When One Share Does Not Mean One Vote:
The Fight Against Dual-Class Capital Structures

Over the past decade, companies have increasingly adopted "dual-class" capital structures, which concentrate control in a small group of company insiders by providing them with stock that has super-sized voting rights. Dual-class structures inherently create a divergence between the insiders' relative economic ownership of a company and their voting power, which results in a heightened risk of self-dealing, while limiting public shareholders' ability to influence the direction of those companies. Regulators, institutional investor groups, and equity index providers have voiced serious concerns with these dual-class capital structures, yet they remain popular today among many company founders and insiders, with numerous high-profile companies announcing their intention to adopt them when they go public in the near future. Institutional investors should be well-informed about the risks associated with dual-class capital structures and consider their options for current or future investments in those companies.

THE TROUBLING INCREASE IN PUBLIC COMPANY DUAL-CLASS STRUCTURES

Dual-class capital structures contradict the traditional "one share, one vote" principle of corporate governance, which is the simple premise that a shareholder's voting power should reflect its economic ownership of the company. Under the typical one-class capital structure, if a majority of a company's equity shares are owned by outside investors, then the company's management is accountable to its board of directors, which, in turn, must answer for poor performance to a majority of voting shareholders. This traditional structure lies at the heart of trillions of dollars of value creation through the corporate form.

A core economic conflict emerges when companies adopt dual-class structures. Under such arrangements, company insiders holding a relatively small minority of the economic interests in the company (and therefore who enjoy only a small percentage of gains from its business successes and suffer only a small percentage of losses from its failures) end up wielding a majority of the voting power. This presents an opportunity for abusive conduct and self-dealing, as company insiders holding super-sized voting power are personally incentivized to use their votes to expropriate personal gains, even if at the expense of the company and other shareholders. When the corporate insiders holding super-voting shares are also senior executives of their companies – which is often the case – they effectively get to select their own bosses (i.e., the company's directors) and thereby determine their own pay (i.e., executive compensation). Through their high-voting shares, these insiders also may effectively drive innumerable other mundane or significant decisions in directions that may not maximize shareholder welfare generally.

Between 2005 and 2017, the number of newly-public companies adopting dual-class share structures increased dramatically.

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In 2005, just 1 percent of U.S. companies went public with dual-class shares, yet in 2017, nearly 20 percent of U.S. companies going public employed a dual-class share structure.

Insiders at start-up technology companies appear particularly attracted to the personal benefits of dual-class capital structures. When taking their company public in March 2017, the founders of the popular social media company, Snap, Inc., issued over $3.5 billion in stock – none of which had any voting rights. Instead of granting shares with voting power, Snap's 27-year old CEO Evan Spiegel and his co-founder kept nearly 90 percent of the company's voting power to themselves, with the other 10 percent going to additional company insiders. Dual-class share critics have pointed out that since taking the company public, Snap's founders holding voting control completely out of proportion with their economic interests have personally benefited while the economic owners of the company have suffered. Indeed, while Snap lost over $700 million in its first year as a public company, Snap's CEO Spiegel received a $638 million annual bonus – the largest of any technology chief executive officer.

The uptick in companies' use of dual-class shares is not limited to the technology sector. A variety of companies have turned to dual-class structures in an effort to concentrate control in the hands of a founder or select corporate insiders. These include, among others, Maryland real estate investment trusts, which have a high frequency of dual-class capital structures and also – not coincidentally – have presented some of the more egregious governance failures and instances of corporate misconduct over the past few years.

Defenders of dual-class capital structures contend that corporate insiders are supposedly more focused than other shareholders on the company's long-term health, so giving them outsized voting rights makes long-term sense. We believe this contention is unfounded. Investors, including public pension funds and other institutional investors, are keenly focused on long-term returns. Indeed, company insiders too often are not focused on long-term results, but rather are concerned with short-term performance that directly impacts their annual bonuses.

MOUNTING CRITICISMS OF DUAL-CLASS STRUCTURES

Over the past few months, government regulators, investor advocacy groups, and major institutional investors have increasingly questioned the utility of dual-class share structures. During a February 13, 2018 presentation, SEC Commissioner Kara Stein criticized dual-class companies as "inherently undemocratic, disconnecting the interests of a company's controlling shareholders from its other shareholders." Commissioner Stein further warned that dual-class shares "provide a means to evade management and board accountability" and are "harmful not just for those companies, their shareholders, and their employees, but for the economy as a whole." She concluded that dual-class capital structures, in effect, "turn the mutualism underlying the corporation-shareholder relationship on its head."

Just a few days later, in his first speech as an SEC commissioner, Robert Jackson Jr. echoed these observations. He explained that "more and more companies choose today to go public with dual-class," which now account for over $5 trillion of investor capital. Commissioner Jackson warned that these dual-class share structures "undermine accountability" and highlighted "the costs for investors – who are left with no way to hold management's feet to the fire while dual-class is in place." He noted that many of these dual-class structures provide insiders and their heirs with a right to dictate the company's voting outcomes in perpetuity. As he explained, these "companies are asking shareholders to trust management's business judgment – not just for five years, or 10 years, or even 50 years. *Forever.*"

Institutional investor groups have also increasingly advocated against dual-class structures. Investor Stewardship Group, a coalition of 16 major institutional investors – including BlackRock, Vanguard Group, State Street, and certain public pension funds – has publicly denounced dual-class governance structures. The group proposed a comprehensive "stewardship code" that memorializes the "one share, one vote" principle and prohibits dual-class shares. The Council of Institutional Investors ("CII") has also voiced strong opposition to dual-class capital structures, explaining that they reflect "bad governance" and lamenting that their continued use is "disappointing."

Prominent institutional investors have also sought relief from the courts in opposing dual-class capital structures used by heavy-handed corporate executives for personal gain. For example, CalPERS succeeded last year in blocking InterActiveCorp ("IAC") from granting its founder, Barry Diller, and his family perpetual control of IAC through the issuance of a class of nonvoting shares. In response to Diller's effort to entrench himself and his family atop IAC's corporate hierarchy, CalPERS filed a class action in the Delaware Chancery Court alleging breaches of fiduciary duty and seeking an order to prevent IAC from diluting voting rights through the issuance of an additional nonvoting class of stock. After contentious litigation, IAC abandoned its plan to issue nonvoting stock.

The major equity index providers also have recently taken a stance against dual-class shares. On July 26, 2017, FTSE Russell, a unit of London Stock Exchange Group PLC, announced that it would begin excluding from its indexes companies that issue shares without voting rights. Under FTSE Russell's new policy, companies that do not issue voting shares, like Snap Inc., are no longer eligible to participate on its indexes. The S&P Dow Jones followed course five days later when it announced that, going forward, companies that adopt dual-class structures in the future were no longer eligible to participate on the S&P 500, as well as its medium and small-stock counterparts.

ADDITIONAL INVESTOR ACTION IS REQUIRED TO CHALLENGE DUAL-CLASS STRUCTURES

Corporate insiders are continuing to adopt dual-class capital structures, notwithstanding opposition from regulators, investors, and other market participants. Just last month, Dropbox Inc., the cloud storage company, unveiled its plan to issue dual-class shares when it goes public later this year. According to its plan, Dropbox's CEO, Drew Houston, and his fellow insiders will receive "high vote" shares that provide 10-times the voting power of a single common share. Through these shares, CEO Houston and a handful of other insiders will effectively retain complete control over the company's affairs despite funding it with public investor capital. Similarly, Spotify Inc., the digital music service provider expected to go public later this year, has announced its intention to adopt a dual-class capital structure that grants super-voting shares to its co-founders and other insiders.

In light of opposition in the U.S., companies and their insiders seeking to implement dual-class capital structures are also now turning their attention abroad. Foreign exchanges have recently begun embracing companies with dual-class capital structures. Most notably, the Hong Kong Stock Exchange late last year announced that it was reversing its longstanding ban on dual-class shares to, among other things, attract Alibaba Group Holding Limited to conduct a secondary offering on its exchange. And in mid-January 2018, the Singapore Stock Exchange followed course and announced that it too will now allow dual-class companies to list on its exchange. Other exchanges, including those in the United Kingdom, are also currently contemplating reforms that will ease or eliminate restrictions on dual-class firms, which (if adopted) may spark a "race-to-the-bottom" among market regulators across the globe.

Signs indicate that company founders and insiders will continue to attempt to adopt dual-share capital structures that threaten institutional investors' right to vote.

Institutional investors wishing to protect their voting rights may want to take action, including by:

- Identifying and refusing to invest in companies that adopt dual-class share structures;
- Encouraging the SEC and other regulators to prohibit or restrict dual-class share structures;
- Petitioning U.S. and foreign stock exchanges and indexes to exclude or limit companies with dual-class share structures; and
- Taking legal action, when necessary, against executives and boards that attempt to dilute shareholder rights by creating non-voting share classes.

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