Harvard Law School Forum on
Corporate Governance and Financial Regulation
SUPPORTED BY:

What's the Problem with Dual Class Stock? A Brief Response to Professors Bebchuk and Kastiel

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Wednesday, April 17, 2019

Editor's note: David Berger is a partner at Wilson Sonsini Goodrich & Rosati. This post is based on a response by Mr. Berger to two recent posts published on the Forum. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock (discussed on the Forum here), and The Perils of Small-Minority Controllers (discussed on the Forum here).

The distinguished scholars Professors Lucian Bebchuk and Kobi Kastiel (both of whom I am proud to call my friends) are once again targeting technology companies with dual class stock. In two posts published in the past two weeks and based on a similar analysis, the subject of their ire has been Lyft and Pinterest, respectively. [1] The Bebchuk/Kastiel posts focus on the "governance costs" facing investors in both companies at some point "down the road" as a result of their dual class structures. In particular, and based upon their earlier research on what they call "small-minority controllers" and "perpetual dual-class stock," Bebchuk and Kastiel conclude that the dual class structures of both companies will eventually pose "substantial risks" for investors, and as a result can be expected to "significantly decrease the economic value of [each company's] low-voting shares that public investors will hold."

The day before Lyft's IPO I was invited by Nasdaq's Listing Council to speak on dual class stock. Specifically, the Council asked that I respond to the petition submitted by the Council of Institutional Investors ("CII") that companies going public with dual class shares include mandatory sunset provisions in their charters, effectively terminating the dual class structure after seven (7) years (my remarks are available on SSRN). [2] CII's Petition relied upon the same scholarship by Professors Bebchuk and Kastiel that they now use to criticize the dual class governance structures adopted by Lyft and Pinterest.

Consistent with my comments to Nasdaq, I believe the primary reason Professors Bebchuk and Kastiel oppose dual class stock is ideological; they believe that any governance structure that differentiates between stock ownership and voting control in a public corporation creates governance risks due to agency problems. While Bebchuk and Kastiel accept the notion that directors manage the corporation (albeit sometimes grudgingly), they believe that stockholders

---

[1] Mr. Berger and his firm represent several companies that have dual class stock, including Lyft, Alphabet (Google), LinkedIn, Dropbox, Snap, and others. The views expressed in this article are Mr. Berger's personal views, and do not represent the views of his firm or any of the firm's clients.

[2] *See* David J. Berger, "*Why Dual Class Stock? A Response To CII's Petition to NASDAQ for Mandatory Sunset Provisions*" (March 28, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365154.

"own" the corporation and therefore any provision that limits the ability of public stockholders to control the board is bad governance.

I see several problems with the Bebchuk/Kastiel construct. First, even assuming at one time there were agency problems arising out of the separation of ownership and control, the Bebchuk/Kastiel analysis fails to account for recent changes in the capital markets, which have dramatically altered the operation of today's public capital markets. Specifically, and as has been well documented by, among others, Delaware Chief Justice Leo Strine and Harvard Professor John Coates, today's capital markets are dominated by what's been called the "separation of ownership from ownership." What this means is that the "owners" of public company stock—the handful of large institutional investors and activist mutual funds that control the shares of most public companies [3]—do not own the capital they are employing to buy these shares. Instead, these large institutions are mere intermediaries, who receive capital from others, often in the form of retirement savings where the actual owners of the capital have little choice over how their savings are invested, and then use that capital to buy stock in public companies.

The growth of these large institutional investors has meant, as Professor Coates has demonstrated, that "the bulk of equity capital," including "the right to vote for directors" of public corporations, is largely controlled by a small number of individuals working for a small number of very large institutional investors. [4] As a result, companies considering selling stock in today's public markets face two alternatives: adopt a single class structure that will result in directors (and other voting decisions) being made by a handful of institutional investors and activist funds (who are often closely aligned) [5]; or choose a dual class structure where the company's founders and other early investors retain some ability to select directors and influence other issues put to a stockholder vote. [6]

Nor is it an answer to suggest that institutional investors often vote for directors nominated by the company. The reason this is no answer is simple: as no less an authority than Chief Justice Strine has recognized, directors respond to those who elect them, and so long as voting control of public corporations remains in the hands of a small number of large institutional investors and activist funds, directors will respond to the demands of these constituents. This "group think" mentality pervades regardless of who is elected to the board of a particular company, as can be seen from the proxy contest for DuPont. [7]

In addition to the changed nature of the capital markets, Professors Bebchuk and Kastiel do not respond to recent empirical research demonstrating why the current system of private ordering

[3] As has by now been well documented, by 2016 institutional investors owned 70% of public shares, and just three money managers held the largest stock position in 88% of the companies in the S&P 500. *See, e.g.*, Hon. Kara M. Stein, Commissioner, S.E.C., *The Markets in 2017: What's At Stake?* February 24, 2017. The concentration of stock ownership among large institutional investors has increased since former Commissioner Stein's speech.

[4] *See* John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve*, Sept. 20, 2018, at 14.

[5] The close relationship between institutional investors and activist funds is further demonstrated by their financial interdependence. For example, as recently described by the New York Times, the profits of many large Fidelity and Vanguard funds largely (if not entirely) because of their stock lending operations. The stock lending operations of these funds allows them to lend the shares they own to various hedge funds. The hedge funds use the borrowed shares to hedge their investment strategies while the large institutional investors are able to obtain more assets under management by offering lower fees. *See* Jeff Sommer, "*How Low Can Fund Fees Go? Try Below Zero*," New York Times, April 7, 2019.

[6] In my speech to Nasdaq I outlined a variety of alternative governance structures used and/or under consideration by various European countries as well as Congress. See David J. Berger, "*Why Dual Class Stock*," supra

[7] , at 10-12.

remains preferable to any type of mandatory or fixed sunset provisions. This research includes recent empirical studies by academics and index funds showing that dual class companies have out-performed their single class peers for at least a decade. [8] In addition, some of this research raises serious questions about the methodology employed by many of the scholars comparing dual class companies to single class companies. These flaws are sufficiently significant that the most recent academic study to consider dual class stock, by Professors Jill Fisch and Steve Davidoff Solomon, concluded that "compulsory sunsets, and time-based sunsets in particular, are an inappropriate response to the potential problems of dual class stock." [9]

Third, but perhaps most troubling with the Bebchuk/Kastiel construct, is their assumption that there is a correlation between a company's capital structure and its corporate governance. The reality, as one scholar recently noted, is that corporate "governance rankings measure only adherence to 'best practices' and this is something completely different than measuring integrity or business success. On the evidence available to us, best practices are not predictive of these latter virtues." [10] Simply put, whether a company has a single class structure or dual class stock does not correlate with better governance, more ethical corporate behavior or even better corporate performance. [11] While there are certainly dual class companies that are poorly governed and/or run, there are many single class companies that suffer from similar issues. What is lacking from the empirical evidence—on both sides—is any linkage showing causation; that is, the empirical evidence simply does not support a claim that ***the reason*** dual class companies perform differently than their single class counterparts is because of their capital structure.

Ultimately I believe that what really drives much of the opposition to dual class stock is ideology, not empirical evidence. [12] I too have questioned the current stockholder primacy ideology of corporate governance, including questioning whether the exchanges and/or corporate codes should allow for governance structures that give a greater voice to other corporate stakeholders, long-term stockholders or others. [13] Yet ideology aside, the real governance question facing our

---

[8] *See* Leo E. Strine Jr., *Corporate Power is Corporate Purpose I: Evidence From My Hometown* (U of Penn, Inst. For Law & Econ. Research Paper No. 16-34, Dec. 9, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2906875.

[9] *See* David J. Berger, "*Why Dual Class Stock*?", *supra*

[10] , at 12.

[11] Jill E. Fisch & Steven Davidoff Solomon, "*The Problem of Sunsets*" at 26, Boston Univ. L. Rev. (forthcoming 2019). For this reason Fisch and Davidoff Solomon recommend that dual class stock should continue to be subject to private ordering rather than any type of regulatory restriction. *Id*.

[12] Bryce C. Tingle, "What is Corporate Governance? Can We Measure It? Can Investment Fiduciaries Rely On It?" 43 Queens L.J.No.2 (2018)

[13] Snap is a classic example of this situation. While governance experts have complained about its non-voting stock while discussing its performance, the consensus in the business and technology communities was that Snap's challenges were primarily the result of business competition, including new products from Facebook, not governance issues. *See, e.g.,* Billy Gallagher, "*Copycat: How Facebook Tried to Squash Snapchat*," Wired (Feb. 16, 2018). Similarly, analysts are attributing Snap's recent improved performance to a variety of business factors. See, e.g., Kaya Yurieff, "*Snap's Stock Price Has Doubled, Analysts Are Optimistic Snap is Growing*," CNN Business (April 10, 2019). There is just no evidence linking Snap's performance to its governance structure, or to support the argument that Snap's corporate performance would have been different if it had a different governance structure. Obviously the same is true for many companies with single class stock, including such prominent companies as GE and Sears.

[12]SEC Commissioner Robert Jackson made ideology the focus of his challenge to what he called "perpetual dual class stock", when he argued that such a structure is contrary to "our country's spirit of democratic accountability which animates how we think about public markets." *See* Hon. Robert J. Jackson, Jr., Commissioner, S.E.C., "*Perpetual Dual Class Stock: The Case Against Corporate Royalty*," Feb.15, 2018 (discussed on the Forum here).

[13]*See, e.g.*, David J. Berger, "*In Search of Lost Time: What If Delaware Had Not Adopted Stockholder Primacy*," in **The Corporate Contract in Changing Times**, (Steven Davidoff Solomon & Randall Thomas eds.:2019); David J. Berger, *"Reconsidering Stockholder Primacy In an Age of Corporate Purpose,"* (Business Lawyer 2019) (forthcoming), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3327647. See also Dave Michaels and Alexander Osipovich, "*Silicon Valley's Stock-Exchange Plan Snagged by Opposition at SEC*," Wall Street Journal, Nov.27, 2018 (discussing effort by Long Term Stock Exchange to gain SEC approval, including its plan for tenure voting).

best companies thinking about selling shares in the public markets today is whether they want to have voting control of the corporation held in the hands of a limited number of institutional investors and activist hedge funds or do they want to keep some portion of control to themselves and their early investors who helped grow the business? Until we offer companies an alternative to a system where voting control is held by a few institutions and activist funds unless the company adopts dual class stock prior to its initial public offering, we should not be surprised by the continued adoption of dual class structures by many of our best and most entrepreneurial companies.