



## ARTICLE

## Nonvoting Shares and Efficient Corporate Governance

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**Abstract.** A growing number of technology companies, including Google, Zillow, and Snap, have issued stock that does not allow investors to vote on corporate decisions. But there is fundamental disagreement among scholars and investors about whether nonvoting stock is beneficial or harmful. Critics argue that nonvoting shares perpetually insulate corporate insiders from influence and oversight, and therefore increase agency costs. By contrast, proponents contend that nonvoting shares may provide benefits that exceed these agency costs, such as enabling corporate insiders to pursue their long-term vision for the company without interference from outside shareholders.

This Article offers a novel perspective on this debate. It demonstrates an important and previously unrecognized benefit of nonvoting stock: that it can be used to make corporate governance more efficient. This is because nonvoting stock allows companies to divide voting power between informed shareholders who value their voting rights and uninformed, “weakly motivated” shareholders who do not. When this efficient sorting happens, a company will lower its cost of capital by reducing agency and transaction costs. Specifically, informed investors will pay more for voting stock that is not diluted by the votes of uninformed, weakly motivated investors; indeed, a company may even entice informed investors to invest by offering two classes of shares. Likewise, weakly motivated investors will gravitate toward shares that do not require them to incur the costs associated with voting, especially because nonvoting stock tends to trade at a discount relative to voting stock. In other words, the company that issues nonvoting shares for its uninformed shareholders will make itself more valuable.

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\* Assistant Professor, USC Gould School of Law. I am grateful for invaluable comments from Rob Anderson, Douglas Baird, Adam Chilton, Dhammika Dharmapala, Sam Erman, Jeffrey Gordon, Hiba Hafiz, Daniel Hemel, Aziz Huq, Saul Levmore, Michael Pollack, Bob Rasmussen, Bernard Sharfman, Laura Weinrib, and Abby Wood; and from participants at the 2018 Annual Meeting of the American Law and Economics Association; the 2018 Chicago-Kent Faculty Workshop; the 2018 USC Gould Faculty Workshop; the 2018 Conference on Differential Voting Shares hosted by the European Corporate Governance Institute and Bar Ilan University; the UC Berkeley Workshop for Law, Economics, and Business; and the Pepperdine Law Faculty Workshop. I would also like to express my gratitude to Stephen Shapiro, the person who taught me everything that I know about legal writing, for his patient guidance and enthusiastic encouragement of my work.

*Nonvoting Shares and Efficient Corporate Governance*  
71 STAN. L. REV. 687 (2019)

This insight has several implications for the law. Most importantly, this Article contends that recent proposals to restrict or deter companies from issuing nonvoting shares should be rejected. Under certain circumstances, nonvoting stock has beneficial functions, and therefore, restricting its use may impede efficient corporate structuring.

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## Introduction

In March 2017, Snap Inc. became the first company to go public on a U.S. stock exchange offering only nonvoting shares to the public.<sup>1</sup> This structure enabled the company's founders, two billionaire internet entrepreneurs in their twenties, to have perpetual control over the company.<sup>2</sup> Moreover, issuing only nonvoting stock allowed Snap to take advantage of exemptions from certain disclosure obligations under federal securities law.<sup>3</sup> Specifically, the company would not be required to release annual proxy statements to the public that would disclose background information about the directors, including their compensation and any conflicts of interest that could affect their decisionmaking.<sup>4</sup> Why bother when the company's shareholders would never have a say in director elections or other matters typically resolved by a shareholder vote?

The public reaction was swift and hostile.<sup>5</sup> Some, including the company itself, believed that Snap could pay for such a move.<sup>6</sup> And yet, the company

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1. See Steven Davidoff Solomon, *Snap's Plan Is Most Unfriendly to Outsiders*, N.Y. TIMES: DEALBOOK (Feb. 3, 2017), <https://perma.cc/2YBB-SFU9>.
  2. See Snap Inc., Amendment No. 2 to Registration Statement (Form S-1), at 130 (Feb. 16, 2017) [hereinafter Snap Registration Statement] (listing the ages of Snap's directors and executives); Davidoff Solomon, *supra* note 1 (noting that the offering is structured such that the "founders' control goes away only if they die" or if they sell 70% of their Class C shares); see also Snap Registration Statement, *supra*, at 19 ("As a result [of this structure], Mr. Spiegel and Mr. Murphy, and potentially either one of them alone, have the ability to control the outcome of all matters submitted to our stockholders for approval . . .").
  3. See Snap Registration Statement, *supra* note 2, at 40 (explaining that the company and its shareholders are exempt from reporting requirements under sections 13(d), 13(g), 14, and 16 of the Securities Exchange Act). The company nonetheless voluntarily agreed to provide certain disclosures to stockholders. See *id.* at 5; see also 15 U.S.C. §§ 78m(d), (g), 78n, 78p (2017).
  4. See Snap Registration Statement, *supra* note 2, at 40.
  5. See, e.g., Paresh Dave, *Big Investor T. Rowe Price Challenges Snapchat Founders' Power*, L.A. TIMES (Jan. 19, 2017, 12:20 PM), <https://perma.cc/8MNQ-2PE3>; Davidoff Solomon, *supra* note 1; Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, WALL ST. J. (updated Jan. 16, 2017, 8:24 PM ET), <https://perma.cc/Y44M-E9TG>.
  6. See Snap Registration Statement, *supra* note 2, at 5 ("We cannot predict whether this structure and the concentrated control it affords Mr. Spiegel and Mr. Murphy will result in a lower trading price or greater fluctuations in the trading price of our Class A common stock as compared to the trading price if the Class A common stock had voting rights."); Ross Kerber & Liana B. Baker, *Lacking Voting Rights, Snap IPO to Test Fund Governance Talk*, REUTERS (Feb. 3, 2017, 12:54 PM), <https://perma.cc/QZ8H-37F7> (quoting a research analyst who reported that his firm typically "discount[s] its valuation of a company by 30 percent" when investors lack voting rights).

encountered little resistance from the market. It priced its initial public offering (IPO) above the marketing range, and closed its first day of trading at a 44% premium to the IPO price.<sup>7</sup>

The success of Snap's offering, however, rallied opponents of companies that issue different classes of stock with unequal voting rights ("dual-class" companies). The traditional dual-class company offers low-voting stock for public investors to buy, keeping the high-voting shares (which typically have ten times as many votes as the low-voting shares) in the possession of the company's insiders.<sup>8</sup> Opponents of dual-class structures contend that depriving investors of voting rights serves to entrench management and insulate them from the consequences of their inefficient or disloyal decisions.<sup>9</sup> These opponents view the increase in dual-class offerings in the United States as a serious problem for investors.<sup>10</sup>

Accordingly, following Snap's IPO, the Council of Institutional Investors (CII)—an investor advocacy group that believes "no-vote shares have no place in public companies"<sup>11</sup>—ramped up lobbying efforts, contending that U.S. stock indices and exchanges should bar companies that offer nonvoting shares to the public.<sup>12</sup> CII has also targeted companies contemplating public offerings with multiple classes of stock.<sup>13</sup> Large institutional investors likewise

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7. See Maureen Farrell et al., *Snapchat Shares Surge 44% in Market Debut*, WALL ST. J. (updated Mar. 2, 2017, 7:57 PM ET), <https://perma.cc/7UCY-4N8G>. Since then, the shares have fallen far below the IPO price. See, e.g., Kurt Wagner & Rani Molla, *Four Reasons Snap's Stock Price Is at an All-Time Low*, RECODE (Sept. 16, 2018, 9:05 AM EDT), <https://perma.cc/E2RX-R89V>.

8. See *Dual-Class Stock*, COUNCIL INSTITUTIONAL INV., <https://perma.cc/2GMR-DR9C> (archived Jan. 25, 2019).

9. See generally *id.*; Blair Nicholas & Brandon Marsh, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 17, 2017), <https://perma.cc/2ATW-7NPY>.

10. See *Dual-Class Stock*, *supra* note 8.

11. *Id.*

12. See Cydney Posner, *CII Petitions NYSE and Nasdaq Regarding Multi-Class Share Structures*, COOLEY PUBCO (Oct. 26, 2018), <https://perma.cc/F2KX-9G2W>. The CII has also directed its advocacy overseas, lobbying the Singapore Exchange to preserve its listing standards that exclude companies with nonvoting stock. See Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv'rs, to Loh Boon Chye, CEO, Sing. Exch. Ltd., and Tan Boon Gin, Chief Regulatory Officer, Sing. Exch. Ltd. (Mar. 29, 2017), <https://perma.cc/957J-KRY3>.

13. See, e.g., Press Release, Council of Institutional Inv'rs, Investor Group Urges Blue Apron to Ditch No-Vote Shares (June 21, 2017), <https://perma.cc/ZX6C-ZXME>.

have lobbied the SEC to ban nonvoting shares.<sup>14</sup> These efforts have caught the attention of the SEC's Investor Advisory Committee, which held a meeting on dual-class stock shortly after Snap's offering.<sup>15</sup>

This public opposition has also begun to influence stock index policy. In June 2017, FTSE Russell announced that it would not add Snap or other companies with nonvoting shares to its major U.S. stock benchmarks.<sup>16</sup> Soon after, S&P Dow Jones Indices stated that it would exclude companies that issue multiple classes of shares from a number of its indices.<sup>17</sup> These decisions dealt a major blow to Snap and will provide a powerful deterrent to other companies planning to issue nonvoting stock in their public offerings. This is because index funds, which make up a significant percentage of the demand for equity shares,<sup>18</sup> will generally not buy stock that is not included on an index.<sup>19</sup> As such, these policy changes impose a high financial penalty on dual-class companies<sup>20</sup> that will likely deter companies from utilizing such a structure in the future.

Hostility to dual-class companies is not new. Indeed, academics and regulators have debated whether to restrict or otherwise regulate the use of

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14. See, e.g., Madison Marriage, *State Street Asks SEC to Block Non-Voting Shares*, FIN. TIMES (June 17, 2017), <https://perma.cc/LYA9-3XAP> (describing such an effort by State Street, the third-largest asset manager in the world). Of course, institutional investor hostility toward the issuance of nonvoting shares complicates the claim that such structures offer efficiency benefits, as will be discussed in Part II.B below.
  15. See Brian Shea, *SEC's Investor Advisory Committee Airs Concerns over Multi-Tiered Offerings Following Snap's IPO*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 9, 2017), <https://perma.cc/J8UU-DXEM>.
  16. Specifically, the index provider announced that it would exclude companies from its indices unless 5% or more of their voting rights are held by public shareholders. See FTSE Russell, *FTSE Russell Voting Rights Consultations—Next Steps 3* (2017), <https://perma.cc/A379-69ET>. In other words, the index provider did not ban outright all companies with nonvoting shares, but instead excluded companies that deprived nearly all public shareholders of voting rights.
  17. See Press Release, S&P Dow Jones Indices, *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules* (July 31, 2017), <https://perma.cc/P9JP-JV25> [hereinafter S&P Dow Jones Indices Press Release]. Existing multiple-class companies, such as Google and Facebook, can remain in the S&P 500. See *id.* But Snap, which never made it into the index, will be excluded.
  18. See, e.g., Tom McGinty et al., *Index Funds Are Taking Over the S&P 500*, WALL ST. J. (Oct. 17, 2016, 10:30 AM ET), <https://perma.cc/C7Q2-P6KP>. Snap's shares sunk to a new all-time low two days after S&P announced that it would exclude Snap from important indices. See Anita Balakrishnan, *Snap Shares Set New All-Time Low as Investor Concerns Pile Up*, CNBC (updated Aug. 2, 2017, 5:51 PM ET), <https://perma.cc/D76J-QPD6>.
  19. See Ari I. Weinberg, *Why Index Funds Have a Limited Presence in the IPO Market*, WALL ST. J. (Sept. 4, 2017, 10:04 PM ET), <https://perma.cc/9WUS-DQMD>.
  20. Cf. Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986) (reporting that inclusion on stock indices increases a stock's demand and results in significant positive abnormal returns).

dual-class structures for at least a century.<sup>21</sup> Yet even after so many years, the arguments on both sides remain the same. Critics of dual-class structures argue that issuing nonvoting or low-voting shares increases agency costs and results in suboptimal decisionmaking.<sup>22</sup> This is because corporate insiders can retain voting control even if their equity stake falls below fifty percent.<sup>23</sup> Because of the wedge between financial interest and control, the insiders' incentives to slack or otherwise misbehave are heightened, while outside investors, who bear the brunt of the risk, have limited options for exercising influence.<sup>24</sup> A newer version of this critique emphasizes that dual-class structures allow the insiders to maintain control in perpetuity, even after it becomes clear that the structure is no longer efficient.<sup>25</sup>

By contrast, proponents of dual-class structures have consistently claimed that nonvoting and low-voting stock have valuable uses.<sup>26</sup> Most importantly, they contend that dual-class structures allow those who control the company—whether it be the family in a family-owned business or the visionary founders of a successful technology company—to retain control without having to bear excessive risk.<sup>27</sup> Although dual-class structures may lead to increased agency costs—investors have to monitor management more closely and have limited

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21. See generally Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN'S L. REV. 863, 890-905 (1994) (providing a historical overview of departures from the one share, one vote rule).

22. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 73 (1991). See generally Lucian Arye Bebchuk et al., *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 (Randall K. Morck ed., 2000); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1, 10-39 (1988).

23. See Bebchuk et al., *supra* note 22, at 297-98.

24. See *id.* at 301-06.

25. See Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

26. See, e.g., Ashton, *supra* note 21, at 870-72 (arguing that such a capital structure is efficient because it places voting rights in the hands of those who value them most); see also David J. Berger et al., *Tenure Voting and the U.S. Public Company*, 72 BUS. LAW. 295, 296 (2017) (summarizing the argument that the dual-class structure enables companies "to plan and act in the long term").

27. If founders could not issue nonvoting or low-voting shares, they would often be forced to hold all or most of their wealth in the company to maintain control, which would subject them to substantial risk. It might also cause them to forgo attractive investment opportunities because the new financing would dilute their voting control, or push them to choose debt rather than equity financing even when debt financing would otherwise be less beneficial. By issuing nonvoting stock, however, the founders can secure new capital without diluting their control. This allows founders to diversify their private wealth, as well as secure outside financing, without losing control of the company.

recourse when problems emerge—the benefits of encouraging controlled companies to access capital markets, and of protecting them from the influence of shareholders with short-term interests, exceed the costs.<sup>28</sup> Moreover, these proponents claim that pressure from capital markets will discourage founders from using dual-class structures when the costs of doing so exceed the benefits.<sup>29</sup>

This Article posits that these arguments for and against dual-class structures ignore the fact that the world has changed dramatically in the past fifty years. Beginning in the 1970s, the shareholder base of U.S. public companies has consolidated in the hands of large institutional investors.<sup>30</sup> And in this new world of concentrated institutional investor ownership, nonvoting stock has a previously unrecognized but valuable function. Specifically, corporate issuance of nonvoting shares need not increase agency costs in all cases, but can actually *reduce* agency and transaction costs by transferring power between outside investors. Although Snap’s IPO was not structured in this way, other companies—including Google (now Alphabet<sup>31</sup>)—offer both nonvoting and voting classes of stock to the public.<sup>32</sup> And under certain conditions, a company that offers both nonvoting and voting stock to the public can lower its cost of capital—not because the structure protects the founding group from interference, but because it reduces inefficiencies associated with voting.

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28. See generally Bernard S. Sharfman, *A Private Ordering Defense of a Company’s Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1 (2018). Of course, companies also have the option to finance using debt, but this Article focuses on equity offerings.

In defending dual-class structures, Sharfman has contended that although dual-class companies incur larger agency costs, those costs are not the only ones that need to be minimized when a company goes public. See *id.* at 25-32. Instead, as Zohar Goshen and Richard Squire have observed, companies and investors seek to minimize total control costs, which include “principal costs”—such as the cost of becoming informed about a company for purposes of disciplining management. See *id.* at 26-27 (quoting Zohar Goshen & Richard Squire, Essay, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017)). This Article takes these observations one step further and suggests that dual-class shares can be used by management to entice informed investors to buy voting stock, thus *reducing* agency costs. Put differently, the tradeoff between minimizing agency costs and minimizing principal costs may not always exist when companies issue nonvoting stock. See *infra* Part II.

29. See *id.* at 26-27.

30. See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 874-88 (2013).

31. This Article refers to “Google,” although the company is now technically called “Alphabet” after a 2015 corporate reorganization. See Conor Dougherty, *Google to Reorganize as Alphabet to Keep Its Lead as an Innovator*, N.Y. TIMES (Aug. 10, 2015), <https://perma.cc/2DF2-BU5T>.

32. See Steven Davidoff Solomon, *New Share Class Gives Google Founders Tighter Control*, N.Y. TIMES: DEALBOOK (Apr. 13, 2012, 9:17 AM), <https://perma.cc/PZY5-QLZ3>.



Not all shareholders value their votes equally. Some, including retail shareholders, value their votes so little that they rarely exercise them.<sup>33</sup> Others, such as hedge fund activists, accumulate shares with the purpose of using their voting power to agitate for changes that would increase the value of their investments.<sup>34</sup> When all shareholders hold voting stock, rationally apathetic investors must either incur the costs associated with voting or let their rights go unused, diluting the influence of other investors' votes.<sup>35</sup> In a better world, shareholders who do not value their votes could sell them to shareholders who do. So long as wealthy shareholders are not able to dominate elections to pursue idiosyncratic interests, the implementation of voting markets should lead to better electoral outcomes for the company and its shareholders.<sup>36</sup> But the law generally makes it difficult for shareholders to sell their votes independent of their shares.<sup>37</sup> This means that

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33. See Mary Ann Cloyd, *2014 Proxy Season Mid-Year Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 17, 2014), <https://perma.cc/9LXW-DEP3> (finding that in the first half of 2014, institutional shareholders had voted 90% of their shares but retail shareholders had voted just 29% of their shares).
34. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007).
35. Problems are likely to arise regardless of whether a company utilizes a majority or plurality voting regime. For example, under a plurality voting rule, a director need not reach any fixed threshold of votes. This means that unexercised votes won't dilute the influence of informed voters, although uninformed votes will. Under a majority voting regime, which requires the director (or proposal) to get more votes "for" than "against," the impact is greater. Not only will uninformed votes dilute the voting power of the informed voters, but abstentions also make it harder for directors to be elected (and for proposals to pass).
36. For discussions of voting markets, see generally Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111 (2000); and Eric A. Posner & E. Glen Weyl, *Quadratic Voting as Efficient Corporate Governance*, 81 U. CHI. L. REV. 251 (2014).
37. Cf. *Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993) (Allen, C.) (expressing doubt whether "in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the 'dangling' right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares"). Developments in financial instruments, however, have made it possible for investors to decouple economic ownership of shares and voting rights. See Hu & Black, *supra* note 36, at 851-53; Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 778-80. In other words, it is possible for investors to use financial instruments to buy votes without increasing their economic ownership of a company. This decoupling could allow votes to move to better-informed hands and therefore enhance the effectiveness of shareholder oversight. See Hu & Black, *supra* note 36, at 852. But "empty voting" can also harm the company when an investor with a negative financial interest in the company nonetheless controls the outcome of a shareholder vote. See *id.* at 820. By contrast, the controller of a dual-class company must maintain a financial interest in that company, even though her voting rights may exceed her economic stake.

voting rights are rarely distributed optimally across shareholders, leading to inefficiencies that depress the total value of the company.

Nonvoting shares, however, can be used to distribute voting rights to the shareholders who value them most, allowing companies and investors to unlock the same efficiency gains that would result if votes could be traded on a market. Specifically, nonvoting shares can be used to allocate voting power to informed investors who value their voting rights and are motivated to use them to maximize the firm's value. For that reason, the presence of nonvoting shares may entice informed investors—think Warren Buffett—to invest in the company, because these investors will get more influence for less money.

Likewise, funneling nonvoting shares to uninformed, weakly motivated shareholders will also make these shareholders better off. This is because these shareholders—whether they are retail shareholders or passively managed mutual funds (which this Article will call “passive funds”)—would often prefer not to incur the expenses associated with voting and instead free ride on other investors.<sup>38</sup>

Take the example of passive funds. Passive funds include index funds and exchange-traded funds (ETFs), which make up a larger proportion of the shareholder base than ever before.<sup>39</sup> Passive funds often qualify as weakly motivated voters because of their investment strategy: They seek only to replicate the performance of a market index, not to outperform it.<sup>40</sup> Therefore, these funds will not benefit from incurring expenditures to monitor and improve the performance of the companies in their large portfolios. In fact, any investment in stewardship or voting is guaranteed to harm a passive fund's relative performance—all rival funds will benefit from the investment, while only the activist fund will bear the costs.<sup>41</sup> And because passive fund investors are particularly fee sensitive, any increase in fees is likely to drive investors to rival funds.<sup>42</sup>

Because of collective action problems, weakly motivated voters should rarely vote in shareholder elections. And when they do vote, their lack of information, coupled with pro-management biases and other conflicts of interest,<sup>43</sup> make it unlikely that their votes will be value enhancing for the company.

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38. See, e.g., Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 495 (2018).

39. See *id.* at 496.

40. See *id.* at 495.

41. See *id.*

42. See *id.*

43. See *id.* at 512-13.

Yet, when a company has only a single class of shares, informed shareholders who highly value their right to vote end up with the same investment as weakly motivated voters who do not. When this happens, weakly motivated voters impose a deadweight loss on corporate governance in three main ways. First and most importantly, agency costs increase when weakly motivated voters dilute the voice of informed voters because it is more costly and difficult for the informed voters to discipline management. Second, the company incurs higher transaction costs when it must manage voting for a larger group. In addition, the weakly motivated shareholders who nonetheless decide to cast votes incur transaction costs associated with voting. And third, when the weakly motivated voters have a large segment of voting power and choose to exercise it, the risk increases that they will move the company in the wrong direction. Although retail shareholders do not vote very often, passive funds almost always do—supposedly because their fiduciary obligations require them to do so.<sup>44</sup> And this fact, coupled with the rapid growth of passive funds,<sup>45</sup> makes this third problem especially concerning.

Issuing nonvoting stock can enable a company to avoid these costs and minimize its cost of capital. By issuing two classes of stock—one with voting rights, one without<sup>46</sup>—a company can reduce agency costs by making

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44. A closer read of the SEC's voting guidance makes clear that mutual fund advisors are not required to vote under all circumstances. See *Proxy Voting by Investment Advisers*, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003) (codified as amended at 17 C.F.R. §§ 275.204-2, .206(4)-6 (2018)); see also Lund, *supra* note 38, at 527-28. For example, if the mutual fund believes that the costs from voting exceed the benefits, its duty would be to *not* vote. See Lund, *supra* note 38, at 526-28. But casting votes in shareholder elections may serve as insurance, insulating the advisor from suits alleging that its failure to vote was a breach of its fiduciary duty. For this reason, mutual fund advisors face strong pressure to vote in shareholder elections.

45. Passive funds hold more than 10% of the equity markets, and this number is a conservative estimate. See John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 10-11 (Sept. 20, 2018) (unpublished manuscript), <https://perma.cc/866A-TAL9>. And as I have noted elsewhere, "some S&P 500 companies have passive fund ownership in excess of 20%." Lund, *supra* note 38, at 496. In addition, the growth of passive investing has given the institutional investors that dominate the passive fund market a substantial voice in corporate governance. Together, Vanguard, BlackRock, and State Street, who primarily operate passive funds, constitute the largest shareholder of approximately 90% of U.S. public companies. See *id.*; see also Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669, 673 n.14 (2017) (quoting Jan Fichtner et al., *Hidden Power of the Big Three?: Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017)).

46. Although this Article focuses on nonvoting stock, low-voting stock can also be used to promote efficient corporate governance. But nonvoting stock is actually the superior tool. Most importantly, nonvoting stock more often trades at a slight but significant discount to voting stock, a reflection of its lack of control rights. See Aaron Stumpf & Andrew Cline, *Price Differentials Between Voting and Nonvoting Stock*, STOUT, <https://perma.cc/H4DT-P46W> (archived Jan. 26, 2019). The discount for low-voting

*footnote continued on next page*

management more accountable to its informed investors while minimizing the transaction costs associated with voting. In this way, issuing nonvoting stock can function as a bonding mechanism by signaling to potential investors that management is especially attuned to the interests of its informed, voting shareholders. The strategy is simply to channel weakly motivated investors to nonvoting stock.

Happily, market forces should accomplish much of this channeling, since nonvoting stock generally trades at a discount to voting stock despite having the same rights to dividends and cash flows.<sup>47</sup> Therefore, weakly motivated voters, who by definition do not value their voting rights, should gravitate toward the discounted stock. Likewise, informed investors will generally pay a premium to buy the voting stock, especially because they will be able to acquire influence more cheaply without weakly motivated voters diluting the vote. From an agency cost perspective, this capital structure attracts capital at a lower cost, enticing informed outside investors to purchase voting shares.

There are, of course, complications. Not all weakly motivated voters will gravitate toward nonvoting stock—for example, some weakly motivated passive funds may purchase voting stock because their indexing strategy requires them to do so.<sup>48</sup> But even minimal dilution of the voting power of weakly motivated shareholders should increase the value of the firm by reducing agency and transaction costs. In other words, imperfect channeling is better than none at all.

A more confounding problem is that thus far, the effect of issuing nonvoting stock has generally been to keep voting control with company insiders, rather than to empower outside investors. Why have capital market participants not caught on? It may be that innovation in dual-class structuring is relatively recent; before the recent wave of dual-class technology company IPOs, typically only family-owned companies or media companies dared to offer low-voting stock.<sup>49</sup> And despite the numerous recent technology company IPOs that have utilized nonvoting stock, its overall use continues to

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stock should be less pronounced, if it exists at all. Accordingly, the use of low-voting stock should result in less beneficial sorting between informed shareholders who value their voting rights and weakly motivated shareholders who would give them up for the right price. *See infra* Part II.B.

47. *See* Stumpf & Cline, *supra* note 46.

48. *See infra* notes 211-15 and accompanying text.

49. *See* Morris DeFeo & Erica Markowitz, *SEC Challenges Dual-Class Structures*, HERRICK (Mar. 2018), <https://perma.cc/V5FH-25EN>; Jeffrey N. Gordon, *Dual Class Common Stock: An Issue of Public and Private Law*, CLS BLUE SKY BLOG (Jan. 2, 2019), <https://perma.cc/4LRC-2L42>; *Listener Question: What's with All the Non-Voting Tech Shares?*, MOTLEY FOOL (Mar. 6, 2018, 3:43 PM), <https://perma.cc/E9DE-X26Z>. For a list of dual-class companies, see Council of Institutional Inv'rs, *Dual Class Companies List* (2017) [hereinafter CII List of Dual-Class Companies], <https://perma.cc/SPB7-BYEL>.

be quite rare.<sup>50</sup> As such, the benefits of using nonvoting stock to sort between informed and weakly motivated investors may have yet to be realized. Over time, the growing concentration of wealth—and thus, voting power—in passive funds should increase the attractiveness of equity structures that concentrate voting power in informed investors. In turn, the growing availability of discounted nonvoting shares should entice passive funds and retail investors to favor them.

A cynical response is that managers cannot be trusted to use nonvoting shares to empower informed investors, and will instead use them to keep themselves in power. For example, Snap, a source of renewed opposition to nonvoting stock,<sup>51</sup> did not issue nonvoting stock to render its founders more accountable to investor pressure. Instead, the goal appears to have been to silence outside investors.<sup>52</sup> The same is true for other technology companies that have utilized dual-class structuring.<sup>53</sup> But presupposing an entrenchment motive ignores the fact that IPO structure is determined by a variety of actors—founders, bankers, and early investors—all of whom are motivated to realize the highest price they can for their shares. There is reason to believe, therefore, that insulation of insiders can be value enhancing for both the insiders and outside investors, at least under certain circumstances. In other situations, where insulation is not value enhancing, the prospect of higher IPO prices should incentivize beneficial experimentation in dual-class structuring to promote accountability, rather than entrenchment. Management teams regularly use bonding mechanisms, such as incorporating in jurisdictions with shareholder-friendly corporate law,<sup>54</sup> to signal their quality to investors.<sup>55</sup> There is no reason to think that nonvoting stock could not be part of this toolkit.

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50. See Steven M. Haas & Charles L. Brewer, *Nonvoting Common Stock: A Legal Overview*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 30, 2017), <https://perma.cc/L94F-NT6J>.

51. See *supra* notes 1-15 and accompanying text.

52. See Annie Palmer, *What Snap's Unusual Structure Says: 'I'm a Genius and Leave Me Alone to Let Me Be a Genius'*, THE STREET (updated June 6, 2017, 8:23 AM EDT), <https://perma.cc/DW8G-RPMX>.

53. See *id.*

54. See generally, e.g., Ofer Eldar & Lorenzo Magnolfi, *Regulatory Competition and the Market for Corporate Law* (Yale Law & Econ. Research Paper No. 528, 2017), <https://perma.cc/HLT9-EVAA> (discussing the interaction between the development of state corporate law and firms' choices of where to incorporate).

55. For evidence that corporate governance changes may be used as a mechanism to signal management quality, see Merritt B. Fox et al., *Corporate Governance Changes as a Signal: Contextualizing the Performance Link* (Eur. Corp. Governance Inst., Law Working Paper No. 323/2016, 2016), <https://perma.cc/C7Z9-X6GD>.

The key implication of this analysis is that the use of nonvoting stock should not be discouraged. When issued alongside high-voting stock, nonvoting stock can make corporate governance more efficient. Therefore, blanket proposals to restrict or deter companies from issuing nonvoting stock should be rejected. Such restrictions could cut off beneficial innovation in dual-class structuring, increasing companies' cost of capital, and worsening their performance and competitiveness. These costs will only increase as investors continue to flock to passive investment vehicles, causing weakly motivated voters to control larger and larger voting blocs.<sup>56</sup>

This does not mean, however, that all uses of nonvoting stock are beneficial, and regulators and investors should continue to be skeptical of companies like Snap that issue *only* nonvoting stock to the public. With only this one class of stock available, investors cannot self-sort based on their sophistication and motivation. While such structures may be efficient at the time of the offering, the prospect for large agency costs and other inefficiencies increases over time because the benefits of the dual-class structure likely recede as firms mature.<sup>57</sup> Moreover, most dual-class structures allow the controlling insiders to gradually reduce their ownership stake without relinquishing control, further weakening their incentives to maximize shareholder value.<sup>58</sup> And yet, without votes, the outside shareholders lack important mechanisms for influencing the direction of the company, such as the right to nominate directors or vote against them. In addition, the company's outside shareholders lack information about what the company's insiders are doing.<sup>59</sup> Thus, if regulation is inevitable, preventing companies from offering *only* nonvoting shares to the public is the better course of action.

This Article proceeds as follows. Part I provides a brief history of the use and regulation of dual-class company structures. It shows that the recent surge in dual-class structuring has corresponded with a major change in the shareholder landscape: the concentration of power and influence with passive institutional investors. Part II offers an overview of the debate over dual-class

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56. See, e.g., John Authers & Chris Newlands, *Exchange Traded Funds: Taking Over the Markets*, FIN. TIMES (Dec. 5, 2016), <https://perma.cc/4442-BS8E>; McGinty et al., *supra* note 18; Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J.: MONEYBEAT (Aug. 26, 2016, 11:46 AM ET), <https://perma.cc/L232-BF5Y>.

57. See Bebchuk & Kastiel, *supra* note 25, at 590; Martijn Cremers et al., *The Life-Cycle of Dual Class Firm Valuation* 3-4, 36-37 (Eur. Corp. Governance Inst., Fin. Working Paper No. 550/2018, 2018), <https://perma.cc/P9TP-WC6W>; Hyunseob Kim & Roni Michaely, *Sticking Around Too Long?: Dynamics of the Benefits of Dual-Class Voting* 3-5 (Eur. Corp. Governance Inst., Fin. Working Paper No. 590/2019, 2019), <https://perma.cc/RA84-LHCD>.

58. See Bebchuk & Kastiel, *supra* note 25, at 607.

59. See *infra* note 270 (discussing how companies can avoid disclosure obligations if they issue only nonvoting stock to the public).

structures and demonstrates that each side has ignored important benefits of nonvoting shares. Specifically, the debate has thus far ignored that nonvoting shares can be used to reduce a firm's agency costs, transaction costs, and likelihood of undergoing misguided corporate changes. Part II also demonstrates that beneficial sorting should occur so long as both classes of stock are available to the public: Weakly motivated voters will have an incentive to buy discounted nonvoting stock, and informed voters will be willing to pay a premium for the right to influence the direction of the company. Part III then discusses implications for the law.

## **I. Dual-Class Companies: Cycles of Innovation and Regulation**

Academics and regulators have debated whether and how to regulate dual-class shares for more than a hundred years. In the Subparts that follow, I map the history of dual-class companies and the cyclical patterns of regulation: Historically, as the number of dual-class companies has risen, those companies have been met with regulatory backlash from stock exchanges, the federal government, and, most recently, stock indices.<sup>60</sup>

### **A. A Brief History of the Regulation of Dual-Class Companies**

Dual-class companies depart from the "one share, one vote" rule by issuing different classes of common shares with unequal voting rights,<sup>61</sup> but equal or similar entitlements to earnings. Although one share, one vote is the default

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60. This Article focuses on dual-class structures in the United States, although such structures are more common in other parts of the world. For instance, the dual-class structure is more common in European countries where family-owned businesses are prevalent, such as France and Italy. See Katie Bentel & Gabriel Walter, *Dual Class Shares 17* (2016) (unpublished seminar paper, University of Pennsylvania Law School), <https://perma.cc/9RK8-3WAG>. Some countries—such as Russia, India, and South Korea—take a more restrictive approach, requiring that corporate structures follow the one share, one vote rule. See *id.*

61. Typically, in the United States, high-vote shares have ten times as many votes as low-vote shares, see CII List of Dual-Class Companies, *supra* note 49, but other structures are possible, such as one in which the high-vote class elects the majority of the board and the low-vote class elects a minority of the board. The New York Times Company is an example of a company with such a structure. See Landon Thomas Jr., *Morgan Stanley Criticizes Stock Structure of Times Co.*, N.Y. TIMES (Nov. 4, 2006), <https://perma.cc/4E8E-EKMF>.

under state corporate law,<sup>62</sup> it has never been mandatory.<sup>63</sup> In fact, in the mid-1800s, before the adoption of general incorporation statutes, the common law rule was that corporations would employ per capita voting, which required one vote per *shareholder*.<sup>64</sup> Over time, state legislatures took control of corporate charters, and these charters varied quite a bit: Some embraced one share, one vote; others limited the voting rights of large shareholders by capping their votes.<sup>65</sup>

By the 1900s, in the face of evidence that mandatory limits on shareholders' ability to accumulate voting power made it difficult for firms to attract capital, states began to converge on a one share, one vote default.<sup>66</sup> This default left companies free to experiment with dual-class structuring, including the use of nonvoting shares, and many companies did.<sup>67</sup> This early innovation in the use of dual-class structuring led to opposition from the public and prominent academics.<sup>68</sup> The stock exchanges also took notice, and in 1926, the New York Stock Exchange (NYSE) refused for the first time to list a company because it issued nonvoting stock.<sup>69</sup> This ad hoc decisionmaking evolved into a formal rule by 1940, when the NYSE adopted a listing requirement that in effect excluded dual-class companies.<sup>70</sup> The requirement remained in place for

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62. See, e.g., DEL. CODE ANN. tit. 8, § 151(a) (2018) (authorizing a corporation to have different classes of stock with "such voting powers, full or limited, or no voting powers, . . . as shall be stated and expressed in the certificate of incorporation . . . , or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation").

63. See Stephen M. Bainbridge, *The Scope of the SEC's Authority over Shareholder Voting Rights* 4-5 (UCLA Sch. of Law Pub. Law & Legal Theory Research Paper Series, Paper No. 07-16, 2007), <https://perma.cc/RYP9-CTW2>.

64. See Ashton, *supra* note 21, at 890-91.

65. See *id.*; Bainbridge, *supra* note 63, at 3.

66. See Bainbridge, *supra* note 63, at 3-4.

67. See Ashton, *supra* note 21, at 890-92 (observing that in the early 1920s "dual-class stock gained in popularity" and many companies utilized nonvoting stock); see also Jeffrey Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality, and Validity* (pt. 1), 15 SEC. REG. L.J. 37, 50 (1987).

68. See Ashton, *supra* note 21, at 892 & n.121.

69. See *id.* at 893; Bebchuk & Kastiel, *supra* note 25, at 596; see also Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693-707 (1986). Nonetheless, dual-class structures remained popular—between 1927 and 1932, at least 288 corporations issued different classes of shares with unequal voting rights. See Ashton, *supra* note 21, at 893.

70. See Ashton, *supra* note 21, at 893.



over four decades, until the exchange allowed General Motors to issue restricted shares as part of a 1984 acquisition.<sup>71</sup>

Around the same time that an exception was made for General Motors, the NYSE designated a subcommittee to recommend a policy regarding dual-class listings.<sup>72</sup> The resulting policy required “two-thirds of shareholders to approve the creation of a second class of stock, in addition to approval by a majority of independent directors . . . , the maintenance of a 10:1 ratio of voting rights between the enhanced shares and the second class of shares, and that all other rights be substantially the same.”<sup>73</sup> If these conditions were met, the NYSE would list the shares.<sup>74</sup>

This new policy, as well as the 1980s takeover wave, led to a resurgence in the use of dual-class offerings, and as before, this innovation in capital structuring led to regulatory scrutiny—this time from the SEC.<sup>75</sup> In 1988, the SEC promulgated Rule 19c-4, which restricted exchanges from listing or continuing to list companies that departed from the one share, one vote default unless certain conditions were met.<sup>76</sup> Specifically, the rule permitted issuers to offer new classes of nonvoting or low-voting stock only if the issuance would not reduce the voting power of existing shareholders.<sup>77</sup> The rule was eventually challenged by the Business Roundtable and struck down by the D.C. Circuit, which held that the SEC did not have the authority to regulate the substance of proxy voting.<sup>78</sup>

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71. *See id.* at 893-94. It appears that increased takeover activity may have prompted the stock exchange’s decision to reconsider the policy. *See id.* at 895. In addition, an increasing number of family-run companies wished to access the public equity markets, and dual-class structures were the only means of gaining access without diluting the family’s control. *See id.* For these reasons, competitor stock exchanges with less restrictive dual-class listing standards were attracting corporate listings and diluting the NYSE’s market share. *See id.* at 895-96.

72. *See* Seligman, *supra* note 69, at 700-01.

73. Bentel & Walter, *supra* note 60, at 22; *see also* Self-Regulatory Organizations; Proposed Rule Change by New York Stock Exchange, Inc. Relating to Amendments to the Exchange’s Voting Rights Listing Standards for Domestic Companies, Exchange Act Release No. 23,724, 51 Fed. Reg. 37,529, 37,530 (Oct. 22, 1986).

74. *See id.*

75. *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 570-71 (1991); Bebchuk & Kastiel, *supra* note 25, at 596-97.

76. *See* Voting Rights Listing Standards; Disenfranchisement Rule, Exchange Act Release No. 25,091, 53 Fed. Reg. 26,376 (July 12, 1988) (codified as amended at 17 C.F.R. § 240.19c-4 (2018)); *see also* Bainbridge, *supra* note 63, at 6-7.

77. *See* Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. at 26,383; *see also* Ashton, *supra* note 21, at 899.

78. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 407, 417 (D.C. Cir. 1990). For a detailed discussion of the *Business Roundtable* litigation and the court’s decision, *see* Bainbridge, *supra* note 63, at 7-14.

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Therefore, after 1990, companies were largely free to depart from the one share, one vote rule.<sup>79</sup> But before 2004, only certain types of companies dared to do so, such as media companies (including News Corp.<sup>80</sup> and The New York Times Company,<sup>81</sup> the latter of which contended that the dual-class structure helped it protect journalistic integrity<sup>82</sup>) and closely held companies (including Berkshire Hathaway and Ford).<sup>83</sup>

In 2004, Google became perhaps the first technology company to adopt a dual-class structure for the explicit purpose of keeping control of the company in the hands of the founding group.<sup>84</sup> To accomplish this, only the low-voting Class A shares (which have one-tenth the voting power of the Class B shares held by insiders) was sold in the company's IPO.<sup>85</sup> In an investor relations letter, cofounder Larry Page explained:

After the IPO, [cofounder] Sergey [Brin], [then-CEO] Eric [Schmidt] and I will control 37.6% of the voting power of Google, and the executive management team and directors as a group will control 61.4% of the voting power. New investors will fully share in Google's long term economic future but will have little ability to influence its strategic decisions through their voting rights.<sup>86</sup>

Since 2004, other technology companies have followed suit, either by going public with dual-class structures or engaging in stock splits to help their founders maintain control. For example, in 2012, Facebook went public

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79. The NYSE and other major U.S. stock exchanges continue to prohibit recapitalizations that reduce the voting rights of existing shareholders. See Kathleen Wells & Ashley Wagner, *In Practice: Retaining Control Post-IPO*, RECORDER 2 (Feb. 28, 2011), <https://perma.cc/NU4N-4PL8>. Essentially, companies that wish to remain listed are permitted to issue new classes of nonvoting or low-voting stock, but they are not able to reduce the voting rights of existing stock. See Stephen M. Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchanges' Uniform Voting Rights Policy*, 22 SEC. REG. L.J. 175, 183-86 (1994).

80. See CII List of Dual-Class Companies, *supra* note 49, at 11. Ironically, News Corp. is the parent company of Dow Jones, the index publisher that has that has recently taken action to exclude new dual-class companies. See Richard Pérez-Peña, *News Corp. Completes Takeover of Dow Jones*, N.Y. TIMES (Dec. 14, 2007), <https://perma.cc/E6U8-B7TU>; *supra* note 17 and accompanying text.

81. See Thomas, *supra* note 61. Newspaper companies usually allow the public shareholders to elect a minority of the board seats (four out of thirteen in the case of the New York Times Company), while the insiders elect the remainder. See *id.*

82. See *id.*

83. See CII List of Dual-Class Companies, *supra* note 49, at 2, 6.

84. See Emily Chasan, *Google's Multi-Class Stock Structure Made Alphabet Move Unique*, WALL ST. J. (Aug. 12, 2015, 4:47 PM ET), <https://perma.cc/3XPZ-DJ53>; John Markoff, *The Google IPO: The Overview*, N.Y. TIMES (Apr. 30, 2004), <https://perma.cc/AR93-FQ6Y>.

85. See Google Inc., Amendment No. 9 to Registration Statement (Form S-1), at 2, 24-25 (Aug. 18, 2004) [hereinafter Google Registration Statement].

86. 2004 Founders' IPO Letter, ALPHABET: INVESTOR REL., <https://perma.cc/REE7-RA9K> (archived Jan. 26, 2019).

offering only Class A shares with a single vote per share to the public, in contrast with the Class B shares, which carried ten votes per share and were owned exclusively by Facebook insiders.<sup>87</sup> This structure allowed Facebook's CEO, Mark Zuckerberg, to retain 57% of the voting power of the company despite owning only 28% of its economic value.<sup>88</sup> "This concentrated control," the company told investors in its registration statement, "will limit your ability to influence corporate matters for the foreseeable future."<sup>89</sup>

More recently, in May 2016, Facebook announced that it would engage in a 3-for-1 stock split by issuing two Class C shares with zero voting rights for every share of Class A and Class B stock held.<sup>90</sup> Unsurprisingly, a majority of shareholders ratified the plan at the company's annual meeting in June 2016, but the board stalled in issuing the stock because of pending litigation in the Delaware Court of Chancery.<sup>91</sup> Two groups of shareholders had filed complaints alleging that the stock split was an attempt to entrench Zuckerberg, who had announced the previous year that he planned to give away 99% of his Facebook equity to charity.<sup>92</sup> In September 2017, Facebook decided to abandon the stock reclassification plan,<sup>93</sup> mooted the litigation.

Google, too, faced shareholder litigation after it announced a stock split in 2012.<sup>94</sup> Rather than simply doubling the number of shares outstanding as is traditionally done in stock splits, Google created a new Class C of nonvoting shares.<sup>95</sup> By distributing one Class C share for every outstanding Class A and Class B share, the split allowed the founders to maintain their voting control, while creating additional equity to use for compensation and acquisition

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87. See Facebook, Inc., Registration Statement (Form S-1), at 31 (Feb. 1, 2012) [hereinafter Facebook Registration Statement].

88. J. O'Dell, *Power Play: How Zuckerberg Wrested Control of Facebook from His Shareholders*, VENTUREBEAT (Feb. 1, 2012, 4:22 PM), <https://perma.cc/J2VC-3CEZ>.

89. Facebook Registration Statement, *supra* note 87, at 31.

90. See Charles Kane, *What Facebook's Latest Stock Move Means for Investors and the SEC*, FORTUNE (May 7, 2016), <https://perma.cc/478D-43XK>.

91. See Jef Feeley & Sarah Frier, *Facebook to Pay \$67.5 Million in Fees in Suit over Shares*, BLOOMBERG (updated Oct. 24, 2018, 4:08 PM PDT), <https://perma.cc/6BD8-VVLW>; see also Deepa Seetharaman & Sarah E. Needleman, *Facebook Abandons Plans to Change Share Structure, Avoiding Lawsuit*, WALL ST. J. (updated Sept. 22, 2017, 7:43 PM ET), <https://perma.cc/QWS4-4JVT>.

92. See Verified Class Action Complaint ¶¶ 1, 30-31, 38, *McGinty v. Zuckerberg*, No. 12282 (Del. Ch. Apr. 29, 2016), 2016 WL 1719348; see also Verified Class Action Complaint ¶¶ 1, 30, 39, 53, *Levy ex rel. Coverdell Educ. Sav. Plan FBO Dash Redding Levy v. Zuckerberg*, No. 12287 (Del. Ch. May 2, 2016), 2016 WL 2606008.

93. See Facebook, Inc., Current Report (Form 8-K), item 3.03 (Sept. 21, 2017).

94. See Verified Class Action Complaint ¶¶ 1-2, 27-37, *In re Google Inc. Class C S'holder Litig.*, No. 7469-CS, 2013 BL 308498 (Del. Ch. Nov. 6, 2013).

95. See Davidoff Solomon, *supra* note 32.

purposes. Some of Google's large institutional investors objected to the stock split and sued in the Delaware Court of Chancery.<sup>96</sup> The litigation eventually settled and the split went forward, but Google agreed in the settlement that if the Class C shares traded at a large enough discount to Class A shares at the end of the first year, the shareholders would be entitled to compensation.<sup>97</sup> By the end of the year, the discount for the nonvoting shares was sufficiently large (1.4%) to require Google to pay over \$500 million to the Class C shareholders.<sup>98</sup>

The prospect of litigation has not deterred other prominent technology companies from utilizing dual-class structures. Since 2004, for example, Groupon, LinkedIn, TripAdvisor, and Zynga have had IPOs in which only low-voting stock was offered to the public.<sup>99</sup> Other companies, such as Under Armour and Zillow, have followed Google's lead and issued nonvoting stock through stock splits.<sup>100</sup>

Despite the increasing popularity of issuing nonvoting stock in a stock split, before 2017, no company had been willing to offer *only* nonvoting stock in an IPO.<sup>101</sup> But in March of that year, Snap did just that.<sup>102</sup> The company utilized a three-tiered structure, reserving its two classes of voting stock for company insiders, with the high-voting stock remaining with the company's

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96. See Verified Class Action Complaint, *supra* note 94.

97. See Google Inc., Current Report (Form 8-K), item 8.01 (Oct. 28, 2013) (reporting the approval of the settlement). For the details of the settlement, see *id.* exhibit 99.1.

98. See Matt Chiappardi, *Attys in Google Stock Split Row Deserve \$25M, Court Told*, LAW360 (Apr. 29, 2015, 8:57 PM EDT), <https://perma.cc/77JU-732V>.

99. See Bebchuk & Kastiel, *supra* note 25, at 594.

100. See Angela Chen, *Zillow Approves Dividend, Creates C Class of Stock*, WALL ST. J. (July 21, 2015, 4:57 PM ET), <https://perma.cc/4GR6-EVGJ>; Miriam Gottfried, *A Double-Digit Return Is Hiding in Plain Sight at Under Armour*, WALL ST. J. (updated Nov. 28, 2016, 1:01 PM ET), <https://perma.cc/SGF3-WXTS>. Under Armour was sued by its shareholders following the split and eventually settled claims that the board of directors breached its fiduciary duties by approving the issuance of nonvoting Class C shares through a stock split of current Class A shares and by amending the company's charter. See Class Action Complaint ¶¶ 1-3, *In re Under Armour S'holder Litig.*, No. 24-C-15-003240 (Md. Cir. Ct. Balt. City June 18, 2015); Under Armour, Inc., Annual Report (Form 10-K), at 59-60 (Feb. 19, 2016) [hereinafter Under Armour Annual Report]. The settlement provided for a \$59 million dividend to be paid to the Class C shareholders to account for their losses as a result of the split. See Under Armour Annual Report, *supra*, at 60.

101. See Snap Registration Statement, *supra* note 2, at 5 ("[T]o our knowledge, no other company has completed an initial public offering of non-voting stock on a U.S. stock exchange.").

102. See *supra* text accompanying notes 1-4.

two young cofounders.<sup>103</sup> As a result of this structure, the cofounders held 88.5% of the company's voting power, but only 18.7% of the outstanding equity.<sup>104</sup>

When Snap announced its plans, many predicted that the company would pay a penalty for its shareholder-unfriendly governance structure.<sup>105</sup> And yet, Snap closed its first day of trading up 44% from its IPO price.<sup>106</sup> In other words, investors, including some of the large institutional investors that vocally opposed the dual-class structure, did not seem to be deterred from purchasing nonvoting shares.<sup>107</sup>

Although no other company has followed Snap's example of issuing *only* nonvoting stock, other companies included nonvoting stock in their public offerings in the months following Snap's IPO. Since March 2017, several companies—including Altice, Blue Apron, and Dropbox—have gone public with a triple-class structure, authorizing single-vote Class A shares for the public, high-voting Class B shares for insiders (typically, founders and early investors), and a reserve of Class C shares with no voting rights that could be issued in the future.<sup>108</sup>

## B. Recent Calls for Regulation

The most recent surge in dual-class stock listings in the United States has generated heated opposition from institutional investors, lawmakers, and investor advocacy groups. Their concerns are reminiscent of complaints levied at the start of the twentieth century: Creating a wedge between investors' economic interest in the company and their voting power not only decreases controllers' incentives to maximize the share price, but also reduces their accountability to the majority of the shareholders.<sup>109</sup>

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103. See Snap Registration Statement, *supra* note 2, at 4, 130.

104. *Id.* at 9. This control only goes away when both die or if each sells off 70% of his high-voting shares. See *id.* at 4-5. If one of the founders were to die, a proxy arrangement specifies that voting control would transfer to the other. See *id.* at 20.

105. See, e.g., Kerber & Baker, *supra* note 6 (noting the opposition to Snap's capital structure from fund managers and academics).

106. See Farrell et al., *supra* note 7.

107. See *Institutional Ownership in Snap*, SEEKING ALPHA (Sept. 5, 2017, 1:39 PM ET), <https://perma.cc/RXK4-HEC5> (reporting that 24% of ownership in Snap is institutional).

108. See Dropbox, Inc., Registration Statement (Form S-1), at 7-8 (Feb. 23, 2018); Tom Zanki, *More Cos. Authorizing No-Vote Shares Despite Resistance*, LAW360 (July 12, 2017, 8:37 PM EDT), <https://perma.cc/VJQ9-MSGK> (discussing the Altice and Blue Apron IPOs).

109. The empirical evidence on this subject is mixed. Compare Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010) (finding evidence that U.S. dual-class companies exhibit increased

*footnote continued on next page*

In light of the SEC's limited ability to regulate dual-class listings following *Business Roundtable v. SEC*,<sup>110</sup> these critics have begun to direct advocacy efforts to stock exchanges and stock indices. Most vocally, the CII—a nonprofit association of major public, union, and corporate pension funds<sup>111</sup>—has lobbied the U.S. exchanges and stock indices since 2012, asking them to implement a one share, one vote rule.<sup>112</sup> Under the CII's preferred policy, the

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agency costs and reduced value), with Scott W. Bauguess et al., *Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights*, 36 J. BANKING & FIN. 1244, 1244-46 (2012) (suggesting that dual-class structures might have some positive effects), Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. CORP. FIN. 342 (2006) (same), and Ronald Anderson et al., *The Dual Class Premium: A Family Affair* 6 (Fox Sch. of Bus., Research Paper No. 17-021, 2017), <https://perma.cc/R59F-RRWP> (finding that dual-class family firms yield higher stock returns than single-class nonfamily firms, suggesting that on average, dual-class structures do not harm outside investors).

Indeed, a recent empirical study commissioned by the CII concluded that dual-class companies did not feature a meaningful increase or decrease in long-term value relative to their single-class peers. See GABRIEL MOREY, COUNCIL OF INSTITUTIONAL INV'RS, MULTI-CLASS STOCK AND FIRM VALUE: DOES MULTI-CLASS STOCK ENHANCE FIRM PERFORMANCE?; A REGRESSION ANALYSIS 31 (2017), <https://perma.cc/CSS6-NM9Y>. For an extensive survey of the empirical evidence evaluating dual-class structures, see Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51 (2008).

110. See 905 F.2d 406, 407, 417 (D.C. Cir. 1990); *supra* text accompanying notes 75-78.

111. See *Members*, COUNCIL INSTITUTIONAL INV., <https://perma.cc/MTV9-D8MM> (archived Jan. 28, 2019).

112. See, e.g., Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv'rs, to FTSE Russell Governance Bd. 1 (Mar. 24, 2017), <https://perma.cc/7F58-2VNH> ("Our members are deeply concerned about a trend in initial public offerings (IPOs) toward unequal and even non-voting shares. We believe unequal voting rights diminish accountability and are detrimental to public markets long-term. We believe a robust and open public consultation on inclusion of non-voting share classes, in particular, would be valuable . . ."); Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv'rs, to MSCI Equity Index Comm. (May 9, 2018), <https://perma.cc/C3VX-D8HP> (providing comments in response to the index provider's proposed treatment of unequal voting structures); Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Edward S. Knight, Exec. Vice President, Gen. Counsel & Chief Regulatory Officer, NASDAQ OMX Grp. 1-2 (Oct. 2, 2012), <https://perma.cc/7PQH-8ZGY> (asking Nasdaq to propose a rule under which companies seeking to trade on the exchange "will be ineligible for a listing if they have two or more classes of common stock with unequal voting rights").

The CII's lobbying efforts have expanded globally: The organization has sent letters to the London, Hong Kong, and Singapore stock exchanges requesting that they exclude dual-class companies. See Letter from Kenneth A. Bertsch to Loh Boon Chye and Tan Boon Gin, *supra* note 12; Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Charles Li Xiaojia, Exec. Dir. & Chief Exec., H.K. Exchs. & Clearing Ltd. (Mar. 27, 2014), <https://perma.cc/DP7E-8WDY>; Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Xavier Rolet, Chief Exec.,

*footnote continued on next page*

exchanges and indices would bar “all new non-voting share classes, including from companies currently included in indexes,” and, at the very least, prohibit companies with *only* nonvoting shares from eligibility.<sup>113</sup> This policy, if implemented, would be a strong deterrent for any company considering whether to issue nonvoting shares because being listed on an index creates substantial demand for a company’s equity, as does inclusion on a stock exchange.<sup>114</sup> The CII’s advocacy is not limited to major stock exchanges and indices—it has also written open letters to companies, including Blue Apron, Roku, and Snap, asking them to abandon their dual-class IPOs<sup>115</sup> or to include sunset provisions that convert high-voting shares unless the low-voting share class votes to extend.<sup>116</sup> The CII has also made its case to the SEC’s Investor Advisory Committee.<sup>117</sup>

Large and influential investors have likewise expressed opposition to dual-class structures. For example, the California Public Employees’ Retirement System (CalPERS), the largest U.S. pension fund, has threatened to boycott any

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London Stock Exch. Grp. (Mar. 27, 2014), <https://perma.cc/4BC3-YPTA>; *see also* Sharfman, *supra* note 28, at 4.

Notwithstanding these lobbying efforts, Hong Kong’s stock exchange recently proposed a reversal of its longstanding policy excluding dual-class companies, in an attempt to attract technology company listings. *See* Benjamin Robertson, *Hong Kong Targets Next Alibaba in Revamp of IPO Rules*, BLOOMBERG (Dec. 15, 2017, 1:21 AM PST), <https://perma.cc/E4VF-CYX3>.

113. *See, e.g.*, Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv’rs, to MSCI Equity Index Comm. 2-3 (Aug. 3, 2017), <https://perma.cc/MD3V-K3TN>.

114. *See, e.g.*, McGinty et al., *supra* note 18.

115. *See* Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv’rs, to Robert P. Goodman, Dir. & Lead Indep. Dir. Designee, Blue Apron Holdings, Inc., et al. (June 20, 2017), <https://perma.cc/6BEC-A4N5>; Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv’rs, et al., to Evan Thomas Spiegel, CEO, Snap Inc., et al. (Feb. 3, 2017), <https://perma.cc/QF7A-4YZL>.

116. *See* Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv’rs, to Ravi Ahuja, Chair, Nominating and Corp. Governance Comm., Roku, Inc., et al. (Sept. 12, 2017), <https://perma.cc/8SF4-WYTZ>.

117. In March 2017, the Investor Advisory Committee held a meeting centering on unequal voting rights. *See Securities and Exchange Commission Investor Advisory Committee: Minutes of the Meeting on March 9, 2017*, U.S. SEC. & EXCHANGE COMMISSION (updated June 23, 2017), <https://perma.cc/J9X8-HH5D>. At that meeting, the CII, as well as other institutional investors, urged the SEC to exercise its regulatory authority over the stock exchanges to limit dual-class structures. *See* David J. Berger, *Dual-Class Stock and Private Ordering: A System That Works*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 24, 2017), <https://perma.cc/K4QX-6ST2>. The chairman of the SEC’s Investor Advisory Committee agreed. He called Snap’s structure “a significant concern” and “a troubling development from the perspective of investor protection and corporate governance.” *See* Therese Poletti, *Potential Snap IPO Effect: More Unicorns to Wall Street, but with Horrible Terms*, MARKETWATCH (Mar. 2, 2017, 7:47 PM ET), <https://perma.cc/6AWL-S3WX>.

dual-class listing that allows a minority of shareholders to control a majority of the votes.<sup>118</sup> The Investor Stewardship Group—a collective of some of the largest U.S. institutional investors, including Vanguard, BlackRock, State Street, and T. Rowe Price—has likewise taken a position against dual-class companies in its Framework for U.S. Stewardship and Governance.<sup>119</sup> The Framework included as a fundamental principal that “[s]hareholders should be entitled to voting rights in proportion to their economic interest.”<sup>120</sup> Separately, T. Rowe Price has stated that it plans to vote against lead independent directors, as well as nominating and corporate governance committee members, at dual-class companies.<sup>121</sup>

Proxy advisor firms also oppose dual-class structures and have adopted policies to discourage their use. For example, Institutional Shareholder Services (ISS) has called them “an autocratic model of governance.”<sup>122</sup> It has proposed to amend its voting policies to recommend that shareholders vote against director nominees at companies that have gone public with dual-class structures unless there is a “reasonable’ sunset provision.”<sup>123</sup>

This wave of advocacy has begun to have an effect. In July 2017, FTSE Russell announced that it would exclude companies from its indices unless 5%

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118. See Shanny Basar, *Calpers Sets Sights on Dual-Class Stock Structures*, WALL ST. J. (Aug. 20, 2012, 12:16 PM ET), <https://perma.cc/2AQU-RDMW>. The California State Teachers’ Retirement System and the Florida State Board of Administration, two other prominent pension funds, have made similar threats. See Bebchuk & Kastiel, *supra* note 25, at 597-98.

119. See *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INVESTOR STEWARDSHIP GROUP, <https://perma.cc/ZP7Z-HAEX> (archived Feb. 20, 2019); Inv’r Stewardship Grp., *Corporate Governance and Stewardship Principles*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 7, 2017), <https://perma.cc/P4RB-8J2J>.

120. See Inv’r Stewardship Grp., *supra* note 119.

121. See Ross Kerber & Jessica Toonkel, *Exclusive: T. Rowe Price to Oppose Key Directors at Super-Voting Share Companies*, REUTERS (Mar. 6, 2016, 10:16 PM), <https://perma.cc/4VV2-S3SD>; Ross Kerber, *U.S. Investor Group Urges Halt to Dual-Class Structures in IPOs*, REUTERS (Mar. 23, 2016, 6:37 AM), <https://perma.cc/U45R-KWRC>.

122. See Institutional S’holder Servs., *The Tragedy of the Dual Class Commons 3* (2012), <https://perma.cc/FQ4E-PLPE>.

123. See Lyuba Goltser, *ISS Proposes New 2017 Voting Policies*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2016), <https://perma.cc/4RGA-UQWJ>.



or more of the company's voting rights were held by public shareholders.<sup>124</sup> Under this policy, Snap has been excluded from all of the index provider's popular indices.<sup>125</sup>

Just days later, S&P Dow Jones Indices announced that the S&P 500, S&P 600, and S&P 400 indices would begin excluding companies with dual-class structures.<sup>126</sup> Under the new policy, new dual-class companies like Snap would be excluded, although dual-class companies like Facebook and Google that had already gone public would remain in the indices.<sup>127</sup> Finally, in January 2018, MSCI announced that it would adjust the weight of dual-class companies in its indices.<sup>128</sup>

These decisions dealt a major blow to Snap and provided a powerful deterrent to other companies considering whether to utilize nonvoting stock. As mentioned above, exclusion from indices means that passive investors—a large and growing source of demand for company stock—will be much less likely to buy the excluded company's shares.<sup>129</sup> For this reason, these policy changes impose a high financial penalty on dual-class companies that is likely to deter future dual-class IPOs in the United States.

In addition, the SEC has become more active in the debate over dual-class voting structures. Commissioner Robert Jackson, in particular, has been a vocal advocate for restrictions on perpetual dual-class structures. In a February 2018 speech, he expressed his hope that stock exchanges would require companies with dual-class structures to include sunset provisions that would phase out unequal voting rights over time.<sup>130</sup> One month later, the SEC's Investor Advisory Committee recommended that the Division of Corporation Finance require more detailed disclosure by dual-class issuers about some of the

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124. See FTSE Russell, *supra* note 16, at 3; see also Richard Teitelbaum, *Index Firms Take Issue with Nonvoting Rights*, WALL ST. J. (Apr. 9, 2017, 8:00 AM ET), <https://perma.cc/M3XK-YNAE>.

125. See *No-Vote Common Stock*, S&C DEALPORTAL (Aug. 4, 2017), <https://perma.cc/3APP-9FDH>. Existing index constituents were given a five-year grace period to bring their capital structures into compliance. See FTSE Russell, *supra* note 16, at 3.

126. See S&P Dow Jones Indices Press Release, *supra* note 17; see also *No-Vote Common Stock*, *supra* note 125. The new policy does not affect the S&P Global BMI Indices and the S&P Total Market Index, which are “intended to represent the investment universe.” S&P Dow Jones Indices Press Release, *supra* note 17.

127. See *No-Vote Common Stock*, *supra* note 125.

128. See MSCI, *Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes 2* (2018), <https://perma.cc/5RUW-TNF9>. MSCI announced that current index participants would be given a three-year grace period before any adjustments of the indices. See *id.*

129. See *supra* notes 17-19 and accompanying text.

130. See Robert J. Jackson Jr., *Perpetual Dual-Class Stock: The Case Against Corporate Royalty*, U.S. SEC. & EXCHANGE COMMISSION (Feb. 15, 2018), <https://perma.cc/5MKA-XLEA>.

risks of dual-class capital structures.<sup>131</sup> Although SEC Chairman Jay Clayton has not indicated a willingness to take immediate action, he has explained that he is “watching the space.”<sup>132</sup>

### C. Changes to the Investment Landscape

The surge in dual-class companies corresponds with a major change in the investment landscape. In the past fifty years, the shareholder base has become consolidated in the hands of large institutional investors—mutual funds, pension funds, and hedge funds. Now, more Americans own U.S. company stock than ever before, but they do so primarily through investment intermediaries.<sup>133</sup> As a result, institutional investor ownership stakes in U.S. public companies have become increasingly concentrated.<sup>134</sup> For example, over 20% of Microsoft’s equity is in the hands of its five largest shareholders, and close to one-third is held by its twenty largest shareholders.<sup>135</sup>

But that is not all. In the past ten years, another major market change has occurred: Investors have been flocking to passive funds in droves. Between 2008 and 2015, investors poured approximately \$1 trillion into passive funds.<sup>136</sup> Most of this growth was at the expense of active funds: During this same period, investors sold approximately \$800 billion of their holdings in active funds.<sup>137</sup> And the growth of passive funds is accelerating. In 2016 alone, investors put \$505 billion into passive funds, increasing the total amount of assets invested in such funds by 10%.<sup>138</sup> Assets under management in passive funds now represent \$5.4 trillion, or 36% of the U.S. mutual fund market, up

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131. See SEC, Recommendation of the Investor Advisory Committee: Dual Class and Other Entrenching Governance Structures in Public Companies 6 (n.d.), <https://perma.cc/GE4P-JMFX>.

132. See Ronald Orol, *SEC’s Clayton ‘Watching’ Insider-Controlled IPOs*, THE STREET (Oct. 12, 2017, 2:51 PM EDT), <https://perma.cc/5LRE-L935>.

133. See Gilson & Gordon, *supra* note 30, at 884. Changes in federal retirement policy were the biggest drivers of the growth of institutional investing. See *id.* at 878-84; Edward B. Rock, *Institutional Investors in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

134. See Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, J. ECON. PERSP., Summer 2017, at 89, 91-93.

135. See *id.* at 92 tbl.1.

136. See Fichtner et al., *supra* note 45, at 299.

137. See *id.*

138. See Morningstar, Morningstar Direct Asset Flows Commentary: United States 1 (2017), <https://perma.cc/59XD-FRRW>.

from just 3% in 1995.<sup>139</sup> And over the past twenty years, “the share of total U.S. market capitalization held by passively managed funds has quadrupled”;<sup>140</sup> as of this writing, it exceeds 10%.<sup>141</sup>

This explosive growth has been driven by a growing awareness of the benefits of passive funds for investors: Studies have generally shown that the average actively managed mutual fund is unlikely to outperform its baseline index, despite charging much higher fees.<sup>142</sup> As such, investor demand for low-fee passive funds is rational. It is also predicted to continue.<sup>143</sup> And already, the three institutional investors that dominate the market for passive funds—Vanguard, BlackRock, and State Street—have become powerful voices in corporate governance. In 2015, the shareholdings of these institutions would have made them, in aggregate, the largest shareholder of approximately 90% of S&P 500 companies.<sup>144</sup> And the three institutions together would make up the single largest shareholder of at least 40% of all companies listed in the United States.<sup>145</sup>

Scholars have questioned whether the rise of passive investing, and institutional investing more broadly, is good for corporate governance. Some have posited that the rise of institutional investing may lead to anticompetitive conduct because institutional shareholders with large horizontal investments across competitor firms in concentrated industries might induce those companies to compete less aggressively.<sup>146</sup> Others worry that the increase in

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139. Compare *id.* (providing data on the funds market in 2016), with Kenechukwu Anadu et al., *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?* 1-2, 2 fig.1 (Fin. & Econ. Discussion Series, Working Paper No. 2018-060, 2018), <https://perma.cc/N2G7-3PF8> (showing the state of the market in 1995 and the steady growth of market share of passive funds thereafter).

140. Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 112 (2016).

141. See Coates, *supra* note 45, at 10.

142. See, e.g., Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 550-51 (2009).

143. Ernst & Young has forecasted annual growth rates for the U.S. ETF industry of between 10% and 15% in the next few years. ERNST & YOUNG, *EY GLOBAL ETF SURVEY: 2015 AND BEYOND 2* (2014), <https://perma.cc/H82E-FXJ5>. Likewise, more than three-fourths of executives surveyed by PricewaterhouseCoopers expected ETF assets to double by 2020. See PRICEWATERHOUSECOOPERS, *ETF 2020: PREPARING FOR A NEW HORIZON 4, 8* (2015), <https://perma.cc/C4VH-K84N>.

144. See Posner et al., *supra* note 45, at 674; see also Fichtner et al., *supra* note 45, at 322. In 2000, this figure would have been 25%. See Posner et al., *supra* note 45, at 674.

145. Fichtner et al., *supra* note 45, at 322.

146. See, e.g., Posner et al., *supra* note 45, at 680-91; see also Einer Elhauge, Essay, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291-92 (2016).

passive investing will lead to insufficient oversight and corporate governance distortions in public companies.<sup>147</sup> As the next Part demonstrates, nonvoting shares may play a role in ameliorating some of these concerns.

## II. Nonvoting Shares and Efficient Corporate Governance

The dispute over the use of nonvoting shares strikes at the heart of one of corporate law's greatest debates: whether shareholder activism should be welcomed as a beneficial force for corporate discipline, or whether it should be viewed as a distraction from the company's long-term goals. Because voting is an important component of investor activism, positions on dual-class companies tend to fall into one of these camps.

Critics of nonvoting shares argue that their use increases agency costs at corporations.<sup>148</sup> The agency cost problem in corporate law is well known: Shareholders finance the company and delegate control to corporate insiders—their agents—but doing so creates a principal-agent problem; insiders who control the company may not always act in the investors' best interests. When the insiders' voting control exceeds their equity stake in the company, the misalignment of incentives between corporate insiders and shareholders is even more pronounced—the insiders will reap a disproportionately small share of the company's gains and losses that result from their decisions, and so they may use their voting power to maximize their private benefits rather than maximize the value of the company's equity.<sup>149</sup> This misalignment can lead to

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147. See, e.g., Bebchuk et al., *supra* note 134, at 100-04; Lund, *supra* note 38, at 510-15. But see Jill Fisch et al., *Passive Investors* (Eur. Corp. Governance Inst., Law Working Paper No. 414/2018, 2018), <https://perma.cc/MU3S-59HK> (arguing that passive investors have an incentive to engage in oversight and that economies of scale give them the ability to do so); Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* (N.Y. Univ. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 18-39, 2018), <https://perma.cc/ABT4-QMHS> (arguing that the large passive index fund providers have better incentives to vote intelligently than most other shareholders). For a discussion of how the increasing concentration of control in a small number of mutual fund complexes may undermine corporate governance and pose problems of legitimacy and accountability, see Coates, *supra* note 45.

148. See, e.g., EASTERBROOK & FISCHER, *supra* note 22, at 73 (“Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management.”); Bebchuk et al., *supra* note 22, at 296, 301-06 (arguing that dual-class structures “distort the decisions that controllers make with respect to firm size, choice of projects, and transfers of control” and “highlight[ing] the potentially large agency costs that such structures involve”); Gordon, *supra* note 22, at 18 (noting that a dual-class structure “gives rise to agency problems not only in merger negotiations but in the management of the firm generally”).

149. See EASTERBROOK & FISCHER, *supra* note 22, at 73; see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983); Michael C.

*footnote continued on next page*

distorted investment decisions,<sup>150</sup> tunneling,<sup>151</sup> and inefficient perquisite consumption. And when problems emerge, the outside shareholders who are most affected will have no recourse aside from selling their shares.

By contrast, under a one share, one vote system, the corporate insiders' incentives are better aligned with those of the outside shareholders. To keep control, the insiders must hold a controlling equity stake, meaning that they will bear a substantial proportion of the costs and benefits of their decisions. If they sell down their ownership stake, outside investors who collectively hold the majority of the equity will be able to vote management out of office when problems arise. This provides an important check against bad behavior—the insiders know that if they shirk their duties or self-deal, their jobs will be at risk.

In sum, economic theory embraces proportionate voting rights as an important mechanism for minimizing agency costs. Proportionate voting also facilitates the market for corporate control—if dispersed shareholders face high coordination costs, they can sell their shares to an outside bidder who can use the votes to bring in new management who will run the firm more efficiently.<sup>152</sup>

Proponents of dual-class structures do not dispute that nonvoting stock can increase agency cost problems.<sup>153</sup> Instead, they contend that providing some isolation from shareholder intervention may still be net beneficial

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Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-13 (1976).

150. See Bebchuk et al., *supra* note 22, at 301-06.

151. "Tunneling" refers to the transfer of resources from a company to its controlling shareholder. See generally Simon Johnson et al., *Tunneling*, AM. ECON. REV., May 2000, at 22.

152. Cf. Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 140 (1987) ("The cost of dual class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced."); Gompers et al., *supra* note 109, at 1059 (noting that "[d]ual-class firms are, on average, significantly older than single-class firms," and positing that the most likely explanation for this difference is that dual-class companies could resist takeovers). See generally Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988) (exploring how the one share, one vote default promotes an efficient market for corporate control).

153. See, e.g., Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 576-77 (2016) (identifying "a fundamental tradeoff between entrepreneurs' pursuit of their idiosyncratic vision and investors' desire for protection from agency costs underl[y]ing many corporate-ownership structures"); Sharfman, *supra* note 28, at 21 (acknowledging the "obvious[]" increase in agency costs inherent to dual-class structures, but arguing that investors are nonetheless willing to invest in dual-class companies because of "the wealth-maximizing efficiency that results from the private ordering of corporate governance arrangements, and the understanding that agency costs are not the only costs of governance that need to be minimized").

because that isolation allows management to pursue its long-term vision of the company without distraction from shareholders with short-term incentives.<sup>154</sup> These proponents also argue that market pressures at the time of the IPO ensure that dual-class structures will only be utilized when they are truly value enhancing—that is, when the benefits from giving the insiders freedom from interference outweighs the heightened agency costs.<sup>155</sup>

In sum, both sides of the debate begin with the assumption that dual-class arrangements increase agency costs. This Article departs from that view by showing that in some cases, nonvoting stock can be used to *reduce* agency costs by allocating voting control to the outside shareholders who have the best incentives to maximize the residual value of the company. In other words, nonvoting stock can be used to promote efficient corporate governance. The Subparts that follow provide more detail.

#### A. Weakly Motivated Voters and Nonvoting Stock

In 1976, Michael Jensen and William Meckling famously proposed that for any given level of equity, there is an optimal proportion of debt to equity that would minimize agency costs.<sup>156</sup> Along those lines, this Article posits that

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154. See, e.g., Goshen & Hamdani, *supra* note 153, at 576-94; see also Berger et al., *supra* note 26, at 296.

155. See Sharfman, *supra* note 28, at 21-22 (suggesting that “the wealth-maximizing efficiency that results from the private ordering of corporate governance arrangements” outweighs the associated increase in agency costs); see also Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808-09 (1987) (“A stock’s limited voting rights are reflected in a reduced price . . .”); Jensen & Meckling, *supra* note 149, at 313 (contending that “[p]rospective minority shareholders will realize that the owner-manager’s interests will diverge somewhat from theirs” and that the price they are willing to pay will reflect that divergence).

Proponents of dual-class structures also contend that they encourage the controlling insiders to access the public capital markets. See, e.g., Jackson, *supra* note 130. Otherwise, the insiders might be forced either to keep the company private forever—an inefficient outcome—or retain control over a high percentage of the equity, making it more difficult for the insiders to diversify risk. See Ashton, *supra* note 21, at 927-28.

156. See Jensen & Meckling, *supra* note 149, at 344-46. Jensen and Meckling emphasized the role of debt in facilitating increased insider ownership of equity. With greater ownership, insiders care more about the company’s performance. But an increase in debt creates new agency costs—the insiders now have heightened incentives to reallocate wealth from the bondholders to themselves by increasing the value of the equity claim through excessive risk-taking. See *id.* That is, when insiders own little equity they “have a strong incentive to engage in activities . . . which promise very high payoffs if successful even if they have a very low probability of success.” *Id.* For “[i]f they turn out well, [they] capture most of the gains, [and] if they turn out badly, the creditors bear most of the costs.” *Id.* Thus, for any level of insider-owned equity, there will be an optimal ratio of outside debt to equity that minimizes these agency costs. See *id.* at 345.

there may be an optimal proportion of nonvoting and voting outside equity that likewise minimizes agency costs and therefore improves corporate efficiency. This is because for most corporations, some shareholders are “weakly motivated voters”—shareholders who face collective action problems that make it irrational for them to incur the costs to become informed about the company and engage in voting and stewardship. When these weakly motivated shareholders do vote, their lack of information makes it unlikely that their input will be welfare enhancing.

The quintessential weakly motivated voter is the retail shareholder, who is likely to refrain from participating in corporate governance because the benefits of doing so are unlikely to exceed the costs.<sup>157</sup> But retail shareholders make up a small fraction of the shareholder base of the modern corporation. As discussed above, the majority of shares of large U.S. corporations are held by institutional investors—pension funds, mutual funds, private equity funds, and hedge funds.<sup>158</sup> These investors tend to have large, concentrated stakes in their portfolio companies, which somewhat reduces their incentive to free ride. This is not to say that their incentives are perfect,<sup>159</sup> but many institutional investors have the resources and sophistication to exercise their votes intelligently, as well as a financial incentive to invest in monitoring and stewardship.<sup>160</sup> For this reason, this Article refers to institutional investors as “informed voters.”

There are important exceptions. Most importantly, a large (and growing) subset of institutional investors—passive funds—will often qualify as weakly

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157. See, e.g., Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 613-14 (2006); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526-30 (1990).

158. See Gilson & Gordon, *supra* note 30, at 874-76, 875 tbl.1; *supra* notes 133-35 and accompanying text.

159. There are several examples of incentive problems involving institutional investors. Large mutual funds face a collective action problem as a result of the structure of their industry. Because funds compete on the basis of relative performance, their incentives to invest in improving the performance of any one firm are diminished. See Gilson & Gordon, *supra* note 30, at 889-90. Activist hedge funds face a different incentive problem by virtue of their short investment horizons. See Leo E. Strine, Jr., Essay, *Can We Do Better by Ordinary Investors?: A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458-59 (2014) (summarizing the view of some scholars that empowering investors with short-term investment horizons, such as activist hedge funds or money managers, will compromise long-term company value). Finally, pension funds face yet another incentive problem—their board members are elected or appointed by politicians and are therefore particularly sensitive to political pressure. See Rock, *supra* note 133, at 367-68.

160. See Lund, *supra* note 38, at 500-01. See generally Black, *supra* note 157, at 575-91 (explaining institutional investors’ “significant incentives to become informed voters”).

motivated voters.<sup>161</sup> Passive funds lack financial incentives to invest in informed voting because their indexing strategies require that they match the performance of an index.<sup>162</sup> Put simply, passive funds won't benefit from incurring the costs necessary to monitor and discipline management. Indeed, informed voting would almost certainly harm the passive fund's relative performance—any expenditure incurred to improve governance at one of the fund's portfolio companies will benefit all rival funds.<sup>163</sup>

Not only that, but informed voting is especially costly for a passive fund. A passive fund's key comparative advantage is that it does not need to hire a team of analysts or incur the costs associated with company-specific research—this is why the fund can charge low fees.<sup>164</sup> But casting an informed vote would require the fund to expend additional resources to learn about the company and evaluate the proposal. And because passive funds have very broad portfolios—much broader than those of active funds<sup>165</sup>—the costs of casting an intelligent vote at each company would have to be replicated across hundreds of companies. Such expenditures would eat away at the cost savings generated by the indexing strategy and would drive fee-sensitive investors to rival funds.

Therefore, like retail shareholders, passive funds are also likely to be weakly motivated voters. For both groups, the rational strategy is to remain uninformed about the company and to free ride on other investors. It may be possible, therefore, for a company to improve its competitiveness and lower its cost of capital by issuing nonvoting shares for weakly motivated voters to buy. The following Subparts explain how doing so would reduce agency costs, transaction costs, and the risk of suboptimal voting outcomes for the company.

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161. The term “passive funds” includes index funds and ETFs, which are designed to automatically track a market index. In addition, some actively managed mutual funds are “quasi-indexers,” meaning they have “diversified holdings and low portfolio turnover.” See Germán Gutiérrez & Thomas Philippon, *Investment-Less Growth: An Empirical Investigation* 3 & n.2 (Nat'l Bureau of Econ. Research Working Paper Series, Working Paper No. 22,897, 2016), <https://perma.cc/UXY2-D6DF>. In other words, although they bill themselves as actively managed, quasi-indexers essentially follow an indexing strategy and thus are unlikely to value their votes very highly.

162. See Lund, *supra* note 38, at 506.

163. For further elaboration, see *id.* at 511-12. For contrary views about passive fund incentives, see Fisch et al., *supra* note 147; and Rock & Kahan, *supra* note 147.

164. See Fisch et al., *supra* note 147, at 3-5.

165. For example, a typical S&P 500 tracker fund will have investments in five hundred companies. Actively managed mutual funds have much smaller portfolios. See Hany A. Shawky & David M. Smith, *Optimal Number of Stock Holdings in Mutual Fund Portfolios Based on Market Performance*, 40 FIN. REV. 481, 486-87 tbl.2 (2005) (reporting that in 2000, the average number of companies in a mutual fund portfolio was 92).



1. Agency costs

This Subpart demonstrates how a company can reduce agency costs by issuing nonvoting stock for weakly motivated voters to buy. The key insight is that by channeling weakly motivated voters to the nonvoting stock, the company will amplify the voice of its informed investors and, under certain circumstances, will make management more accountable to them.

To see why, consider the following stylized example. Suppose Company *A* is a dual-class company, and that 60% of Company *A*'s stock has voting rights. The other 40% of the stock is nonvoting. The insiders at Company *A* hold one-third of the voting stock.<sup>166</sup> The informed outside investors hold the remainder of the voting stock, and the weakly motivated investors hold all of the nonvoting stock. To summarize, Company *A*'s weakly motivated shareholders hold 40% of its stock—all of it nonvoting. The voting shares are unevenly split between the insiders and the informed shareholders, with the insiders holding 20% of the total equity—one-third of the voting shares—and the informed shareholders holding the remaining 40%—two-thirds of the voting shares.

Now compare Company *A* to Company *B*, a company that is identical in all respects except that it has only a single class of stock. As before, the Company *B* insiders hold 20% of the shares, the informed shareholders hold 40%, and the weakly motivated shareholders hold the remaining 40%. Company *A*'s equity will be more valuable than Company *B*'s for a few reasons. For one, Company *A* has reduced its agency costs by issuing nonvoting stock, because doing so has made the informed investors' votes more powerful—they hold 40% of the company's equity, but two-thirds of the voting shares. In other words, management at Company *A* knows that if it fails to act in the best interests of the informed shareholders, it will be more likely than its Company *B* counterpart to face discipline in the form of shareholder proposals, "no" votes on executive compensation, "no" votes in director elections, and even proxy contests. This structure provides a powerful incentive for management to act in the shareholders' interests. Moreover, issuing nonvoting

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166. Note that in this example, the company insiders keep a minority of the voting stock and use the nonvoting stock to sort between informed and weakly motivated voters. This is very different than the allocation of voting power in typical dual-class companies, which issue nonvoting or low-voting stock to keep voting control with insiders. But even if the insiders were to keep control in this example, the efficiency benefits would remain. Most importantly, the informed, motivated shareholders would be able to speak out against management and send strong signals of their displeasure without dilution from rationally apathetic shareholders.

stock will make Company A more desirable to informed investors ex ante, further reducing agency costs: Informed investors who are willing to spend on monitoring and discipline will gravitate to companies that reduce the costs associated with doing so.

By contrast, at Company B, management knows that if it underperforms, it has a layer of security thanks to the weakly motivated voters. For example, if management were threatened with a proxy contest, it could prevail by convincing just 39% of the outside shareholders—informed and weakly motivated alike (i.e., 31% of the overall votes)—that the company's current rocky situation is part of the long-term plan or is otherwise no cause for alarm.<sup>167</sup> Luckily for Company B management, weakly motivated voters are much more likely to defer to management, if they participate at all.<sup>168</sup> Knowing this, management may be less willing to change its behavior to satisfy the informed investors who are unhappy with the direction of the company.

Likewise, informed investors may be deterred from investing or intervening at Company B, even if the company would benefit from shareholder monitoring, because of the costs associated with an intervention.<sup>169</sup> Were informed investors to bring a proxy contest at Company B, for example, they would have to lobby and rely on weakly motivated voters to cobble together the necessary majority, an expensive and risky endeavor. Indeed, we see this phenomenon play out more and more often. As one example, Nelson Peltz's 2017 proxy campaign against Procter & Gamble cost his hedge fund, Trian

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167. Indeed, companies have shown an increased willingness to lobby their largest shareholders as a defense against activism. Cf. Sonali Basak & Beth Jinks, *Lazard Banker Wrangles with Activists Empowered by ETF Flows*, BLOOMBERG PROF. SERVS. (Feb. 3, 2017), <https://perma.cc/TK8D-A3U6>. Note that this analysis assumes that the company employs a majority voting standard for director elections, as many do. See Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1121 (2016) (noting the recent shift from plurality voting to majority voting).

168. See Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds 3* (Apr. 16, 2018) (unpublished manuscript), <https://perma.cc/L3WM-9455> (noting that the three largest passive funds “support management at much greater rates” than other types of shareholders); Choonsik Lee & Matthew E. Souther, *Managerial Reliance on the Retail Shareholder Vote: Evidence from Proxy Delivery Methods*, MGMT. SCI. (forthcoming 2019) (manuscript at 2), <https://perma.cc/ED3U-RV7D> (noting that retail shareholders also “tend to follow management recommendations”).

169. A recent study reveals that the presence of “activism-friendly” investors increases the likelihood that a firm will be targeted by activists. See Simi Kedia et al., *Institutional Investors and Hedge Fund Activism* (Sept. 2017) (unpublished manuscript), <https://perma.cc/8PSP-SBVP>.

Partners, \$30 million.<sup>170</sup> Much of these costs were incurred in attempts to sway retail investors and passive institutions using websites, social media, videos, and letters.<sup>171</sup>

The proxy contest was also costly for Procter & Gamble—the company’s successful attempt to overcome the rational apathy of its weakly motivated investors cost it \$100 million, a portion of which was of course also borne by the challenger in its capacity as a shareholder.<sup>172</sup> Nonvoting shares can help companies avoid these costs: When Company A performs badly, management will be able to interface with a small group of informed investors who are already aware of the company’s problems and will be interested in finding a solution—a much less expensive task than wooing all the shareholders, informed and weakly motivated alike.<sup>173</sup> In addition, because management will more easily be able to take the temperature of its voting investors, it will be more likely to reach an agreement with them, obviating the need for those shareholders to wage expensive and disruptive proxy contests.<sup>174</sup>

This is not to say that informed investors will always agree about what constitutes the right course of action for the company. The informed investors may disagree on the company’s goals or the best strategies to achieve them.<sup>175</sup>

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170. See Hamlin Lovell, *Shareholder Activism Knows No Bounds*, HEDGE FUND J. 1 (Nov.-Dec. 2017), <https://perma.cc/YR43-235N>.

171. See David Benoit, *P&G vs. Nelson Peltz: The Most-Expensive Shareholder War Ever*, WALL ST. J. (updated Oct. 6, 2017, 6:07 PM ET), <https://perma.cc/N2VM-4PGU>; see also Lovell, *supra* note 170, at 1 (“Websites, social media (LinkedIn, Twitter and Facebook), television appearances, video recordings, automated dial in messages, and pamphlets can all be used to influence retail investors.” (quoting Ele Klein, Partner, Schulte Roth & Zabel LLP)). For another example, take the battle between Elliot Management and Arconic, in which the activist hedge fund sought to install four directors at the company’s annual meeting. See Ronald Orol, *Paul Singer Pulls Out All the Stops in Battle for Arconic*, THE STREET (updated May 12, 2017, 10:04 AM EDT), <https://perma.cc/UC9L-88N6>. The fund mailed thousands of video players to retail investors containing a plea for the investors’ votes. See *id.* For additional examples of activist funds waging proxy battles by lobbying retail investors, see Ronald Orol, *Retail Campaigning: Why Mom and Pop Make a Difference in Proxy Fights*, THE STREET (Mar. 16, 2015, 2:49 PM EDT), <https://perma.cc/X37B-93U2>.

172. See Lovell, *supra* note 170, at 1.

173. Cf. M. Todd Henderson & Dorothy Shapiro Lund, Opinion, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J. (June 22, 2017, 6:30 PM ET), <https://perma.cc/DV4P-G9X6> (“[I]f the passive institutional investors had not been in the picture, the Arconic proxy battle would have been settled months earlier, saving millions for shareholders.”).

174. Cf. Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2911-13 (2016) (providing evidence that investors prefer to engage management informally than to resort to the proxy machinery).

175. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1283 (2008) (noting that there are often conflicts between different groups of informed shareholders).

Indeed, it may be that a vocal minority of informed investors will agitate for a course of action that benefits its own interests. The prototypical example is that of hedge fund activists; these shareholders have been accused of pushing for actions that generate short-term returns but sacrifice long-term growth.<sup>176</sup> And critics will likely contend that Company A may have higher transaction costs, because empowering activist hedge funds will induce them to wage proxy contests or otherwise distract management from pursuing courses of action that benefit shareholders with longer time horizons. But just as issuing nonvoting shares amplifies the voting power of activist investors, it also empowers other informed investors, including actively managed mutual funds and pension funds. And if the activist investors hope to prevail in a proxy contest, they still have to convince the other informed investors that the activists' proposed course of action is warranted.

Put simply, Company A management need only be responsive to the needs of a majority of the informed shareholders. And the majority of the informed shareholders is more likely to push the company in the right direction when it can be heard clearly than when it is drowned out by the voices of uninformed, weakly motivated voters. Although there is some risk that empowering hedge fund activists will lead to short-termism, there are also reasons to believe that diluting the influence of weakly motivated voters will have the opposite effect. Because Company A management will have a better understanding of the wishes and preferences of the company's informed, engaged investors, it will be less likely to settle with an activist out of a misplaced fear that the activist could catalyze the voting power of a majority of the shareholders. By contrast, Company B management may settle with activist investors simply to avoid the expenses and risks that accompany proxy contests.<sup>177</sup>

The market for corporate control should also function more efficiently in the case of Company A. In the first place, it is difficult and costly to acquire a large voting bloc from disparate retail shareholders. Moreover, passive funds often refuse to tender their shares to hostile acquirers even if they believe the deal is beneficial, because the decision to tender could introduce tracking error

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176. See generally Kahan & Rock, *supra* note 34.

177. Cf. Ian R. Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism 22* (Nat'l Bureau of Econ. Research Working Paper Series, Working Paper No. 22,707, 2016), <https://perma.cc/G8QR-C49J> (finding that companies with a higher percentage of passive shareholders are more likely to settle with activists). See generally John C. Coffee, Jr., *The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* (Eur. Corp. Governance Inst., Law Working Paper No. 373/2017, 2017), <https://perma.cc/8BP8-DBA3> (explaining that management is increasingly likely to settle with activist investors, rather than take its chances on a proxy contest).

if the security remains in the index.<sup>178</sup> Therefore, the lower the concentration of voting shares in the hands of weakly motivated voters, the easier it will be to accomplish a takeover, a fact which further reduces agency costs.<sup>179</sup>

In sum, a company that issues nonvoting shares reduces agency costs in a variety of ways. By issuing nonvoting shares, management bonds itself to the company's informed investors by making management more susceptible to shareholder influence. This increases management's ex ante incentives to promote shareholder interests. Quieting weakly motivated shareholders likewise reduces the risk of expensive proxy contests and misguided settlements with activist investors by making it easier for management to understand the desires of its informed and engaged shareholder base.

## 2. Transaction costs

A company that channels weakly motivated shareholders to nonvoting stock can also reduce transaction costs for itself and its shareholders. Consider again Company *B*, the company that issues only voting shares. That company must incur costs associated with managing a larger number of voting investors, including preparing and mailing voting materials,<sup>180</sup> as well as tallying votes, which is itself a costly and complicated process.<sup>181</sup> And the company must incur these costs for all investors, despite the fact that most weakly motivated investors would prefer not to be involved in governance at all.

Weakly motivated voters may also incur costs associated with voting when they buy Company *B*'s voting shares. Some rationally apathetic retail investors may feel compelled to vote when lobbied by management or other investors, and may therefore spend time and money evaluating proposals and casting votes. (They may also choose to vote without becoming informed, which leads to different problems described in the next Subpart.) In addition, passive institutional investors almost always vote in shareholder elections out

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178. See David Fox et al., Kirkland & Ellis LLP, Kirkland M&A Update: Some Tender Offer Quirks 1 (2009), <https://perma.cc/UJ7M-N33J>; see also *Tracking Error*, INVESTOPEDIA, <https://perma.cc/H9TB-8DRY> (last updated Jan. 2, 2019).

179. Cf. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (positing that shareholder participation in governance is not necessary to ensure firm efficiency so long as a robust market for corporate control exists).

180. The cost of mailing the proxy statement alone is not insignificant. Broadridge—a firm that processes proxies—estimated that its 12,000 corporate clients spent a total of \$425 million to print proxy statements and mail them to shareholders. See Maxwell Murphy, *Mailing Proxy Statements Costs Companies Big Bucks*, WALL ST. J. (Feb. 21, 2012, 6:52 PM ET), <https://perma.cc/D3J4-2NJS>.

181. See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1247-49 (2008). For a discussion of the complexity of the shareholder voting system, see generally *id.* at 1248-70.

of a mistaken view of their fiduciary obligations.<sup>182</sup> Most of the institutions that favor passive management strategies have established corporate governance groups charged with casting votes for their rationally apathetic passive fund managers.<sup>183</sup> These governance groups must research issues and cast votes at thousands of companies, which imposes a financial burden on the institution and its investors.

In sum, when weakly motivated investors buy voting shares, they pay for a right that they would prefer not to exercise. They should therefore prefer to invest in a company that offers nonvoting shares; not only will the company have lower agency and transaction costs, but this structure will allow weakly motivated investors to free ride without any obligation (actual or perceived) to incur the costs associated with voting. Likewise, the company will benefit, since it will have to manage the voting process for a smaller number of investors.

### 3. Suboptimal voting outcomes

A company that channels weakly motivated shareholders to nonvoting stock also reduces the risk of suboptimal voting outcomes. Weakly motivated voters have three choices: They can choose not to exercise their vote, they can vote blindly, or they can invest in gathering the information necessary to cast an informed vote. And because weakly motivated voters by definition face collective action problems, we should suspect that they will choose the second approach if they are pressured to vote. Issuing nonvoting shares for weakly motivated investors to buy therefore reduces the risk of suboptimal outcomes that can result from uninformed voting. This is another reason why in the example above, all types of shareholders should prefer Company *A* equity to that of Company *B*: Company *B* faces the risk that the weakly motivated shareholders' votes will not be wealth maximizing.

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182. SEC regulations dictate that mutual fund managers have a fiduciary duty to vote when doing so is in the best interest of their investors, and this mandate has been widely interpreted as requiring mutual funds to vote. *See* Lund, *supra* note 38, at 526-27; *see also* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified as amended in scattered sections of 17 C.F.R.). It may be that these mutual fund managers misunderstand their legal obligations; more likely, they view voting as a form of insurance that insulates them from suits for breach of fiduciary duty. *See supra* note 44.

183. *See* Lund, *supra* note 38, at 515.

This risk is all the more likely in a world where passive funds comprise significant voting blocs in public companies. As discussed, passive funds almost always vote in shareholder elections, and yet their influence is unlikely to move the company in the right direction. This is true for two reasons. First, because weakly motivated passive funds lack firm-specific information and the incentive to devote appropriate resources to governance, they are especially likely to follow preset, one-size-fits-all voting guidelines on governance questions.<sup>184</sup> But there is no consensus about universal governance best practices.<sup>185</sup> As such, a one-size-fits-all approach to governance imposed across vastly different companies is likely to make many of those companies worse off.<sup>186</sup>

Moreover, weakly motivated passive funds have strong conflicts of interest. The compensation of passive fund managers, like that of other mutual fund managers, is tied to the amount of assets in the fund, rather than to the fund's performance.<sup>187</sup> And while actively managed mutual funds can attract investors based on past performance (and thus, future expectations of performance), passive fund managers have only two ways to compete: by offering lower fees or by maintaining strong relationships with their clients. Because corporate pension funds are some of the largest pools of capital invested in passive funds, a

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184. Vanguard, BlackRock, and State Street, the three largest institutional passive fund investors, *see* Bubb & Catan, *supra* note 168, at 3; *see also supra* note 45, have very similar voting guidelines that they each follow closely. Each institution's guidelines articulate a preference for director independence, the belief that there should be a relationship between long-term company performance and executive compensation, and a skepticism about antitakeover provisions. *See* BlackRock Inv. Stewardship, Global Corporate Governance & Engagement Principles 4-6 (2017), <https://perma.cc/YG4T-QD4L>; *Policies and Guidelines: Our Principles*, VANGUARD, <https://perma.cc/GGX4-G33H> (archived Feb. 20, 2019); State St. Glob. Advisors, Global Proxy Voting and Engagement Principles 4 (2016), <https://perma.cc/A579-4HY9>. These institutions also rely on proxy advisory firms for certain issues, and those firms also tend to follow one-size-fits-all voting policies. *See* Charles M. Nathan, *Proxy Advisory Business: Apotheosis or Apogee?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 23, 2011), <https://perma.cc/PH2J-6SHD>.

185. Scholarship over the decades has concluded that good governance is "endogenous to the particular firm" and its circumstances. *See* Lund, *supra* note 38, at 518.

186. For example, one study found that companies following proxy advisor recommendations on executive compensation reported lower returns than those that did not follow the advisors' recommendations. *See* David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 176 (2015).

187. *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 52-53 (2016).

passive fund manager may be especially inclined to support management so as to preserve her fund's access to the company's 401(k) accounts.<sup>188</sup>

For these reasons, passive fund voting may lead to suboptimal outcomes for companies. To continue with the example from above, suppose that a shareholder at Company *B* has proposed to separate the positions of chairman and CEO.<sup>189</sup> Recall that Company *B* has a single class of stock, with 20% held by insiders and the rest split evenly between the weakly motivated and informed outside shareholders. The insiders vociferously oppose the proposal, arguing that splitting the position will make it harder for the board to understand business operations, which are highly technical. Of the informed outside investors, 60% (24% of the total vote) also disagree with the proposal for the same reasons; the others (16% of the total vote), for varied reasons, support the proposal.<sup>190</sup> Among the weakly motivated voters, 87% (35% of the total vote) support the proposal because it aligns with their internal governance guidelines, which they apply across all portfolio companies, and the rest follow advice from their active fund counterparts and vote against the proposal (or simply abstain). In this example, the

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188. See, e.g., Simon CY Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, 26 BUTTERWORTHS J. INT'L BANKING & FIN. L. 481, 481 (2011) ("Institutionally, the core conflict of interest pertains to asset managers' unwillingness to actively engage and hold the boards and management of investee companies accountable because they fear losing corporate business."); Henderson & Lund, *supra* note 173 ("[T]hese institutions face a conflict of interest: Challenging management of a company can threaten their ability to retain that company as a client for corporate retirement fund assets.").

189. Whether to separate the chairman and CEO positions is a hotly contested issue in corporate governance. In recent years, the trend has been to separate the two positions, in spite of the fact that the literature does not consider this change to be "unambiguously positive." See David F. Larcker & Brian Tayan, *Chairman and CEO: The Controversy over Board Leadership*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 26, 2016), <https://perma.cc/6PQM-A595>. In fact, there is little research demonstrating that separating the two positions improves firm performance or governance quality, and one study has found that separation occurring due to shareholder pressure is associated with a decrease in performance metrics. See Aiysha Dey et al., *CEO and Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595, 1613 (2011).

190. Perhaps, for example, some of the informed investors are activist hedge funds that believe that separating the CEO and chairman positions will make the company an easier takeover target.



proposal will narrowly pass (with 51% of the vote), even though a clear majority of informed investors disagree with it.<sup>191</sup>

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These examples demonstrate why both informed and weakly motivated investors should prefer Company A stock to Company B stock. Informed investors will understand that Company A management is more likely to be attuned to their interests, which will reduce both general monitoring costs and the costs of intervention when problems emerge. Likewise, weakly motivated investors will more highly value an investment that does not require them to incur the costs associated with becoming informed, evaluating proposals from other shareholders, and casting votes.<sup>192</sup> And all shareholders will benefit from

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191. Although this is a simplified example for explanatory purposes, this is not an uncommon occurrence. In light of the growing market share of passive institutional investors and their largely uniform preferences regarding governance, *see supra* note 184 and accompanying text, passive funds have already begun to influence voting outcomes. A recent empirical study showed that an increase in passive fund ownership is correlated with the successful implementation of controversial shareholder governance proposals, including proposals that remove poison pills and other takeover defenses, and those that eliminate dual-class structures. *See Appel et al., supra* note 140, at 114. In addition, passive institutional investors are usually viewed as the tiebreakers in close proxy contests, and they regularly support management even when the majority of active investors support the dissident slate. *See, e.g., Henderson & Lund, supra* note 173 (describing how the major institutional passive investors were reluctant to support the activist side in the Arconic proxy battle out of concern for losing retirement fund accounts).

192. The literature on “empty voting” reveals that derivative products can enable shareholders to decouple voting rights from economic interest, potentially generating similar governance benefits. *See generally* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008); Hu & Black, *supra* note 36; Martin & Partnoy, *supra* note 37. And there is evidence that some passively managed funds broadly lend out their shares, which suggests that they do trade voting powers for fees. *See* Simon Moore, *How Securities Lending Makes Some ETFs Free*, FORBES (Aug. 29, 2014, 1:05 PM), <https://perma.cc/JTX2-RAVE>; *see also* Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2900-02 (2007) (“[W]hile the equity loan market exists to facilitate short selling, it also facilitates the trading of votes.”).

But the problem with decoupling as a solution is that there is no way for companies or investors to know whether it will be used to improve corporate governance. Indeed, derivative products have instead been used by hedge funds to neutralize their economic interest in a company and then use their voting power to benefit other investments. *See* Hu & Black, *supra* note 36, at 816. By contrast, using nonvoting shares to improve governance avoids this risk: Companies that offer nonvoting stock will continue to be controlled by shareholders with a financial interest in the company. Moreover, the dual-class structure will be apparent to investors *ex ante*, and they can therefore account for this structure when purchasing shares. Equity decoupling, by contrast, presents a hidden risk for investors.

Although this Article assumes for the sake of simplicity that equity decoupling is not possible, it is worth noting that the continued availability of nonvoting shares could

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the reduced risk of suboptimal voting outcomes that can occur when uninformed, weakly motivated shareholders weigh in. For these reasons, a company that provides nonvoting stock for weakly motivated voters to purchase makes all shareholders better off.

Although offering both voting and nonvoting stock is a relatively new phenomenon for U.S. public companies, the concept of separating voting rights and residual interest is not. A privately held company that is solely financed by debt provides one simple example. In that case, the debt holders have a claim on the company's residual value, but they are given no control rights unless the company is in financial distress. Such arrangements are uncontroversial, even though the residual claimants lack both the ability to exit without cost and to exercise voice through voting.

Consider also the example of a limited partnership, which consists of a general partner as well as limited partners.<sup>193</sup> The general partner is tasked with managing the company's day-to-day affairs; the limited partners provide equity but are uninvolved in company operations.<sup>194</sup> For this reason, the partners often agree to restrict the limited partners' voting privileges to specific issues, such as amendments to the partnership agreement.<sup>195</sup> The parties may also agree to allocate reduced voting rights to the limited partners.<sup>196</sup> In other words, the parties designing the limited partnership's structure often depart from a proportionate voting system to put control in the hands of those with more expertise and better information.<sup>197</sup>

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ameliorate problems associated with empty voting. Weakly motivated voters are the most likely to part with their votes. If weakly motivated voters purchase nonvoting stock, they can continue to lend their shares, but there will be less of a risk that their voting power will be used by others in ways that could harm the company.

193. Some limited partnerships, such as master limited partnerships, are publicly traded. See Paul Hastings, *Master Limited Partnership Overview 2* (2013), <https://perma.cc/5PS4-98PJ>. In a master limited partnership, the limited partners have "very limited voting rights," restricted to material events. See *id.* at 11.

194. See *Limited Partner*, INVESTOPEDIA, <https://perma.cc/6FJT-BG89> (last updated Apr. 17, 2018).

195. See Rod Howell, *Voting Rights in a Limited Partnership*, CHRON, <https://perma.cc/F7PX-2GFV> (archived Feb. 3, 2019).

196. See *id.*

197. Note that this analysis does not extend beyond shareholder democracy to civic democracy. First and most importantly, shareholder democracy is not really a democracy at all—votes are allocated on a per-share basis, meaning that the larger the investment, the larger the investor's voting power. This is because voting is a means to an end—efficient corporate governance. By contrast, there are important sociological justifications for voting in civic elections that are not present in the corporate context. Citizen voting serves to further self-actualization and educate the public about important issues, among other benefits. Second, democratic control is more important for a civic democracy, in which legislators have substantial power over the lives of citizens, than it is for a corporate democracy. Finally, shareholders have other

*footnote continued on next page*

Likewise, vote-buying markets provide a mechanism for votes to be transferred from weakly motivated to informed shareholders. Although Delaware courts tend to view strict vote-buying arrangements with suspicion,<sup>198</sup> derivatives and other equity markets could enable informed voters to accumulate voting power.<sup>199</sup> And there is some evidence that securities lending markets result in the sorting of votes along these lines,<sup>200</sup> in spite of the fact that the institutional investors that lend shares are supposed to recall proxies before a material voting event.<sup>201</sup> But voting markets may create more problems than efficiencies for shareholders. Most importantly, the vote buyer is able to accumulate voting power even when she has a negative financial interest in the company, which may result in those votes being cast in a way that does not maximize, and may even reduce, shareholder value.<sup>202</sup> The issuance of nonvoting stock largely avoids this problem: The holders of voting stock may have larger voting power relative to their financial stakes, but they must maintain *some* economic stake in the company in order to vote. Thus, the issuance of nonvoting stock better aligns the incentives of the voting shareholders with those of the nonvoting shareholders than does the use of voting markets.

In the case of public companies, however, nonvoting stock has not yet been used with the explicit purpose of enticing and empowering informed outside shareholders. More often, companies offer nonvoting stock to all of

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accountability mechanisms available to them: They can exit, sue, or discipline management through the market for corporate control. Citizens, by contrast, generally lack the ability to exit when displeased with their government, and their ability to discipline their representatives is likewise limited.

198. Cf. *Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993) (Allen, C.) (expressing doubt “whether, in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the ‘dangling’ right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares”); *Schreiber v. Carney*, 447 A.2d 17, 23 (Del. Ch. 1982) (collecting cases in which the Delaware Chancery Court “summarily voided . . . challenged votes as being purchased and thus contrary to public policy and in fraud of the other stockholders”).

199. See Hu & Black, *supra* note 36, at 823 (“The derivatives revolution in finance, combined with the growth of the share lending market, is making the decoupling of economic ownership from voting rights ever easier and cheaper.”).

200. See, e.g., Christoffersen et al., *supra* note 192, at 2900-02.

201. See *Securities Lending by U.S. Open-End and Closed-End Investment Companies*, U.S. SEC. & EXCHANGE COMMISSION, <https://perma.cc/RAC8-N2NY> (last updated Feb. 27, 2014); see also Reena Aggarwal et al., *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 70 J. FIN. 2309, 2310 (2015) (“We find a marked reduction in the lendable supply [of shares] prior to the proxy record date and an increase in borrowing demand and the borrowing fee around the record date.”).

202. See *supra* note 192.

their outside investors, including the informed investors. So what should be done to help companies unlock the potential of nonvoting shares? As will be explained in the following Subparts, the answer is: not much.

#### B. Nonvoting Shares: Demand-Side Issues

Companies seeking to reduce the agency and transaction costs associated with voting need only take one step: offer two classes of stock, one nonvoting and one voting, to the public. When this happens, market forces should drive beneficial sorting, because nonvoting shares trade at a discount to voting shares, generally observed to be between 3% and 5%.<sup>203</sup> They are otherwise identical investments, with the same rights to dividends and cash flows. This makes them especially appealing investments for weakly motivated voters, who by definition do not value their vote very much (if at all).<sup>204</sup>

In other words, companies like Google, Under Armour, and Zillow—companies that offer investors the choice between nonvoting and voting shares<sup>205</sup>—may be more valuable by virtue of their dual-class structure, and not just for the reasons that those companies typically claim.<sup>206</sup> If the weakly motivated voters buy the company's nonvoting stock and the informed voters buy the voting stock, the company's governance will be more efficient.<sup>207</sup> And

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203. See Stumpf & Cline, *supra* note 46. The presence of a voting premium is somewhat surprising. Most often, nonvoting and low-voting shares have the same cash flow rights as voting shares. They are generally entitled to the same dividends as well as the same treatment in the event of a merger, liquidation, or reorganization. See, e.g., Google Registration Statement, *supra* note 85, at 105-06; see also Kirby Smith, Essay, *The Agency Costs of Equal Treatment Clauses*, 127 YALE L.J.F. 543, 547 (2017). And yet, investors pay a premium for voting stock. This is likely so for two reasons. First, in the event that the company becomes a takeover target, the value of the vote will increase. Second, if a firm is underperforming, the vote will rise in value because the right to influence management will be perceived as more valuable: The voting shareholders can use their voting power to influence the direction of the company. For these reasons, the voting premium is rarely static; it varies based on the market's view of the quality of management and other circumstances facing the company.

204. Dual-class companies that offer low-voting stock instead of nonvoting stock may also reduce the agency costs associated with voting, although the smaller premium may reduce the incidence of beneficial sorting.

205. See CII List of Dual-Class Companies, *supra* note 49, at 1, 17, 19.

206. See, e.g., 2004 Founders' IPO Letter, *supra* note 86 ("[T]he standard structure of public ownership may jeopardize the independence and focused objectivity that have been most important in Google's past success and that we consider most fundamental for its future. Therefore, we have implemented a corporate structure that is designed to protect Google's ability to innovate and retain its most distinctive characteristics.").

207. Note that in the case of Google, the decision to use a dual-class structure to keep control with the founding group was made in 2004, ten years before the recapitalization that called for the issuance of both nonvoting stock and voting stock to the public. See Davidoff Solomon, *supra* note 32. The decision to keep control with the founders may

*footnote continued on next page*

the weakly motivated voters have two additional reasons to gravitate toward the nonvoting stock: It is cheaper, and it allows them to avoid the costs associated with voting.

In theory, therefore, weakly motivated voters should always favor nonvoting shares. But reality, of course, is more complicated. Take Google as an example. Recall that Google split its stock in 2014, creating a new class of nonvoting shares (Class C).<sup>208</sup> The Class A voting shares have consistently traded at a premium (up to 2%) to the Class C shares,<sup>209</sup> in spite of an equal treatment clause providing that in the event of a change in control, the Class C shares will be eligible for the same rights and privileges as the Class A shares.<sup>210</sup> And despite this non-negligible voting premium, the three institutional investors that primarily invest in passive investment vehicles—Vanguard, BlackRock, and State Street—hold nearly identical amounts of voting and nonvoting stock in Google.<sup>211</sup> Why are these passive investors not gravitating to nonvoting stock?

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or may not have been inefficient, but the choice to recapitalize by issuing two different share classes to the public may have actually reduced the costs associated with the entrenching structure by allowing investors to self-sort.

208. See Davidoff Solomon, *supra* note 32. Google also has Class B shares, owned by insiders, that have ten votes per share. See *id.* Those shares are not available to the public. See *id.*; see also Steven Russolillo, *What Google's Stock Split Means for You*, WALL ST. J. (Apr. 3, 2014, 1:14 PM ET), <https://perma.cc/ANZ8-QA6T>.

209. See Jesse Emspak, *GOOG or GOOGL: Which Stock Do You Buy?*, INVESTOPEDIA (updated June 28, 2018), <https://perma.cc/9F77-5Y9S>.

210. See Alphabet Inc., Current Report (Form 8-K), item 3.03 (Oct. 2, 2015).

211. Compare *Alphabet Inc. Institutional Ownership: GOOGL*, NASDAQ, <https://perma.cc/4US7-PM8U> (last updated Feb. 1, 2019) (reporting that as of September 30, 2018, Vanguard, BlackRock, and State Street collectively owned approximately 50.7 million shares of Class A (voting) Google stock), with *Alphabet Inc. Institutional Ownership: GOOG*, NASDAQ, <https://perma.cc/7HSV-39PF> (last updated Feb. 1, 2019) (reporting that as of the same date, the three institutions collectively owned approximately 52.1 million shares of Class C (nonvoting) Google stock).

Retail shareholders, however, make up a much smaller percentage of the owners of the voting shares: Retail investors hold about 20% of Class A shares, compared to about 30% of Class C shares. Compare *Alphabet Inc. (GOOGL): Holders*, YAHOO! FIN., <https://perma.cc/54HL-942T> (last updated Feb. 27, 2019) (reporting that approximately 80% of ownership in Class A (voting) Google stock is institutional), with *Alphabet Inc. (GOOG): Holders*, YAHOO! FIN., <https://perma.cc/HT77-S6UU> (last updated Feb. 27, 2019) (reporting that approximately 70% of ownership in Class C (nonvoting) Google stock is institutional). This is likely because retail shareholders understand that nonvoting stock is cheaper yet offers the same returns. See, e.g., Bram de Haas, *Google: Why I Prefer the Non-Voting Shares*, SEEKING ALPHA (June 4, 2015, 2:27 PM ET), <https://perma.cc/3M9T-Z3A8> (“The Class C shares are cheaper with the same economic interest compared to the [C]lass A shares.”).

One answer that the CII, which represents these investors,<sup>212</sup> emphasizes is that passive funds are compelled to invest in whatever companies and share classes are listed on an index.<sup>213</sup> That may explain why Vanguard owns approximately the same number of Class A (voting) and Class C (nonvoting) shares of Google<sup>214</sup>—if both are weighted nearly equally on the index, as they are on the S&P 500,<sup>215</sup> the tracker funds will be forced to buy both share classes in equal quantities.

When it comes to passive funds, therefore, perfect sorting (that is, where all weakly motivated shareholders purchase nonvoting stock) may not be possible. But imperfect sorting is better than none at all. If a weakly motivated passive fund has 50% less voting power, the voice of other informed investors will be somewhat stronger, and accordingly, agency costs, as well as the risk of suboptimal voting outcomes, will be somewhat lower. Not only that, but the passive funds will themselves benefit from purchasing the discounted stock, increasing their returns.<sup>216</sup> In sum, passive funds that buy nonvoting shares should have better relative performance than those that do not, and they should therefore welcome the issuance of nonvoting stock. Why then are passive funds among the investors lobbying stock indices to exclude companies that issue nonvoting stock?<sup>217</sup>

Their opposition is grounded in the same simple argument that for years has motivated calls to prohibit dual-class structuring—that dual-class structures are tools for entrenchment. And because passive funds are forced to buy stocks that are included on a market index, they will not be able to demonstrate their opposition by refusing to purchase nonvoting shares. They contend that a market-based solution—dual-class structures leading to reduced investor demand, leading in turn to lower prices for dual-class company shares that would discourage future dual-class offerings—is therefore unlikely to

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212. See *Associate Members*, COUNCIL INSTITUTIONAL INV., <https://perma.cc/286Q-RKN5> (archived Feb. 20, 2019).

213. See Alexandra Scaggs, *Investor Group to Exchanges: Stop Dual-Class Listings*, WALL ST. J. (Oct. 11, 2012, 12:29 PM ET), <https://perma.cc/M3VH-J325>.

214. Compare *Alphabet Inc. Institutional Ownership: GOOGL*, *supra* note 211 (reporting that as of September 30, 2018, Vanguard owned approximately 21.3 million shares of Class A Google stock), with *Alphabet Inc. Institutional Ownership: GOOG*, *supra* note 211 (reporting that as of the same date, Vanguard owned approximately 21.7 million shares of Class C Google stock).

215. See *S&P 500 Companies by Weight*, SLICKCHARTS, <https://perma.cc/U7CT-BN3Y> (last updated Feb. 18, 2019).

216. The nonvoting index fund would likely provide higher returns for investors because an initial investment could purchase more shares of the nonvoting fund, generating more dividends over time. Moreover, in the event of a takeover, the holder of the nonvoting fund would have more shares that would receive the takeover premium.

217. See *supra* note 14 and accompanying text.

manifest. Instead, they argue that regulatory action in the form of index exclusion is necessary.<sup>218</sup> Put simply, the large institutional providers of passive funds are essentially lobbying the indices to save them from themselves.<sup>219</sup>

But is the market solution really out of reach? If a passive fund portfolio manager believed that nonvoting shares were harmful for the fund and for the company, she could easily depart from a “full replication” methodology, which requires the fund to buy every stock in the index,<sup>220</sup> and instead purchase only voting shares. Because nonvoting shares receive the same cash flow rights as voting shares,<sup>221</sup> scrubbing nonvoting shares from the index fund’s portfolio would not be a difficult task (that is, so long as both share classes were available to purchase). Indeed, many funds deviate from their baseline indices to purchase a representative subset of companies,<sup>222</sup> a strategy which is much more likely to introduce tracking error than simply substituting voting shares for nonvoting shares of the same company’s stock. And funds are increasingly taking steps to modify their indices, not just for ease of management, but also to promote environmental, social, and governance goals.<sup>223</sup> There is no reason why a passive fund couldn’t follow this same approach to purchase voting, rather than nonvoting, stock.

There may be another reason for passive funds’ opposition to dual-class stock: The *institution* that houses passive funds may benefit from enhanced voting power, even if that voting power does not necessarily economically

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218. See *Major Stock Index Providers to Limit Inclusion of Multi-Class Companies: What It Means and Why It Matters*, EUR. AM. CHAMBER COM. N.Y., <https://perma.cc/9GBD-LK98> (archived Feb. 20, 2019).

219. Recently, BlackRock reversed its position on this issue, stating:

BlackRock is a strong advocate for equal voting rights for all shareholders. However, we disagree with index providers’ recent decisions to exclude certain companies from broad market indices due to governance concerns. Those decisions could limit our index-based clients’ access to the investable universe of public companies and deprive them of opportunities for returns.

BlackRock, Inc., *Voting Rights and Index Inclusion*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 9, 2017), <https://perma.cc/33US-FM7Q>. Vanguard and State Street made similar statements in the wake of FTSE Russell’s decision to bar dual-class companies. See James Rufus Koren & Paresh Dave, *Snap Won’t Give Shareholders Voting Rights. For That, It’s Being Shunned by a Major Stock Index*, L.A. TIMES (July 28, 2017, 10:40 AM), <https://perma.cc/9K5Z-Q3P6>.

220. See RBC Glob. Asset Mgmt., *Understanding Index Tracking Methodologies 1* (2017), <https://perma.cc/NY5Z-YH3X>.

221. See *supra* note 203.

222. See *Investor Bulletin: Index Funds*, U.S. SEC. & EXCHANGE COMMISSION (Aug. 6, 2018), <https://perma.cc/Q9YR-S87G> (“An index fund may not perfectly track its index.”).

223. See, e.g., Rachel Siegel, *BlackRock Unveils Gun-Free Investment Options*, WASH. POST (Apr. 6, 2018), <https://perma.cc/DA8K-MHG9>.

benefit its passive funds' *investors*. For example, the institution might hold on to voting power to benefit the institution's political interests or to appease its clients. As an example, CalPERS and other public pension funds are vocal proponents of good governance and are bound to consider governance expertise when selecting outside asset managers.<sup>224</sup> For that reason, the institution may believe that voting power will help its funds attract assets from these types of investors. Retail investors, too, may seek investment vehicles that advertise themselves as being active players in governance; perhaps they would be less likely to invest in funds that admit to being weakly motivated.<sup>225</sup> In addition, voting power can be used to appease another key client: company management, which is an important source of corporate 401(k) assets invested in passive funds.<sup>226</sup>

For these reasons, it is unlikely that weakly motivated voters will always purchase nonvoting stock, even when it is discounted. But even imperfect sorting will lower agency and transaction costs. And over time, the prospect of discounted stock and avoiding voting expenses should increase the appeal of nonvoting shares to weakly motivated voters. In fact, market forces should eventually push index fund providers to replace voting with nonvoting stock. Passive funds that purchase nonvoting shares will improve their relative performance; investors, in turn, should gravitate to those passive funds, which would promise stable returns for even lower fees.

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224. See CAL. PUB. EMPS.' RET. SYS., GLOBAL GOVERNANCE PRINCIPLES 6-9 (2015), <https://perma.cc/JEM2-JYB9> (explaining that improving corporate governance is at the core of the pension fund's investment strategy).

225. See, e.g., Bank of Am. Merrill Lynch, Equity Strategy Focus Point: ESG; Good Companies Can Make Good Stocks 8-13 (2016), <https://perma.cc/L593-HZ9X> (estimating that assets in socially responsible investment vehicles grew by 33% between 2014 and 2016, with much of this growth driven by millennials, 93% of whom consider "impact investing" to be important).

226. In 2015, 401(k) assets totaled \$4.7 trillion, with 60% held in mutual funds. Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2015, ICI RES. PERSP. 2 (July 2016), <https://perma.cc/TD7D-2JU4>. The desire to keep management happy in order to secure 401(k) assets may compromise stewardship and cause funds to act in ways that do not benefit their investors. For more on conflicts of interest faced by institutional investors, see Wong, *supra* note 188.

A less cynical perspective is that a passive fund complex wants to hold on to voting power for the benefit of the institution's active fund managers—that is, so that the active fund managers will be more effective when they intervene in governance. For evidence that beneficial information sharing occurs across large institutional investors, see Peter Iliev & Michelle Lowry, *Are Mutual Funds Active Voters?*, 28 REV. FIN. STUD. 446, 453-56 (2015). Assuming that passive fund and active fund investors share the same goals, such information sharing across funds is less problematic.



There may be another obstacle to perfect sorting. Just as weakly motivated voters may purchase voting stock, it is also possible that some informed investors will gravitate toward discounted, nonvoting shares. In other words, the presence of nonvoting shares could increase the incidence of free riding in public companies.

This result is possible but unlikely. Informed voters would be most likely to migrate to nonvoting shares and free ride when the premium for voting shares is very high. But in those cases, the market values the vote highly precisely because of the potential benefits that flow from the ability to exercise influence—perhaps the company is likely to become a takeover target, or perhaps the company is poorly managed and thus the voting shareholders will be best positioned to advocate for their interests. Under these circumstances, the informed investors will be more likely to pay a premium for voting stock so that they can exert influence.

By contrast, when the company is well run and the market is optimistic about management, the voting premium may be small.<sup>227</sup> In that case, the informed voters are likely to view the premium as a small price to pay for the ability to exercise control at some future date, and they will therefore purchase the voting stock. Even if the informed voters do decide to free ride and purchase nonvoting stock during this calm period, they will have the ability and incentive to purchase voting shares at some future point, when problems at the company manifest.

Of course, there is something perverse about requiring informed voters to pay a premium for activity that benefits all shareholders. It would be better if the informed voters received a discount or some payment for their purchase of voting stock, rather than the weakly motivated shareholders who take a free ride. But the informed shareholder who purchases voting shares at a company that has channeled its uninformed, weakly motivated voters toward nonvoting stock will get more for her money—a more powerful vote and a more efficiently run company. Therefore, although encouraging weakly motivated voters to bypass their governance obligations is suboptimal (it would be better if nobody took a free ride), it is preferable to a world in which weakly motivated voters dilute the voice of informed voters.

### C. Nonvoting Shares: Supply-Side Issues

Although weakly motivated voters should have an incentive to buy nonvoting shares, whether companies can be counted on to supply them in the right numbers and for the right reasons is more complicated. In theory, so long

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227. Cf. Stumpf & Cline, *supra* note 46 (“All else held constant, voting shares should trade at a greater premium to nonvoting shares at poorly managed companies relative to optimally managed companies.”).

as market participants are not restricted or deterred from issuing nonvoting equity, market pressure should encourage certain companies to issue nonvoting stock to some, but likely not all, outside investors. In other words, because companies want to get the highest price for their shares in IPOs or secondary offerings, some ought to issue nonvoting stock—not for entrenchment purposes, but rather to amplify the voice of informed investors and thereby increase the value of the company's equity.

But there are reasons to believe that management might not always use nonvoting stock in this way. The first reason is technical: It would be difficult for the company to ascertain how much nonvoting stock to issue *ex ante* because the optimal number depends on the composition of the shareholder base, which is always changing.<sup>228</sup> Second and more importantly, the insiders may issue nonvoting stock for the opposite purpose: to silence outside investors so that the insiders can reap private benefits of control. Indeed, nonvoting shares have generally been used to keep control with insiders, rather than to empower informed investors.<sup>229</sup> And even though these arrangements may be efficient under certain circumstances, the prospect of entrenchment has motivated much of the backlash against nonvoting shares.

What can we infer from the fact that nonvoting shares have not been used to sort between informed and weakly motivated voters? It is possible that management cannot ever be counted on to use nonvoting shares for this purpose. It may be that the prospect of entrenchment is too alluring, or the possibility of outside interference too risky, to support the use of nonvoting shares as a bonding mechanism. After all, the main casualty of efficient corporate governance is inept management, who will be more vulnerable to scrutiny and displacement.<sup>230</sup> Not only that, fears of investor-driven short-term thinking may deter even high-quality management teams from amplifying the voice of their investor base.

Ultimately, however, there are many high-quality management teams that would benefit from using nonvoting stock as a bonding mechanism and to signal their quality to outside investors.<sup>231</sup> In addition, struggling management

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228. The amount of insider stock is continually in flux as well. One driver of this is that employees are often granted stock options that can be exercised at any time, making it difficult to ascertain the level of insider ownership.

229. See, e.g., *supra* text accompanying note 86; *supra* note 206.

230. See generally Thomas Keusch, Board Monitoring, CEO Incentives, and Shareholder Activism (July 2018) (unpublished manuscript), <https://perma.cc/ZCZ4-4CLH> (finding evidence that shareholder activism leads to the ouster of underperforming CEOs).

231. Cf. Fox et al., *supra* note 55, at 13-17 (hypothesizing that governance structure provides a signal of management quality). In addition, when management uses nonvoting stock in this way, it can also serve as an early warning system, as fluctuations in the voting premium will provide information about whether the market perceives the management team to be strong or weak.

teams could use nonvoting stock to lure smart, engaged investors—the Warren Buffetts of the world—to invest. As discussed, issuing nonvoting stock for the weakly motivated shareholders to buy would attract informed investors, who might jump at the opportunity to purchase shares with enhanced voting power. Other insiders (including the banks, venture capitalists, and other early investors who cash out after a company’s IPO) should also demand the issuance of nonvoting stock to the degree that would maximize the company’s share price. It is therefore puzzling that we have not yet seen nonvoting stock used for this purpose.

It is possible that the market is currently in disequilibrium, and that the potential of nonvoting stock has yet to be unlocked. True, nonvoting stock has been in use for over a century,<sup>232</sup> but innovation in dual-class structuring is relatively recent.<sup>233</sup> In addition, recent trends in corporate governance and changes in financial markets have increased the appeal of nonvoting stock. In the past ten years, shareholder power has grown dramatically.<sup>234</sup> Shareholders now have the ability to directly intervene and weigh in on a variety of corporate issues, from executive compensation to decisions about corporate strategy.<sup>235</sup> At the same time, company ownership has become increasingly concentrated in the hands of institutional investors with agency problems of their own, as well as conflicts of interests.<sup>236</sup> To protect against distortions that occur when large, passive institutional investors wield substantial voting power, companies may find the benefits of nonvoting stock to be too great to ignore. That is, so long as companies that seek to issue nonvoting stock do not face legal or market barriers that would deter further innovation.

### III. Implications for the Law

This Article demonstrates that under certain conditions, nonvoting stock can enable a company to operate more efficiently. A prohibition on nonvoting shares, therefore, would prevent some companies from implementing optimal

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232. See Ashton, *supra* note 21, at 890-92.

233. See Lindsay Baran et al., Dual Class Share Structure and Innovation 1 (Dec. 21, 2018) (unpublished manuscript), <https://perma.cc/P5SN-MM34> (“While only a mere 1% of firms conducting their IPOs in 2005 went public with a dual class equity structure, the proportion of such firms increased to 15% in 2014 and 24% in 2015.”).

234. See Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1359-60 (2014) (“Shareholder voting . . . has come roaring back as a key part of American corporate governance.”).

235. See *id.*

236. For discussions of the agency problems that face institutional investors, see Bebchuk et al., *supra* note 134; Gilson & Gordon, *supra* note 30; and Lund, *supra* note 38, at 506-23.

equity structures, harming performance and increasing their cost of capital. Applying this analysis, this Part considers recently enacted or proposed restrictions on dual-class structures. It concludes that these restrictions are misguided. It then offers an alternate path for reform—prohibiting companies from issuing *only* nonvoting shares to the public.

#### A. Misguided Policies

As discussed, the recent controversy over dual-class stock has motivated investors and investor advocacy groups to lobby against dual-class structures and the use of nonvoting shares.<sup>237</sup> Their actions have not fallen on deaf ears: Both S&P Dow Jones Indices and Russell FTSE no longer list companies with nonvoting stock in their U.S. benchmarks, and MSCI has reduced the weight that dual class companies occupy in its indices.<sup>238</sup> Those indices are drivers of passive fund demand for U.S. stocks,<sup>239</sup> so their decisions are likely to substantially deter dual-class IPOs in the United States. Moreover, the stock indices' decisions to eschew companies with nonvoting stock will undo much of the beneficial sorting that had already occurred: Instead of being channeled toward nonvoting stock, weakly motivated passive funds will purchase voting shares, and dual-class companies will be excluded from their baseline indices.

These policy changes ignore the fact that nonvoting stock can play an important role in improving firm efficiency by reducing agency costs and the transaction costs associated with voting.<sup>240</sup> These benefits will only grow as assets continue to flow into passive investment vehicles.<sup>241</sup> And although very few U.S. companies offer both voting and nonvoting stock to the public, it is likely that market pressure would continue to push more and more companies in this direction.<sup>242</sup> By deterring companies from issuing nonvoting stock, however, the indices impede beneficial experimentation in capital structuring.

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237. See *supra* Part I.B.

238. See *supra* notes 124-28 and accompanying text.

239. See *supra* notes 18-19 and accompanying text.

240. Indeed, it is incongruous that the indices are willing to list companies with other characteristics that could be deemed entrenching, such as poison pills. This may be because the scholarly consensus is that poison pills can be welfare enhancing when used correctly. See Lynn A. Stout, Response, *Do Antitakeover Defenses Decrease Shareholder Wealth?: The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 847-56 (2002). But this Article reveals that nonvoting stock, like poison pills, has a beneficial function in certain cases, and therefore should likewise not be subject to a blanket prohibition.

241. See generally Lund, *supra* note 38, at 506-23 (describing the rapid rise of passive funds and their growing influence over corporate governance).

242. Some European countries are implementing laws in order to enhance the voice of long-term outside shareholders, and these laws will increase the incidence of companies with differential voting rights. For example, in France, "loyalty" shares that are held for two years automatically receive double voting rights. See Berger et al., *supra* note 26, *footnote continued on next page*

The recent wave of advocacy for mandatory sunset provisions for dual-class structures is similarly wrongheaded.<sup>243</sup> Sunset provisions ensure that dual-class structures automatically wind down after a predetermined period of time, such as ten years.<sup>244</sup> These provisions are just one of many tools available to companies that seek to reduce the agency costs associated with dual-class structures.<sup>245</sup> Requiring them, however, is a crude solution, as it is unclear *ex ante* at what point in the future the dual-class structure will become inefficient. Providing shareholders unaffiliated with the controller an opportunity to extend the dual-class structure lessens this concern, but in some cases, many of the shareholders tasked with approving the extension will be the same weakly motivated voters that warranted the use of nonvoting shares in the first place.<sup>246</sup>

#### B. Possible Restrictions

Even with a greater understanding of the benefits provided by dual-class structures, it is likely that calls for regulation will continue. And if securities regulators, stock exchanges, or stock indices are compelled to take a stance against nonvoting stock, they should favor a more moderate approach: prohibiting or deterring companies from offering *only* nonvoting stock to the public. In other words, rather than a total prohibition on dual-class structures, the law (or indices adopting standards for inclusion) could require a company that issues nonvoting stock to also issue a non-negligible amount of voting stock to the public.<sup>247</sup> FTSE Russell has adopted a modest rule of this kind—it

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at 297 & n.4; Michael Stothard, *French Companies Fight Back Against Florange Double-Vote Law*, FIN. TIMES (Apr. 16, 2015), <https://perma.cc/3M8R-GSLD>. Italy also allows companies to grant two votes per share to shareholders who have held their stock for at least two years. See *Analysis: Differentiated Voting Rights in Europe*, ISS, <https://perma.cc/QD59-88KF> (archived Feb. 4, 2019).

243. See *supra* Part I.B. For an argument that if dual-class structures are to be used at all, they should at least include sunset provisions, see Bebchuk & Kastiel, *supra* note 25, at 617-21.

244. See Bebchuk & Kastiel, *supra* note 25, at 618.

245. Indeed, Google has a sunset provision for its dual-class structure that is triggered by specific events—such as if the company is liquidated—rather than the passage of time. See Google Registration Statement, *supra* note 85, at 106 (“Upon our liquidation, dissolution or winding-up, the holders of Class A common stock and Class B common stock shall be entitled to share equally all assets remaining after the payment of any liabilities and the liquidation preferences on any outstanding preferred stock.”).

246. Institutional pressures could cause a weakly motivated voter to vote for unification when an extension would be more efficient. For example, Vanguard might worry that were it to vote to extend the company’s dual-class structure, this highly visible decision would attract the ire of its clients.

247. This means that if the company issued a material quantity of voting shares to the public, it would be eligible for inclusion. The right number of voting shares would

*footnote continued on next page*

requires companies to have at least 5% of their voting rights across all share classes in the hands of outside shareholders in order to be eligible for inclusion in its indices.<sup>248</sup>

It is possible that offering only nonvoting stock to the public might be the most efficient structure for certain companies at a certain moment in time. If investors were extremely confident in the leadership of the company, perhaps they would be willing to pay a higher price for shares in a company whose capital structure gave the visionary management room to breathe than they would for a company whose proportionate voting structure would subject management to outside interference. It is therefore possible that the Snap IPO was structured optimally at the time of the offering.

But even if it were optimal to issue only nonvoting stock in the IPO, it is unlikely to be optimal for an extended period. Over time, the advantages of such a structure likely decrease, especially for companies in sectors in which disruptive innovations are expected.<sup>249</sup> The costs of such a structure are also likely to increase over time—insiders are likely to dilute their economic position in the company in order to diversify risk, which will only increase agency cost problems because the insiders will bear less of the costs and benefits of their decisions. And even when the company's structure has become patently inefficient, insiders who reap private benefits of control could have an incentive to maintain it.<sup>250</sup> When this happens, investors will lack important mechanisms for accelerating change, such as the ability to nominate directors and cast votes at annual meetings.<sup>251</sup>

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depend on each company, but ideally the number would be sufficiently large that it would give the outside investors leverage over management and a path toward unseating management in the future. See Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 88-103 (discussing the mechanisms available to activist investors for waging successful campaigns at controlled companies, most of which require the power to vote).

248. See FTSE Russell, FAQ: Minimum Voting Rights Hurdle 3 (2018), <https://perma.cc/X9FW-T2PY>; FTSE Russell, *supra* note 16, at 3. Whether 5% is a large enough number remains to be seen; future research should address whether there is an optimal amount of voting participation by outside investors in dual-class companies.

249. See Bebchuk & Kastiel, *supra* note 25, at 609-12 (explaining how the benefits of dual-class structures are likely to recede over time).

250. See *id.* at 609-10. These concerns have motivated calls for mandatory sunset provisions for dual-class structures, which, for the reasons discussed, provide a clumsy and partial solution. See *id.* at 593; *supra* notes 243-46 and accompanying text.

251. Holders of nonvoting stock can still drum up negative publicity about a company as leverage for their demands. See Kastiel, *supra* note 247, at 107 (“[R]eputation markets could affect controlling shareholders in two different ways: either directly, by undermining the professional image of the controller in the business community, or indirectly, by depressing the target share price.”). But unless minority shareholders hold some legal bargaining chip, such as the ability to veto mergers and acquisitions or nominate a minority director, the insiders are much more likely to ignore their

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By contrast, when informed investors have voting shares, even when they are in the minority, they will have some ability to influence the direction of the company—including the decision whether to maintain the dual-class structure. If the outside investors believe that management is entrenched and insufficiently attuned to shareholder interests, they have several tools at their disposal as a result of their voting rights. Those outside shareholders can submit a shareholder proposal requesting reclassification of the company's stock. They can vote against board nominees or executive compensation at the annual meeting. They can nominate a candidate to the board and encourage other voting shareholders to support her,<sup>252</sup> or they can threaten to veto mergers or acquisitions initiated by the controlling shareholder.<sup>253</sup> They can even form coalitions with insiders in an attempt to unseat some of the incumbents.

Therefore, even though minority investors lack the power to change the company's structure unilaterally, a showing of unified displeasure among outside investors using the tools that voting shares provide can send a clear

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demands. *See id.* at 107-11, 110 tbl.4 (reviewing activist campaigns waged against controlled companies and finding that only 11% of campaigns that lacked a bargaining mechanism other than the threat of a reputational penalty were successful). In addition, the likelihood of securing media coverage for an activist campaign is strongly correlated with the decision to wage a proxy battle. *See id.* at 115.

252. *See* Ronald Orol, *Activist Investors Target Snapchat Parent Snap over Non-Voting IPO Shares*, THESTREET (updated Feb. 8, 2017, 8:51 PM EST), <https://perma.cc/MN55-DBYU> (“Activist hedge funds can still target dual-class companies with unequal voting structures by nominating director candidates in the hopes that a large vote of the noninsider shareholders will back their nominees, sending an embarrassing message to the company that change is needed.”). For companies that allow the right to nominate and elect minority directors, this tool is even more powerful. *See* Kastiel, *supra* note 247, at 90 (“[T]he ability to nominate and elect minority representatives to the board . . . is an important channel through which activism can be deployed in controlled U.S. firms.”). For example, an activist campaign targeting Dillard's, which had a dual-class structure but allowed the minority shareholders to nominate a director, secured major changes, including compensation cuts, by threatening to nominate a new minority director. *See id.* at 92-93.
253. In Delaware, “controllers are not required by law to get the approval of the majority of minority shareholders before consummating a conflicted going-private transaction,” but “Delaware courts incentivize controllers to seek such approval.” Kastiel, *supra* note 247, at 99; *see also* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 654 (Del. 2014) (en banc) (holding that the business judgment rule applies when a controlling shareholder transaction “is conditioned . . . upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders”), *overruled in other part* by Flood v. Synutra Int'l, Inc., 195 A.3d 754 (Del. 2018) (en banc). This provides another important channel for activism by minority shareholders at controlled companies. *See* Kastiel, *supra* note 247, at 100-02.

message to management and the board. It can also send a message to the capital markets and other investors, depressing demand for the company's stock and complicating future fundraising efforts.

If it seems implausible that a company would pay attention to a shareholder who lacks power to threaten management's control, consider this example. In 2016, Forest City Realty Trust agreed to abandon its dual-class structure, which had allocated voting control to a single family for nearly a hundred years.<sup>254</sup> Forest City reclassified its shares because of pressure from an activist investor, Scopia Capital Management, that had a 7.4% stake in Forest City.<sup>255</sup> Scopia had no chance of acquiring control of the board in a proxy fight.<sup>256</sup> Nonetheless, Scopia's persistent public campaign, coupled with its ability to call for a nonbinding vote on the company's equity structure, eventually moved the needle.<sup>257</sup>

Likewise, pressure from an activist investor sped up the unwinding of the dual-class structure of the publisher of *Reader's Digest*. Since the company was listed on the NYSE in 1990, it had offered both voting and nonvoting shares to the public, but voting control had remained with an entity created by the founders.<sup>258</sup> In the early 2000s, outside investors became increasingly unhappy with the company's structure and strategy, and began to pressure the company for changes.<sup>259</sup> Most prominently, Highfields Capital Management, an investment firm that owned about 10% of the publisher's nonvoting stock and a small fraction of the voting stock, made an offer to buy voting shares with the explicit purpose of eliminating the dual-class structure.<sup>260</sup> The company rejected the offer, but the pressure from its investors accelerated discussions to reclassify the company's shares.<sup>261</sup> Shortly after rejecting the offer, the company agreed to eliminate its dual-class structure.<sup>262</sup>

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254. See David Benoit, *Activist Pressures Ratner Family to Relax Control of Forest City*, WALL ST. J. (Aug. 10, 2016, 12:00 AM ET), <https://perma.cc/S94X-JDKS>; see also Ethan A. Klingsberg, *Index Eligibility as Governance Battlefield: Why the System Is Not Broken and We Can Live with Dual Class Issuers*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 5, 2017), <https://perma.cc/VZ8R-W496>.

255. See Benoit, *supra* note 254.

256. See *id.* (explaining that the trust's dual-class structure gave the Ratner family "voting control" and would allow it "block any effort to unseat Forest City's board").

257. See *id.*

258. See Matthew Rose, *Reader's Digest's Shareholders to Give Up Control of Publisher*, WALL ST. J. (updated Apr. 15, 2002, 12:01 AM ET), <https://perma.cc/AW4P-8WKB>; see also Isabelle Clary, *Reader's Digest Starts Trading on NYSE*, UPI (Feb. 15, 1990), <https://perma.cc/5C6M-ZE36>.

259. See Rose, *supra* note 258.

260. See *id.*

261. See *id.*

262. See *id.*



There are other examples in which a dual-class company has bent to the wishes of a minority investor with some voting power. In 2006, activist investor Morgan Stanley Investment Management put pressure on The New York Times Company to reform its dual-class structure.<sup>263</sup> That structure permitted the low-voting Class A shareholders to elect a minority of the company's directors.<sup>264</sup> The company resisted this pressure for two years, even after 42% of the Class A shareholders withheld their votes for directors at the company's 2007 annual meeting.<sup>265</sup> Eventually, Morgan Stanley exited the investment, but the campaign attracted the attention of another group of activist investors, the hedge fund Harbinger Capital Partners and the investment firm Firebrand Partners.<sup>266</sup> These funds eventually secured a settlement with the company that allowed them to increase the size of the board as well as appoint their own directors.<sup>267</sup> And in the years following the campaign, the company implemented many of the activists' proposed policy changes.<sup>268</sup>

These examples demonstrate how shareholders with voting rights are able to influence management even when they are not able to credibly threaten management's control.<sup>269</sup> And although the founders' grip on the company

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263. See Thomas, *supra* note 61.

264. See Joshua Chaffin, *Hedge Fund Lashes Out at NYT Board*, FIN. TIMES (Jan. 27, 2008), <https://perma.cc/2H2E-G5XE>.

265. See Merissa Marr, *New York Times Co. Relents on Board Seats*, WALL ST. J. (updated Mar. 18, 2008, 12:01 AM ET), <https://perma.cc/R2FM-SVQT>; Landon Thomas Jr., *Shareholders of Times Co. Hold Out 42% of Board Vote*, N.Y. TIMES (Apr. 25, 2007), <https://perma.cc/65BT-KVD7>.

266. See Marr, *supra* note 265.

267. See *id.*

268. See Kastiel, *supra* note 247, at 63 (noting that in the wake of the activism, the company "reduced spending, lowered its operating costs, and divested itself of underperforming assets such as [the] *Boston Globe*" (footnote omitted)).

269. Advisory shareholder votes on executive compensation have also proven to be influential. For example, in 2012, a strong showing of investor disapproval in the form of an advisory "say-on-pay" vote by Citigroup shareholders against CEO Vikram Pandit's pay package led to his departure and to substantial changes to executive compensation. See Tom Braithwaite et al., *Citigroup Sees Off Shareholder Revolt on Executive Pay*, FIN. TIMES (Apr. 24, 2013), <https://perma.cc/47D9-44NR>; Jessica Silver-Greenberg & Nelson D. Schwartz, *Citigroup's Chief Rebuffed on Pay by Shareholders*, N.Y. TIMES: DEALBOOK (Apr. 17, 2012, 1:28 PM), <https://perma.cc/9AY8-MYK6>. More than half of Citigroup shareholders (55%) voted against the pay package, which was taken as a strong signal of displeasure. See Silver-Greenberg & Schwartz, *supra*. One analyst described the vote as follows: "This is a milestone for corporate America. When shareholders speak up about issues on which they've been complacent, it's definitely a wake-up call." *Id.* (quoting Mike Mayo, Analyst, Credit Agricole Sec.).

In addition, empirical studies have generally revealed that Dodd-Frank's mandatory say-on-pay vote for public companies has influenced compensation practices, even though the vote is nonbinding. See, e.g., Yonca Ertimur et al., *Shareholder Votes and Proxy*  
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may be tight at the time of the IPO, that grip may loosen over time, providing even greater opportunity for the voting shareholders to influence or even unseat management.

By contrast, a company that issues only nonvoting shares to the public ensures that its insiders will be able to ignore influence from outside investors in perpetuity. For some companies, the benefits provided by insulation may outweigh the risks, but this is unlikely to occur very often, and even when it does occur, it is unlikely to remain an efficient structure forever. Therefore, a requirement that companies make a non-negligible amount of voting shares available to the public when issuing nonvoting shares would be least likely to impede efficient structuring, and would at the same time protect shareholders from future inefficiencies.<sup>270</sup>

### Conclusion

Nonvoting shares are under attack. Investors, regulators, and stock indices have embraced the view that nonvoting shares are tools of managerial entrenchment and have supported proposals that would limit companies' ability to issue them. But this Article shows that nonvoting shares have important benefits, and that issuing some combination of voting and nonvoting stock might well reduce a company's agency costs and prove to be the best way to attract capital. Weakly motivated voters can get in the way of

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*Advisors: Evidence from Say on Pay*, 51 J. ACCT. RES. 951, 952, 983-86 (2013); *see also* Investor Protection and Securities Reform Act of 2010, Pub. L. No. 111-203, tit. IX, sec. 951, § 14A(a), 124 Stat. 1376, 1899 (codified as amended at 15 U.S.C. § 78n-1(a) (2017)) (mandating shareholder votes to approve executive compensation).

270. There is another reason why regulators might wish to prohibit companies from issuing only nonvoting shares to the public: Doing so may allow companies to avoid certain disclosure requirements under securities law. For example, if it does not issue voting securities, a company need not provide a proxy statement to shareholders, which would otherwise be required under section 14(a) of the Securities Exchange Act. *See, e.g.*, Snap Registration Statement, *supra* note 2, at 5 ("Because our Class A common stock will be our only class of stock registered under Section 12 of the Exchange Act and is non-voting, we will not be required to file proxy statements or information statements under Section 14 of the Exchange Act unless a vote of the Class A common stock is required by applicable law."); *see also* 15 U.S.C. § 78n(a). Those proxy statements include financial statements, background information about the company's directors (including potential conflicts of interest), board compensation, and executive compensation. *See* 17 C.F.R. §§ 229.402, 240.14a-3(b)(1), (8) (2018). This information would be of particular interest to outside shareholders of a company that has such a high potential for agency costs. Moreover, these disclosure requirements are important to regulators who monitor the company.

For an argument that the lack of disclosure requirements for companies that issue nonvoting shares poses a serious problem for investors and warrants regulation, see Dov Solomon, *The Importance of Inferior Voting Rights in Dual-Class Firms*, 2018 BYU L. REV. (forthcoming 2019), <https://perma.cc/5SXH-BNWX>.

informed investors' ability to discipline management; accordingly, a company can better attract informed investors by issuing nonvoting stock for the weakly motivated voters to buy. Moreover, weakly motivated voters ought to prefer purchasing discounted stock that allows them to avoid unwanted information-gathering costs and other costs associated with voting. In sum, all investors should prefer a company in which nonvoting stock is available for weakly motivated voters.

For these reasons, recent stock index policy changes excluding companies that issue nonvoting stock are misguided. These policies are a powerful deterrent to companies that are considering whether to go public with a dual-class structure. And when optimal forms of structuring are taken off the table, the result is corporate inefficiency and higher costs of capital. If regulation is inevitable, a wiser form would require issuers of nonvoting stock to also offer a non-negligible amount of voting stock to the public, providing investors a choice between engagement and passivity in governance.