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THE PERILS OF SMALL-MINORITY CONTROLLERS

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Forthcoming, *Georgetown Law Journal*, 2019

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Abstract

This Article contributes to the long-standing and heated debate over dual-class companies by placing a spotlight on a significant set of dual-class companies whose structures raise especially severe governance concerns: those with controllers holding a small minority of the company's equity capital. Such small-minority controllers dominate some of the country's largest companies, and we show that their numbers can be expected to grow.

We begin by analyzing the perils of small-minority controllers, explaining how they generate considerable governance costs and risks and showing how these costs can be expected to escalate as the controller's stake decreases. We then identify the mechanisms that enable such controllers to retain their power despite holding a small or even a tiny minority of the company's equity capital. Using a hand-collected analysis of governance documents of these companies, we present novel empirical evidence of the current incidence and potential growth of small-minority and tiny-minority controllers. Among other things, we show that governance arrangements at a substantial majority of dual-class companies enable the controllers to reduce their equity stake to below 10% and still retain a lock on control, and that a sizable fraction of such companies enable retaining control with less than a 5% stake.

Finally, we examine the considerable policy implications that arise from recognizing the perils of small-minority controllers. We first discuss disclosures necessary to make transparent to investors the extent to which arrangements enable controllers to reduce their stake without forgoing control. We then identify and examine measures that public officials or institutional investors could take to ensure that controllers maintain a minimum fraction of equity capital; to provide public investors with extra protections in the presence of small-minority controllers; or to screen midstream changes that can introduce or increase the costs of small-minority controllers.

Keywords: Corporate governance, agency problems, dual-class, controlling shareholders, small-minority controllers, tiny-minority controllers, wedge, nonvoting stock, IPO.

JEL Classification: G32, G34, K22

Table of Content

I. INTRODUCTION

Snap, the owner of the disappearing-message application Snapchat, went public last year at a valuation exceeding $20 billion with a multiple-class structure that creates significant risks. Following the initial public offering, Snap's young co-founders, Evan Spiegel and Bobby Murphy, owned a substantial fraction of Snap's equity capital—about 18% each. Our analysis of Snap's IPO structure, however, indicates that it would enable the co-founders to unload an overwhelming majority of their shares—lowering their economic stakes to 1.4% of the company's equity capital each—and still retain control.[1] Snap's offering documents do not disclose this significant aspect or discuss the considerable governance risks that it generates.[2]

Facebook, Snap's larger and older rival, went public in 2012 with a dual-class structure that placed some limits on the ability of its founder, Mark Zuckerberg, to reduce his fraction of equity capital without relinquishing control.[3] In April 2016, however, Facebook passed a reclassification plan, approved by Zuckerberg's majority voting power, that would have enabled Zuckerberg to sell two-thirds of his Facebook shares—reducing his stake of equity capital to about 4% and possibly less—without losing his controlling voting power. Eventually, in September 2017, Facebook announced its decision not to proceed with the reclassification plan for the time being, and Zuckerberg currently continues to face significant limits on his freedom to unload shares without losing his control.[4]

In this Article, we seek to place a spotlight on dual-class structures that enable controllers to have a lock on control (that is, the ownership of more than 50% of the voting power) with only a small or even a tiny fraction of the company's equity capital. We argue that such structures can be expected to generate considerable governance risks and costs, and that they therefore deserve the close attention of public officials and institutional investors. We also show that these governance risks and costs are expected to rise steeply as the controller's stake declines.

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[1] For information on Snap's IPO structure and the ability of the company's co-founders to unwind their equity position, see *infra* notes 76–82 and 94–95 and accompanying text.

[2] Similarly, Dropbox went public recently, and our analysis of its IPO documents also reveals the considerable risk that the company's co-founders, Andrew Houston and Arash Ferdowsi, would be able to hold lifetime control even if they would retain only a tiny minority of the company's equity capital. Although the IPO documents do not make this risk transparent to investors, a close analysis shows that the IPO structure contains some of the governance mechanisms that we identify below as facilitating extreme separation between voting power and equity ownership. For the preliminary IPO documents of Dropbox, s*ee* Dropbox Inc., Registration Statement (Form S-1) 1 (Feb 23, 2018).

[3] The statements of this paragraph are based on an analysis of the data in Facebook 2012 IPO's prospectus and 2016 disclosures. *See* Facebook Inc., Amendment No. 8 to Registration Statement (Form S-1) 141 (May 16, 2012); Facebook Inc., Proxy Statement (Form DEF 14A) 37–40, 55–74 (June 2, 2016); and Facebook Inc., Current Report (Form 8-K) (June 20, 2016).

[4] *See infra* note 98.

Furthermore, using a hand-collected dataset of governance provisions in dual-class companies, we provide the first empirical evidence on the incidence of various mechanisms that facilitate the retention of control with only a small equity stake; the incidence of small-minority controllers; and, perhaps most importantly, the potential incidence of small-minority controllers that existing governance arrangements permit. Using these arrangements, our empirical analysis indicates, a substantial majority of dual-class controllers can retain a lock on control with a below-10% equity stake, and a sizable fraction of such controllers can retain control with a below-5% equity stake.

Finally, we analyze the considerable implications that recognizing the perils of small-minority controllers have on both public officials (including regulators and courts) and institutional investors. To that end, we examine both regulatory interventions and private-ordering responses.

The use of dual-class structures has been the subject of a heated debate.[5] Companies have increasingly gone public with dual-class structures, including some of the country's most well-known companies, such as Alphabet (formerly Google), Berkshire Hathaway, Facebook, Ford, News Corp, Nike, and Viacom.[6] At the same time, leading institutional investors and market participants have increasingly expressed strong opposition to dual-class structures.[7] In this long-standing debate, both proponents and opponents have often lumped all dual-class structures together into one category. By contrast, we seek to reorient the debate by stressing certain key differences among dual-class structures.

Dual-class structures generally enable a shareholder to retain a lock on control with less than a majority ownership stake. Thus, they commonly create what the literature refers to as a "controlling minority shareholder," a term introduced in an early work that one of us co-authored with Reinier Kraakman and George Triantis.[8] In this currently Article, we wish to focus on the subset of controlling minority shareholders using a dual-class structure whose stake is not merely a minority stake, but rather a "small-minority" stake (defined as below 15% of equity capital), a "very-small-minority" stake (below 10%), or even a "tiny-minority" stake (below 5%). Controllers

[5] *See infra* Section II.A.

[6] *See* Investor Responsibility Research Center Institute, Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk, 84–90, Mar. 2016, http://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf. In 2015, Google announced a corporate reorganization that created a holding company, Alphabet Inc., with Google as a subsidiary. Julia D'Onfro, *Google Is Now Alphabet*, BUS. INSIDER: TECH INSIDER (Oct. 2, 2015, 10:56 AM), http://www.businessinsider.com/google-officially-becomesalphabet-today-2015-10. Because the Google name is still commonly used, that name will also be used in this Article.

[7] *See infra* notes 19–23.

[8] *See* Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 298–301 (Randall K. Morck ed., 2000).

holding such stakes pose enhanced governance risks relative to other controlling minority shareholders.

The analysis of this Article is organized as follows. Part II begins by discussing the long-standing and heated debate over dual-class structures and how we aim to contribute to and reorient it. We then explain why structures with small-minority controllers can be expected to produce considerable governance risks and costs. In companies that are widely held, the market for corporate control and the threat of replacement incentivize corporate insiders to serve the interests of public investors. In companies with a majority owner, the disciplinary force of the control market does not operate, but the controller's ownership stake forces the controller to bear the majority of the effect of his choices on total market capitalization: this thus provides strong ownership incentives that align the controller's interests with those of public investors. By contrast, a company with a small-minority controller lacks both the discipline of the control market and the incentives generated by having to bear a majority of any effect on total market capitalization.

We show how the decisions made by small-minority controllers can be expected to be distorted across a wide range of corporate choices, including allocation of opportunities and talents, decisions whether to remain as the CEO, choices of strategy and company scale, related-party-transactions, and responses to acquisition offers. In these contexts, small-minority controllers can be expected to make value-reducing choices. Furthermore, the generated agency distortions and costs can be expected to steeply escalate when the controller's equity stake declines. Finally, we discuss a body of empirical evidence that supports our conclusions regarding the expected costs of small-minority controllers and the relationship of these costs to the controller's ownership stake.

Part III identifies and explains the operation of mechanisms that are used to enable shareholders to retain control despite owning only a small minority of the company's equity capital. Furthermore, using a hand-collected dataset of governance arrangements in dual-class companies, we provide empirical evidence about the incidence and use of these mechanisms.

The mechanisms that Part III analyzes include (i) "hardwiring" provisions granting the controller the ability to elect a majority of board members, or to cast a fixed fraction of votes, regardless of how small the controller's equity stake might become; (ii) a large difference between the voting power of high-vote and low-vote shares; (iii) nonvoting shares, which represent an extreme case of infinitely high ratio between the voting power of high-vote and low-vote shares; (iv) arrangements aimed at limiting the consequences that the controller's stock sales could have for the controller's lock on power; and (v) arrangements aimed at constraining the consequences that high-voting shares held by third parties could have on the controller's lock on power.

Part III also analyzes midstream changes, such as nonvoting stock reclassifications, that can be used to amend existing governance arrangements to enhance the controller's ability to unload shares without relinquishing control. Google, for example, recently adopted such a

nonvoting stock reclassification, paving the way for its co-founders to substantially reduce their ownership stake while remaining firmly in control.[9] We show that the future use of such nonvoting stock reclassification could enable controllers to reduce their ownership stakes to negligible levels without weakening their grip on control.

Part IV presents novel empirical evidence, on the basis of our hand-collected dataset of governance provisions in dual-class structures, of the incidence of small-minority, very-small-minority, and tiny-minority controllers. Importantly, we analyze not only current equity stakes but also the extent to which controllers would be able to reduce their equity stakes in the future without relinquishing control. Existing governance provisions plant the seeds for future increases in the separation between control and ownership stake, so we also analyze the minimum equity stake that the controller at each company would need to hold to retain control.

We find that, in a *sizable fraction* of cases, the governance provisions in place would enable the controller to hold less than 5% of the equity capital (and thus be a "tiny-minority controller") and still retain control. Furthermore, in a *substantial majority* of cases, the governance provisions in place would enable the controller to hold less than 10% of the equity capital (and thus be a "very-small-minority") and still retain control. Finally, in an *overwhelming majority*, the governance provisions in place would enable the controller to hold less than 15% of the equity capital (and thus be a "small-minority controller") and still retain control.

Part V discusses the implications of our analysis for future policy making and capital market practices. To begin, public officials and institutional investors should recognize the substantial governance risks associated with small-minority controllers. The extent to which governance arrangements can be used to expand the "wedge"—the gap between the controller's fraction of voting rights and fraction of equity capital—is commonly not transparent to investors. Thus, disclosure rules should require companies to provide such information. In assessing the extent to which dual-class companies pose governance risks, public officials and institutional investors should play close attention to the existing and potential level of the wedge.

Furthermore, we identify and discuss arrangements that could be used to address the current and future presence of small-minority controllers. Institutional investors could press for or encourage the introduction of such measures, and public officials could consider using their legal and regulatory tools to ensure a uniform adoption of such measures. Here we discuss three types of arrangements: (i) those aimed at limiting the extent to which controllers can lower their ownership stake without weakening their lock on control; (ii) those aimed at providing additional protections to public investors in situations where small-minority controllers would remain in control; and (iii) those aimed at preventing midstream changes, such as nonvoting stock

[9] *See infra* Section III.F.

reclassifications, that would introduce or exacerbate the governance costs of small-minority controllers.

Before proceeding, we should note that some corporate law scholars oppose any limits on the structures that companies going public may offer to investors.[10] The debate on contractual freedom in corporate law is long-standing and raises general questions that go beyond the scope of this Article.[11] While we subscribe to the view that it is desirable to place some constrain on IPO choices, as existing corporate and securities law do, this Article does not seek to repeat the arguments for this view or otherwise to contribute to the debate on contractual freedom.[12] However, because we recognize that some readers could well support in principle allowing companies to go public with any structures they choose, we wish to stress that our analysis should be of interest even to such readers.

To be sure, such readers would not support requiring dual-class companies to adopt governance provisions that place any limit on the size of the stake that controllers would be required to have to retain control. However, the main contribution of our Article, and one which should be of interest even to such readers, is to provide an understanding of the governance risks posed by small-minority controllers. To the extent that such risks are significant, even such readers should recognize the benefits to public officials and institutional investors of understanding these risks. Obtaining such an understanding would be essential for facilitating the introduction of private-ordering arrangements that would serve the interests of public investors; for judicial application of an appropriate level of scrutiny to controller actions; and for the development of disclosures that would provide adequate transparency of the risks posed to public investors and help IPO investors to price these arrangements accurately.

We believe that, in assessing public companies, public officials and institutional investors would benefit from a recognition of the perils of small-minority controllers, the mechanisms that enable the retention of their control, and the potential measures for responding to them. We therefore hope that our analysis, and the framework we put forward, will prove useful to any future examination of dual-class structures by public officials and institutional investors.

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[10] Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989).

[11] For a well-known collection of articles expressing different views on the subject, *see* Symposium on Contractual Freedom in Corporate Law, 89 COLUM. L. REV. (1989).

[12] One of us sought to contribute to this debate, and to support this view in early work, *see* Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

II. PLACING A SPOTLIGHT ON SMALL-MINORITY CONTROLLERS

A. The Debate over Dual-Class Stock

We begin this Section by discussing the long-standing debate over dual-class stock, in which both opponents and supporters have tended to lump together all dual-class structures. In this Article, we seek to reorient the debate and identify an important subset of dual-class structures that pose much more severe governance problems than other such structures.

For many decades, the New York Stock Exchange (NYSE) restricted the use of dual-class structures.[13] During the mid-1980s, however, the NYSE dropped this restriction after lobbying by supporters of these structures. Companies with dual-class structures may now list, regardless of the size of their controllers' equity stake.[14]

Once all companies were allowed to go public with dual-class structures, they began to play an important role in the U.S. economy. As of July 2016, companies with dual-class structures had an aggregate market capitalization exceeding $3 trillion.[15] Since Google went public with dual-class stock in 2004, IPOs have increasingly featured dual-class stock: 22% of the companies listed on U.S. exchanges in 2017 used a dual-class structure, compared with just 1% in 2005.[16] This trend is particularly pronounced in the tech sector with prominent dual-class public companies, including Dropbox, Expedia, Facebook, Groupon, LinkedIn, Snap, TripAdvisor, Zillow, and Zynga.[17]

The growing use of dual-class structures has generated substantial opposition among institutional investors.[18] In particular, leading mutual funds and public pension funds, such as

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[13] For a detailed account of the history of dual-class structures in the United States, see Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986).

[14] NYSE Listed Company Manual § 313.00 (permitting the issuance of multiple classes prior to the IPO). *See* also NASDAQ Stock Market Rule 5640 (same).

[15] This statement is based on our analysis of the Bloomberg database as of July 11, 2016.

[16] *See* Press Release, Council of Institutional Investors, Institutional Investors Oppose Stitch Fix Dual-Class Structure but Welcome Sunset Provision (Nov. 16, 2017), https://advisornews.com/oarticle/institutional-investors-oppose-stitch-fix-dual-class-structure-but-welcome-sunset-provision.

[17] Jeff Green & Ari Levy, *Zuckerberg Grip Becomes New Normal in Silicon Valley*, BLOOMBERG 2 (May 7, 2012), http://www.bloomberg.com/news/articles/2012-05-07/zuckerberg-stock-grip-becomes-new-normal-in-silicon-valley-tech (noting that from the time of Google's IPO until May 2012, "about 27 technology and Internet companies went public with dual shares"); Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, while Founders Keep Control*, WALL ST. J. (Jan. 16, 2017), http://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034 (presenting evidence that "[b]etween 2012 and 2016, roughly 19 per cent of US tech firms that went public did so with dual-class structures—more than double the share over the prior five-year period").

[18] For example, in summer 2016, a group of leaders of asset managers as well as operating companies issued a set of consensus governance principles including a statement that "dual-class voting is not a best practice."

Fidelity, Vanguard, CalPERS, and CalSTRS, have committed to corporate governance guidelines that oppose all dual-class structures.[19] Similarly, the Council of Institutional Investors (CII), an organization of more than 140 public, union, and corporate pension funds, has recently pressed U.S. exchanges to limit the use of dual-class stock across the board, declaring the structure to be "fundamentally flawed as a long-term capital model."[20]

These opponents and their advisors often lump together the different categories of dual-class structures. By doing so, however, they fail to recognize a distinct subset of dual-class companies that are likely to generate some of the most severe governance problems—those with small-minority controllers. For example, Institutional Shareholder Services (ISS), the leading proxy advisory firm, operates a well-known corporate-governance-rating system that, despite its comprehensiveness, contains only a single item—a checkbox—for dual-class structures, noting their existence or absence.[21] This binary scoring system does not measure the degree of separation between a controller's equity capital and voting rights.[22] Similarly, in 2017, a group of prominent institutional investors adopted a stewardship code, which stipulated that "[s]hareholders should be entitled to voting rights in proportion to their economic interest."[23] This shareholder initiative, however, has not distinguished the dual-class companies with small-minority controllers from other versions of the structure, and these are the ones that raise the most severe governance concerns.

Sard Verbinnen & Co, *Commonsense Principles of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jul. 22, 2016), https://corpgov.law.harvard.edu /2016/07/22/commonsense-principles-of-corporate-governance/.

[19] For statements reflecting the opposition of major institutional investors to dual-class structures, see, e.g., Vanguard, Vanguard's Proxy Voting Guidelines (2016), https://about.vanguard.com/vanguard-proxy-voting/voting-guidelines ("[w]e are opposed to dual-class capitalization structures that provide disparate voting rights to different groups of shareholders with similar economic investments"); Fidelity Investments, Corporate Governance and Proxy Guidelines (2016), https://www.fidelity.com/about-fidelity/fidelity-by-numbers/fmr/proxy-guidelines (Fidelity is supportive of the principle of one share, one vote); California Public Employees' Retirement System, Statement of Investment Policy for Global Governance 12 (Mar. 16, 2015), https://www.calpers.ca.gov/docs/policy-global-governance.pdf ("[a]ll investors must be treated equitably and upon the principle of one-share/one-vote.").

[20] *See Dual-class Stock: Governance at the Edge*, DIRECTORS & BOARDS, Third Quarter 2012, at 38 http://sites.udel.edu/wccg/files/2012/10/Dual-Shares-Q3-20121.pdf (quoting Ann Yerger, then Executive Director of the CII).

[21] ISS rating system, currently named "ISS Governance QuickScore 3.0," is a scoring system (from 1 to 10) designed to help institutional investors identify governance risks posed by portfolio companies. The system rates over 200 governance factors. *See* INST. S'HOLDER SERVS., GOVERNANCE QUICKSCORE 3.0: FACTORS BY REGION (Oct. 23, 2014), http://www.issgovernance.com/file/products/qs3-appendix-final.pdf.

[22] We examined ISS reports on a number of companies with extreme separation of cash-flow rights and votes, such as Viacom and CBS, and did not find any reference to the size of the wedge (reports on file with the authors).

[23] Investor Stewardship Group, *Commonsense Principles of Corporate Governance,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 7, 2017), https://corpgov.law.harvard.edu/2017/02/07/corporate-governance-and-stewardship-principles/.

Overall, the heated debate over dual-class stock has thus far focused on whether it is desirable for companies to go public with such a structure. In this general debate, we side with those who are skeptical of the value of dual-class IPOs. However, even in jurisdictions that enable the use of dual-class shares, such as the United States, there is still an important place for a policy debate about the need to limit the use of certain types of dual-class structures, about the rationale behind these limitations, and about their legal design.

We believe that all market participants should recognize that an assessment of dual-class structures very much depends on the size of the equity interest held by the controller. As we explain in the next Section, this factor can be expected to have a major impact on the financial incentives of the controllers and, in turn, on the magnitude of agency costs that the dual-class structure potentially generates.

B. The Costs of Small-Minority Controllers

1. Combining Entrenchment with Weak Ownership Incentives

The goal of this Section is to highlight the severe governance issues that plague dual-class companies with small-minority controllers. To that end, it is worthwhile to compare such companies to two other common structures: widely held companies and controlled companies with majority owners. Each of these structures has a mechanism that protects public investors by aligning their interests with those of corporate decision makers.

In a widely held company, a manager owns a small fraction of cash-flow rights and thus has limited financial incentives to maximize company value. However, this manager is not entrenched and can be removed at any time if he underperforms or otherwise acts against the interests of other public investors. Therefore, the market for corporate control limits the extent to which a manager can underperform and serves a disciplinary function that reduces agency costs.[24] Indeed, empirical evidence indicates that the threat of removal provides managers with incentives to perform.[25]

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[24] For a theoretical analysis of this point, *see, e.g.* Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) ; Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013).

[25] *See, e.g.*, Scott Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. ACCT. ECON. 94, 94, 113 (2008) (showing that dual-class companies trade at lower prices than do single-class companies, both at the IPO date and for at least the subsequent five years, and attributing this to the inability of outsiders to replace incumbents in dual-class companies). For studies showing that proximity to director elections has a significant positive impact on CEO turnover-performance sensitivity, *see e.g.* Paul Fischer, Jeffrey Gramlich, Brian Miller & Hal White, *Investor Perceptions of Board Performance: Evidence from*

Conversely, while a majority owner cannot be replaced and would not be disciplined by the market for corporate control, his large equity stake in the controlled company provides powerful financial incentives to maximize company value. A majority owner bears most of the costs of his actions and captures most of the benefits.[26]

A dual-class structure with a small-minority controller lacks both mechanisms. In both widely held companies and those with small-minority controller structures, corporate decision makers have a small minority of the company's equity stake and therefore lack powerful ownership-based incentives. However, unlike CEOs of widely held firms, small-minority controllers are insulated from market disciplinary forces and thus lack incentives generated by the threat of replacement, which would mitigate the risk that they would act in ways that are contrary to the interests of other public investors.

Similarly, in both majority-owned companies and small-minority controller structures, corporate decision makers face no discipline from the threat of replacement and the market for corporate control. However, unlike in majority-owned firms, small-minority controllers lack the powerful incentives generated by a large equity stake.[27]

In sum, dual-class structures with small-minority controllers generate significant governance risks because they feature a unique absence of incentive alignment. These controllers own a small fraction of the company's equity capital and thus bear only a small (and sometime extremely small) share of the losses that their actions may inflict on the company's value. Yet they exercise effective control over decision making and can capture the full private benefits of that control. This means that they may tolerate underperformance by the company where their private incentives offset any cost to their small shareholdings. At the same time, they are fully insulated from market disciplinary forces, and no threat of removal exists to help ensure that they will not act against the interests of other public investors. This combination of entrenchment and weak

Uncontested Director Elections, 48 J. ACCOUNT. & ECON. 172, 180-82 (2009) and Vyacheslav Fos, Kai Li & Margarita Tsoutsoura, *Do Director Elections Matter?* REV. FIN. STUD. (forthcoming, 2018).

[26] For a discussion of controllers' incentives to monitor management, *see, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281-82, 1284-85 (2008); Zohar Goshen, *Controlling Corporate Agency Costs: A United States–Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 100-101 (1998).

[27] *See also* Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy: Problems and Policies* 1, 7-8 (a report prepared for the Committee on Increasing Competitiveness in the Israeli Economy, 2012 and providing a basis for the subsequent Israeli legislation on the subject), available at http://mof.gov.il/Lists/CompetitivenessCommittee_4/Attachments/3/Opinion_2.pdf (describing the incentive and entrenchment problems created by the use of control-enhancing mechanisms).

ownership incentives could well lead to a wide range of distorted choices, which we discuss in detail in Section C.[28]

2. The Severe Distortions of Small Equity Stakes

Corporate governance research pays close attention to "agency problems" that arise when controllers have incentives to act in ways that are not optimal for the company and other shareholders. This Section focuses on the well-accepted relationship between the fraction of equity capital held by the controller and the severity of the controller's agency problems—that is, the smaller the equity fraction, the more that distorted incentives and their expected costs will increase.[29]

To illustrate how the distortion in a controller's incentives depends on the controller's fraction of equity capital, let us consider the following examples. Imagine a dual-class company with a controller who holds 25% of the company's equity capital. Further suppose that the value of the company is V and that the controller may bring about a corporate action that would result in a loss of ΔV to the public company but a gain in private benefits of $100 million to the controller.[30] In this scenario, the controller would prefer to avoid the value-reducing action only if the decrease in ΔV exceeds $400 million and, accordingly, his pro rata share (25% of ΔV) exceeds $100 million. If an action reduces corporate value by more than $400 million, a 25% controller would avoid it.

Now let us suppose that the same controller reduces his fraction of cash-flow rights to 5% while still retaining control over the company through the use of one of the separation mechanisms discussed in Part III. If he takes the same inefficient corporate action, the controller would now lose only 5% of ΔV but would still receive $100 million in private benefits. Therefore, he would now prefer to avoid the value-reducing action only if 5% of ΔV exceeds $100 million—that is, only if the decrease in value (ΔV) exceeds $2 billion. Thus, in the range of situations in which ΔV is between $400 million and $2 billion, the 25% controller would prefer to avoid the value-reducing action but the 5% controller would not. Accordingly, the range of value-reducing choices

[28] One could argue that majority controllers may be too risk averse owing to their large equity stake, while small-minority controllers may have greater incentives to undertake take more risks; in that sense, their interests could be more aligned with those of diversified public shareholders. These potential advantages, however, have to be offset against the costs of entrenchment and weak ownership incentives that are created by this structure. As demonstrated in Subsection II.D., our economic analysis of the costs generated by small-minority controllers is supported by a significant body of empirical work that documents the association of an enlarged wedge with lower value and higher agency costs.

[29] See Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 56, 66 (2008) (stating that "many papers are primarily concerned with the magnitude of the difference, or wedge, between votes and cash-flow rights").

[30] Legal rules may preclude some value-reducing actions. However, corporate governance scholars generally assume that, because legal rules leave insiders with significant discretion, they cannot be expected to eliminate all agency problems, which is why insiders' incentives are viewed as important.

that would serve the controller's private interests would be considerably larger for the 5% controller than for the 25% controller.

This problem can be stated in a more general fashion. Suppose that a controller owns a fraction, α, of the company's equity capital and that the market capitalization of the controlled company is *V*. Suppose further that the controller is considering an action that would decrease the value of the public company by a large amount, ΔV, but would provide private benefits of *B* to the controller. In this case, taking the value-reducing action would serve the interests of the controller if and only if

$$\alpha \Delta V < B,$$

which would be the case if and only if

$$\Delta V < B / \alpha.$$

The above equation defines the range of circumstances in which the controller's private interests would favor taking an inefficient action. The equation implies that this range of circumstances expands—and the expected severity of distortion increases—when the controller's fraction of equity capital (α) is smaller. As α declines, expected costs to the company and other shareholders increase in two ways. First, the growth of the wedge raises the likelihood that the controller will favor value-reducing choices. Second, if a value-reducing choice is favored, the expected reduction in value from that choice will be higher.[31]

C. Dimensions

The general structure of the economic problem analyzed above is relevant to a wide array of corporate situations and choices faced by a controller. It applies to any situation in which a controller faces a choice that affects both the value of the controlled company and the controller's private interests. To highlight the importance of this problem, we analyze a number of situations that might arise when an enlarged wedge affects the controller's interests. The examples below are intended only to illustrate the problem and not to provide an exhaustive account of all the situations in which the problem may arise. For illustrative purposes, let us consider the same hypothetical reduction in controller's fraction of cash-flow rights from 25% to 5% and its consequences on six types of choices.

[31] In our example, we assume that there is no fluctuation in the value of the company (aside from the inefficient action that could decrease that value by ΔV). Of course, if the company's value increases (irrespective of the controller's potential actions), one could think of a situation in which the reduced incentives due to the decline in the controller's equity stake would be partially offset by the nominal increase in the firm's value.

(i) Self-dealing. Suppose that a controller could engage in a self-dealing transaction in which a dual-class company buys an asset from an entity that is wholly owned by the controller. Further suppose that the transaction would reduce the wealth of the dual-class company by ΔV but would provide the controller with a private benefit of B. Finally, suppose that $\Delta V > B$, so that it would be inefficient for the company to engage in this self-dealing transaction.[32]

In this case, with 25% of the cash-flow rights, the controller would engage in the self-dealing transaction if and only if B is larger than 25% of ΔV. By contrast, with 5% of the cash-flow rights, the controller would benefit from the self-dealing transaction if and only if B is larger than 5% of ΔV. Thus, in the range of situations in which $5\% * \Delta V < B < 25\% * \Delta V$, the controller would be better off engaging in inefficient self-dealing if he has only 5% of the cash-flow rights but not 25% of those rights. Thus, the reduction in cash-flow rights would be expected to increase the range of value-reducing choices with respect to allocation decisions that would serve the controller's private interests.

(ii) Allocating Opportunities and Talents. Suppose that a controller encounters some opportunities for making new investments or attracting new talent and can direct those opportunities either to the controlled dual-class company or to an entity that is wholly owned by the controller, but not to both. Further suppose that allocating the opportunities to the dual-class company would provide that company with a gain of ΔV. By contrast, allocating the opportunities to the wholly owned entity would provide the controller with a private benefit of B and would prevent the dual-class company from gaining the value ΔV. Finally, suppose that $\Delta V > B$. Following the same reasoning as above, it can be shown that, in the range of situations in which $5\% * \Delta V < B < 25\% * \Delta V$, allocating the opportunity to the wholly owned entity would benefit the controller if he has only 5% of the cash-flow rights but not 25% of them.

(iii) Remaining as the CEO. Suppose that a controller serves as the company's CEO and that holding this position provides him with a private benefit of B. Suppose further that the controller has ceased to be a good choice for this role and that replacing him with a professional manager would increase the company's value by ΔV while depriving the controller of his private benefits of B. Following the same reasoning as above, it can be shown that, in the range of situations in which $5\% * \Delta V < B < 25\% * \Delta V$, maintaining an executive position would make the controller better off if he has only 5% of the cash-flow rights but not 25% of them.

(iv) Favoring Corporate Strategies That Serve Private Benefits. Suppose that a controller faces a choice between pursuing two strategies, one of which would reduce the controlled company's value by ΔV. Suppose, however, that pursuing this strategy would provide the

[32] For concrete examples and an analysis of the different types of self-dealing transactions, *see* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000), and Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 IOWA J. CORP. L. 1, 8 (2011).

controller with a private benefit of *B* because it would either enhance his legacy or reputation or would move the world in a direction that he favors.[33] Following the same reasoning as above, it can be shown that, in the range of situations in which 5% * $\Delta V < B <$ 25% * ΔV, pursuing the value-reducing strategic direction would make the controller better off in the 5% scenario but not in the 25% scenario.

(v) Empire Building. A well-known agency problem concerns the interests of controllers in excessive expansion, when expansion would be expected to increase their private benefits.[34] Suppose that a controller could make a series of acquisitions that would substantially increase the size of the controlled company while reducing the wealth of the company's preacquisition shareholders by ΔV. Suppose further that, by increasing the company's size and importance, the acquisitions would increase controller's influence, power, and stature, thereby providing him with private benefits of *B*. Following the same reasoning as above, it can be shown that, in the range of situations in which 5% * $\Delta V < B <$ 25% * ΔV, making the value-reducing acquisitions would benefit the controller if he has only 5% of the cash-flow rights but not 25% of them.

(vi) Blocking Efficient Sales. Commonly, the controller must decide whether to accept a value-enhancing offer to acquire the company—perhaps because the hopeful acquirer recognizes it has been inefficiently managed owing to the above distortions. To illustrate, suppose that control over a dual-class company provides the controller with private benefits of *B*. Further suppose that, in an acquisition of that company, the controller would receive his pro rata share of the acquisition price but lose all his private benefits of control.[35] The controller will accede to the offer only if the increase in value of his stake exceeds the loss of his private benefits. Thus, the reduction in cash-flow rights from 25% to 5% would quintuple the necessary premium to induce the controller to accept a value-enhancing acquisition offer.

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[33] *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1667 (2006) (discussing how controlling shareholders' decisions to acquire a media or entertainment company may be motivated by those shareholders' desire to increase their consumption of nonpecuniary private benefits rather than maximize company value).

[34] For well-known studies that analyze empire building and management's tendency to avoid distributing cash or assets to shareholders, *see* Sanford J. Grossman & Oliver D. Hart, Corporate Financial Structure and Managerial Incentives, in THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107–40 (John J. McCall ed., 1982); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986); and Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 903 (2005).

[35] Our analysis assumes that the acquisition price will be distributed pro rata. Of course, the controller might be willing to sell the whole company if he could obtain a larger per-share price than other public investors. However, courts have placed limits on the ability of a controller to sell the controlled company to a third party in exchange for a benefit not shared by other shareholders. *See, e.g.*, In re Tele-Commc'ns, Inc. S'holders Litig., No. CIV. A. 16470, 2005 WL 3642727, at *7 (Del. Ch. Dec. 21, 2005); In re LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 178 (Del. Ch. Nov. 4, 2005). While such limits might well be justified, their consequence is that the controller might often prefer to retain a dual-class structure even if it becomes inefficient.

To be clear, the analysis presented in this Section does not suggest that a reduction in the fraction of equity capital held by the controller would *always* lead him to prefer choices that would increase his private benefits but reduce the value of the company for public investors. The important takeaway is that the enlargement in the wedge raises the structural bias in favor of such choices and thereby exacerbates agency problems and distortions. In particular, the reduction in cash-flow rights would be expected to considerably expand the range of situations in which value-reducing choices would benefit the controller.

D. Empirical Evidence

As this Section explains, our economic analysis is supported by a significant body of empirical work. Empirical studies consistently document an association of an enlarged wedge with lower value and higher agency costs.

To begin, a study by Paul Gompers, Joy Ishii, and Andrew Metrick used hand-collected data on U.S. dual-class companies during 1995–2002 to analyze the relationship between cash-flow rights and company value as measured by industry-adjusted Tobin's Q. The authors found "strong evidence that firm value is increasing in insiders' cash-flow rights and decreasing in insider voting rights." They explain that "[t]he strongest results come from the separation sample, where insiders have voting control but less than 50% of the cash-flow rights. For these firms, all the evidence supports the positive effect of cash-flow on valuation."[36]

Furthermore, a study by Ronald Masulis, Cong Wang, and Fei Xie examined how the divergence between insider voting rights and equity capital at dual-class companies affects various agency problems. Using the same sample as Gompers, Ishii, and Metrick, these authors found that, "as this divergence widens, corporate cash holdings are worth less to outside shareholders, CEOs receive higher levels of compensation, managers make shareholder value-destroying acquisitions more often, and capital expenditures contribute less to shareholder value."[37] Accordingly, they conclude, "[t]hese findings support the agency hypothesis that managers with greater excess control rights over cash-flow rights are more prone to pursue private benefits at shareholders' expense, and help explain why company value is decreasing in insider excess control rights."[38]

In a third study, Matthew T. Billett, Paul Hribar, and Yixin Liu examined a sample of 111 U.S. dual-class firms from 1990 to 2005 and reported that "the credit ratings worsen, and the cost

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[36] *See, e.g.*, Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1084–85 (2010).
[37] Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1717 (2009). For companies where insiders own at least 50% of the voting rights, the authors find that the coefficients of all key explanatory variables "are larger in magnitude and statistically more significant than those in the full sample." *Id.*
[38] *Id.*

of debt and overall cost of capital increase in the separation between managerial voting rights and cash-flow rights."[39] The authors also found that "leverage increases in voting rights and declines in cash-flow rights," and they conclude that "the value gain from properly aligning the interests of managers and shareholders may be larger than previously thought."[40]

The negative economic effects of an enlarged wedge are also supported by studies on dual-class companies outside the United States. These studies report that, as the wedge between a controller's cash-flow rights and voting rights widens, company value declines;[41] the likelihood of takeover substantially decreases as controlling shareholders "hang on to the control too long;"[42] the dividend payout ratio decreases;[43] and the cost of debt financing, the likelihood of stock price crashes, and investment in projects with negative present value all increase.[44] Another study found that a high separation of ownership and control is negatively correlated with the likelihood of announcing a corporate acquisition and with abnormal returns around such an announcement.[45] Other evidence shows that the amount of industry- and market-level information incorporated into stock prices decreases as the wedge widens, which is consistent with the prediction that the

[39] Matthew T. Billett, Paul Hribar & Yixin Liu, *Shareholder-Manager Alignment and the Cost of Debt* (Jan. 2015, (working paper, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=958991, last viewed June 29, 2017)).

[40] *Id.*, at 3-4.

[41] Henrik Cronvqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANT. ANALYSIS 695, 695–96, 709 (2003) (reporting a "strong negative relation between controlling owner vote ownership and firm value [as measured by Tobin's Q").

[42] *Id.* at 697.

[43] Mikko Zerni, Juha-Pekka Kallunki & Henrik Nilsson, *The Entrenchment Problem, Corporate Governance Mechanisms and Firm Value*, 27 CONTEMP. ACCT. RES. 1169, 1201 (2010) (using a sample of Swedish companies and finding that "both the stock market valuation of free cash flow and the dividend payout ratio of a firm increase with major shareholders and board members' ownership of cash-flow rights").

[44] *See* Chen Lin, Yue Ma, Paul Malatesta & Yuhai Xuan, *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FIN. ECON. 1, 2, 10 (2011) (using a sample of East Asian and Western European companies and finding that an increase of one standard deviation in divergence increased the average loan spread by 14% to 18%); Sabri Boubaker, Hatem Mansali & Hatem Rjiba, *Large Controlling Shareholders and Stock Price Synchronicity*, 40 J. BANKING & FIN. 80, 88–89 (2014) (using a sample of French-listed companies and finding that a one-standard-deviation increase in the wedge is associated with a 3.14% increase in stock price crash risk); and Zerni, Kallunki & Nilsson, *supra* note 43, at 1172 (reporting that, "when corporate insider incentives are better aligned with those of outside shareholders, the funds of a firm are more likely to be distributed as dividends to shareholders rather than (over)invested in projects with less-than-zero present value").

[45] François Belot, *Excess Control Rights and Corporate Acquisitions* 3–4 (Sept. 2014) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695061 (examining corporate acquisitions by dual-class companies using a sample of French-listed companies and finding that "[a] one standard deviation increase in the wedge between control and cash-flow rights from the mean is associated with a 1.40% reduction in the likelihood of acquiring" and that "a one standard deviation increase in the proxy for excess control is associated with a 0.40% decrease in abnormal returns around the announcement of the transaction").

"control-ownership wedge gives controlling shareholders incentives to limit the flow of firm-specific information to the market to keep any opportunistic behavior outside the glare of external scrutiny."[46]

The effect of enlarging the wedge between voting power and cash-flow rights has also been empirically investigated in the context of additional control-enhancing mechanisms, such as pyramidal structures, which are prevalent in many countries around the world and, like dual-class structures, produce just such a wedge.[47] A significant body of evidence indicates that companies in pyramidal structures with a larger wedge between voting power and cash-flow rights are associated with more severe reductions in value and larger agency problems.[48]

E. How Costs Escalate When Equity Stakes Decrease

We have demonstrated thus far that as the equity stake decreases, the expected governance costs are likely to increase. It is important to emphasize, however, that such an increase is not linear; rather, as explained below, the costs go up at an increasing rate as the controller's cash-flow rights become smaller. Thus, when the controller's equity stake decreases from 10% to 5%, it creates a much bigger increase in expected governance costs than would a decrease from 30% to 25%.

Using the same numeric example as above, consider a 30% controller and a 10% controller, each of whom reduces his equity stake by five percentage points. In the case of the 30% controller, the decrease in his equity stake to 25% would increase the range of situations in which he would prefer to avoid a value-increasing action to cases in which ΔV is between $333.3 million to $400

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[46] Sabri Boubaker, Hatem Mansali & Hatem Rjiba, *Large Controlling Shareholders and Stock Price Synchronicity*, 40 J. BANKING & FIN. 80, 93 (2014).

[47] Corporate pyramidal structures provide another mechanism that separates cash-flow rights and voting power and thereby enables a party to control corporate assets while contributing only a minority of the underlying equity capital. For an economic analysis of the relationship between dual-class structures and corporate pyramids, *see* Bebchuk, Kraakman & Triantis, *supra* note 8, at 297-299.

[48] For empirical studies on corporate pyramids that document a negative association between increased wedge and worse economic outcomes, *see, e.g.*, Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002) (studying eight East Asian countries); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159 (2003) (studying eighteen emerging markets); Sung Wook Joh, *Corporate Governance and Firm Profitability: Evidence from Korea before the Economic Crisis*, 68 J. FIN. ECON. 287 (2003) (using data from Korea). For international studies documenting the agency costs of the wedge, *see, e.g.*, Yves Bozec & Claude Laurin, *Large Shareholder Entrenchment and Performance: Empirical Evidence from Canada*, 35 J. BUS. FIN. & ACCT. 25, 26 (2008) (evidence from Canada); Guohua Jiang, Charles M.C. Lee & Heng Yue, *Tunneling through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (2010) (evidence from China); Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment?: Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857 (2005) (evidence from Taiwan).

million (a total increase of $66.6 million).[49] In contrast, in the second case, exactly the same percentage-point decrease in equity stake—from 10% to 5%—would increase the range of distortions to cases in which ΔV is between $1 billion to $2 billion (a total increase of $1 billion).[50]

To illustrate this important pattern, it is useful to consider the context in which an offer to acquire the company is rejected. Suppose that a controller decreases his equity stake from 10% to 5%. In absolute levels, the rejection in cash-flow rights is just 5%. However, this reduction would double the premium that would be necessary to induce the controller to accept a value-enhancing acquisition offer, thereby greatly expanding the range of potentially value-increasing offers that the controller would have an incentive to reject.

This analysis is consistent with empirical evidence we presented in the previous Section, which shows that the decrease in the controller's equity stake is associated with lower value and higher agency costs. In particular, Gompers, Ishii, and Metrick show that the relationship between the controller's cash-flow rights and company value (as measured by Tobin's Q) is a nonlinear one, with the costs going up in an increasing rate as ownership stake declines.[51] This evidence reinforces concerns that we raise in this Article about controllers that have especially small equity stakes.

III. THE MECHANISMS OF EXTREME SEPARATION

This Part identifies and analyzes the main governance arrangements that are used to enable controllers of dual-class companies to retain control with a small or even a tiny fraction of the equity capital. An understanding of these mechanisms is necessary to identify the extent to which governance arrangements in place enable the controller to substantially reduce his equity stake without relinquishing control. In Sections A–F, we analyze six types of mechanisms that operate to enable controllers to do so.[52] In Section G, we show that, although some dual-class companies have adopted ownership-based sunset provisions, the provisions adopted in practice do not place substantial limits on controllers' ability to unload shares without losing control.

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[49] We obtained these figures by using the general formula presented above:
100 [B]/0.3 [α] = 333.3 [ΔV]; 100/0.25 = 400.

[50] 100/0.1 = 1,000; 100/0.05 = 2,000.

[51] Gompers et al., *supra* note 36, at 1073-78.

[52] We do not attempt in this Part to provide an exhaustive list of all the separation mechanisms but rather to present the main avenues that have thus far been used to create extreme separation. Undoubtedly, with the assistance of creative legal counsel, controllers may be able to develop additional mechanisms in the future. For instance, prior to Dropbox IPO, the company co-founders received "Co-Founder Grants," enabling them to vote these shares immediately upon grant and prior to their vesting. These grants were equal to around 30% of the shares the co-founders had prior to the grant. Enabling Dropbox's co-founders to vote these large amount of shares immediately and prior to their vesting is another separation mechanisms. *See* Dropbox Inc., Registration Statement (Form S-1) 38 (Feb 23, 2018).

In addition to identifying and analyzing these mechanisms, we provide in this Part novel empirical evidence of the incidence of each mechanism in existing dual-class companies as well as in recent dual-class IPOs. To this end, we hand collected the governance provisions of two sets of companies. The first set, labeled below as "the Dual-Class Dataset," includes all controlled dual-class companies in the Russell 3000 as of 2017 (122 companies).[53] Although a dominant shareholder could exercise effective control over a company by holding less than 50% of the voting rights, we included in our two samples only companies in which the controllers had 50% or more of the voting rights.[54] The second set, labeled below as "Dual-Class IPOs Dataset," includes dual-class IPOs during the period 2013–2017 (forty-eight companies).[55]

A. Hardwiring for Votes or Directors

Controllers of dual-class companies can incorporate provisions into governance documents that allocate to themselves preferential governance rights. These provisions sever the relationship between governance rights and equity ownership: so long as the controller holds the shares with preferential rights—regardless of his percentage of equity capital—he holds the right to a fixed percentage of votes or a fixed number of board seats.

First, controllers may "hardwire" a fixed percentage of voting rights to themselves, which we refer to as "hardwiring for votes." Mechanically, these provisions allocate more votes to the control class (or fewer to the public shares) as the controller's equity stake decreases. Absent a

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[53] For the construction of this dataset, we used the list of dual-class controlled companies as of March 2017, provided by Council of Institutional Investors Report, https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf. Consistent with prior research in the field, we also excluded REITs, LLPs and financial firms from both datasets. See *infra* note 115.

[54] *See, e.g.*, In re Zhongpin Inc. Stockholders Litigation, C.A. 7393-VCN (Nov. 26, 2014) (determining that a 17.5% stockholder could be deemed a controller). A Delaware court has held that "there is no absolute percentage of voting power that is required in order for there to be a finding that a controlling stockholder exists" (In re PNB Hldg. Co. S'holders Litig., 2006 Del. Ch. LEXIS 158, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006). Instead, the Court considered whether the dominant stockholder "exercises 'such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control.'" ((In re Morton's Rest. Gp., Inc. S'holders Litig., 74 A.3d 656, 665 (Del. Ch. 2013) (quoting In re PNB). *See also* In re Cysive, Inc. S'holders Litig., 836 A.2d 531, 553 (Del. Ch. 2003).

[55] We derived the list of dual-class IPOs from the Compustat dataset. Information on the governance provisions of these companies was hand-collected from their prospectuses and registration statements filed on the SEC's EDGAR system. Consistent with prior research in the field, we also excluded REITs, LLPs, LLCs and financial firms from both datasets. See *infra* note 115. We also eliminated from our sample companies in which the dominant shareholder held the low-vote shares. We included in this dataset all dual-class IPOs regardless of whether their controllers had a lock on control at the time of the IPO. This is because the voting power of certain controllers may increase after the IPO, once other holders of high-vote shares sell their shares and those shares are automatically converted into low-vote shares. *See infra* Subsection II.E.2.

sunset provision, a controller will retain the same voting percentage no matter how negligible his equity stake becomes.

To illustrate, consider the example of Ford Motor Company. Ford's charter provides the members of the controlling family with the right to exercise 40% of the company's voting power, regardless of the size of its equity stake. This governance mechanism ensures that the family will maintain effective control over the company even if it substantially decreases its equity stake over time.[56] Therefore, although the equity stake of the Ford controlling family has fallen significantly over the years—from 12% in 1956 to 1.78% in early 2015—the family members have constantly held 40% of the company's voting power.[57]

Another prominent example is Comcast, the country's largest provider of cable services.[58] Since its initial public offering in 1972, the company's capital structure has provided the founding Roberts family with three votes per share and public shareholders with one vote per share.[59] Over time, the controlling family preserved its controlling stake through a series of amendments to Comcast's governing documents, which gradually increased the family's voting power.[60] In 2001, Comcast's articles of incorporation were amended to include a new voting rights formula that gave the Roberts family an undilutable one-third voting interest in the company.[61] As a result of this formula, public shareholders have been entitled to just 0.0599 votes per share, while the Roberts family is entitled to 15 votes per share—over 200 times as many votes as other public investors.[62]

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[56] Ford Motor Co., Proxy Statement (Schedule 14A) at 80 (Mar. 31, 2017) (stating that the public shareholders hold common stock with "60% of the general voting power" and that class B shareholders, the Ford family members, "have the remaining 40% of the general voting power"). To maintain the hardwiring for votes, the number of votes allocated to the controlling family is calculated each year in accordance with the company charter. As of 2017, each share with superior voting rights held by the controlling family was entitled to 36.8 votes. *Id.*

[57] *Id.*, at 17-19.

[58] *FAQs*, COMCAST, http://www.cmcsa.com/faq.cfm (last visited Nov. 17, 2015); *Our History*, COMCAST BUSINESS, http://business.comcast.com/about-us/our-history (last visited Nov. 17, 2015).

[59] COMCAST CORP., PROSPECTUS 24 (1978).

[60] The votes-per-share entitlement of the class of shares held by the Roberts family increased to seven in 1982 and then to fifteen in 1984. *See* COMCAST CORP., CERTIFICATE OF AMENDMENT 82-39833, 82-39835 (July 20, 1982) (on file with the Department of State of the Commonwealth of Pennsylvania); COMCAST CORP., CERTIFICATE OF AMENDMENT 84541491, 84541493 (Aug. 22, 1984) (on file with the Department of State of the Commonwealth of Pennsylvania).

[61] *See* Comcast Corp., Definitive Proxy Statement (Schedule 14A) 6 (Apr. 28, 2017) [hereinafter Comcast 2017 Proxy Statement] (stating that the shares beneficially owned by Mr. Brian L. Roberts represent 33.33% of the combined voting power of the company). The formula operates by holding the shares with superior voting power—those held by the Roberts family—constant at fifteen votes per share and adjusting the votes-per-share entitlement of public shareholders so that the Roberts family will have at all times a one-third voting interest. *Id.*, at 5.

[62] *Id.*, at 5.

This hardwiring provision has enabled the family to retain effective control even as its equity stake has shrunk from 42% in 1978 to less than 1% today.[63]

Second, controllers can also include provisions in governance documents that permit the controlling class to elect a majority of the board members. A typical example of this mechanism, which we refer to as "hardwiring for directors," stipulates that holders of each class of shares—the public investors and the controller—should vote separately as a single class on the election of directors. The controller is generally entitled to elect a majority of the board members, and the public shareholders elect the remaining, minority directors.[64] Proportional voting for directors ensures that a controlling shareholder will always exercise control over the board, even after he substantially reduces his equity investment. The New York Times Company, for example, incorporated into its governing documents a provision that enables the controlling family to elect 70% of the board members even though it holds less than 11% of the company's equity capital.[65]

Our data show that hardwiring into governance documents is an important separation mechanism that currently exists in a non-negligible number of companies in the Dual-Class Dataset dual-class companies. Twenty-five percent of these companies grant their controlling shareholders the ability to exercise control by hardwiring such control into governance documents.[66] Furthermore, 10.4 percent of the companies in the Dual-Class IPOs Dataset went public with such a mechanism.[67]

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[63] COMCAST CORP., ANNUAL REPORT 61 (1976); Comcast 2017 Proxy, at 5-7.

[64] One could also imagine a governance arrangement that enables a controller to elect all of the company's directors. However, such an arrangement was precluded by the listing standards of the American Stock Exchange (AMEX), which was a major exchange that permitted the use of dual-class stock in the 1970s and 1980s. *See* Seligman, *supra* note 13, at 704 n.90.

[65] *See, e.g.*, N.Y. TIMES, CERTIFICATE OF INCORPORATION art. 4.II ("The holders of the Class A Common Stock [the class held by the public] shall be entitled to one vote for each share thereof held by them in the election of 30% of the Board of Directors proposed to be elected at any meeting of shareholders held for that purpose (or the nearest larger whole number if such percentage is not a whole number) voting separately and as a class; and the holders of the Class B Common Stock [the class held by the controller] shall be entitled to one vote for each share held by them . . . ."); New York Times Co., Definitive Proxy Statement (Schedule 14A) 7-14 (Mar. 22, 2016).

[66] The vast majority (twenty-nine) of the thirty-one companies with hardwiring provisions established hardwiring for directors. There are seven additional companies that provided hardwiring solely for the election of minority directors, while the rest of the directors are elected by both classes. In this case, the hardwiring does not serve as a control-enhancing mechanism, so we did not include these companies in our calculations.

[67] The certificates of incorporation of two of the five companies that went public with such a mechanism provides that the number of directors that a controller can elect does not remain constant, but rather declines when the controller's equity stake decreases below certain thresholds.

B. Large Ratio of High/Low Votes

Another major mechanism for the creation of extreme separation is the initial allocation of extensive voting power to the class of shares held by the controller. An overwhelming majority of dual-class companies use this high/low vote mechanism, with most setting the ratio at 10:1 or higher.[68] A dual-class structure with a 10:1 ratio allows the controller to hold an equity stake as low as 9.1% without losing full control over the company, becoming a very-small-minority controller. A numeric example illustrates this point. Suppose a company has 1,000 shares: 91 high-vote shares (10 votes per share) that are held by a controller and 909 ordinary shares (1 vote per share) that are held by public investors. In this example, the controller would control 910 votes (91*10), and public investors would hold 909 votes (909 * 1). Therefore, the controller would be able to exercise full control as long as he holds 9.1% of the equity capital.

The high/low vote ratio adopted at the IPO determines the extent to which a controlling shareholder could reduce his equity stake over time without losing majority control. If, instead of a 10:1 ratio, issuers adopt a ratio of 5:1, 4:1, 3:1, or 2:1, a controller would need to hold at least 18.2%, 20%, 25%, or 33.3%, respectively, of the company's equity capital to maintain majority control. However, unlike certain other jurisdictions, U.S. exchanges impose no limits on the ratio of high/low votes, and issuers are allowed to allocate as many votes as they desire to the class with the superior voting rights.[69] Indeed, some companies choose to adopt a ratio that is higher than 10:1.

To illustrate, consider the example of Zynga, Inc., which went public in 2012 with three classes of common stock. Zynga Class C common shares are exclusively held by Zynga's founder, Mark Pincus and are entitled to seventy votes per share. Zynga Class B common shares are held by other pre-IPO shareholders and are entitled to seven votes per share. Zynga Class A common shares are entitled to one vote per share.[70] Creating a class with a favorable voting power of 70:7:1 at the IPO stage allows Zynga's founder to concentrate control in his hands for a longer period. In particular, the ratios prescribed in this triple-class structure enable Pincus to control 63.5% of Zynga's voting rights while holding only 10% of the company's equity capital.[71] Moreover, as long as Pincus has 1.5% of equity capital, he will have more votes than public investors in the aggregate.

Zynga also adopted a sunset provision stipulating that the company's triple-class structure will be dismantled when the number of outstanding shares of Class B and Class C common stock

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[68] *See infra* note 74 and accompanying text.
[69] For a discussion of the use of limits that other jurisdictions impose on using high/low vote ratios, *see infra* notes 139-142 and accompanying text.
[70] Zynga Inc., Amendment No. 9 to Registration Statement (Form S-1) 137-138 (Dec. 15, 2011).
[71] Zynga Inc., Definitive Proxy Statement (Schedule 14A) 41 (Apr. 28, 2016).

represent less than 10% of the aggregate *voting power* of the company's capital stock.[72] This is a fig leaf, since Pincus could unwind his stake to as low as 0.15% of total equity without triggering the sunset clause.[73]

Our hand-collected data show that the allocation of extensive voting power to the shares held by the controller is another important mechanism for facilitating extreme separation. Of all companies in the Dual-Class Dataset, 43% use a 10:1 ratio while 8% allocate the controller even more votes. In an additional 19% of the cases, public shareholders have no voting power at all (a mechanism that we discuss in greater detail in the next Subsection), and in 25% of the cases, the control is hardwired. Therefore, in only 5% of the cases, dual-class companies have a ratio that was lower than 10:1 and no hardwiring mechanism. Similarly, 97% of the companies in our Dual-Class IPOs Dataset, which did not use nonvoting shares or hardwiring, went public with a ratio that is equal to or larger than 10:1.[74] As we demonstrated in the beginning of this Section, absent a sunset provision, a controller of a dual-class company with a 10:1 ratio (or higher) can hold as little as 9.1% (or lower) without losing majority control.

C. Nonvoting Stock

A controlling shareholder can also take a dual-class company public with a capital structure that authorizes the issuance of nonvoting shares. Nonvoting shares can be viewed as a subset of the high/low vote structure where the ratio is infinite. Alternatively, it can be viewed as equivalent to hardwiring for 100% of the votes.

When the dual-class structure concentrates all the high-vote shares in the hands of the controller and provides no voting power to other public shareholders, the controller retains control no matter how negligible his equity stake compared to the public shareholders. When there are other pre-IPO shareholders who hold high-vote shares, the extent to which the controller can lower his fraction of equity capital without relinquishing control depends on two factors: (i) the number of high-vote shares held by the other pre-IPO investors and the pace at which such investors sell those shares relative to the controller; and (ii) the number of authorized nonvoting shares that are approved at the IPO stage and could ultimately be issued as dividends over time.[75]

To illustrate this point, consider a dual-class company "ABC Corp.," which went public with a structure that concentrates all the high-vote shares in the hands of the controller and certain pre-IPO shareholders and provides no voting power to other public shareholders. Assume that, given the initial distribution of voting rights between the controller and the other pre-IPO shareholders, the controller will lose his lock on control when he holds less than 10% of the company's equity

[72] *Id.*
[73] This calculation is based on the beneficial ownership data retrieved from Snap's registration statement.
[74] In the vast majority of these IPOs, issuers used a 10:1 ratio.
[75] If the company's governance structure includes an ownership-based sunset provision, that provision could also limit the controller's ability to unload his equity stake.

capital. ABC Corp. could issue authorized nonvoting shares as stock dividends, and the controller would be able to sell them on the market and reduce his fraction of cash-flow rights without affecting his fraction of votes.

Table 1 below demonstrates how the percentage of shares that a controller would be able to sell is a function of the number of authorized shares to be issued as dividends at a later stage. Consider first a dividend ratio of 1:1—that is, one nonvoting share issued as a stock dividend for each of the company's outstanding shares. In such a case, the controller would be able to sell half his shares, and his equity stake would be reduced from 10% to 5%.

Table 1: Dividend Ratio and Controller's Equity Stake

Dividend Ratio	% of Shares that a Controller Could Sell	Controller's Total Equity Stake, %
1:1	50.0	5.00
2:1	66.6	3.33
3:1	75.0	2.50
4:1	80.0	2.00
5:1	83.0	1.70
6:1	85.7	1.43
7:1	87.5	1.25
8:1	88.9	1.11
9:1	90.0	1.00
10:1	90.9	0.91

If ABC Corp. authorizes a sufficiently large number of nonvoting shares at the IPO stage, there is no practical limit on the extent to which its controller could reduce his fraction of equity stake without any diminution of his voting power. Suppose that the ratio between the authorized but unissued nonvoting shares and the company's issued shares is 50:1 after the IPO. If ABC Corp. later distributes all these authorized nonvoting shares as dividends, its controller would be able to sell up to 98% of his equity capital and retain as little as 0.2% of company's equity capital without losing any of his voting power.

To see how this theoretical analysis applies in reality, consider the example of Snap, which sold only nonvoting shares at its IPO.[76] By doing so, Snap adopted an unusual triple-class share structure: its founders, Evan Spiegel and Bobby Murphy, retain super-voting shares (ten votes per

[76] Snap, Inc., Registration Statement (Form S-1) 153–55 (Feb. 2, 2017).

share); other pre-IPO investors' shares have a lesser voting power (one vote per share); and IPO investors hold zero votes.[77]

Immediately after the IPO, Spiegel and Murphy controlled 89% of the company voting power while holding approximately 36% of the company's equity capital. The triple-class capital structure enables them to maintain a lock on control even if they dilute their ownership stake significantly over time.[78] Moreover, since Snap issued a dividend of one nonvoting share to all its equity holders prior to filing for the IPO, each co-founder could liquidate half of his holdings without diminishing his voting control.[79]

Finally, the company also authorized 3 billion nonvoting shares at the IPO (only 519,013,572 of which were issued prior to the IPO's filing).[80] In the future, Snap can issue pro rata dividends from some of the remaining authorized nonvoting shares, which Spiegel and Murphy may unload into the public market without any diminution of their voting power.[81] Our calculation indicates that, if the company uses this avenue to the fullest extent possible, each co-founder would be able to sell 92.2% of his equity stake—lowering it to about 1.4% of the company's equity capital—without any losing their majority voting power.[82]

Our hand-collected data of governance provisions in dual-class companies indicates that nonvoting shares are currently in place at 19% of companies in the Dual-Class Dataset.[83] This percentage, however, includes not only companies that adopted nonvoting shares at the IPO stage but also those that introduced it through a midstream reclassification, discussed further in Section F. Additionally, 12.5% of the companies in the our Dual-Class IPOs Dataset went public with a dual-class structure that includes nonvoting shares.[84]

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[77] *Id.*
[78] *Id.*, at 155-159.
[79] *Id.*, at 8.
[80] *Id.*, at 153.
[81] Snap's certificate of incorporation obligates the company to hold in reserve a sufficient number of authorized nonvoting shares to honor its conversion rights (see Section 3(7)). The company has outstanding 279,490,968 shares of Class B stock and 215,887,848 shares of Class C stock, which could be converted into nonvoting shares. Additionally, the company has around 620 million shares of nonvoting reserved under existing option plans and commitments. *Id.*, at 10. We therefore assume that the actual amount of authorized nonvoting shares that the company could issue in the future is around 1.2 billion.
[82] This estimation is based on the assumption that Snap will issue 1.2 billion authorized nonvoting shares, and that each co-founder would avoid triggering a sunset provision that Snap adopted at the IPO.
[83] Excluding companies with hardwiring.
[84] Although the majority of them (four of these six companies) had a class of nonvoting shares that were authorized but not issued at the time of the IPO.

D. Dealing with Sales of Controller Shares

Controllers of dual-class companies often have incentives to sell their high-vote shares to diversify their portfolios and reduce idiosyncratic risk.[85] However, any sale of high-vote shares would decrease their total voting power. This Section presents two major mechanisms that mitigate this decrease and, in some circumstances, could even increase the separation between voting rights and cash-flow rights: voluntary conversion clauses and the distribution of low-vote shares as dividends.

1. Voluntary Conversion

The organizational documents of dual-class companies often include a provision that permits the holders of high-vote shares to convert them into low-vote shares upon their transfer to a third party. This clause has an entrenchment effect when the controller sells his shares on the market: the conversion of the high-vote shares into low-vote shares reduces the pace at which the controller's voting power is diluted.

For illustration, suppose that, at the IPO stage, a dual-class company has 100 shares: 40 high-vote shares entitling the controller to 10 votes per share, and an additional 60 ordinary shares entitling their holders to one vote per share. At that point, the controller holds 87% of the company's voting power (400 out of 460 votes) and 40% of the company's equity (40 out of 100 shares). In the years following the IPO, the controller liquidates half of his equity position, reducing it to 20%, by selling the high-vote shares on the market. What happens to his voting power?

The answer depends on whether the company's charter includes a conversion provision. In the absence of this provision, the controller's voting power will be reduced to 43.5% of the votes because the secondary market purchasers will hold 10 vote shares. If, however, the company's charter includes a conversion provision, the high-vote shares lose their superior voting power upon a sale to a third party. In this case, after the sale, the dual-class company would have 20 high-vote shares and 80 ordinary shares, so the controller would hold 71.4% of the company's voting power (200 out of 280 votes) and 20% of the company's equity (20 out of 100 shares). While the sale reduced the controller's *total* voting power, the conversion clause mitigates this decrease and allows the controller to retain majority control while holding a lower equity stake. More importantly, this provision increased the wedge between voting rights and cash-flow rights—from 47% before the sale to 51.4% after.

Data we hand-collected indicates that this mechanism is quite common among dual-class companies. In particular, such a mechanism is in place at 92% of the companies in the Dual-Class

[85] *See*, e.g., George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 749 (1986); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VIR. L. REV. 807, 812 (1987).

Dataset. Furthermore, 90% of the companies in the Dual-Class IPOs Dataset went public with such a mechanism.

2. Dividends in Low-Vote Shares

Another mechanism that mitigates the decrease in the controller's voting power is the authorization of a large amount of low-vote shares at the IPO stage and their issuance to all shareholders as a dividend at a later stage. Once these shares are issued on a pro rata basis after the IPO, the controller can sell them on the market, instead of selling his high-vote shares, and thus slow down the pace at which his voting stake is diluted.[86] This separation mechanism is similar to the one described for nonvoting shares in Section C. Here again, when the number of authorized but unissued shares increases, the controller is better able to reduce his fraction of equity stake through the distribution and sale of the low-vote shares, and with a minimal impact on his voting power.

To illustrate the effect of this mechanism, consider the same scenario as in Subsection D.1 above, in which the controller maintains 40% of the company's equity (40 out of 100 shares) and 87% of the company's voting power (400 out of 460 votes) through the holding of high-vote shares. In the years following the IPO, the controller decides to reduce his equity stake by half. To maintain majority control, he could distribute low-vote shares as dividends to all shareholders and then sell those shares on the market. After the dividend, the controller's voting power would be 78.6% (440 out of 560 votes), and selling his 40 new low-vote shares would reduce his voting power to 71.4% (400 out of 560 votes), compared to 43.5% if he had sold half his high-vote shares.[87] The controller retains majority control while unwinding half of his equity.

Dividends in low-vote shares could be particularly useful when there are other pre-IPO shareholders who avoid selling their high-vote shares. In latter scenario, any sale of high-vote shares by the controller would change the proportional holding of high-vote shares to his detriment (regardless of whether the automatic conversion provision is triggered). A controlling shareholder could prevent that change by issuing low-vote shares as dividends.

What happens when there are not enough authorized low-vote shares? In that case, the company would have to authorize and issue additional ones. It could also create a new class of

[86] Match Group went public in 2015 with a triple-class structure that included a class with ten votes per share, a class with one vote per share, and a class of nonvoting shares that were authorized but not issued at the time of the IPO. *See* Match Group Inc., Amendment No. 4 to Registration Statement (Form S-1) 59 (Nov. 17, 2015).

[87] Following the distribution of the dividend, there will be 200 shares (40 high-vote shares and 160 low-vote shares), the controller will have 440 votes (400 + 40), and other shareholders will have 120 votes (60 + 60).

nonvoting shares through a midstream change to the governing documents. This mechanism and the special problem it creates will be discussed in the Section F.

E. Dealing with High-Vote Shares Not Held by the Controller

When a corporation adopts a dual-class structure at the IPO stage, it often entitles high-vote shares to certain pre-IPO investors other than the founder, such as venture capital funds or employees. This Section discusses two major contractual arrangements with these pre-IPO investors that controlling founders use to maintain a high degree of separation. The first separation mechanism, post-IPO voting agreements, applies as long as pre-IPO investors still hold the high-vote shares. The second mechanism, automatic conversion into low-vote shares, is triggered in the event that these shares are sold by any of the pre-IPO investors.

1. Post-IPO Voting Agreements

Voting agreements are often used to allocate control rights among investors prior to the IPO. Occasionally, the agreements survive the IPO. In the typical scenario, certain pre-IPO shareholders who hold high-vote shares commit to vote them as directed by the controller. These shares amplify the controller's voting power even though he does not own their underlying economic rights. Thus, as long as the voting agreement remains in place and the covered shareholders hold the stock, the agreement will further increase the wedge between the controller's equity stake and his voting rights. Our Dual-Class Dataset includes ten companies (8%) that have voting agreement in place.[88] Additionally, 23% of the companies in our Dual-Class IPOs Dataset went public with a voting agreement that survived the IPO.

For example, when Facebook went public in 2012, Mark Zuckerberg entered into voting agreements with certain pre-IPO shareholders, pursuant to which these shareholders agreed to vote all of their shares as he directed, except under limited circumstances. Following the IPO, Zuckerberg's shares entitled him to 30.9% of Facebook voting rights, and he controlled a majority of the voting power only by virtue of his proxy rights over shares with an additional 27.6% of the votes.[89]

Moreover, while pre-IPO shareholders are often free to sell their shares subject to the voting agreement after the IPO, such sales would not necessarily undermine the controller's majority voting power. If, as is now common, the company has an automatic conversion provision, a sale

[88] Voting agreements are likely to be less common in mature dual-class companies since pre-IPO investors often liquidate their positions in the years following the IPO.

[89] Facebook Inc. Prospectus (Form 424B4) 141, 150 (May 18, 2015). For another example, *see* TMS International Corp., Amendment No. 8 to Registration Statement (Form S-1) 36–37 (Apr. 8, 2011). In this case, the investor stockholder agreement increased the post-IPO voting power of the controller by 11%.

of shares by a pre-IPO shareholder will trigger conversion into low-vote shares and cement the controlling shareholder's control.

2. Automatic Conversion

High-vote shares held by pre-IPO shareholders often have automatic conversion provisions, which automatically converts high-vote shares into low-vote shares upon their transfer to a third party. This mechanism would seem to benefit public investors because it ensures that only the pre-IPO shareholders who played an important role in the company's business development exercise the shares' superior voting power.

The automatic conversion mechanism, however, has a "hidden" entrenchment effect, which is triggered when certain holders of high-vote shares, such as the venture capital fund, sell their shares on the market more quickly after the IPO than the original founder.[90] This will often be the case, given that controllers have incentives to maintain control and the venture capital business model generally requires funds to liquidate their positions within ten years of an IPO. For illustration, suppose that at the IPO stage, a dual-class company with an automatic conversation clause has 100 shares: 20 high-vote shares entitling their holders to 10 votes per share, and 80 ordinary shares entitling their holders to 1 vote per share. Suppose further that the company has two pre-IPO shareholders, a founder and a venture capital fund, each of which holds 10 high-vote shares. At that point, the founder maintains 35.7% of the company's voting power (100 out of 280 votes) and 10% of the company's equity (10 out of 100 shares).

After the IPO, the venture capital fund liquidates its entire position, selling its 10 high-vote shares on the market. By operation of the conversion clause, these high-vote shares become low-vote shares, leaving the company with only 10 high-vote shares (held by the founder) and 90 low-vote shares (the original 80 plus the 10 formerly high-vote shares held by the venture capital fund). The conversion shrinks the total number of votes to 190, meaning that the founder's voting power leaps to majority control—53% (100 out of 190 votes)—even as its equity stake remains unchanged at 10%.

In the above example, we assumed that the founder maintained the same equity stake after the IPO. However, an automatic conversion clause could also substantially increase the founder's voting power even when the founder unloads a significant fraction of his equity stake after the IPO. Consider the example of Google. The cumulative voting power of its founders, Larry Page and Sergey Brin, has increased significantly since the company's IPO: from 32% of the company's total voting rights in 2004 to more than 55% in 2015.[91] During the same period, Page and Brin

[90] *See infra* notes 91–93.

[91] Google, Inc., Amendment No. 5 to Registration Statement (Form S-1) 98–100 (Nov. 23, 2004) [hereinafter Google Registration Statement]; Google, Inc., Definitive Proxy Statement (Form DEF 14A) 22–23 (Apr. 23, 2015).

reduced their share of equity capital from 28% to 11.9%.[92] This unusual ownership pattern was facilitated by an automatic conversion mechanism that was repeatedly triggered by sales of high-vote shares to third parties.[93] Because venture capital funds sold their high-vote shares faster after the IPO than Google's founders did, the latter were able to substantially increase their cumulative voting power despite the sizable decrease in their equity interest.

Snap also adopted an automatic conversion clause at its IPO. When each of its co-founders sells his Class C shares (which entitle the holder to ten votes per share), those shares will convert into Class B shares (which will entitle the holder to one vote). Furthermore, when holders of Class B shares (including venture capital funds and other pre-IPO holders) sell their Class B shares, those shares will also convert into nonvoting shares.[94]

To illustrate the point, suppose that over the course of the decade following Snap's IPO, co-founders Spiegel and Murphy reduce their equity stake to around 2.8% each but avoid triggering the sunset provision. In such a scenario, their combined voting power will decline from 89% to around 60.5%. Now, let us further suppose that Murphy decides to liquidate the rest of his equity position. Because of the automatic conversion mechanism, Spiegel will still control 41.5% of Snap's votes, despite owning only 2.8% of the company. But even this understates the degree of separation between cash-flow rights and voting rights in this case. The combination of the venture capital business model and the automatic conversion provision applicable to the Class B shares held by the venture capital funds means that if even only 30% of the holders of Class B shares sell, Spiegel would control the majority of the company's voting rights with the same low equity stake.[95]

The automatic conversion provision adopted by Google and Snap is far from unusual. Data we hand collected show that it is quite common among dual-class companies, existing in more than 65% of those in the Dual-Class Dataset. Interestingly, we also find that in the overwhelming majority of these cases (96%), the governing documents exempt transfers of shares to the controller's family members, estate, or trust from the automatic conversation mechanism. In the absence of a sunset arrangement, this waiver ensures that the founding family will retain the controlling stake in perpetuity. Additionally, 80% of the companies in the Dual-Class IPOs Dataset

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[92] *Id.*

[93] Google Registration Statement, *supra* note 91, at 102 (describing the conversion mechanism of Google's shares).

[94] Snap Registration Statement, *supra* note 76, at 19, 34.

[95] We retrieved the beneficial ownership information from Snap's registration statement. *Id.*, at 155-159. We first assume that no Class B holders transfer their Class B shares during the ten-year period after the IPO and that the remaining co-founder avoids triggering the sunset provision by retaining 30% of his Class C shares. In that case, the remaining founder will still be able to control 41.5% of Snap's votes. We then relax the unrealistic assumption that all Class B holders will continue to hold their shares during this ten-year period and show that if even 30% of them sell their shares, the remaining founder will still control the majority of the company's voting rights.

went public with an automatic conversion provision, with majority of these cases (90%) exempting transfers of shares to the controller's family members, estate, or trust.

F. Midstream Changes

The separation mechanisms presented in the preceding Sections were incorporated into the governing documents of corporations at the IPO stage, but such mechanisms could also be introduced midstream. Because the governance terms that set them forth are generally grounded in the charter, a midstream charter amendment would require shareholder approval. However, when the charter amendments do not require a separate vote of the low-vote class, the controlling shareholder would be able to use his majority voting power unilaterally to approve this midstream change. This raises the possibility of introducing midstream governance arrangements that enable further reduction in controller cash-flow rights below what could be generated by the mechanisms that were already present at the IPO stage.

There are significant governance changes that do not require a separate class vote that the controller could introduce midstream, including the creation of additional classes of low-vote shares or the adoption of an automatic conversion provision. However, the type of midstream change that has received most attention in recent years is the introduction of nonvoting shares in dual-class companies that went public without them. Prominent companies, including Google and Under Armour, have adopted such a reclassification.[96] While these reclassifications were subject to shareholder suits, those suits were settled before going to trial, and the reclassifications took effect.[97] Facebook and IAC/InterActiveCorp also announced plans for such a reclassification but abandoned these plans in the face of shareholder suits.[98] Recently, the Delaware Court of Chancery approved a similar reclassification at NRG Yield, declining to apply a strict standard of review based in part on the approval of the transaction by a majority of the company's public investors.[99]

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[96] In 2011, Google announced a reclassification plan. The plan's centerpiece was the distribution of a new, nonvoting class of shares as a dividend to the company's existing shareholders. These nonvoting shares were meant to supplement Google's existing two classes of stock, which had a high/low vote share ratio of 10:1. In June 2012, the board and the company's shareholders approved the plan, using the majority voting power held by Google's co-founders. *See* Google Inc., Proxy Statement (Form DEF 14A) 56–87 (May 9, 2012); Google Inc., Current Report (Form 8-K) (June 21, 2012). For a description of Under Armour reclassification, *see* Under Armour Inc., Proxy Statement (Form DEF 14A) 5–35 (July 13, 2015).

[97] *See* In Re Google Inc. Class C Shareholder Litig., No. 7469-CS, 2013 WL 6735045 (Del. Ch. Oct. 28, 2013); Under Armour Inc., Current Report (Form 8-K) (Oct. 5, 2015).

[98] Facebook Inc., Current Report (Form 8-K) (Sep. 21, 2017); IAC/InterActiveCorp, Current Report (Form 8-K) (Jun. 23, 2017).

[99] IRA Trust FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017) (ruling that the business judgment rule should apply in the case because the reclassification followed the dual procedural protections of *MFW*, including obtaining "majority-of-the-minority" approval).

The permissibility and level of judicial scrutiny of midstream reclassifications that do not obtain a vote of approval from the company's public investors, however, are not fully settled.

When the controller issues a new class of nonvoting shares midstream and distributes it as a dividend to all shareholders, he is able to sell those shares and reduce his fraction of cash-flow rights without affecting his fraction of votes and needing the approval of other public investors. As we highlighted in Section C, the number of authorized nonvoting shares and the stock dividend ratio are important factors that determine the extent to which the controller can reduce his equity stake without diminishing his voting power. A reclassification with a 1:1 dividend ratio, similar to that used in the Google and Under Armor reclassifications, would enable the controller to unload half his equity stake. As the ratio increases, the controller would be able to unload a larger fraction of his equity stake without relinquishing control.[100]

Midstream reclassifications pose governance risks beyond those present in the separation mechanisms discussed earlier in this Part. These additional risks should concern even those who in principle support allowing companies to go public with any structure they choose. When a company goes public with a separation mechanism, supporters of this view posit that public investors might be able to form reasonable expectations as to the extent to which its controller could decouple control from his ownership stake and that the company's IPO price would have reflected these expectations. By changing the governance bargain struck at the IPO, midstream reclassifications would thus extract value from the public investors.

Moreover, a controller who chooses to conduct the midstream issuance of nonvoting shares could do so in a substantially unilateral way. While the proposal to reclassify the capital structure requires shareholder approval, it passes because of the controller's majority voting power. In Google's reclassification, a majority of the company's public investors unaffiliated with the controllers voted against the reclassification proposals, but this vote had no effect on the result.[101] Allowing this type of reclassification to be adopted midstream, without the approval of public investors unaffiliated with the controller, raises the concern that the controller is using his majority voting power to make himself better off at the expense of public investors.

G. The Unfulfilled Promise of Existing Sunset Provisions

Certain companies have adopted sunset provisions that lead to the elimination of the dual-class structure if the controller's ownership falls below a specified threshold. As we will explain in Part V, appropriately designed sunset provisions can limit the extent to which cash-flow rights can be separated from voting rights and to which dual-class structures can give control rights to small-minority controllers. However, the empirical analysis that we conducted at actual market

[100] See *Table* 1.

[101] *See* Google Inc., Current Report (Form 8-K) (June 21, 2012). Over 85% of Google's public shareholders unaffiliated with Brin and Page voted against the issuance of nonvoting shares.

practices indicates that the current use of the sunset provision provides a weak and often nonexistent constraint on the mechanisms of extreme separation discussed in this Article.

For example, Snap incorporated such a provision into its governance documents at the IPO stage.[102] This sunset clause received attention in the various media articles covering the Snap IPO and was highlighted in the company's offering documents.[103] A careful examination of it reveals that the sunset provision hardly limits the ability of the company's co-founders to become tiny-minority controllers in the future and to retain control while reducing their equity stake to as low as 1%. Since the provision is tied to only the number of *high-vote* shares held by the founders at the IPO, it will not be triggered by the founders' sale of their *nonvoting* shares.[104]

To further examine this issue, we hand collected the corporate charters of all companies in the Dual-Class Dataset to identify all the cases in which sunset provisions were used. Altogether we examined 122 companies, 69 of which (about 57%) do not have any ownership-based sunset provisions and thus have no limitations on the mechanisms of extreme separation. Of the 53 that do have ownership-based sunset provisions, 41 (77%) set the threshold at or under 10% of outstanding equity. This threshold, which enables a very-small-minority controller to remain in perpetuity, still permits a substantial amount of incentive distortion.

We also noticed that when a dual-class company has hardwiring for director election, it is often the case that the sunset clause applies only to the hardwiring for director election but not to the multiple class itself. Therefore, even if the company triggers the sunset provision, it just eliminates controller's special rights for director election but not the company's differential voting rights.[105]

Finally, a closer look at the data reveals a strong correlation between the high/low vote ratio and the ownership threshold triggering the sunset clause adopted at the IPO. For instance, controllers of dual-class companies with a 10:1 high/low vote ratio, which permits majority control with 9.1% of the company's equity capital, also tend to use sunset provisions with a lower ownership threshold (usually no more than 10%). At this point, the sunset provisions would come

[102] Snap Registration Statement, *supra* note 76, at 157 (providing that the high-vote shares held by each founder will convert to low-vote shares when the founder's holdings drop below a certain threshold (30%) of high-vote shares that the founder held at the IPO).

[103] *See, e.g.*, Farrell, *supra* note 17 ("[t]he [company] setup includes some features meant to protect public investors"); *See also* Stephen Grocer, *Snap's IPO Filing: Everything You Need to Know*, WALL ST. J. (Feb. 2, 2017); Snap Registration Statement, *supra* note 76, at 4-5, 19, 164, 166.

[104] *Supra* note 82, and accompanying text.

[105] For examples of companies that incorporated this type of sunset into their governance documents, *see* Bio-Rad Laboratories, Dell Technologies, Haverty Furniture Companies, Ingles Markets, NIKE, Ralph Lauren, Telephone and Data Systems, United States Cellular, and Watsco.

into effect only when the controllers are about to lose majority control anyway: the clause is little more than a fig leaf. In fact, this correlation often negates the impact of a sunset provision.[106]

However, sunset provisions are not inherently incapable of placing effective limits on the creation of extreme separation. As we will discuss in Part V, investors may consider pushing for stronger and more meaningful sunset provisions than the ones that have been adopted by controllers. However, on the basis of our empirical analysis, we conclude that the current use of sunset provisions does not adequately limit the mechanisms of extreme separation.

IV. THE PREVALENCE OF EXTREME SEPARATION

This Part provides evidence of the incidence of dual-class companies with extreme separation in the U.S economy. In particular, we show that this problem is not merely theoretical. Moreover, we show that a large number of companies in our sample could have extreme separation in the future, as their controllers have the ability to further unwind their equity positions without losing control.

This Article is the first to provide empirical evidence of this subject. The dual-class study by Gompers, Ishii, and Metrick reports the average stake held by controllers in the study's sample.[107] However, our analysis focuses on the distribution of controllers' equity stakes, which shows significant variation among controllers, and we thus are able to identify the incidence of small-minority controllers. Furthermore, and importantly, we analyze and report the minimum stakes that controllers can retain without relinquishing control, given the existing governance provisions. We thus provide the first empirical evidence of the potential evolution of controller stakes that existing governance arrangements facilitate—and thus on the scale of governance risks that these arrangements pose.

A. A Typology of Small-Minority Controllers

As we have shown in Part II, the distortion of a controller's incentives and the generated agency costs become more severe, at an escalating rate, when the controller's equity stake declines. Therefore, in assessing the governance risks and problems of a dual-class company, it is important

[106] Our review of the Dual-Class IPOs Dataset yielded similar results. We found that 60% adopted a sunset provision with an ownership threshold at the IPO stage, and the vast majority of these provisions (twenty-five of twenty-nine companies) had a minimum ownership threshold at or under 10%. Our analysis puts aside time-based sunset provisions that are not based on the controller's equity stake. For an analysis of time-based sunsets, s*ee* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-class Stock*, 101 VA. L. REV. 585 (2017); Andrew Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures* (Jul. 2017) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3001574.

[107] Gompers et al., *supra* note 36, at 1053.

to examine the controller's equity stake as well as the expected evolution of this stake, including the extent to which it could decline in the future without the controller relinquishing control.

In our empirical analysis below, we examine controller equity stakes depending on whether they equal or fall below one or more thresholds—50%, 15%, 10%, and 5%—of the company's equity capital. Based on these thresholds, we refer below to four types of controllers. In addition to the term "controlling minority shareholder" already used in the literature,[108] we define below three additional types: small-minority controllers, very-small-minority controllers, and tiny-minority controllers.

Controlling Minority Shareholder: Following the literature, we refer to any controller that owns less than 50% of the company's equity capital, but maintains a lock on control, as a controlling minority shareholder. Dual-class structures generally enable a controller to have a lock on control with such minority ownership. Our focus in this Article, however, is not on controllers that merely hold a minority stake but rather on ones that hold a much smaller stake.

Small-Minority Controller: We define a small-minority controller as one that owns 15% or less of the company's equity capital but maintains a lock on control. In the absence of a dual-class structure, such shareholder would fail to have a dominant position, not to speak of a lock on control. In a one-share-one vote company, we note, Delaware's antitakeover statute regards 15% as the threshold at which a blockholder could have sufficient influence on corporate decision making to trigger the application of the statute.[109] We also note that, even under the most extreme supermajority requirements used in practice, owners of 15% or less of the company's equity capital do not have a veto even over decisions that require such supermajority approval.[110]

Very-Small-Minority Controllers: We define a very-small-minority controller as one that owns 10% or less of the company's equity capital but maintains a lock on control. We note that, in companies without a dual-class structure, owners of a below-10% block are regarded by the

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[108] *See* Bebchuk, Kraakman & Triantis, *supra* note 8.

[109] DEL. CODE ANN. tit. 8, § 203. The Delaware business combination statute prevents a bidder from engaging in a wide range of transactions with an acquired company for three years after the bidder acquires a "controlling stake" that is equal to at least 15% of the target's shares. DEL. CODE ANN. tit. 8, § 203(a) (2001 & Supp. 2008). *See also* Guhan Subramanian, Steven Herscovici & Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1998–2008*, 65 BUS. LAW. 685, 686 (2010) (noting that Delaware antitakeover law covers "more than half of all U.S. corporations and an even larger fraction of U.S. stock market capitalization").

[110] Data collected from the SharkRepellent dataset show that companies with a supermajority requirement for charter amendments rarely use a threshold above 80% of all outstanding shares. As of February 2017, only 2% of all companies with supermajority provisions (1,439 companies) had a higher threshold. Therefore, in the absence of a dual-class structure, small-minority controllers would not even have a veto power over charter amendments that require supermajority approval.

securities laws as having insufficient influence to trigger the disclosure obligations, and the duty to return short-swing profits, that Section 16 insiders have.[111]

Tiny-Minority Controller: We define a tiny-minority controller as one that owns 5% or less of the company's equity capital. In the absence of a dual-class structure, the presence of a below-5% blockholder is regarded by the securities laws as sufficiently insignificant so as not to require the blockholder to disclose its presence and position to the market.[112] Below-5% shareholders are viewed as sufficiently inconsequential to trigger a reporting requirement under Schedule 13D or even Schedule 13G.[113]

B. Current and Potential Small-Minority Controllers

The analysis in this Section covers all dual-class companies in the Russell 3000 as of 2017 whose controllers have a lock on control by either (i) holding 50% or more of the voting rights or (ii) being entitled to elect a majority of the board of directors.[114] Data on ownership rights, voting rights, and contractual arrangements to nominate directors were hand collected and analyzed from proxy statements and annual reports filed on the SEC's EDGAR system, allowing us to eliminate from our initial Dual-Class Dataset all companies that do not fall into one of these two categories. Consistent with prior research in the field, we also excluded ADRs, Closed-End Funds, REITs, limited liability partnerships, limited liability companies, and financial firms.[115] We also excluded companies with time-phased voting, as this control-enhancing mechanism is different from dual-class structure. After all of these exclusions, we remain with a sample of 122 companies.

First, for each dual-class company in this sample, we collected data that enabled us to calculate the fraction of equity capital currently held by its controller. The data we collected included information on number of classes of issued and outstanding shares; the rights allocated to each class (including both voting rights and special rights to elect a fixed number of directors), the number of outstanding shares of each class, and the number of shares of each class held by the controlling shareholder. When a company has two (or more) co-founders or a number of

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[111] *See* Section 16 of the Securities Exchange Act of 1934.

[112] *See, e.g.*, Regulation S-K; 17 C.F.R. § 240.14a-101 (Schedule 14A) (requiring disclosure of the beneficial ownership of officers, directors, and any beneficial owner of more than 5% of a class of the registrant's voting securities).

[113] 17 C.F.R. § 240.13d-101 & § 240.13d-102 (Schedules 13D and 13G) (providing that active and passive beneficial owners of more than 5% of any voting class of a publicly traded equity security must file a Schedule 13D or 13G, respectively, disclosing their interests).

[114] This definition is similar to the exchanges' definition for controlled companies.

[115] *See, e.g.*, Gompers et al., *supra* note 36, at 1055. In particular, we excluded companies with the following industry codes: 6021, 6022, 6029, 6141, 6163, 6211, 6282, 6311, 6331, 6411, 6512, 6531, 6798.

shareholders who have family relationship, we assumed (unless otherwise specified in the proxy statement) that these shareholders exercise control in concert.[116]

Next, we estimated the extent to which controllers can unwind their equity position in the future without relinquishing their lock on control. To that end, we hand collected information on the existence of mandatory conversion provisions that are exercised upon the sale of shares, voluntary conversion provision that are exercised at the discretion of the high-vote holder, and the ratio of conversion (if different from 1:1). We also collected information on whether a sale of the controller's shares would trigger a sunset clause with a minimal ownership requirement (i.e., a provision that automatically eliminates the dual-class structure if the controller goes below a certain percentage ownership threshold or a certain percentage of shares held by the controller at the time of the IPO). If such a sunset existed, we reviewed its triggering terms and also examined whether the triggering of the sunset would lead to the dismantling of the dual class or merely to the elimination of special right to elect a fixed number of directors.

In calculating the minimum equity capital that a controller must hold in order to retain at least 50% of the voting rights, we proceeded as follows. First, we conducted this analysis assuming that the controller would not try to change the governance arrangements midstream but, rather, would just take full advantage of the arrangements currently in place. To that end, we assumed that the controller would first sell as many low-vote shares as he could, and then as many high-vote shares as he could, without losing majority control. If, at some point, the sale of low- or high-vote share would cause the controller to lose majority control, we assume that the controller would stop the selling process and maintains the necessary amount of shares needed to retain control.

Second, we assumed that venture capital funds and other pre-IPO shareholders would sell their shares at a faster rate than the controller, as often happens.[117] Third, we examined whether a sale of the controller's shares would trigger a sunset clause with a minimal ownership requirement. If such a sunset clause exists, we examined the specific sunset terms (which can vary from

[116] Despite the dispersion of ownership interests among a number of affiliated holders, we assume that there is a unified decision maker that approximates the situation in all the cases in our dataset. In one line of these cases, the control is transferred to heirs of the founder, one of whom exercises actual day-to-day control whereas the others receive the cash-flow benefits. We recognize that, in this scenario, the other heirs may not have the same interest in the private benefits of control as the family member who exercises the actual control. At the same time, these heirs are unlikely to exercise the same intensity of oversight as an unaffiliated third party with a large equity stake. Another line of cases involves co-founders who hold executive positions in the controlled company. In this situation, the co-founders could make retention or expansion choices that would increase the private benefits of *both* of them.

[117] *See infra* notes 90–93. We found that in approximately 80% of the companies in our Dual-Class Sample, the controller holds over 90% of the high-vote shares, on average. In additional 9%, the control holds, on average, over 80% of the high-vote shares. These data reinforce our assumption that other holders of the high-vote shares sell their shares at a faster rate than the controller.

company to company). We assumed that the controller would avoid triggering the sunset, if such action leads to the elimination of its majority control.

Finally, when a controlling shareholder exercises full control over the election of the company's directors, or when a dual-class company has an outstanding class of nonvoting stock, we assumed, in the absence of a sunset provision, that a controlling shareholder has the right to unwind almost all of his equity position without losing control. Here again, if such a sunset clause exists, we assumed that the controller would stop selling shares to avoid triggering a sunset clause that would cause him to lose the special election rights. The calculation of these percentages required significant work for a number of reasons.

To begin, as will be stressed later in Section V.B., the information necessary for our analysis is generally not transparent. Companies with a dual-class structure are required to disclose only the number of high/low vote shares held by the controller. However, such disclosure is often not straightforward as companies have significant leeway in detailing shares held by family members, trusts and other stakeholders affiliated with the controller. Moreover, companies are not required to disclose the controller's combined equity stake or any information on the extent to which the controller could use the various arrangements in the company's governance documents to unload shares without relinquishing control.

Second, the sale of high-vote shares, by either the controller or other high-vote holders, usually triggers a mandatory or voluntary conversion provision. Therefore, to calculate estimated equity stake of the controller, we had to examine the changes to the total outstanding number of shares of each class upon a sale of the high-vote share. Since companies in our sample had different conversion provisions, this analysis had to be conducted separately for each company.

In companies with automatic conversion provisions, we assumed that the high-vote shares are automatically converted into low-vote shares upon their sale to a third party, raising the total number of outstanding high-vote shares and reducing the total number of low-vote shares. If a company has only a voluntary conversion, we assumed that the controlling shareholder would always convert the high-vote shares into low-vote shares before their sale in order to reduce the potential dilution in his voting stake.[118] However, to determine what other high-vote holders would do upon a sale, we had to examine whether the additional class of high-vote share was publicly traded. If the class of high-vote share was not publicly traded, we assumed that the other high-vote holders would choose to convert their shares before selling. However, if the class of high-vote share was publicly traded, we assumed that the other holders would not convert, leading to the same result as if no shares were sold, as they are still held by new noncontroller high-vote holders. In companies with no conversion mechanism, we assumed that the sale of high-vote shares, either

[118] *See supra* Subsection II.D.1.

by the controller or other high-vote holders, would lead to these shares being held by noncontroller high-vote holders.

Third, as noted above, the calculation of the effective threshold required a cross-reference between a number of simultaneous conditions, the number of shares the controller would have to maintain in order to preserve majority voting control after taking into account the potential effects of the conversion mechanisms (as described in the previous paragraph), the number of shares the controller would need to maintain to preserve voting control of the board (depending on whether there is a unique voting structure for board election), and the number of shares the controller needs to maintain to avoid triggering a sunset, if that sunset leads to loss of control.

Fourth, some companies had more than two outstanding classes of shares. For these companies, the same steps described in the previous paragraph were undertaken, depending on the conversion rights between the three (or more) classes of shares and more complex sunset conditions.

Table 2 below, which shows the results of our empirical analysis, reports the current incidence of controlling minority shareholders, small-minority shareholders, very-small-minority-shareholders, and tiny-minority shareholders. It also reports the expected incidence of these groups under the scenario in which controllers take full advantage of existing governance provisions to reduce their equity stake to the lowest level that would be consistent with retaining a lock on control.

Table 2: Types of Controllers of Dual-class Companies in the Russell 3000

	Incidence at Present, %	Potential Incidence, %
Controlling Minority Shareholders	83.6	100.0
Small-Minority Controllers	18.9	91.8
Very-Small-Minority Controllers	9.8	81.2
Tiny-Minority Controllers	1.6	30.3

Controlling Minority Shareholder: As expected, an overwhelming majority (81%) of dual-class companies have, and all of them could have in the future, a controlling minority shareholder

with less than 50% of the equity capital. The contribution of our empirical analysis is in documenting the large fraction of dual-class companies that already have, or could have in the future accordance to governance provisions already in place, a controller with a small-minority stake, a very-small-minority stake, or even a tiny-minority stake.

Small-Minority Controllers: As the Table reports, 91.8% of the companies in our sample have, or could have based on the governance provisions already in place, a small-minority controller with a 15%-block or less. Moreover, 18.9% of dual-class companies already have a small-minority controller, and an additional 72.9% could have one if the controller continues to unload shares without relinquishing control to the fullest extent made possible by existing governance arrangements.

Very-Small-Minority Controller: Furthermore, as the Table indicates, 81.2% of the studied companies already have, or could have based on the governance provisions already in place, a very-small-minority controller with a 10% block or less. Around 9.8% of dual-class companies already have a very-small-minority controller, and an additional 71.4% could have one if the controller lowers its equity ownership to the minimum stake sufficient for having a lock on control.

Tiny-Minority Controllers: Finally, and most strikingly, 30.3% of the studied companies have, or could have, a tiny-minority controller with a 5% stake or less. About 1.6% of dual-class companies already have a tiny-minority controller, but an additional 28.7% could have a tiny-minority controller if their controllers take advantage of governance provisions in place to unwind their equity positions to the fullest extent possible without relinquishing control.

Our analysis so far has taken as given the number of outstanding shares of each class, as well as the number of low-vote shares issued to the controller, as given. However, as we explained in Section III.D.2, another mechanism that could mitigate the decrease in the controller's voting power is the issuance of a large amount of low-vote shares at the IPO stage and their issuance to all shareholders as a dividend at a later stage. Once these shares are issued on a pro rata basis after the IPO, the controller could sell them on the market instead of selling his high-vote shares, and could thus slow down the pace at which his voting stake is diluted.

We therefore also examined to what extent the issuance of additional authorized but unissued shares would impact the expected incidences of controlling minority shareholders, small-minority shareholders, very-small-minority-shareholders, and tiny-minority shareholders. We assumed that the company would issue as dividend as many low-vote shares as possible in order to enable the controller to preserve majority control. However, when a company has a conversion provision, we assumed that it has to maintain enough authorized but not outstanding low-vote shares, to enable conversion of outstanding high-vote shares in the future. As expected, after taking into account the controller's ability to issue additional authorized low-vote shares, we document an additional increase in the expected incidences of small-minority shareholders (93.5%), very-small-minority-shareholders (82.8%), and tiny-minority shareholders (33.6%).

Finally, we should stress that our analysis took as given the governance provisions in place and abstracted from the possibility that the controller would seek to increase his freedom to unload shares without relinquishing control by bringing about a midstream change, such as a nonvoting stock reclassification. As explained in Section III.F, some dual-class companies, including Google, went through such a reclassification. A nonvoting stock reclassification that authorizes a sufficiently large number of nonvoting shares would enable the controller to lower its equity stake without relinquishing control to as low a level as the controller desires. Thus, to the extent that courts were to allow such reclassifications without a vote of approval from disinterested public investors, they would enable all controllers to become tiny-minority controllers if those controllers were to choose to do so.

We recognize that there are other considerations that may cause small-minority controllers to avoid unwinding their equity positions to the fullest extent possible. For example, once such a controller unloads a significant fraction of her equity position and most of her wealth is no longer tied to the dual-class company, the marginal diversification benefits from selling additional shares decline. Furthermore, when the diversification benefits decline, tax considerations could also prevent her selling additional shares. This is because such sales would create capital gains liabilities, and the small-minority controller could defer these tax liabilities by postponing additional sales.

To be sure, despite the decreasing diversification benefits, in some cases the controllers might still be interested in unloading their shares to the fullest extent possible, or become close to it. For example, if the controllers have significant liquidity needs, they would sell their shares to the fullest extent possible. Similarly, if they create a foundation and want to spend most of their wealth on charitable causes, they might again be interested in selling their shares to the fullest extent possible. Indeed, Facebook's reclassification plan was aimed at weakening some of the limits imposed at the IPO stage on Mark Zuckerberg's freedom to unload shares without losing his control. Had the plan been adopted, he would have been able to reduce his stake of equity capital to about 4% and possibly less—without losing his controlling voting power.[119]

In any event, having information on the extent to which controllers would be able to unwind their equity positions without losing majority control is important for assessing the governance risks a dual-class company may face in the future. For this reason, we seek to estimate this level in this Section and, in Section V.B, require companies to make this level transparent to public investors.

The analysis of the hand-collected dataset of governance provisions in dual-class companies that we complied in this Section provides empirical evidence of the practical significance of small-minority controllers. These governance provisions enable the emergence of small-minority controllers, very-small-minority controllers—and even tiny-minority controllers in

[119] *See* supra note 98.

a sizable fraction of dual-class companies. The problem of small-minority controllers, therefore, deserves the urgent attention of public officials and institutional investors.

V. POLICY IMPLICATIONS

In this Part, we identify and analyze the main policy implications for public officials and institutional investors that arise from our analysis. Section A begins by noting the importance for these entities to recognize the governance risks that small-minority controllers pose.[120] Going forward, any examination of dual-class companies should be informed by the recognition of these risks. Following the lesson of our empirical analysis, Section B explains that in companies with small-minority controllers, the existing controller's equity stake and the extent to which this stake could decline without the controller relinquishing the lock on control are often not transparent to investors. Accordingly, it proposes two disclosure requirements that would provide investors with adequate information on the subject.

Section C identifies and discusses alternative measures that could be used to limit the extent to which controllers can lower their fraction of equity capital and still retain control. Even those who are reluctant to adopt such limitations via regulation may consider private ordering and investor actions to that end. Section D explains that, even if public officials and institutional investors take as given the growing incidence of small-minority controllers and do not seek to restrict their diminishing stake, they may consider other legal governance and judicial steps that small-minority controller companies could adopt to protect public investors from controllers' opportunism. Finally, Section E analyzes how public officials and institutional investors should approach midstream changes that enable controllers to substantially reduce their equity stake while retaining a lock on control. In particular, it discusses how making any such changes conditional on a vote of approval from disinterested public investors could preclude changes that would divert value from public investors to small-minority controllers.

A. Recognizing the Problem

While public officials and institutional investors often lump together all dual-class structures, our analysis shows that there is a subset of dual-class companies—those with small-minority controllers—that generates severe governance concerns and risks. Furthermore, our analysis in Part IV demonstrates that such governance risks are already present or could emerge down the road in most dual-class companies. Thus, the first clear takeaway is that, going forward, both public officials and institutional investors should recognize and pay special attention to the perils of small-minority controllers.

[120] By public officials, we refer to all those who make or apply laws, rules, and regulations, including legislators, regulators, and judges.

With respect to public officials, recognition of the problem may lead them to proceed in one or more of the directions that we analyze in this Part. They may consider enhancing disclosure requirements to make the governance risks posed by small-minority controllers adequately transparent. They may also consider adopting alternative measures for constraining, or at least discouraging, structures with small-minority controllers, as well as taking additional steps to protect public investors when such controllers are present. Finally, they should pay close attention to the midstream problem that we have analyzed. While we suggest four main directions that public officials may pursue, recognizing the significance of the problem might lead them to identify other directions that are worth exploring as well.

With respect to institutional investors, those that seek to understand and limit the governance costs and risks they face must also recognize the problem of small-minority controllers to appreciate the governance problems that dual-class structures pose for them. This recognition might lead institutional investors to back public officials' adoption of the kind of arrangements discussed in the next four Sections. Alternatively, as we discuss below, institutional investors may seek to move in such a direction by private ordering and investor initiative.

Finally, putting aside efforts to constrain and reduce the problems resulting from small-minority controllers, institutional investors should modify their allocation and investment decisions in accordance with the governance risks posed by small-minority controllers and the likelihood that such controllers will arise in a company given its governance arrangements. Investors will benefit, and the allocation of capital in the economy will be improved, if investors learn to appreciate which companies pose greater or smaller governance risks. Recall in this connection that the prominent proxy advisory firm, ISS, lumps together all dual-class structures when it provides public investors with assessments of the governance risks posed by these companies.[121] For ISS to recognize the problem implies that it should provide nuanced information and separately flag dual-class structures that have small-minority controllers so that public investors might adequately assess them.

B. Improving Disclosures

As we explained in Part II, the expected agency problem significantly depends on the controller's fraction of equity capital. Therefore, to assess the governance risks that dual-class structures pose, public investors would benefit from knowing (i) the controller's equity stake and (ii) the extent to which the company's governance arrangements would enable the controller to reduce his stake in the future without relinquishing control. As we argue below, disclosure mandates should be amended to require companies to make this information transparent to investors.

[121] *See supra* notes 21-22, and accompanying text.

Disclosure mandates often require companies to supply information that many investors could benefit from having, rather than require each investor to bear the costs of obtaining such information independently. For example, in the context of executive compensation, U.S. securities law mandates a unified disclosure in a single location—the Summary Compensation Table—of a comprehensive overview of a company's executive pay practices.[122] One could argue that there is no need to provide such information, as large investors with resources could collect and analyze it by themselves. The SEC, however, has concluded that is valuable to make this information transparent to investors. This disclosure mandate is based on the recognition that it is costlier for each shareholder to calculate executive compensation separately. Since companies already have the information needed to quantify executive compensation, it is more efficient for each company to provide that information to its shareholders in a unified fashion.[123] The standardized compensation tables have also made the camouflage of the costs of executive compensation more difficult.[124]

Indeed, in our empirical analysis for this Article, we have found that determining the current and future levels of a controller's equity stake requires significant research and calculation, as this information does not appear in the standard datasets. Moreover, as discussed below, in some cases there are special governance arrangements that are not even accessible to outside investors. Thus, public officials should require companies to supply information on the current and expected levels of controller's stake to investors.

We note that the SEC's Investor Advisory Committee recently issued a discussion draft on dual-class stock that cites an earlier version of this Article and endorses our proposal below for enhancing disclosure.[125] In our view, the SEC would do well to follow this committee's advice and adopt our proposal for enhanced disclosure.

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[122] See 17 CFR 229.402 (Item 402) (Executive Compensation); SEC, Executive Compensation, https://perma.cc/NT99-MVH6.

[123] For an economic justification of mandatory disclosure grounded in the notion that firms are the lowest cost obtainers of most information relevant to securities valuation, *see, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048-49 (1995). See also Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 853 (2005); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 111-15 (2007).

[124] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 67 (2004).

[125] Investor Advisory Committee, Discussion Draft Re: Dual Class and Other Entrenching Governance Structures in Public Companies (Dec. 12, 2017), *available* at https://www.sec.gov/spotlight/investor-advisory-committee-2012/discussion-draft-dual-class-recommendation-iac-120717.pdf.

1. The Controller's Current Stake

The securities laws require that an issuer explicitly and precisely provide the "total number of shares beneficially owned" by 5%-holders and "the percent of the class so owned."[126] However, to the extent that a controller owns the shares through private entities (such as trusts) in which other parties have ownership rights, he is not required to provide additional information on his total ownership incentives.[127] Additionally, even when the proxy statement contains all the information necessary for calculating a controller's combined ownership and voting rights, it is not always made available to investors in a transparent way, and certain companies avoid reporting it in the customary ownership table.[128]

For instance, Nike discloses that its controllers have the right to nominate the majority of the board, but it does not disclose the total *ownership interest* of the controllers, information that must be hand calculated by investors.[129] Moreover, in 2015, Nike's founder and controller, Philip Knight, transferred the majority of his shares, as well as the right to elect 75% of the Nike board, to a limited liability company named Swoosh, LLC, which is currently managed by five members, including Knight and his son.[130] However, the proxy statement does not clearly identify the Knight family's effective ownership interest in Swoosh, LLC or the degree to which that company preserves the family's economic interest in Nike.

Second, in carrying out our empirical analysis, we encountered situations in which different family members were holding shares through various trusts and private entities, and there is some overlap between the equity holding of these family members, which in turn generated the concern that some of equity interests held by the controlling family were double counting. In such situations, however, the company disclosure might not disclose the precise *combined* ownership stake of the controlling family in the customary ownership table.

For example, Movado, the watchmaker company, disclosed in its costumery ownership table that one member of the controlling family, Alexander Grinberg, controls 50.14% of the company voting power, and that another member, Efraim Grinberg, controls 69.51% of the voting power.[131] To avoid an overestimation of the controlling family stake, there is a need to closely

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[126] 17 CFR 229.403 (Item 403) (security ownership of certain beneficial owners and management).

[127] Consider a situation in which a controller owns 50% of a private entity that has 50% ownership in a public company. The ownership stake of the private entity (50%) will be disclosed in the disclosure document, but the total ownership stake of the controller in the public company (25%) does not have to be disclosed.

[128] In some instances, the combined voting or ownership rights are noted only in text, not in tabular form; in other instances, the information is not spelled out in the proxy statement and therefore must be hand collected. For a similar criticism, *see* Kobi Kastiel, *Executive Compensation in Controlled Companies*, 90 IND. L.J. 1131, 1175 (2015).

[129] *See* NIKE, Inc., Definitive Proxy Statement (Schedule 14A) 13–14 (July 25, 2016).

[130] *NIKE, Inc. and Phil Knight Announce Ownership and Governance Actions*, NIKE NEWS (June 30, 2015), http://news.nike.com/news/nike-inc-and-phil-knight-announce-ownership-and-governance-actions.

[131] *See* Movado Group, Inc., Definitive Proxy Statement (Schedule 14A) 5–8 (May 9, 2017).

review the detailed, and often technical, language of the footnotes to customary ownership table, make some inferences from these footnotes as to what percentage of equity stake is double counted in the table, and hand calculate the precise ownership stake manually. This could be a daunting task, not only for lay investors but also for the more sophisticated players. Indeed, in its report on dual-class firms, the ISS noted that the Grinberg family controls a majority of the voting rights, without detailing its exact combined voting stake.

To address the above problems, companies should be required to disclose in their annual proxy materials not just how many shares their controllers own, but also the combined percentage of equity stake and voting rights their controllers have in these companies. The information presented in the beneficial ownership table should also eliminate potential double counting of controllers' shares. To the extent that investors own the shares through private entities, arrangements that affect the calculation of a controller's total ownership stake in the controlled company should also be disclosed. This would enable investors to better assess any agency problems resulting from the wedge between the controller's equity stake and his voting power. It would also facilitate research on these and related topics, which would, in turn, further contribute to investors' understanding of the desirability of these structures.

2. The Risk of Future Reduction

To identify the minimum equity stake a controller must hold while maintaining control, one must analyze the capital structure and governance provisions of a dual-class company and the interaction between them. Companies are currently not required to provide any information in this regard, and in the course of our empirical analysis, we spent a significant amount of time in each case identifying the minimum equity stake that a controller would have to hold in order to retain control.

For example, Snap disclosed in its IPO registration statement the ownership interest of its co-founders, but it failed to disclose the minimum equity stake that its co-founders could own without relinquishing control. We had to perform this calculation, taking into account the capital structure and governance arrangements that the company adopted at the IPO stage, including such factors as the number of authorized nonvoting shares, the equity ownership of other pre-IPO investors, and the potential effects of the sunset clause and the automatic conversion provision. Our analysis concluded that each co-founder could reduce his equity stake to 1.4% without relinquishing control.[132] To the best of our knowledge, this information was not transparent to

[132] *See supra* note 82, and accompanying text.

public investors, and the vast majority of the media articles that covered the Snap IPO did not note the extremely low minimum equity stake that would be sufficient to retain control.[133]

Both at and after the IPO, a clear disclosure of the minimum equity stake required for the controller to maintain control would enable investors to better evaluate the governance risks that a dual-class structure could generate. Assessing this risk requires understanding not only the current level of the controller's equity stake, but also the magnitude of the risk that the wedge between his equity and voting rights will increase in the future. We note that in the context of executive compensation, companies are already required to provide investors with information about the future value that relevant compensation variables may take.[134] Given the significance of potential increases in the wedge without a relinquishment of control, companies should disclose to their investors the minimum equity stake that is consistent with their controllers retaining control.

C. Limiting the Wedge

The analysis of this Article has highlighted the costs that small-minority controllers can be expected to generate and has shown that those costs are expected to escalate as the controller's equity stake declines. Recognizing this problem should lead public officials and institutional investors to consider ways of precluding, or at least discouraging, dual-class structures with small-minority controllers. In this Section, we discuss several avenues in which this could be done, examining regulatory legal interventions and private ordering efforts by institutional investors.

1. Ownership-based Sunset Provisions

One way to limit the problem of small-minority controllers is to have an arrangement that would require sunsetting the dual-class structure if the controller's equity stake falls below a specified threshold. Once triggered, the sunset clause will automatically convert high-vote shares

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[133] *See, e.g.*, Michael de la Merced, *Snap Aims for Valuation of More Than $20 Billion in I.P.O.*, N.Y. TIMES DEALBOOK (Feb. 17, 2017), at B3; Farrell, *supra* note 17; Dominic Rushe, *Snapchat to Make High-Profile Stock Debut after Revealing IPO Plans*, THE GUARDIAN (Feb. 2, 2017), https://www.theguardian.com/technology/2017/feb/02/snapchat-ipo-goes-public-evan-spiegel-owner-tech.

[134] For example, the disclosure of present value of option award or accumulated pension benefits require certain valuation assumptions. *See* Fredric W. Cook, *SEC Staff Updates Interpretive Guidance on Executive and Director Compensation Disclosure Rules* (Nov. 1, 2016), available at https://www.fwcook.com/content/documents/publications/11-01-2016__ORIGINALLY_01-29-07__-_SEC_Staff_Updates_Interpretive_Guidance_on_Executive_and_Director_Compensation_Disclosure_Rules.pdf.

to ordinary shares.[135] As explained below, this could be done through either regulation or private ordering.

An ownership-based sunset clause directly addresses the concern of dual-class structures with extreme separation by forcing a controlling shareholder to retain a certain percentage of the company's equity capital. A controller with a sizable equity holding is likely to better internalize the interests of other public shareholders. Some might worry that there are circumstances in which it would be desirable to enable the controller to retain the dual-class structure. In such cases, the sunset arrangement could be refined to have the dual-class structure remain in place if its retention receives a vote of approval by a majority of public investors unaffiliated with the controller.

The use of a sunset provision with an ownership threshold is not new to U.S. equity markets. From mid-1970s to mid-1980s, AMEX had an arrangement that permitted dual-class stock but subjected it to certain limitations,[136] including decreasing voting power of high-vote shares if they fell below a certain percentage of total capitalization.[137] AMEX later dropped this arrangement, and other exchanges do not have such an arrangement. Our analysis of the perils of small-minority controllers suggests that regulators should now seriously consider adopting an AMEX-like requirement.

An ownership-based sunset clause could also be introduced through private ordering. Companies going public with a dual-class structure can include such a governance arrangement in their charters, as various such companies have already done.[138] However, for it to be effective in addressing the problem, the devil is in the details. As we explained in Section III.G., most dual-class companies still do not have a sunset provision, and in those that do, the specified threshold is generally low enough to permit small-minority controllers. In our view, to the extent to which public officials do not adopt AMEX-like requirements, institutional investors should seek to encourage companies going public with dual-class structures to adopt effective and meaningful sunset provisions.

2. Limiting High/Low Vote Ratio.

As our analysis of the mechanisms of extreme separation has shown, the high/low vote ratio plays an important role in determining the extent to which a controller can reduce his equity stake while maintaining a lock on control. Therefore, public officials and institutional investors

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[135] AMC, LinkedIn, and Zynga are among the companies that adopted an ownership-percentage sunset clause when they went public. *See* Hong Kong Exchanges and Clearing Limited, *Concept Paper on Weighted Voting Rights*, 46-48 (August, 2014).

[136] Seligman, *supra* note 13, at 704 n.90.

[137] *Id.* ("[t]he Exchange will generally require that the "super" class lose certain of its attributes should the number of such shares fall below a certain percentage of the total capitalization").

[138] *See supra* Section III.G.

who are concerned about the governance costs of small-minority controllers should pay close attention to the high/low vote ratio that dual-class companies use.

The high/low vote ratio could be limited by regulation or the exchange listing standard. For example, AMEX's old statement policy subjected dual-class listings to a 10:1 high/low vote ratio.[139] Similar rules exist in other countries. In Italian private companies, the maximum high/low vote ratio is 3:1.[140] In Poland, before enacting a prohibition on the use of high-vote shares, the maximum high/low vote ratio was 5:1.[141] And in Denmark, Hungary, Sweden, and Switzerland, the ratio is 10:1, as it was in AMEX policy.[142] However, the present listing standards of U.S. exchanges impose no limits on the use of the high/low vote ratio. The exchanges could well have economic incentives to list companies that use very high ratios, but given concerns about small-minority controllers, regulators may consider requiring exchanges to have some meaningful cap on their high/low vote ratios.

Absent regulatory or exchange requirements, our analysis suggests that institutional investors should pay close attention not just to whether companies have a dual-class structure but also to the vote ratio that is employed. A high vote ratio plants the seeds for the emergence of extreme separation between cash-flow rights and voting rights and therefore exposes public investors to substantial governance risks. We note that ISS operates a corporate-governance-rating system that examines only the existence or absence of a dual-class structure.[143] In our view, any assessment of governance risks that is provided to institutional investors should also give significant weight to the high/low vote ratio.

3. Limits to the Issuance of Nonvoting Shares.

As explained earlier, introducing nonvoting stock represents an "infinite" ratio of high/low voting shares. As our analysis shows, when assessing the potential for extreme separation, what matters is not only the mere existence of a class of nonvoting stock but also the number of authorized but unissued nonvoting shares. Recall that in our analysis of Snap, it was the large

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[139] Seligman, *supra* note 13, at 704 n.90 ("There may not be a voting ratio greater than 10 to 1 in favor of the 'super' voting class on all matters other than the election of directors").
[140] Article 2351(4) Italian Civil Code.
[141] Sherman & Sterling et al., PROPORTIONALITY BETWEEN OWNERSHIP AND CONTROL IN EU LISTED COMPANIES: COMPARATIVE LEGAL STUDY, Exhibit C, Part II, at 165 (2007), http://www.ecgi.org/osov/final_report.php [hereinafter COMPARATIVE LEGAL STUDY].
[142] For a description of the governing arrangements in these countries, see S'holder Servs., Sherman & Sterling & Eur. Corp. Governance Inst., REPORT ON THE PROPORTIONALITY PRINCIPLE IN THE EUROPEAN UNION 19 (2006), http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf (Denmark, Hungary and Sweden); Daniel Schoch, Annina Müller & Christophe Pétermann, *Switzerland*, *in* GETTING THE DEAL THROUGH: CORPORATE GOVERNANCE 2017 164 (Holly J. Gregory ed., 2017) (Switzerland).
[143] *See supra* notes 21-22.

number of authorized and unissued nonvoting shares—rather than the number of issued nonvoting shares—that provided the basis for our conclusion that Snap's co-founders would be able to retain majority control in the future while unloading the vast majority of their shares and retaining only a tiny equity stake.[144] Therefore, public officials and institutional investors who are concerned about the governance costs of small-minority controllers should pay close attention to both the number of nonvoting shares that have already been issued and the number that would remain in the company coffer and could be used for future dividend distributions in a way that could significantly reduce the controller's equity stake.

We note that numerous jurisdictions around the world prohibit outright the use of nonvoting shares. For instance, in Denmark, the Netherlands, and Sweden, corporations cannot issue nonvoting shares.[145] Some other jurisdictions allow the use of nonvoting shares but limit them to a fraction of the company's equity capital, depending on the jurisdiction: 25% in France; 33% in Austria, Belgium, and Estonia; 40% in Greece; and 50% in Germany, Hungary, Italy, Japan, Luxembourg, and Spain.[146]

In the United States, current regulation and exchange requirements place no limits on the use of nonvoting shares, and this state of affairs enables companies to adopt structures in which nonvoting stock could form the overwhelming majority of the equity capital. For example, Snap's initial charter authorizes a large number of nonvoting shares that, once fully issued, would result in nonvoting stock constituting about 90% of company's the equity capital.[147] Our analysis suggests that public officials overseeing the U.S. capital market may want to consider whether the expansive freedom to use nonvoting stock is warranted.

Some institutional investors have been seeking to limit the use of nonvoting shares via private ordering. As part of this effort, one of the world's largest index providers has recently announced its plans to exclude companies with multiple-class share structures from its index.[148]

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[144] *See supra* note 82.

[145] COMPARATIVE LEGAL STUDY, *supra* note 141, Part I at 65, Part II at 118-119, 233-236.

[146] France (COMPARATIVE LEGAL STUDY, *supra* note 141, Part I at 249); Austria, Belgium, and Estonia (Eva Fischer, *Austria, in* GETTING THE DEAL THROUGH, *supra* note 142, at 13; COMPARATIVE LEGAL STUDY, *supra* note 141, Part I at 5, 136); Greece (COMPARATIVE LEGAL STUDY, *supra* note 141, Part I at 173) and Germany, Hungary, Italy, Japan, Luxembourg, and Spain (COMPARATIVE LEGAL STUDY, *supra* note 141, Part I at 99, 200, Part II at 12, 47, 338, 342 and Article 2351(4) Italian Civil Code). Some of the above-mentioned jurisdictions only allow the use of nonvoting preferred shares, which have no voting power but are protected by enjoying preferential dividend rights.

[147] At the time of the IPO, Snap issued 3 billion nonvoting class C shares. In addition, as of October 2017, the company had two additional classes of voting shares (Class A and Class B) with a total of 341,204,476 class A and Class B shares outstanding. If all authorized nonvoting shares are issued, they will constitute over 90% of company's equity capital (3,000,000,000 / 3,341,204,476).

[148] Davis Polk & Wardwell LLP, *Snap Decision: Leading Index Providers Nix Multi-Class Shares*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Aug. 2, 2017), https://corpgov.law.harvard.edu /2017/08/02/snap-decision-leading-index-providers-nix-multi-class-shares/.

However, the change to the S&P 1500 Composite will not affect existing index constituents, and at this stage, it is not clear whether and to what extent it will discourage companies from going public with dual-class structures.[149]

In sum, nonvoting shares can be a powerful tool for creating an extreme separation between cash-flow rights and voting rights. Our analysis suggests that public officials and institutional investors would do well to consider measures aimed at discouraging the use of nonvoting stock to enable the creation of small-minority, or even tiny-minority, controllers.

D. Additional Investor Protections in Companies with Small-Minority Controllers

In the preceding Section, we discussed measures that public officials and institutional investors could adopt to reduce the incidence of companies with small-minority controllers. Should they decide not to pursue such measures or to pursue them in a limited fashion, a significant incidence of small-minority controllers would still exist. Furthermore, even if public officials and institutional investors succeeded in limiting the creation of new public companies with small-minority controllers, these structures could remain in companies that went public in the past. Thus, we now examine corporate governance measures for protecting public investors in situations where small-minority controllers would remain in control.

In general, the design of corporate law rules takes into account the potential for certain agency problems. For example, when a company has a controlling shareholder, corporate law provides special rules to address concerns about that controller using its power to divert value from public investors.[150] Since we have shown that the presence of a small-minority controller generates severe governance costs and risks, this insight should inform the design of rules and arrangements that govern decision making in companies with small-minority controllers.

The recognition of the potential for governance risks generated by small-minority controllers should encourage public officials (including both regulators and courts) and institutional investors to address this problem. Below we highlight several avenues in which public officials and institutional investors could seek to provide public investors with additional protections from small-minority controllers. Our analysis is not intended to be exhaustive but rather to show that there are governance tools and protections available for serve this purpose.

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[149] *Id. See* also Wilson Sonsini Goodrich & Rosati, *The Continuing Support for Dual-Class Stock by Companies and Investors* (Oct. 17, 2017), available at https://www.wsgr.com/WSGR/Display .aspx?Section Name=publications/PDFSearch/wsgralert-dual-class-stock-1017.htm ("multi-class stock structures will continue to be adopted by emerging growth companies").

[150] *See infra* note 166 (discussing Delaware court approach to controller's related-party transactions).

1. Strengthening Limits on Conflicted Decisions

Corporate law has long recognized the problems that arise from the potential opportunism of controlling shareholders, and it provides an elaborate set of rules and doctrines to limit these problems. For example, both in the United States and around the world, it has special rules that limit potential value diversion as a result of related-party transactions between the controlled company and entities affiliated with the controller.[151] Because we have shown that agency problems and distortions are likely to be more severe when the controller has a small stake in the controlled companies, the protection of public investors in such situations could well call for heightened rules and doctrines.

Judicial Scrutiny. For example, courts that examine self-dealing transactions should consider applying heightened scrutiny when the controller is a small- or tiny-minority controller. We note that in Ezcorp, a self-dealing case, Vice Chancellor Laster observed that the controller owned 100% of the voting power but only a 5.5% economic stake owing to the existence of a dual-class structure.[152] That extreme separation, according to the court, created a strong incentive for the controller to obtain returns through nonratable direct transfers and thus played a role in the court's decision to subject the related-party agreements between the controller and the company to the "entire fairness" framework of review (rather than to the more deferential business judgment rule).[153] Our analysis suggests that courts should generally attach weight to the size of the controller's stake and apply heightened scrutiny when that stake is smaller.

Limiting the Voting Rights of the Controller. Another way to limit the agency costs of small-minority controllers is to allow such controllers to continue determining the identity of the board, but to limit their ability to use their voting power to adopt measures that could divert value from public investors. For example, in Switzerland, disproportionate voting rights do not apply to consideration of any resolution concerning the instigation of a special audit or the initiation of a liability action.[154] Similar restrictions on the exercise of a controlling shareholder's superior voting power in conflicted transactions exist in several other countries.[155] Such an approach, if adopted by U.S. regulators, would let a small-minority controller determine the company's strategic and managerial direction but, given the substantial agency distortion, would limit the controller's

[151] For a detailed analysis of the corporate governance problems in controlled companies and the importance of related-party transactions, *see* Bebchuk & Hamdani, *The Elusive Quest for Global Governance Standards*, *supra* note 26.

[152] In re Ezcorp Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245 at *5 (Del. Ch. Jan. 25, 2016).

[153] *Id.*, at 5–9, 97.

[154] GETTING THE DEAL THROUGH, *supra* note 142, at 161.

[155] In some European countries, corporate law prohibits a controlling shareholder from voting on certain resolutions that could provide the controller with non–pro rata benefits. See GETTING THE DEAL THROUGH, *supra* note 142, at 44–45, 139, 167.

power to pass, without the support of public investors, measures that could adversely affect their interests.

Finally, we note that enhanced judicial scrutiny or limitations on conflicted decisions could also be introduced through private ordering. Thus, institutional investors might try to encourage companies going public with dual-class structures to adopt provisions that provide additional protections in the event that a small-minority controller emerges. For example, a charter provision could limit the ability of such a controller to use its disproportional voting power to unilaterally determine the vote of certain matters, such as charter amendments affecting the interests of public investors.

2. Requiring Majority of Independent Directors

Another protective arrangement to consider is having a majority of independent directors on the boards of companies with small-minority controllers. The Sarbanes–Oxley Act of 2002 and the applicable stock exchange listing standards require that boards of widely held companies have a majority of independent directors.[156] However, the listing standards exempt all controlled companies, regardless of the equity stake of their controllers, from director independence requirements.[157] Our analysis suggests that exchanges should consider limiting this exception only to companies where controllers have a sufficiently large equity stake. Since the financial incentives of small-minority controllers are less likely to be aligned with those of other public shareholders, the presence of independent directors is more crucial in dual-class companies with extreme separation than in other controlled companies.

Moreover, even without action by the exchanges or other type of regulators, requirements for a majority of independent directors could be adopted through private ordering. Thus, in assessing companies that plan to go public with a dual-class structure that could give rise to small-minority controllers, institutional investors should try to press such companies to introduce charter provisions that ensure a majority of independent directors.

3. Enhanced Director Independence

Another way to protect public investors in companies with small-minority controllers is to provide them with influence over the election of some independent directors. Under the existing arrangements, even when the controller has a small- or a tiny-minority stake, he has the power to

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[156] *See* 15 U.S.C. § 7211(e)(6) (2012) and *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2187 (2004) ("The revised listing standards of both the NYSE and NASDAQ… require (with a few exceptions) that listed-company boards have a majority of independent directors…").

[157] *See* SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence, FindLaw (last visited Feb. 1, 2018), available at http://corporate.findlaw.com/finance/secapproves-nyse-and-nasdaq-proposals-relating-to-director.html.

appoint or terminate all independent directors. As was highlighted in a recent article co-authored by one of us and Assaf Hamdani, the controller's power to appoint and elect independent directors provides these directors with incentives to favor the controller and weakens their ability to screen conflicted decisions and guard the interests of public investors.[158]

To provide improved incentives, public investors in a company with small-minority controllers could be given the right to elect, or at least approve, the selection of some independent directors, who would then be required to approve conflicted decisions. Having such enhanced independent directors would not take away from the controller's ability to set the company's strategic and managerial directions. Rather, it would ensure that decisions in conflicted situations would be made only if approved by independent directors that have heightened incentives to serve the interests of public investors.[159]

In those dual-class companies that went public between the mid-1970s and mid-1980s at AMEX, this arrangement has been functioning well, requiring them to grant public holders the right to elect at least 25% of the board of directors.[160] The arrangement still exists in some mature dual-class companies,[161] but it is rare in companies with small-minority controllers that did not go public at AMEX.[162] In our view, even if the presence of small-minority controllers were to be accepted, it would be desirable to introduce enhanced-independent directors in all companies with such controllers. Regulators could adopt such a mandate; courts could encourage it by imposing enhanced scrutiny for conflicted decisions not approved by them; and institutional investors should look for arrangements that provide for enhanced-independence directors when deciding whether to invest in such companies.

In sum, taking as a given that companies with small-minority controllers will continue to exist, public officials and institutional investors approaching such companies should be informed by a keen understanding of the special governance problems that they pose and the need to provide their public investors with additional protections to address those problems. We have identified above some key measures that could be considered for this purpose, and our analysis could provide a basis for identifying and developing additional measures.

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[158] Lucian A. Bebchuk & Assaf Hamdani, *Making Independent Directors Work*, 165 U. PA. L. REV. 1271 (2017).
[159] For a detailed analysis of the potential benefits of this arrangement, *see id*.
[160] Seligman, *supra* note 13, at 704 n.90 (describing the history of dual-class structures in the United States).
[161] Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 16 COLUM. BUS. L. REV. 60, 131–36 (2016) (providing examples of companies that still maintain this structure).
[162] *Id.*, at 167.

E. Screening Midstream Changes

Thus far, we have focused on what arrangements dual-class companies should adopt when they go public. We have discussed arrangements that would limit or discourage the ability of a controller to retain control while holding only a small equity stake, as well as arrangements that would provide public investors with additional protections from a small-minority controller. However, while the IPO arrangements are clearly important, we now turn to the problem of midstream charter changes. In a dual-class company with a majority controller, the controller may use his voting power to amend at a later stage some governance arrangements that were adopted at the IPO.

In this Section, we examine how public officials and institutional investors should seek to address midstream governance changes. Such changes could take different forms. The controller might make changes that would enable him to retain control with a smaller fraction of the equity capital than would have otherwise been possible. For example, a charter amendment that authorizes the issuance of a sufficiently large number of low-vote shares or nonvoting shares would enable the controller to reduce the minimum equity stake necessary to retain control to as low a level as he desires.[163] Another midstream governance change might introduce a conversion clause that would mitigate the expected decrease of the controller's total voting power upon a sale of shares by the controller or other pre-IPO shareholders.[164]

Of course, these charter amendments require a vote of shareholder approval. However, a controller who controls the majority of votes would be able to have a charter amendment passed against the wishes of public investors. This introduces the concern of "opportunistic" midstream changes that would serve the controller's private interests even if they would likely have a significantly adverse effect on public investors. For example, a nonvoting share reclassification would serve the controller's private interests by enabling him to obtain the liquidity and diversification benefits that come from unloading shares without bearing the costs of losing control. At the same time, however, because such a change would reduce the controller's equity stake, it would be expected to increase agency distortions and costs.

One way to guard against midstream governance changes would be to preclude the controller from making any changes in the IPO structure. However, such a rigid approach might have its costs, as it would also preclude the possibility of governance changes that may be needed to address changing circumstances to the benefit of both the controller and public investors. Therefore, it would be desirable to have an adequate screening mechanism that would preclude opportunistic, value-decreasing changes while enabling efficient changes that would serve the interests of both the controller and public investors.

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[163] *See* Sections III.D.2 & III.G.
[164] *See* Sections III.D.1 & III.E.2.

Another way to address midstream governance changes is to subject them to a vote of approval by public shareholders unaffiliated with the controller.[165] Such a requirement would prevent changes that public investors view as opportunistic and against their interests. At the same time, however, because public investors would be expected to vote in favor of midstream charter amendments that would serve both their interests and the interests of the controller, such an approval requirement should not preclude beneficial changes.

Requiring a vote of approval from public investors for midstream governance changes in controlled dual-class companies would be an effective way to deal with the problem of such changes. In our view, the significant problem with recent dual-class nonvoting stock reclassifications, such as the one adopted by Google and the one attempted by Facebook, is that the controllers chose to pass the proposed charter amendments using their own voting power and without making the adoptions contingent on the approval of disinterested public investors.

One way to introduce an approval vote by disinterested public investors is through judicial intervention. In freeze-out transactions, such votes of approval became common after the Delaware court held that it would subject a freeze-out to an exacting "entire fairness" scrutiny unless the freeze-out proposal was made conditional on receiving the approval of public investors, among other things.[166] Such a special approval mechanism is used to eliminate freeze-outs that are motivated by the controllers' private interests and are value reducing for public investors.[167] Similarly, in our context, court could—and, in our view, should—adopt a similar approach with respect to midstream charter amendments.

In the well-known *Williams v. Geier* case, the Supreme Court provided a business judgment differential review to the decision of a controller to pass a charter amendment that was expected to entrench the controlling family.[168] In a recent case involving a midstream reclassification aimed at preserving the voting power of the controller, Chancellor Bouchard thought to limit the scope of *Williams* (though without expressly rebutting it).[169] In our view, it would be desirable for the Delaware Supreme Court to overrule *Williams* in general, or at least in the case of multiple-class

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[165] Public officials could also impose a flat prohibition against midstream reclassifications, as AMEX's prior policy did. *See* Seligman, *supra* note 13, at 704 n.90 ("No additional stock (whether designated as common or preferred) may be created which can in any way diminish voting power granted to the holders of the limited voting class."). However, such a prohibition could be opposed on grounds that it might block efficient midstream reclassifications.

[166] The Delaware courts have encouraged controllers to obtain the approval of unaffiliated shareholders to the terms of a freeze-out merger by holding that transactions not enjoying such approval would be subject to strict scrutiny. *See* e.g. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014), affirming MFW, 67 A.3d 496.

[167] S*ee* Guhan Subramanian, *Post-Siliconix Freeze-Outs: Theory and Evidence*, 36 J. LEG. STUD. 1, 14 (2007) (finding that minority shareholders receive lower cumulative abnormal returns in tender-offer freeze-outs not subject to the entire fairness standard than in statutory merger freeze-outs).

[168] *Williams v. Geier*, 671 A.2d 1368, 1371 (Del. 1996).

[169] *Supra* note 99.

share reclassifications. Concerns about opportunistic midstream changes by small-minority controllers fully warrant such an approach by the court.

Finally, a requirement for approval of midstream charter changes in dual-class companies could be introduced through private ordering. The IPO charter of companies going public with a dual-class structure could contain provisions that require majority approval from public investors for any specified charter amendments that could adversely affect the interests of public investors.

VI. CONCLUSION

This Article has sought to place spotlight on the perils of small-minority controllers. Such controllers pose substantial governance risks, generate considerable governance costs, and deserve the close attention of public officials and investors.

The Article has provided a systematic analysis of the drivers, incidence, costs, and policy implications of small-minority controllers. We have analyzed the considerable agency costs and distortions of small-minority controllers; how they can be expected to rise steeply when the controller's equity stake declines; and the mechanisms that enable small-minority shareholders to retain a lock on control. Based on a hand-collected dataset of governance provisions that we put together, we provide novel empirical evidence of the current and potential incidence of small-minority controllers. Our finding that the governance provisions of a substantial majority of dual-class companies would enable the controller to retain control with an equity stake of below 10% and, in a sizable fraction of these cases, with even less than 5%-stake, highlights the significance of the issue and the concerns it raises. Finally, we have examined the significant policy implications that small-minority controllers have for public officials and institutional investors. We hope that our analysis will be useful to them, helping them to recognize and address the pernicious problems produced by small-minority controllers.