Dual Class Stock Structures
Overview

• Dual Class Stock Structures have experienced a bit of a resurgence
• A number of high profile tech companies have drawn attention to these structures in recent years— but the concepts have been around for many years
• What we’ll cover:
  – What are dual class stock structures and how do they work?
  – What stock exchange rules apply to dual class stock structures?
  – What are the arguments for and against dual class structures?
  – How common are dual class structures?
  – How are dual class structures typically structured in relation to equity incentive plans?
  – How are dual class structures perceived by the public markets?
  – What fiduciary duty issues arise when a company implements a dual class structure?
  – How do you implement a dual class structure?
What is a Dual Class Stock Structure?

• A dual class structure is a capital structure in which a company has two or more classes of common stock (high voting and low voting) to allow sponsors or founders to maintain operational control without necessarily holding a majority economic stake in the company.

• Typical example: The company adopts a dual class structure with shares of Class A and Class B common stock.
  – The Class A shares have one vote per share and generally the Class B shares have 10 votes per share.
  – Class A (low voting shares) are issued to the public and are publicly traded.
  – Sponsors or founders retain the Class B shares while the company issues the lower voting common stock to the public or other minority shareholders.
  – Typically, Class B shares will also have the right to convert into Class A shares at any time.

• Typically, charters will state that the super-voting shares will convert to low vote shares when (a) a founder holding super-voting shares sells the shares (except for transfers for estate planning purposes), (b) the super-voting shares represent less than a specified percentage of the outstanding shares or voting power or (c) the company undergoes a change of control.
What Stock Exchange Rules Apply to Dual Class Structures?

- Regulatory History
  - The most basic principle underlying share ownership and voting rights is the concept of one share-one vote—but companies have been adopting dual class voting structures for years (and the debate about dual class structure has been raging for years)
  - SEC Rule 19c-4
    - In 1988, the Securities and Exchange Commission adopted Rule 19c-4, in which the SEC prohibited self-regulatory organizations (like NYSE and AMEX) from listing and trading the stock of any company that issued new shares carrying more than one vote per share
    - But in 1990, the United States Court of Appeals for the District of Columbia unanimously ruled that the SEC had exceeded its authority
    - Nevertheless, the major stock exchanges implemented policies similar to rule 19c-4, each with certain enumerated exceptions
What Stock Exchange Rules Apply to Dual Class Structures? (cont…)

• Current Exchange Policies
  – NYSE Listed Company Manual Section 313.00.
    “The policy is more flexible than Rule 19c-4. Accordingly, the [NYSE] will continue to
    permit corporate actions or issuances by listed companies that would have been permitted
    under Rule 19c-4, as well as other actions or issuances that are not inconsistent with the
    new Policy.”
    “Voting rights of existing shareholders of publicly traded common stock registered under
    Section 12 of the Exchange Act cannot be disparately reduced or restricted through any
    corporate action or issuance. Examples of such corporate action or issuance include, but
    are not limited to,
      o the adoption of time-phased voting plans,
      o the adoption of capped voting rights plans,
      o the issuance of super-voting stock, or
      o the issuance of stock with voting rights less than the per share voting rights of the
        existing common stock through an exchange offer.”
What Stock Exchange Rules Apply to Dual Class Structures? (cont…)

“The restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this policy.”

– The NASDAQ Equity Rules contain nearly identical language

• Practical Advice and Observations
  – Stock exchange rules are designed to prevent coercive implementation of dual class structures
  – If a company implements a dual class/multi-class stock structure prior to going public, it has wide latitude to structure a multi-class structure without violating exchange policies – because investors are given a choice whether to invest
  – Post-IPO, the exchange policies generally prohibit the issuance of new super-voting stock; however, they still appear to give companies latitude to implement dual class/multi-class stock structures through the issuance of low-voting/non-voting stock
The Arguments in Support of Dual Class Structures

- Founders or management have a legitimate need to maintain control of the strategic direction of the company
  - Placing voting control in the hands of managers allows managers to focus on value maximization (i.e., moving forward with risky projects, etc.) without paying attention to temporary fluctuations in share value
    - Dual class structures eliminate the risk to management that shareholders will terminate their employment or sell shares to a purchaser of control who might change the firm’s business direction
    - Management can then focus on the long-term health of the company and not be bothered by the short-term objectives of minority shareholders
  - Centralizing control in those receiving the class with superior voting rights will increase the value of the company and, as a result, concurrently increase the value of the shares with limited voting rights
The Arguments in Support of Dual Class Structures (cont…)

• Dual Class Structures Can Help Companies Resist Unwanted Takeover Attempts
  – Effectiveness of dual class systems as a takeover defense is widely accepted
  – Collective action problems prevent many shareholders from acting in concert, dampening their negotiating power
  – A single controlling group in a takeover scenario has the effect of increasing the power of all shareholders and lowering the risk of unwanted takeovers

• If implemented in connection with an IPO, investors are fully informed and can make their own choice
The Arguments in Opposition to Dual Class Structures

- Dual class structures have an anti-takeover effect – discouraging lucrative offers/premiums that shareholders should have the opportunity to consider
- Dual class structures lead to management entrenchment
- Dual class structures increase the risk that insiders will pursue underperforming projects (or acquisitions) because of the lack of shareholder accountability
- Dual class structures foster divergent interests generally among shareholders (insiders vs. outsiders)
- Institutional Shareholder Services (ISS) and others, like CALPERS, do not like dual class structures

- ISS Article from February 13, 2012: “By establishing a dual-class structure at the onset of public trading, companies divide ownership interests into potentially opposing groups. These early fractures can widen into fault lines, eventually resulting in a costly, distracting, and potentially unpopular restructuring. In this way, dual class structures create a vulnerability not unlike the tragedy of the commons, where individual actors working to maximize their own self-interest collectively diminish or destroy the resources they share.”
How Common Are Dual Class Stock Structures?

• According to ISS, approximately 6% of companies in the S&P 500 have dual class stock structures

• Historically, dual class structures have been popular among traditional media companies
  
  ➤ **Examples:** The Washington Post Company, the New York Times Company and News Corporation
  
  ➤ **Reason:** Placing voting control with the founders or existing managers of a company allows them to preserve and protect a distinctive corporate culture and maintain editorial integrity
How Common Are Dual Class Stock Structures? (cont…)

- Twenty dual class IPOs occurred in the United States in 2011. In 2010, there were twelve dual class IPOs.

- Recently, dual class stock structures have been popular among tech/social media companies
  - Google
  - Zynga
  - Zillow
  - Groupon
  - Linkedin
  - Facebook

- How have these companies fared?
Dual Class Structures and Equity Incentive Plans

- In multi-class stock structures, typically, low voting shares (i.e., the shares that are sold in the public market) are the shares that are included in the company’s stock incentive plan
  
  - Two simple reasons:
    
    o Employees want/need liquidity with respect to the equity interests they receive, so the shares they receive must be the same as the low voting shares issued to the public and publicly listed
    
    o Controlling shareholders do not want high vote shares to be granted to employees which would further dilute their voting interests
    
  - While it is possible for a founder/manager to include high vote shares in his or her equity incentive plan, we have not seen this in our experience
Dual Class Structures and Equity Incentive Plans (cont…)

• A recent executive compensation development – Google will issue non-voting stock to employees (and others) going forward
  – In April 2012, Google announced its proposal to create a third class of stock: non-voting Class C shares
  – Google will distribute one non-voting Class C share for each outstanding Class A share
    ➢ Impact on RSUs
    ➢ Impact on stock options
  – Going forward, when new shares are issued under employee stock plans and in acquisitions, the recipients will not receive Class A shares with one vote per share (which would otherwise dilute the founders’ voting interest) - they will get Class C non-voting shares which won’t dilute the founders’ interests at all
  – This is permissible under exchange rules because it doesn’t involve the creation or issuance of new high-voting stock
• Stockholders are not universally supportive - some have sued on fiduciary duty grounds (as discussed below)
Do Dual Class Stock Structures Adversely Impact the Public Market for the Issuer’s Stock?

- Dual class structures are sometimes criticized because of the possible adverse impact on the IPO offering price and market price (for the low-voting stock)
  - In theory, the inability of a third party to obtain control of the company by acquiring shares on the open market reduces the value of the shares
    - The penalty is a lower per-share value for the issued shares than would otherwise be the case if the shares were fully voting - thus, the newly public company suffers an increase in its cost of capital and a lower market cap
  - Underwriters also often advise against a dual class structure because of the potential adverse perception associated with super-voting shares and company founders (and their families) retaining control
Do Dual Class Stock Structures Adversely Impact the Public Market for the Issuer’s Stock? (cont…)

- What the Data Shows:
  - There is no clear evidence that dual class firms underperform single class firms
  - Some research has found that dual-class IPOs tend to be priced at lower price-earnings and price-sales ratios than comparable single-class IPOs, suggesting that there may be some market penalty - but the data is not dispositive
  - Recent stock price performance of tech companies with dual class structures may not be a fair barometer
  - Research does show that (i) shareholders with super-voting rights dislike raising capital through the sale of additional shares because such issuances tend to dilute voting power, (ii) dual class companies tend to pay their CEOs more and (iii) dual class companies may make more questionable acquisitions.
Fiduciary Duty Issues

• Does a board of directors’ decision to recapitalize into a dual class stock structure violate the board’s fiduciary duties?
  – Some argue that use of the dual class structure by management is an attempt to retain office in violation of fiduciary duties to all shareholders and otherwise decreases the value of the corporation to stockholders by exposing them to greater risks and otherwise depriving them of potential acquisition premiums
  – Courts have generally not agreed with such sentiments to date
  – High-vote holders enjoy an increased level of flexibility, but their decision making is still constrained solely by the state law fiduciary duty principles

• The Delphi and Google cases
Fiduciary Duty Issues (cont…)

• A case study on discounts and control premiums: the Delphi case
  – The Facts:
    o Delphi has a two-class common stock structure: Class A shares, held largely by the public, and Class B shares, held by Robert Rosenkranz, Delphi’s controlling stockholder, CEO and Chairman of the Board
    o Each share of Rosenkranz’s Class B has 10 votes per share to Class A’s one vote per share—Rosenkranz holds 49.9% of the vote, but only 13% of the equity
    o When Delphi went public in 1990, its charter included a provision mandating that both classes of stock must receive the same consideration in any merger transaction (i.e., Rosenkranz gave up the right to receive a premium for his shares)
Fiduciary Duty Issues (cont…)

The Merger:

- In 2011, Tokio Marine approached Delphi about a deal
- In light of the possible conflicts between Rosenkranz and the other stockholders, the Delphi board formed an independent special committee to oversee negotiations
- Notwithstanding the existence of the charter prohibition against disparate consideration, Rosenkranz demanded an additional premium for his shares
- The parties agreed to a deal resulting in a price of $44.875 per share to the Class A holders (a 76% premium over the market price) and $53.875 to Rosenkranz for his Class B shares
- The merger was conditioned upon the amendment of Delphi’s charter to remove the prohibition on disparate consideration, which required majority stockholder approval
Fiduciary Duty Issues (cont…)

- The Lawsuit:
  - In the Delphi case, the plaintiffs’ suit alleged breaches of fiduciary duties and contract by the Delphi board and Rosenkranz.
  - Although denying the requested preliminary injunction and allowing the merger to go forward, the court noted Rosenkranz’s additional control premium could be in violation of his contractual and fiduciary duties to the minority stockholders.
  - The court found that Rosenkranz had already bargained away his right to a control premium when the company went public in 1990 with the charter prohibition against disparate consideration in what presumably resulted in a higher offering price.
  - Thus, to give Rosenkranz a second control premium in the context of the merger would result in a wrongful transfer of the merger consideration from the Class A stockholders to Rosenkranz.
  - The court denied the preliminary injunction but noted that Rosenkranz may have violated his fiduciary duty—disgorgement remedies would suffice.
Fiduciary Duty Issues (cont.)

- The Google case (pending)
  - In spite of a 6 month long special committee approval with respect to the Google Class C structure and the inclusion of special restrictions on the founders, some stockholders have sued alleging:
    - Entrenchment and self-dealing
    - Conflicts of interest on the part of the special committee that approved the structure
    - A failure by the board to analyze the value to the founders of the additional voting power granted through the Class C structure and to negotiate for fair compensation to the company
    - A failure to insist on disinterested Class A stockholder approval
    - The special protections that were obtained for the benefit of Class A stockholders (founder Class C stock transfer restrictions and provisions requiring equal treatment of Class A, B and C shares in any sale) are largely hollow
    - The founders are not restricted from using their voting power in the future to eliminate these provisions in any event
How to Implement a Dual Class Structure

• Charter Amendment
  – An amendment to the charter creating the various classes of stock must be approved by the voting shareholders
  – Charter amendments sometimes do not call for immediate implementation
    o Shareholders can provide management with the power to install a dual-class capital structure at some future date without the need for further shareholder approval
    o Management can also be granted the right to issue preferred shares at will with the prerogative to establish the voting rights when the shares are issued
How to Implement a Dual Class Structure (cont.)

- Specific Implementation Methods – How to get high voting shares and low voting shares in the right hands
  - Initial Public Offering – The simplest approach
    o The company creates a new class of low-voting/non-voting shares (Class A)
    o The original shareholders keep their existing Class B voting shares and the company issues the Class A shares to the public investors
  - Stock Dividends - The proposed Google Class C dividend
    o The company creates a new class of low-voting/non-voting shares (typically Class A) and then issues those shares in a stock dividend: each share of existing Class B receives one share of the new Class A stock
    o The company then issues additional Class A low-voting/non-voting shares to additional investors
    o Existing shareholders are arguably all treated equally (although some have still complained - as noted in the Google example)
How to Implement a Dual Class Structure (cont.)

- “Dividend Sweeteners”
  - The company creates a new class of shares with less voting power but with higher dividends
  - Existing shareholders are given the option to convert to the new inferior voting class with higher dividends
    
    For minority shareholders who do not have enough shares to impact company decisions, it is in their best interest to move to the new class to take advantage of the dividend preference
    
    Accordingly, large blockholders can maintain superior voting shares and control of the firm
  - This mechanism can also be achieved through share exchanges or stock swaps. For example, each shareholder can choose to accept an offer to exchange high voting shares for multiple shares of lower voting shares
How to Implement a Dual Class Structure (cont.)

- Voting Plans
  - Under a voting plan, the company amends its charter to create two classes of stock based on the length of time the shares are held—one short and one long
    - Long term shares are defined as those acquired before the date the charter amendment is approved and held continuously thereafter or shares that are purchased and held for a designated period of time, usually about 4 years
    - All other shares are considered short term
  - Shares that are sold, transferred or otherwise violate certain stated transfer restrictions convert from long term designated shares to short term
  - Thus, shareholders that hold shares over long periods of time can acquire and maintain voting rights—the process is a gradual one
Certain other issues to consider with dual class stock structures

- Disclosure
  - Company registration statements are explicit that existing shareholders seek to maintain control and that shares have economic value but little voting power
  - Shareholders should generally be on notice that the founders are willing to exchange a potential penalty in the form of a lower price per share for access to equity markets without the dilution of founders/management control

- “Controlled Companies” exception to certain Governance Requirements
  - If the class also results in majority voting power, it can allow a company to qualify for “controlled company” exceptions (under the NASD), thereby exempting the company from various governance requirements such as the requirement for a majority independent board
  - Facebook has indicated that it will not have an independent nominating function for its board and states that it reserves the right to eschew independent directors and an independent compensation committee
Certain other issues to consider with dual class stock structures (cont.)

- Unification

  - In many instances, companies with a dual class stock structure will choose to collapse the two classes into one single class

  - Unification, it can be argued, would have some benefits:
    - greater liquidity of lower vote shares
    - alignment of voting rights with economic considerations
    - increased flexibility to use equity as an acquisition currency or to raise additional capital

  - Unification is almost always decided by the class with the majority voting interest, and for the most part, would be against the interest of the controlling shareholder
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