of Shareholder Activism and its Place in Corporate Law*, 82 TENN. L. REV. 791, 794 (2015).

activism does not necessarily get it right in each individual instance,[60] on average the ability of activist hedge funds to significantly increase the value of a targeted company's stock has been repeatedly tested and affirmed,[61] allowing Paul Rose and Bernard Sharfman to argue that hedge fund activism acts as a "corrective mechanism" in the governance of a public company.[62]

Third, after going through several rounds of private financing where the universe of shareholders was confined to sophisticated investors trying to maximize the value of their investment, the post-IPO company must now face a much more diverse group of institutional shareholders, including many more that may be both uninformed and not always acting with the objective of maximizing shareholder wealth, such as those institutions that make up the shareholder empowerment movement.

Somewhat surprisingly, uninformed investors also include mega-mutual fund advisors, such as Blackrock, Vanguard, State Street Global Advisors, and Fidelity, etc., who manage the bulk of the increasingly popular passive index funds, funds that track a market weighted-index such as the S&P 500. They are uninformed because the industry practice is to delegate voting rights, not just portfolio management, to mutual fund advisors. In turn, these advisors must find a cost effective way of dealing with this overwhelming responsibility. The current solution is to delegate corporate governance advocacy and policy and the voting on hundreds of thousands of director elections and board and shareholder proposals to small internal corporate governance/voting departments of the advisor.[63] For example, Vanguard's Investor Stewardship team voted by proxy at over sixteen thousand annual meetings covering nearly 160,000 votes for the twelve months ending June 30, 2016.[64] As of January 2017, Vanguard's governance team only employed 20 people.[65] Therefore, these small departments of corporate governance professionals cannot possibly meet the definition of informed investors as they must deal with an overwhelming number of companies and votes. The result may be cost-effective for the mutual fund advisors, but they only allow for a one-size-fits approach[66] with some limited number of exceptions.

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[60] Goshen and Squire, *supra* note 26, at 821 ("Yet activist funds can also generate principal costs [costs of shareholders making decisions], a downside that their academic supporters dismiss. Because information asymmetries can prevent shareholders from differentiating good activist campaigns from bad ones, a fund might force managers to slash capital expenditures that are actually efficient. Ultimately, the impact of activism on control costs–the reduction in agent costs, net of the increase in principal costs–will be specific to the target firm.").

[61] Lucian A. Bebchuk, Alon P. Brav and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (June 2015); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731 (2008); Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 175–78, 201 (2011); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 374 (2009); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 213, 217–18 (2009).

[62] Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1014 (2014).

[63] M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, Wall Street Journal (June 22, 2017), available at https://www.wsj.com/article_email/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623-lMyQjAxMTA3MTI3MjYyNjI1Wj/.

[64] Vanguard, *Our engagement efforts and proxy voting: An update*, https://about.vanguard.com/investment-stewardship/update-on-voting/index.html.

[65] Madison Marriage, BlackRock, Vanguard and State Street bulk up governance staff, Financial Times (Jan. 28, 2017) (It was also reported that Blackrock had 31, Fidelity had 12 and State Street Global Advisors had 11.), available at https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a?mhq5j=e3.

[66] Henderson and Shapiro, *supra* note 63.

Moreover, this delegation of voting rights may be leading to an increasing amount of opportunistic behavior on the part of mega-mutual fund advisors. It has been argued that mega-mutual fund advisors have been drawn into an alliance with the shareholder empowerment movement on the issues of proxy access and dual class share structures simply because of the business opportunity such an alliance represents.[67] That opportunity is to attract or retain the business of public pension funds and union related funds, the institutional leaders in the shareholder empowerment movement, which are shifting their portfolios away from high cost, actively managed mutual funds and hedge funds to low cost indexed funds, the kind of funds that the top 10 largest mutual fund advisors dominate in terms of market share.[68]

By utilizing a dual class share structure the Board of Alphabet (Google) will not have to be responsive to these *uninformed* and potentially opportunistic shareholders.

Fourth, the founders will have the luxury of implementing their strategic vision without feeling the pressure to make changes just because their quarterly results have disappointed shareholders. For example, Mark Zuckerberg faced a lot of criticism back in April 2012 for his decision to have Facebook purchase "an app that had 13 employees and zero revenue."[69] This acquisition occurred just one month before the company launched its IPO with a dual class share structure. As reported, the then 27 year old CEO of Facebook completed the acquisition prior to even consulting the Board that he was negotiating the purchase.[70] To add fuel to the fire the price of Facebook stock fell like a rock shortly after its IPO, down 54% after four months of public trading.[71] As late as July 2015, analysts were still wondering if the acquisition would earn money for Facebook.[72] That acquisition was Instagram, the Facebook subsidiary that may currently be worth up $25 billion to $35 billion if not higher[73] and is expected to generate revenues of $3.92 billion in 2017.[74] Without a dual class share structure providing Zuckerberg with control of Facebook, the young CEO may have felt quarterly pressure to prove that he had made the right decision, perhaps undermining his credibility in the eyes of an independent Board as well as his

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[67] Bernard S. Sharfman, *Mutual Fund Advisors' Empty Voting Raises New Governance Issues*, Columbia Law School's Blue Sky Blog (July 3, 2017), available at http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/.

[68] Investment Company Institute, 2017 Investment Company Fact Book, at 18 ("the growing popularity of index funds increased concentration because the 10 largest fund complexes manage most of the assets in index mutual funds"), available at http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2017/2017_factbook.pdf.

[69] Alexei Oreskovic, *Everyone thought Mark Zuckerberg was crazy to buy a 13-person app for $1 billion − now Instagram looks like one of the most brilliant tech acquisitions ever made*, Business Insider (Jan. 30, 2016), http://www.businessinsider.com/instagram-zuckerbergs-biggest-win-so-far-2016-1.

[70] Joe Coscarelli, *Mark Zuckerberg Bought Instagram Without Really Asking the Facebook Board*, New York Magazine (April 18, 2012), available at http://nymag.com/daily/intelligencer/2012/04/mark-zuckerberg-bought-instagram-without-asking-facebook-board.html.

[71] Matthew Galgani, *A Tale Of 4 IPOs: Facebook, Alibaba, Snap And Square*, Investor's Business Daily (September 7, 2017), available at http://www.investors.com/how-to-invest/investors-corner/a-tale-of-4-ipos-facebook-alibaba-snap-and-square/.

[72] Erin Griffith, *Wall Street wants to know if Instagram can make money*, Fortune (July 29, 2015), available at http://fortune.com/2015/07/29/wall-street-wants-to-know-if-instagram-can-make-money/.

[73] Yoni Heisler, *Once mocked, Facebook's $1 billion acquisition of Instagram was a stroke of genius*, Yahoo! Tech (December 29, 2016), available at https://www.yahoo.com/tech/once-mocked-facebook-1-billion-acquisition-instagram-stroke-042604919.html.

[74] Kathleen Chaykowski, *Facebook Reports Strong First Quarter; Revenue, Earnings Beat Estimates*, Forbes (May 3, 2017), available at https://www.forbes.com/sites/kathleenchaykowski/2017/05/03/facebook-shares-rise-on-first-quarter-revenue-that-beat-estimates/#27c5afdc6b6d.

managerial authority, and thereby undermining his credibility as not only the right person to be the company's CEO but also the one whose vision the Board still needs to implement.

Fifth, empirical research is still ambiguous regarding the value of dual class share structures.[75] This should not be surprising. As noted by Renee Adams, "Because ownership structures are endogenous," i.e. companies do not choose to use this structure based on some random process, "many difficulties arise in estimating the impact of disproportional ownership on firm and market outcomes." That is, whatever results may be derived from a study, there is the potential that they will be significantly biased. Moreover, once a company enters the public market with a dual class share structure, trying to figure out how it would perform without such an equity structure becomes a *counterfactual*. That is, we will never know if Alphabet (Google), Alibaba, Comcast Corporation, Facebook, etc. would have fared better or worse without super-voting stock. However, we do know that they and other firms have been wildly successful with such a structure. As stated by Daniel Fischel in the context of firms with dual class shares:

> It is even possible that the market value of the shares of such firms would be higher if the family or founding entrepreneur would relinquish control. In this event, the family or entrepreneur is paying for its preference for control in the form of a higher cost of capital. Of course, the opposite can also be true. The market value of shares in a firm controlled by a family or founding entrepreneur may be higher if, for example, continuity of management is valued by investors and there exist alternative governance mechanisms to align the interests of managers and investors.[76]

Also, the most significant data on IPOs with dual class shares is relatively new and could use seasoning before being analyzed. The 2004 Google IPO started the trend of large market value IPOs favoring the dual class share structure and this trend has picked up in the last several years.[77] This critical

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[75] Goshen and Squire, *supra* note 26, at 815-16 ("While some studies have linked the dual-class share structure to lower firm value, others have found no correlation once firm-specific attributes are taken into account."). Perhaps most telling, even a recent CII report could not make the case that dual class shares were wealth reducing. *See*, Gabriel Morey, *Multi-Class Stock and Firm Value: Does Multi-Class Stock Enhance Firm Performance? A Regression Analysis*, Council of Institutional Investors (May 2017) ("A multi-class common equity structure with unequal voting rights neither increases nor decreases a company's annualized return on invested capital (ROIC)."), available at http://www.cii.org/files/publications/misc/05_10_17_dual-class_value_study.pdf; Ronald Anderson, Ezgi Ottolenghi, and David Reeb, *The Dual Class Premium: A Family Affair*, (August 14, 2017) at 29-30 ("Using industry adjusted, market adjusted, and Fama-French size and book-to market adjusted returns, we find that a buy-and-hold strategy of dual class family firms earns excess returns of about 350 basis points per year relative to our benchmark (single class nonfamily firms)," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3006669. Moreover, "after controlling for time, industry, and a wide variety of firm-specific factors, our analysis does not lend support to the notion that dual class structures harm outside investors. Rather, our results suggest that the dual class structure − in-and-of itself − has no effect on outside investors." *Id.* at 5; *See also*, Ekkehart Böhmer, Gary C. Sanger, and Sanjay B. Varshney (1996). *The effect of consolidated control on firm performance: the case of dual-class IPOs.* In: Levis, M. (Ed.), Empirical Issues in Raising Equity Capital. Elsevier, Amsterdam. (finding that between 1984 and 1988 "dual-class firms substantially outperform a matched sample of similar risk, single-class firms during the three years following the IPO, both in terms of stock returns and operating performance."), available at https://www.researchgate.net/profile/Gary_Sanger/publication/225615101_Managerial_bonding_and_stock_liquidity_An_analysis_of_dual-class_firms/links/574f115308ae10b2ec0342c3.pdf; *But see*, Gompers et al., *supra* note 20, at 1051 (finding that "firm value is increasing in insiders' cash-flow rights and decreasing in insider voting rights").

[76] Fischel, *supra* note 13, at 136.

[77] Aswath Damodaran, Weekly Puzzle #2: Dual Class Shares, Boon or Bane?, The Corporate Finance Email Chronicles: Spring 2017, Damodaran Online, http://people.stern.nyu.edu/adamodar/New_Home_Page/cfpuzzles/cfspr17puzzle2.htm.

data has yet to be incorporated into the analysis of dual class share structures.[78] The existence of large market value companies with dual class shares also suggests that analysis of the data would benefit from some sort of market value weighting.

Finally, when the shareholder empowerment movement tries to support its advocacy with empirical analysis, one should not accept the research used without a thorough review of the data, methodology and results. For example, when the CII utilized an Investor Responsibility Research Center Institute report on controlled companies[79] in its advocacy to ban dual class share structures in IPOs.[80] This study has been described by Yvan Allaire, PhD (MIT), as "sloppy in design, amateurish and misleading in its statistics, and biased in its interpretation. Had that report been submitted as a term paper by first-year MBA students, it would have received a fail grade."[81]

A. Troubling Aspects of the Dual Class Share Structure

An IPO that incorporates a dual class share structure has other troubling aspects besides being immune from the corrective mechanisms found in the market for corporate control and hedge fund activism. As previously noted, such IPOs can create a widening gap between voting and cash flow rights. This gap is called the "wedge" and can become quite extreme. For example, in 1978, almost 40 years ago, the Roberts family held 42% of all equity shares of Comcast Corporation, but only 0.4% in 2015.[82] Yet, through a family trust holding super-voting shares, Mr. Brian Roberts, the current Comcast Chairman and CEO and son of co-founder Ralph Roberts, effectively controls the company with 33.33% voting power.[83] As of March 16, 2017, Comcast had outstanding 4,732,039,722 shares of Class A common stock and 9,444,375 shares of Class B common stock.[84] Each holder of Class A common stock is entitled to 0.0599 votes per share and each holder of Class B common stock is entitled to 15 votes per share.[85] Notably, Mr. Roberts, who has been at the helm of Comcast since 1990, is a widely respected CEO, having led the company to a market valuation of approximately $180 billion as of May 17th, 2017.

Lucian Bebchuk and Kobe Kastiel find this aspect of dual class share structures to be extremely troubling, arguing that even if the structure is efficient at the time of the IPO, "the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to recede, and

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[78] *See e.g.*, Anderson, Ottolenghi, and Reeb, *supra* note 75, at 8. This recent study used Russell 3000 data from December 31, 2001 through 2015. However, firms such as Alphabet (Google), Facebook and Alibaba were not included in the dataset because they issued their dual class shares after December 31, 2001.

[79] Investor Responsibility Research Center Institute, *Controlled Companies in the Standard & Poor's 1500: A Ten-Year Performance and Risk Review* (Oct. 2012), http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf. Interestingly, while the Investor Responsibility Research Center Institute commissioned and funded this report, the research for the paper was conducted by the proxy advisory firm Institutional Shareholder Services (ISS) and authored by Sean Quinn, a vice president with ISS. *See*, Investor Responsibility Research Center Institute, Press Release, *New Study Says Multiclass Voting Companies Underperform, Riskier* (October 2, 2012), available at https://irrcinstitute.org/news/new-study-says-multiclass-voting-companies-underperform-riskier/.

[80] *See* Letters from Jeff Mahoney to the NYSE and NASDAQ, respectively, *supra*, note 16.

[81] Yvan Allaire and François Dauphin, Two flawed studies about controlled corporations by ISS and IRRCI, Institute for Governance and Public Policy (April 2016), available at https://igopp.org/wp-content/uploads/2016/04/IGOPP_Article_2flawedStudiesControlledCorpoISSandIRRC_EN_vf.pdf.

[82] Bebchuk and Kastiel, *supra* note 4.

[83] Comcast Corp. Proxy Statement, at 6 (April 28, 2017), available at https://materials.proxyvote.com/Approved/20030N/20170316/NPS_322517/images/Comcast-Proxy2017.pdf.

[84] *Id.* at 5.

[85] *Id.*

the potential costs tend to rise, as time passes from the IPO."[86] Moreover, "controllers have perverse incentives to retain dual-class structures even when those structures become inefficient over time."[87] That is, "controllers with low equity holdings bear only a small fraction of the negative effects of their actions on the company value while capturing the full private benefits."[88] Private benefits of control are a sub-category of agency costs ("the economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value"[89]) that may "include entering into conflicts-of interest transactions, misusing corporate resources for personal ends, expropriating corporate opportunities, pursuing pet projects, and building a conglomerate empire."[90] As a result, "controllers' incentives regarding certain issues may become distorted and misaligned with the preferences of public investors."[91] Presumably their argument would eventually hold even at a consistently high functioning company such as Comcast.

To remedy the problem of the growing wedge and the potential ebbing of superior leadership skills over time, they recommend that a perpetual dual class share structure not be allowed and sunset provisions be required that expire "after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller."[92] In this way, companies can avoid the "elderly leader problem," a situation that occurs when an elderly leader is perceived to lack the competence to hold voting control,[93] and the problem of the "idiot heir."[94]

B. The Snap IPO

Yet, stock market investors have been very willing to ignore the "potential" issues that are associated with the dual class share structure, even to the point of investing in dual class share structures where the ordinary shares have no voting rights and barely any sunset provisions. For example, Snap Inc. went public on March 2, 2017 with a three-class capital structure: Class A non-voting shares (listed on the

[86] Bebchuk and Kastiel, *supra* note 4.
[87] *Id.*
[88] *Id.* However, recent empirical evidence suggests the issue of the wedge may be a non-issue. See, Anderson, Ottolenghi and Reeb, *supra* note 72 (In finding that dual class shares lead to higher, not lower rates of returns for investors, the authors also found that "single and dual class family firms with similar levels of control exhibit similar excess returns, suggesting the premium centers on family control rather than dual class shares.").
[89] Goshen and Squire, *supra* note 19, at 775. *See also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361 (2010) (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)). As explained by Professor Rose:

> Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager's ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager's behavior by aligning the manager's interests with the shareholders' interests.

Id. at 1361 (citations omitted).
[90] Albert Choi, *Concentrated Control and Long-Term Shareholder Value*, HARV. BUS. L. REV. at 4 (2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2619462.
[91] Bebchuk and Kastiel, *supra* note 4.
[92] *Id.*
[93] *Id.*
[94] *Id.*

NYSE), Class B regular voting shares (unlisted, held by management and early investors) and Class C super-voting shares (unlisted, held by the two co-founders, 10 votes per share, representing 88.6% of Snap's total voting power).[95] The lack of voting rights in the Snap offering was a first for an IPO with a dual class share structure even though Facebook, Alphabet, and Under Armour had previously offered shares with no voting rights in secondary public offerings.[96] Even though the Snap shares sold to the public did not come with voting rights or much of a sunset provision (voting rights would attach only upon death of its two founders who are both in their 20s), the offering was received by the investor community with great enthusiasm.[97] Snap, Inc priced its IPO at $17 per share, giving it a market valuation of roughly $24 billion.[98] The book was more than 10 times oversubscribed and Snap could have priced the IPO at a price up to $19 per share.[99]

Most importantly, the initial investors in Snap's IPO were not passive, uninformed index fund investors, since the Snap non-voting shares have yet to be included in an index, but were mainly sophisticated investors who can be referred to as "information traders."[100] The information trader is "willing and able to devote resources to gathering and analyzing information as a basis for its investment decisions."[101] Information traders look for differences between value and price based on the information they possess and "then trade to capture the value of their informational advantage."[102] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[103] Given the lack of voting rights, we should also expect the purchasers to be "value investors." A value investor is a special type of information trader that devotes "[w]hatever limited time, resources, and skill they have to valuation," and basically lets other investors worry about voting, trying to gain control of the company or investing in recommendations on how to correct managerial inefficiencies.[104]

The list of value investors that have purchased Snap shares during or soon after the IPO include mutual fund(s) actively managed by Blackrock Inc., the mega-mutual fund advisor (9.4 million shares).[105] This is somewhat ironic, as its Investment Stewardship team, the unit that speaks out on corporate governance issues on behalf of Blackrock Inc., has been very outspoken in its criticism of dual class share structures.[106] Other information traders who have invested in Snap shares include NBCUniversal, a unit of

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[95] Kaitlin Descovich, Melanie A. Conroy, Cathy Dixon and Ellen Odoner, Weil, Gotshal & Manges LLP, *Voting Rights Gone in a Snap − Unequal Voting Rights Back in the Spotlight*, Governance & Securities Alert (April 3, 2016), available at, http://www.weil.com/~/media/publications/alerts/2017/pcag-alert.pdf.
[96] *Id.*
[97] Michael Greene, *Snap IPO Gets Investors Fired Up Over Dual-Class Stock*, The Bureau of National Affairs, Inc. (March 9, 2017), www.bna.com /snap-ipo-gets-n57982084963/.
[98] Lauren Hirsch, *Snap's shares pop after year's biggest IPO*, Reuters (March 2, 2017), http://www.reuters.com/article/us-snap-ipo-idUSKBN1690I7.
[99] *Id.*
[100] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 714 (2006).
[101] *Id*. at 723.
[102] *Id.* at 726.
[103] *Id.* at 719.
[104] Rose & Sharfman, *supra* note 62, at 1033.
[105] Noel Randewich and Trevor Hunnicutt, *Snap surges after Wall Street heavyweights reveal stakes*, Reuters (May 15, 2017), available at http://www.reuters.com/article/snap-stocks-idUSL2N1IH0XV.
[106] Letter from Pru Bennett and Winnie Pun, Blackrock Inc. to Listing Policy & Product Admission, Singapore Exchange Limited, *RE: Possible Listing Framework for Dual Class Share Structures* (April 13, 2017) (encouraging the Singapore stock exchange not to list dual class shares), available at https://www.blackrock.com/corporate/en-co/insights/public-policy/viewpoints-letters-consultations#letters-and-consultations.

Comcast Corp, who invested $500 million in the Snap Inc. IPO (approximately 29.4 million shares),[107] Third Point LLC (2.25 million shares) and Jana Partners LLC (550 thousand shares); investment banker and asset manager, Goldman Sachs Group Inc. (1.1 million); and large asset managers such as Soros Fund Management LLC (approximately 1.7 million shares)[108] and Och-Ziff Capital Management (approximately 1 million shares).[109]

What is most interesting about this list of investors, besides the Blackrock investment, is the notable appearance of two activist hedge funds, Third Point LLC and Jana Partners LLC. These investors usually find it critical to hold significant amounts of voting stock, 5%-10% of the voting shares outstanding, in order to have some foundation to at least threaten a proxy contest if their recommendations are ignored by the target's Board. But with their investment in Snap Inc. non-voting shares, they appear to be taking on the role of value investor, not hedge fund activist. It is also noteworthy to mention that Third Point purchased 3 million shares of Facebook worth approximately $426 million during the first quarter of 2017.[110] Perhaps even without much or any voting power, Third Point and Jana Partners still felt they could influence these companies when circumstances created a receptive environment for their advice.

In sum, there was no lack of institutional investor interest in the Snap IPO. This is consistent with the finding by Anderson, Ottolenghi and Reeb that institutional investors hold 87.4% of the free float in dual class firms that still have family members with voting power equal to or greater than 5%.[111] Moreover, investors in the Snap IPO were not passive, uninformed investors but those who can be described as value investors.

C. The Value of Private Ordering

Why would value investors in Snap's IPO be so tolerant of a unique corporate governance arrangement, a dual class share structure with non-voting shares, that so obviously increases the potential for agency costs? There are two reasons: the wealth maximizing efficiency that results from the private ordering of corporate governance arrangements, and the understanding that agency costs are not the only costs of governance that need to be minimized.

An understanding of private ordering begins with Michael Jensen and William Meckling famously describing an organization as a "legal fiction" that serves "as a nexus for a set of contracting relationships among individuals."[112] How those contracting relationships are shaped "depend on the outcome of the *bargaining process* that takes place between the contracting parties."[113] This bargaining process in the context of corporate governance arrangements is referred to as *private ordering*.

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[107] Adam Lashinsky, *Why NBC Universal Got In on Snap's IPO*, Fortune (March 6, 2017), http://fortune.com/2017/03/06/why-nbc-universal-got-in-on-snaps-ipo/.

[108] Noel Randewich and Trevor Hunnicutt, *Snap surges after Wall Street reveal stakes*, Reuters (May 15, 2017), available at www.reuters.com /article/us-snap-stocks-idUSKCN18B26D.

[109] Jennifer Ablan, Svea Herbst-Bayliss and Trevor Hunnicutt, *High-profile Snap stakeholders revealed in filings*, Reuters (May 12, 2017), available at http://www.reuters.com/article/us-investment-funds-idUSKBN18830X.

[110] Third Point LLC, Form 13F-HR, Information Table as of March 31, 2017 (filed May 12, 2017), available at https://www.sec.gov/Archives/edgar/data/1040273/000108514617001247/xslForm13F_X01/form13fInfoTable.xml.

[111] Anderson, Ottolenghi and Reeb, *supra* note 75, at 28.

[112] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

[113] Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1272 (1999).

Private ordering is considered efficient and desirable because it allows for the implementation of market-driven corporate governance arrangements.[114] That is, it "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[115] In effect, "observed governance choices are the result of value-maximizing contracts between shareholders and management."[116]

Shareholders, the sole claimants to the residual cash flows generated by the firm, would argue that since they are the least contractually protected versus other parties, they deserve shareholder wealth maximization as the gap filler in their corporate contract.[117] That is, they are the parties to the corporate contract that have the greatest risk of ending up with nothing as a result of their dealings with the corporation. Why other stakeholders would support a Board and executive management targeting shareholder wealth maximization is because all other parties that have contracted with the corporation must be paid off prior to the shareholders receiving a residual, if any.[118] Moreover, as stated by Henry Manne, the result of shareholder wealth maximization being the corporate objective is an example of "pure positive economics"[119] and should be accepted as such.

It is also important to note that public companies overwhelmingly take the corporate form so they can take advantage of the private ordering that corporate law allows. Corporate law enables private ordering by providing default, not mandatory, rules.[120] For example, Delaware General Corporation Law 212(a) provides for a default rule of one-share one-vote.[121] However, Delaware General Corporation Law 151(a) allows for the use of dual class share structures if provided for in the company's certificate of incorporation.[122] Moreover, state corporate law and its provision for private ordering are not expected to be interfered with by federal law. As the Supreme Court has said, "[c]orporations are creatures of state

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[114] According to Macey,

> [B]ecause informal norms generate outcomes that are generally welfare-enhancing, while law *at best* generates outcomes that are mixed (and tend strongly towards the welfare-reducing), informal norms should come with a strong presumption of legitimacy. Formal legal rules are likely to be inefficient at best and amorally redistributive at worst. Thus, under a wide range of circumstances, such as when society is interested in maximizing utilitarian considerations, and when society is interested in resolving standard legal disputes within groups, lawmakers are unlikely to improve upon the customary rules the group develops through voluntary, private interaction.

Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1140 (1997).

[115] Troy A. Paredes, Comm'r, US Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009tap.htm.

[116] David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

[117] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 579 (2003).

[118] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 107-108 (1991) at 38 ("[M]aximizing profits for equity investors assists the other "constituencies" automatically.").

[119] E-mail from Henry G. Manne, Professor Emeritus of Law, Geo. Mason Univ., to Bernard S. Sharfman (December 29, 2012) (on file with author).

[120] According to the Court in *Williams v Geier*, "At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial *private ordering*, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored." 671 A.2d 1368, 1381 (1996).

[121] DGCL § 212(a).

[122] DGCL § 151(a).

law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[123] As such, "The voting rules are considered to be a matter of private contract between the firm and its various types of investors."[124]

Most significantly, private ordering under corporate law is not a free-for-all. It is a structured approach that purposefully selects the Board to take the lead in determining the optimal corporate governance arrangements. According to Michael Klausner, "The contractarian theory of the firm . . . implies a theory of the role of corporate law: corporate law should merely provide a set of default rules that managers may adopt on behalf of their firms, while leaving managers free to customize their companies' charters with legally enforceable rights and obligations."[125]

Board-initiated private ordering of governance arrangements is an application of the most important default rule under corporate law,[126] the rule that provides the board with ultimate decision-making authority. For example, under Delaware corporate law, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[127] On its face, that statutory rule provides the board with unlimited managerial authority, subject only to the limitations imposed by judical equity.[128] Public companies never substantively modify the default rule,[129] and its lack of modification needs to be acknowledged as the first and most fundamental step in such a company's private ordering process.[130] The default rule is so universally accepted that it most likely could have been written as a mandatory rule without restricting the contracting parties' abilities to enter into private ordering.[131] That is, if a bargaining process truly goes on between contracting parties in a public company, then there seems to be overwhelming support for allowing the board to retain ultimate decision-making authority.[132]

Superior decision-making efficiency and the expected result of shareholder wealth maximization is the rationale that explains why the outcome of the bargaining process always allows section 141(a) of Delaware General Corporate Law (DGCL) to be incorporated without modification into a public company's charter and that by extension allows the board to control the private ordering of corporate

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[123] Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 479 quoting Cort v. Ash, 422 U.S. 66, 84 (1975).
[124] Fischel, *supra* note 20, at 120.
[125] Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 780 (2006).
[126] Although default rules can be modified, "the default rule is tailored toward what the legislature believes most, but not all, of an organization's stakeholders would have agreed to if contracting were efficient." James D. Cox, *Corporate Law and the Limits of Private Ordering* (Duke Law School, Public Law & Legal Theory No. 2015-47, 2015), at 7, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2671850.
[127] DEL. GEN. CORP. L. § 141(a) (2011).
[128] Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, NYU J. BUS. & L. (2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2888052.
[129] *Id. See also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").
[130] Bernard S. Sharfman, *What Theory and Empirical Evidence Tell Us about Proxy Access*, 13 J. L. ECON. & POLICY 1, 9 (2017).
[131] Bernard S. Sharfman, *The Tension Between Hedge Fund Activism and Corporate Law*, 12 J. L. ECON. & POLICY 251, 264 (2016).
[132] *Id*.

governance arrangements, including the decision of whether or not to use a dual class share structure when going public.[133] Corporate law concentrates ultimate decision-making authority in the board because lawmakers recognize that a centralized, hierarchical authority is necessary for the successful management of a public company that can become extremely large in size.[134] In sum, what is desired by the contracting parties in terms of decision-making can be summarized in the following statement by Stephen Bainbridge: "Preservation of managerial discretion should always be the null hypothesis."[135]

D. Why Shareholders Agree to the Dual Class Share Structure

Through the bargaining process, the dual class share structure arises. Again, why would rational investors who purchase shares in an IPO voluntarily go beyond the default rules of corporate law and hand over control to insiders, such as the founders, especially when it comes in the form of no voting rights and nominal sunset provisions such as in the Snap Inc. IPO?

The answer can be found in looking at an IPO with a dual class share structure as a continuum of what has occurred prior to the IPO. During the time when a successful company is still in the pre-IPO phase but not generating enough positive cash flow, if any, to meet its cash needs, it will go through several rounds of private financing, including new equity financing. For example, Snap Inc. went through several rounds of larger and larger pre-IPO financing that started with a small amount of seed money provided by Lightspeed Venture Partners in 2012.[136] Investors in these later rounds of private funding included four Fidelity mutual funds and T. Rowe Price.[137] During each round of new financing, the issue

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[133] *Id.*

[134] According to Robert Clark, hierarchies in large organizations lead to the "facilitation of cooperation in the carrying out of large-scale tasks." ROBERT CHARLES CLARK, CORPORATE LAW 801 (1986). According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority for a large organization to make informed decisions and minimize error in decision-making. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974). Armen Alchian and Harold Demsetz argue that a centralized authority is necessary to eliminate the problems associated with having a large number of shareholders:

> If every stock owner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group, whose main function is to negotiate with and manage (renegotiate with) the other inputs of the team.

Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972). As observed by Michael Dooley, for companies with a large number of shareholders, it is much more efficient for the board—the corporate actor that possesses overwhelming advantages in terms of information, including nonpublic information—to make corporate decisions than for shareholders or any other party that contracts with the corporation to do so. Michael P. Dooley, *Two Models of Corporate Governance,* 47 BUS. LAW. 461, 467 (1992).

[135] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VANDERBILT L. REV. 83, 109 (2004).

[136] Alex Konrad, *Snap's IPO Means A Huge Windfall For These VC Investors*, Forbes.com (Feb. 2, 2017), https://www.forbes.com/sites/alexkonrad/2017/02/02/snap-ipo-means-big-windfall-for-early-snapchat-investors/#4c8168b1b414.

[137] Tim McLaughlin, Fidelity, *T. Rowe Poised for Gains on Snap IPO*, Reuters (Feb. 24, 2017), available at http://www.reuters.com/article/us-snap-ipo-funds-idUSKBN16323B. Mutual funds, such as Fidelity and Blackrock, have been increasing their investment in successful private companies during the later rounds of their pre-IPO financing. *See* Sergey Chernenko, Josh Lerner, and Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns* (Jan. 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2897254.

of whether the founders or some other insiders are to maintain voting control of the company will need to be addressed. Assuming they are able to maintain control, it will be the result of those investors providing the fresh round of new private equity financing agreeing with insiders that such control is necessary in order for the company to flourish and for the value of their investment to be maximized.

The investors who agree to insider control during the rounds of private financing are not uninformed of the agency costs that could potentially arise from allowing insiders to retain control. They are, after all, savvy investors who are able to seriously bargain with insiders on the issue of continued control. They are, or should be, the most informed of all when it comes to understanding this particular company.

This same bargaining process continues when it is time for the IPO.[138] This process requires informed investors to consider the value of having insider control and the costs of shareholder participation in corporate decision making, not just agency costs. That is, it requires informed investors to utilize a holistic calculus, not just a calculus based on agency costs. This holistic calculus is best understood in the context of Zohar Goshen and Richard Squire's newly proposed "principal-cost theory."[139] This theory posits that a firm's optimal corporate governance arrangements result from the minimization of total control costs as defined below:

> [E]ach firm's optimal governance structure minimizes the sum of *principal costs*, produced when investors exercise control, and *agent costs*, produced when managers exercise control. Both principal costs and agent costs can arise from honest mistakes (which generate *competence costs*) and from disloyal conduct (which generate *conflict costs*). When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs. To avoid such costs, they delegate control to more competent managers. But delegation separates ownership from control, leading to agent conflict costs, and also to principal conflict costs to the extent that principals retain the power to hold managers accountable. Finally, managers themselves can make honest mistakes, generating *agent competence costs*. Thus, the allocation of control rights in a governance structure is aimed at minimizing total *control costs* (i.e., the sum of all four categories).
>
> Agent costs and principal costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other. The rate of substitution is firm-specific, driven by factors such as business strategy, industry, and the personal characteristics of the key parties. Therefore, each firm has a *distinct* division of control rights that minimizes total control costs. Because the cost-minimizing division varies by firm, the optimal governance structure does as well. The implication is that law's proper role is to allow firms to select from a wide range of governance structures, rather than mandating some structures and banning others.

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[138] Although Uber already had a dual class structure in place, it will be interesting to see if the management debacle at Uber, a company valued at up to $70 billion even though it has yet to go public, still leads to a dual class share structure when and if it has an IPO. *See* Heather Somerville, *Uber CEO's iron grip poses challenge in COO search*, Reuters (April 13, 2017), available at http://www.reuters.com/article/us-uber-governance-idUSKBN17F1CO. An internal investigation of Uber found that the company was suffering from a toxic work culture. This led to the resignation of Travis Kalanick as Chief Executive Officer even though he had significant voting power as the holder of super-voting shares. *See* Mike Isaac, *Inside Travis Kalanick's Resignation as Uber's C.E.O.*, New York Times (June 21, 2017), available at https://www.nytimes.com/2017/06/21/technology/uber-travis-kalanick-final-hours.html.

[139] Goshen and Squire, *supra* note 26, at 767.

> Agency-cost essentialists focus on one of the four categories of control cost we have identified: agent conflict costs. They downplay agent competence costs, and more important, they largely disregard both types of principal cost. Yet principal costs are more fundamental than agent costs, as the goal of reducing them is the reason that investors delegate control to managers, generating the conflict costs that preoccupy agency-cost scholars. A firm that seeks to maximize total returns will weigh principal costs against agent costs when deciding how much control to allocate to managers and how much to restrict the power of investors to hold the managers accountable.[140]

This approach to identifying the optimal corporate governance arrangements at a particular firm utilizes a calculus that seeks to minimize total control costs. Most importantly, it is a calculus that allows for the fundamental value of authority in large organizations to be respected, after all that is why shareholders delegate managerial authority to the Board and executive management in the first place. According to Kenneth Arrow, when discussing the trade-off between authority and responsibility in a large organization:[141]

> There is much to be done in the design of institutions to reconcile the values of responsibility and authority, …. To serve its functions, responsibility must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and *continuous* organ of responsibility can easily amount to a denial of authority." If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[142]

This calculus is also consistent with Stephen Bainbridge's normative explanation of his director primacy model of corporate governance: "As a normative theory of corporate governance, director primacy claims that resolving the resulting tension between authority [the Board and by delegation, executive management] and accountability [by shareholders] is the central problem of corporate law."[143] The calculus also allows for the potential for Bainbridge's director primacy as a positive theory to be proven correct for any particular firm: "As a positive theory of corporate governance, the director primacy model strongly emphasizes the role of fiat - i.e., the centralized decisionmaking authority possessed by the board of directors."[144] In the context of Goshen and Squire's calculus, Bainbridge is arguing that principal costs will greatly outweigh agency costs when total control costs are minimized.

Moreover, according to Michael Dooley, "Where the residual claimants are not expected to run the firm and especially when they are many in number (thus increasing disparities in information and interests), their function becomes specialized to risk-bearing, thereby creating both the opportunity and necessity for managerial specialists."[145] According to Sharfman, "Especially where there are a large number of shareholders, it is much more efficient, in terms of maximizing shareholder value, for the Board and executive management—the corporate actors that possess overwhelming advantages in terms

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[140] Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, The CLS Blue Sky Blog (May 8, 2017), available at http://clsbluesky.law.columbia.edu/2017/05/08/principal-costs-a-new-theory-for-corporate-law-and-governance/ citing Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 770-72 (2017).
[141] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974).
[142] *Id.* at 77-78.
[143] Stephen B. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 605 (2003).
[144] *Id.*
[145] Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 467 (1992).

of information, including nonpublic information, and whose skills in the management of the company are honed by specialization in the management of this one company—to make corporate decisions rather than shareholders."[146]

The need to protect the value of authority is at its optimum, and *agent competence costs* at their lowest, when insiders, such as the founders, possess an "idiosyncratic vision" of where the company should go at the time of the IPO.[147] Dual class share structures "provides the entrepreneur with maximum ability to realize her idiosyncratic vision"[148] and appears to be an explanation for why this structure has been bargained for at Snap (Evan Spiegel and Robert Murphy) and also at firms such as Berkshire Hathaway (Warren Buffet), Alphabet (Larry Page and Sergey Brin), Facebook (Mark Zuckerberg), Alibaba (Jack Ma) and Comcast (Roberts family).

According to Zohar Goshen and Assaf Hamandi, voting control allows the entrepreneur "to retain control over management decisions to pursue her idiosyncratic vision for producing above market returns. That is, [voting] control enables entrepreneurs to capture the value that they attach to the execution of their idiosyncratic vision."[149] Therefore, when shareholders allow the bargaining to result in an IPO with a dual class share structure they are expressing their understanding that the "genuine values of authority" need to be preserved and that the best way to minimize total control costs is through the retaining of control by those insiders who possess an idiosyncratic vision. The protection of this idiosyncratic vision more than compensates for an expected increase in *agent conflict costs*.

Once we start thinking in terms of minimizing total control costs, it becomes easier to accept that allowing for the private benefits of control associated with dual class share structures may actually be a contributing factor to the long-term value of the firm.[150] According to Albert Choi, "the larger the private benefits of control, the more likely that the controller will be locked-in with the firm for the long-term and care about the firm's long-run performance."[151] If so, then all shareholders should benefit from this lock-in effect despite the agency costs that are also generated.[152]

From the perspective of market participants, Bebchuk and Kastiel's expectation of rising *agent competence* and *conflicts costs* over time are most likely minimized by the expectation that the potential for an erosion of leadership skills and the development of a significant wedge, respectively, may not occur for many years or decades into the future, if ever. Examples include the long-term success of Warren Buffett at Berkshire Hathaway and Brian Roberts at Comcast, LinkedIn being bought out by Microsoft soon after its IPO, or a mid-stream conversion (post IPO) of super-voting shares to ordinary shares when the controllers believe it will be wealth enhancing for them and other shareholders.[153] In regard to a mid-stream conversion, Forest City Realty Trust, Inc.'s recent elimination of its dual class

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[146] Sharfman, *supra* note 59, at 817.
[147] Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560 (2016).
[148] *Id.* at 590.
[149] *Id.* at 566.
[150] Albert Choi, *supra* note 90.
[151] *Id.* at 6.
[152] *Id.*
[153] Valentin Dimitrov and 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) (finding that a sample of 178 controlled firms that went through a process of recapitalization utilizing a dual class share structure from 1979 to 1998 earned abnormal positive returns).

share structure serves as an example.[154] At Forest City, the elimination was meant to create a corporate governance structure more in line with other publicly traded REITs, helping to interest more investors who specialize in purchasing REITs.[155] As a result, the Ratner family, who controlled the company through the ownership of super-voting shares, is voluntarily giving up voting control of the company.[156] Worthy of mention is that the change was spearheaded by an activist hedge fund, Scopia Capital Management, who owned 8.4% of the ordinary shares.[157] Moreover, the odds of an elderly leader problem developing at a company like Snap look extremely remote. For better or worse, unexpected events unrelated to having a dual class share structure can affect Snap and its young leadership in the many years between now and when this issue may develop, making the risk of having such a result very low if not de minimis.

In addition, the concern about the wedge may be overblown. According to a recent empirical study by Anderson, Ottolenghi and Reeb, no evidence was found "of a significant relation between stock returns and the wedge separating voting rights and cash flow rights."[158] However, what they did find was that dual class shares yielded excess returns over a 15-year time frame and "that single and dual class family firms with similar levels of control exhibit similar excess returns, suggesting the premium centers on family control rather than dual class shares."[159]

Of course, the pricing of the IPO is central to allowing the private ordering process to take place and moving the company toward the most optimal corporate governance arrangements. Utilizing a dual class share structure when it does not minimize total control costs comes at a financial cost to both insiders and the company, encouraging them to use such a structure only when it is truly value enhancing for all parties. That is, the offering price and future trading price of the stock will need to be adjusted downward if the optimal corporate governance arrangements are not implemented up-front. If so, the wealth of the insiders in the form of company stock may be significantly reduced and the funds provided to the company in the IPO may be significantly less than what could have been raised. Conversely the offering price in an IPO will be at its maximum when total control costs are minimized. Perhaps this is why IPOs with dual class share structures are still the exception to the rule, as the market provides sufficient incentives and penalties to make sure they are used only when minimizing total control costs.

E. Summary

A dual class share structure allows for the continuation of the governance arrangements that existed prior to the IPO. It also provides the founders the right to manage the company as if it were still private. From the perspective of agency costs, an IPO that incorporates such a structure has many troubling aspects including being immune to the corrective mechanisms found in the market for corporate control and hedge fund activism, a "wedge" between voting and cash flow rights that can be become quite extreme over time, and a value of leadership that may erode over time. However, agency costs are not the only costs involved in determining a firm's optimal corporate governance arrangements. As described by

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[154]Michelle Jarboe, *Forest City to eliminate dual-class stock structure, reduce Ratner family's presence on board*, Cleveland.com, (December 6, 2016) (the stock jumped 9.8% on the news), http://realestate.cleveland.com/realestate-news/2016/12/forest_city_to_eliminate_dual-.html.
[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] Anderson, Ottolenghi and Reeb, *supra* note 75, at 5.
[159] *Id.*

Goshen and Squire, principal costs, including actions by the shareholder empowerment movement that are intended to maximize shareholder wealth, must also be considered and the calculus involved in determining the optimal arrangements requires a focus on total control costs, not just agency costs.

Most importantly, private ordering pressures a Board to launch an IPO with corporate governance arrangements that minimizes these total control costs. If not, then the founders and the company face potentially stiff financial penalties. Moreover, the imprudent use of the dual class share structure should not penalize the IPO investor. According to Daniel Fischel:

> As a theoretical matter, initial public offerings of limited or non-voting stock can never harm investors. The price of a security when a firm goes public reflects the value of that security to investors. Investors only purchase a security when they estimate that the value of whatever rights and cash flows it carries equals or exceeds its price. If investors' value voting rights and a firm fails to provide them, then the firm's securities simply sell at a lower price. The organizers of the firm may be worse off, but investors are not.[160]

Consistent with this statement, but also rationalizing the absence of the market for corporate control, Ronald Gilson states:

> A stock's limited voting rights are reflected in a reduced price, so that the company's owners at the time it goes public, and not the purchasers, bear the cost. Shareholders are not fooled and there is no reason to expect that third parties will be adversely affected. Although a company that goes public with a class of stock with limited voting rights will be substantially sheltered from the market for corporate control, this is not a change in status. *The company also was not subject to the market for corporate control before it went public.*[161]

Gilson's statement would appear to apply to hedge fund activism as well.

CONCLUSION

It is important to understand that while excellent arguments can be made that the private ordering of dual class share structures must incorporate certain provisions, such as sunset provisions,[162] it is an overreach for academics and shareholder activists to dictate to sophisticated capital market participants, the ones who actually take the financial risk of investing in IPOs, including those with dual class share structures, how to structure corporate governance arrangements. Obviously, all the sophisticated players in the capital markets who participate in an IPO with dual class shares can read the latest academic articles on dual class share structures, including the excellent new article by Lucian Bebchuk and Kobi Kastiel,[163] and incorporate that information in the bargaining process without being dictated to by parties who are not involved in the process. If, as a result of this bargaining, the dual class share structure has no sunset provision and perhaps even no voting rights in the shares offered, then we must conclude that these

[160] Fischel, *supra* note 20, at 147. Anderson, Ottolenghi, and Reeb found a valuation discount of approximately 12%. *See supra* note 75, at 30.
[161] Ronald Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808–809 (1987).
[162] Bebchuk and Kastiel, supra note 4.
[163] *Id.*

terms were what the parties required in order to get the deal done, with the risks of the structure being well understood.

It is just as important to closely scrutinize arguments that would disrupt this private ordering in order to meet non-wealth maximizing objectives. For example, the argument that this private ordering must be disrupted in order to make sure that index funds are not ultimately forced to hold non-voting or less equal voting shares into their portfolios. While excluding dual class shares would potentially serve the non-wealth maximizing purposes of those institutions that make up the shareholder empowerment movement, the vast bulk of index fund investors would be harmed because they would be denied the opportunity to invest in the excluded stocks. Without the inclusion of dual class shares, the index funds would be less representative of what they are trying to represent.[164] For example, it would be hard to imagine investing in an S&P 500 index fund without the inclusion of such companies as Alphabet (Google), Facebook, Comcast, Alibaba, Berkshire Hathaway and Snap Inc. Given that these and similar companies fuel the growth in the value of our stock markets; their absence would greatly challenge the benefit of having such indexes in the first place. It would be even worse for those investors who are investing in an index of technology stocks that exclude dual class shares since technology stocks rely more heavily on dual class share structures.

Moreover, index funds cater to liquidity traders, traders "who buy and hold a portfolio of stocks based on consumption/saving considerations independently of general market or firm-specific information."[165] They are the ultimate non-information trader who sees little or no value in the ability to vote.[166] What value would such exclusions have to these investors?

Ironically, investors could ultimately have access to excluded stocks, but they would be forced to include them through direct purchases or through higher cost actively managed mutual funds that allow for such purchases. Of course, the whole point of index funds is that passive, uninformed investors can avoid the costs of creating their own portfolios, the search costs of identifying actively managed funds which can be expected to earn excess returns and the payment of high annual management fees.

A senior leader in the shareholder empowerment movement stated that "Anybody who buys non-voting shares is a nitwit."[167] Obviously, given the impressive list of information traders who have purchased Snap's non-voting shares, this insult is without foundation. These investors may at times incorrectly gauge the value of a particular stock, but they are far from being nitwits. Neither is it the kind of guidance needed to determine if a dual class share structure with or without voting shares yields the optimal corporate governance arrangement. The determination requires analysis and above all else, bargaining, not a conclusory statement. Instead, we need to follow the guidance of Daniel Fischel, the famous corporate law scholar who had a clear vision of the role played by dual class shares in the private ordering of corporate governance arrangements:

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[164] Alex Bryan, Unintended Biases in ESG Index Funds, (July 6, 2016), available at http://www.morningstar.com/advisor/t/115903938/unintended-biases-in-esg-index-funds.htm

[165] Goshen & Parchomovsky, supra note 100, at 714.

[166] Id. at 721–23 (2006). Non-information traders also include *insiders* such as directors and executive management who have access to non-public information but are significantly restricted in the trading of that information; *noise traders* who invest based on fads, rumors or old information; and *market makers*, professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis. *Id.* at 720–26.

[167] Matt Townsend and Michelle F. Davis, Why Under Armour CEO's Power Play Looks Like Bad Governance (June 16, 2015), available at https://www.bloomberg.com/news/articles/2015-06-16/why-under-armour-ceo-s-power-play-looks-like-bad-governance.

> Some may argue that unequal voting rights are undesirable because they are inconsistent with the principle of "corporate democracy." This argument, however, is fundamentally flawed. All firms, including corporations, consist of contractual relationships freely entered into by economic actors to maximize their joint welfare. Who has the right to vote and how and when the vote can be exercised are rights that are typically allocated by contract. In contrast to governmental democracies--which are usually designed to serve broader goals than wealth maximization--*the optimal voting rules for any particular firm are those that maximize its value*.[168]

In sum, capital markets paternalism is not required when it comes to IPOs with dual class share structures.

[168] Fischel, *supra* note 20, at 140-41.