Revisiting Dual-Class Stock

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INTRODUCTION

“Through an evolutionary process, firms gravitate toward efficient ownership structures.”¹ As Frank Easterbrook and Daniel Fischel have noted, “[t]he best structure cannot be derived from theory; it must be developed through experience.”² Such experience, shaped by common macroeconomic factors as well as firm-specific and industry-specific factors, influences and guides the corporate evolutionary process. Structural metamorphosis, however, can be slow³ and unrecognizable until larger events pre-

¹ J. Gregory Sidak & Susan E. Woodward, Takeover Premiums, Appraisal Rights and the Price Elasticity of a Firm's Publicly Traded Stock, 25 GA. L. REV. 783, 796 (1991). “In particular, it is efficient to divide functions between investors and managers even though investors consequently must expend resources to specify and monitor the performance of managers.” Id. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (noting structural models which divide functions between investors and managers have been dominant for over sixty years). The dominance of the model does not necessarily mean that it is universally optimal. Rather, the model is refined by firms and outside forces as the firm interacts within relevant markets.


³ The airline industry is a prime example. The reevaluation of corporate governance structures in the airline industry following deregulation in 1978 required almost ten years to complete. See Stacy Kole et al., Deregulation and the Governance of Airlines (1993) (unpublished working paper, University of Pittsburgh, Katz School of Business). When more general structural change is effected at a fast pace, however, we can expect to see resulting governance changes over time. Such was the case with the 1982 antitrust decree that divided the American Telephone and Telegraph Company (AT&T) into eight separate firms and spun off two other telephone companies in which AT&T had a minority interest. See ROBERT W. CRANDALL, AFTER THE BREAKUP: US TELECOMMUNICATIONS IN A MORE COMPETITIVE ERA 1 (Brookings Institution 1991); United States v. American Tel. and Tel. Co., 552 F. Supp. 131 (D.D.C. 1982), aff’d sub nom., Maryland v. United States, 460 U.S. 1001 (1983). Recently, sweeping new government price controls on the cable television industry set off an insider-selling spree.
scribe reevaluation, and sometimes abrupt change, of a firm's ownership structure.\(^4\) We should be skeptical of claims that any one structure (or even class of structures) is best for all firms because each firm has qualities which distinguish it from the larger corporate population within which it operates.\(^5\) Likewise, we should also be skeptical of claims that any one type of capital structuring device, or combination of devices, is best. Different firms require different capitalizations, which in turn require different capitalization devices.

Forays into capital markets (when internal funds are exhausted) initiate the reevaluation.\(^6\) Firms must initially choose

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\(^4\) Such triggering events may originate from a variety of sources, including capital markets, product markets, corporate control markets, and regulatory bodies. For example, the feasibility of debt or equity financing may be influenced by contracts with original financing groups such as venture capitalists, or by the supply and demand conditions already existing in the capital markets. Specifically, interest rates (both short and long-term), market value, replacement costs, and general capital access dictate to the firm which structuring mechanisms are available. Firm-specific triggering events may also force the reevaluation. Examples of these events include: the development of a new product line, the need to expand production beyond current capabilities, or impending bankruptcy proceedings. Also, the attributes of the industry within which the firm operates can trigger structural reevaluation, while simultaneously dictating the parameters of this choice. For example, certain industries by their nature cannot be heavily leveraged. Thus, forays into equity markets are necessary when substantial funding is needed. In the recent past, corporate control markets have also played a significant role in triggering structural change. For example, in the 1960s and 1980s, American enterprises began defensively leveraging in reaction to increased acquisition activity involving large amounts of debt financing. See Victor Brudney & Marvin A. Chirelstein, Cases and Materials on Corporate Finance 437 (1987).

\(^5\) See Easterbrook & Fischel, supra note 2, at 12-13. "The choice of organization... will depend on the size of the firm, the identity of the managers, and the industry (or spectrum of industries) in which the corporation participates. The organization of finance and control is equally variable." Id. An analysis of the shareholder-optimal capital structure is also dependent on multiple variables and is extremely complex. See Henry T.C. Hu, Risk, Time, and Fiduciary Principles in Corporate Investment, 38 UCLA L. Rev. 277, 344-45 (1990) [hereinafter Hu, Corporate Investment]. "There is no neat formula that you can plug in to find the optimal capital structure." Id. (quoting Richard Brealey & Stewart Myers, Principles of Corporate Finance 437 (3d ed. 1988)). It is dependent on a broad range of factors including: tax effects, the agency problems associated with different securities, and the costs of issuing securities, including those created by adverse selection. Antonio S. Mello & John E. Parsons, Measuring the Agency Cost of Debt, 47 J. Fin. 1887 (1992).

\(^6\) In what has been referred to as the "pecking order" of finance sourcing, firms are thought to first utilize internal funds before resorting to outside financing. This
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between equity or debt financing, or a combination of both. With respect to the use of equity instruments, subsequent choices will focus on the type of stock to be issued. The options include the issuance of preferred stock, cumulative preferred stock, convertible cumulative preferred stock, exchangeable convertible cumulative preferred stock, floating rate preferred stock, or common stock.7 In most cases, the firm selects a capital structure that is characterized by a combination of debt and equity, the equity portion typically consisting of one class of common stock and one or more classes of preferred stock.8 Occasionally, a firm will issue

theory rests upon the notion that transaction, agency, and financial distress costs, in addition to tax advantages and asymmetric information, make internal financing less costly. See Hu, supra note 5, at 343 n.189 (citing Fazzari, Hubbard & Petersen, Financing Constraints and Corporate Investment, in Brookings Papers on Econ. Activity 141 (1988)).

7 The shareholder’s rights under each of these equity instruments can vary significantly. Plain vanilla convertible preferred stock gives the investor a right to convert the preferred share into a share of common stock at a fixed price. Preferred convertible stock can also come in different forms such as that issued by Masco Tech., Inc.’s Dividend Enhancement Convertible Security or DECs. Each DEC (noncallable for three years) sold for the same price as the company’s common stock and has an annual yield of six percent. Four years after the stock’s June 1993 issue date, each DEC automatically converts into one common share. See Leslie Scism, Variants ofConvertible Preferred Stock Can Leave Investors With a Bad Taste, WALL ST. J., July 27, 1993, at C1, C18. Floating rate preferred stock, on the other hand, is stock with floating or variable dividends. The applicable rate of the dividend is determined by reference to an external measure such as treasury bills or commercial paper rates. COOPERS & LYBRAND, A GUIDE TO FINANCIAL INVESTMENTS 51-63 (1987). Meanwhile, convertible exchangeable preferred stock gives the holder a right to convert a share of preferred stock into a share of common stock and gives the issuer the right to force an exchange of the preferred stock for the issuer’s convertible debentures. See Henry T.C. Hu, New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare, 69 Tex. L. Rev. 1273, 1294 (1991) [hereinafter Hu, Shareholder Welfare].

The list of choices investors have in choosing an equity instrument will presumably continue to grow as firms innovate, and participants merge conventional forms of “straight nest” and equity securities to satisfy the changing needs of investors and firms alike. New equity products include: debt with premium puts, debt payable in common stock, and debt with equity warrants. COOPERS & LYBRAND, supra.

8 As new financial products are continually introduced, a shift will take place from the traditional focus on optimal levels of “debt” relative to “equity,” and corporations will begin to examine and manipulate the specific characteristics of each debt and equity instrument. See Hu, Shareholder Welfare, supra note 7, at 1298-99; ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? (R. Kopcke & E. Rosengren eds. 1989). Common stock is a prime example of this process as firms have broken the stock down into its economic components, realizing that the optimal division of voting rights will not always involve a traditional one-share-one-vote split.

Until stopped by regulatory and marketing difficulties, investment bankers who had developed “unbundled stock units” sought to separate an issuer’s
more than one class of common stock, so that one class carries disproportionate voting rights and sometimes different dividend rights.\(^9\) Whenever a firm issues multiple classes of common stock, one of which possesses disparate voting rights, the firm is said to possess a dual-class capital structure.

Whether a corporation decides to issue a single set of preferred and common stock or to adopt a dual-class common stock structure is an esoteric question that affects not only the firm's capitalization, but also the firm's corporate governance. Whether the firm adopts a dual-class structure when the stock originally goes public\(^10\) or does so through a recapitalization\(^11\) determines the extent of change that occurs to the existing shareholder-manager relationship and the policing mechanisms in place to monitor it. The extent of change is a function of whether shareholders are disenfranchised (a dual-class recapitalization) or whether the right to vote is never lost because it was never owned (a dual-class capitalization).

The disenfranchising nature of dual-class-stock recapitalizations has caused many to view its use skeptically.\(^12\) This skepticism has been partly fueled by the example of General Motors Corporation, which has a complex capital structure.

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\(^10\) "When a company goes public with a disparate voting capital structure, it is said to have undergone a 'dual-class capitalization.'" Peter N. Flocos, Comment, Toward a Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph For The SEC's Rule 19c-4?, 138 U. PA. L. REV. 1761, 1762 n.5 (1990) (citing W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1268 (6th ed. 1988)).

\(^11\) A 'recapitalization,' however, is a material readjustment in the rights of a corporation's existing capital stock. Hence, when a public company reclassifies its single class of common stock into two new classes with disparate voting rights, the firm is said to have undergone a 'dual-class recapitalization.'" Id.

cism has spawned regulation of dual class stock which is disproportionate to the commonality of its use.\textsuperscript{13} However, for the handful of public firms that find it desirable to change their current equity structure to a dual-class system, the restrictions are real.\textsuperscript{14} When optimal forms of structuring are impeded or prohibited entirely, a firm's structure will be less than optimal and its overall performance will suffer.\textsuperscript{15} Much to the same degree that inefficiencies result when capital markets function imperfectly,\textsuperscript{16} defects in a firm's capital structure eventually result in poor decision making. Profitable projects will go unfunded, capital costs will rise, and eventually the firm's ultimate competitive posture will suffer. These misallocations create costs which negatively impact the competitiveness of those firms whose capital structure.

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\textsuperscript{13} See Will F. Sander, Shareholder Voting Almanac 40 (1991). The number of proposals containing dual-class recapitalization plans that have been put to a shareholder vote has declined substantially since 1986:

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Proposals</th>
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<tbody>
<tr>
<td>1986</td>
<td>28</td>
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<tr>
<td>1987</td>
<td>18</td>
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<td>1988</td>
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Between 1977 and 1987, however, at least 94 firms underwent dual-class recapitalizations, sixty-seven of which were made after 1982. Over half of these were from firms listed on the New York Stock Exchange (NYSE). Gregg A. Jarrell & Annette B. Poulsen, Dual-Class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence, 20 J. Fin. Econ. 129, 130 (1988).

\textsuperscript{14} See supra note 13.

\textsuperscript{15} Cf. Michael C. Jensen, The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, 48 J. Fin. 831, 868 (1993). "The evidence from LBOs, leveraged restructurings, takeovers, and venture capital firms has demonstrated that leverage, payout policy, and ownership structure (that is, who owns the firm's securities) do in fact affect organizational efficiency, cash flow, and therefore value." Id. The history of corporations has been that firms failing to adapt their governance structures are ground under by competition. Easterbrook & Fischel, supra note 2, at 13. See generally Oliver E. Williamson, The Economic Institutions of Capitalism (1985); Alfred D. Chandler, Jr., The Visible Hand, The Managerial Revolution in American Business (1977).

would otherwise include dual-class stock. Because such costs are opportunity costs, they often go unnoticed.\textsuperscript{17}

In the context of a publicly held corporation, there is no reason why a shareholder's proportional entitlement to the residual profits of the corporation must correspond exactly to the shareholder's proportional voting power.\textsuperscript{18} If a disproportionate voting structure is more efficient in financing and managing the corporation, then if permitted by law, the corporation should adopt such a structure, rather than the one share, one vote structure.\textsuperscript{19} The value of the vote lost in a recapitalization will simply reappear through the operation of the corporate governance contract. Similarly, in the case of an initial public offering ("IPO"), the value of the vote will be discounted and reflected in the price on which the buyer and seller have agreed. Consequently, in an IPO the purchasing shareholder suffers no real economic loss.

Some, however, believe that:

[\textit{v}otes 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; that disproportionate voting power will result in less than optimal decision making, because those with disproportionate voting power will

\begin{footnotes}
\textsuperscript{17} The opportunity cost of a good or course of action is the best alternative that is given up in order to produce the good or follow the course of action. J. Vernon Henderson & William Poole, Principles of Microeconomics 44 (1991). A dual-class structure, in some cases, may be the best alternative given up.

\textsuperscript{18} In the context of the closely held corporation, for example, many states explicitly permit classified stock and weighted voting techniques to assure that minority shareholders will have representation on the board of directors. See, e.g., N.Y. Bus. Corp. Law § 703 (McKinney 1986). Most of the remaining statutes implicitly validate similar techniques by providing that a corporation may have one or more classes of stock with voting powers as shall be stated in the certificate of incorporation. See Cary & Eisenberg, supra note 10, at 375-76 (discussing Del. Code Ann. tit. 8, § 151(a) (1991)). Additionally, close corporations with major block holders frequently use voting agreements which are also generally permitted under state law. See Del. Code Ann. tit. 8, § 218(c) (1991). Similar to vote buying, voting agreements (such as standstill agreements) are not a one-time deal, and thus tend to have a longer duration. Robert J. Klein, The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right, 44 Stan. L. Rev. 129, 142 (1991). "In a public corporation, a standstill agreement is one between different shareholders, or between shareholders and the corporation, in which the shareholders agree not to increase or decrease their percentage ownership in the corporation without the consent of the other parties." Id. at 142 n.78.

\end{footnotes}
not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control.  

Proponents of this position fail to recognize the versatility and significance inherent in the voting mechanism itself. It does not necessarily follow that an unequal relationship between voting power and residual interest invariably creates larger agency costs or inefficiencies. Specifically, decreasing the risk associated with firm-specific capital investing while increasing the incentives for firm-specific human capital investing may outweigh the values associated with meaningful outside shareholder voting power. Moreover, once the parties can isolate the value of the vote from the underlying share, the process of capital formation becomes less inhibited. The vote and the value attached to it can be manipulated to maximize the aggregate value of the firm's securities. Without that ability, firms forego the opportunity to benefit some shareholders without hurting others. A simple application of the Coase theorem is illustrative.

Ronald Coase observed that in the absence of transaction costs the ultimate use of a resource will be determined not by the initial assignment of property rights between two parties, but rather by which of two parties can put the resources to its higher-valued use: The one who values the resource more highly will have the means and incentive to induce the other party to exchange his rights to the resource.

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20 See Easterbrook & Fischel, supra note 2, at 73. Restrictions on vote buying, cumulative voting, and the absence of tenure of office are also considered as devices to assure that the residual claimants have the final say in corporate affairs. Id. at 72-76.

21 See Milton Harris & Artur Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. Fin. Econ. 203, 205 (1988). In addition to a voting right and a residual claim on the assets of the corporation attached to each share, there is also what might be termed a "maximization right" affixed to each share of each class of common stock. See Hu, Shareholder Welfare, supra note 7, at 1287. A maximization right is defined as a right to expect management to act to maximize each share's value. Id. While the proliferation of financial products has blurred the distinction between those securities which offer maximization rights and those that do not, there is general agreement that securities designated as common stock embody such maximization rights. Id.; see also Victor Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Cal. L. Rev. 1072 (1983) (discussing problems associated with agency costs and diversion of assets by controlling shareholders to detriment of minority shareholders of same class); John C. Carter, The Fiduciary Rights of Shareholders, 29 Wm. & Mary L. Rev. 823, 831-41 (1988) (discussing agency costs).

For our purposes, we will assume that dual-class, common-stock recapitalizations are an unrestricted method of capital structuring on a given exchange. Since the vote attached to the share under such a regulatory framework is not restricted in terms of exchangeability, the ultimate destination of the rights attached to the vote will be determined by the initial arrangements made between the parties when the stock is first offered publicly, and then later upon exchanges between existing shareholders, in which the right to vote shifts to those who value it most. Those who value voting rights the most are typically families or controlling shareholder groups. Such groups may eventually bargain with other shareholders in order to make an exchange in which capital is raised without diluting their present control positions.23

Bargaining between shareholders is an ongoing process that firms can modify or reverse. Specifically, firms may decide to shift from a dual-class structure to a single-class structure at a later date,24 or simply choose to alter the dual-class structure currently

23 Early Delaware courts held that vote buying was illegal per se. See Macht v. Merchants Mortgage & Credit Co., 194 A. 19, 22 (Del. Ch. 1937) ("To allow voting rights that are bought to be exercised is against public policy, and would be in fraud of the other stockholders."). But see Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (holding agreement involving transfer of stock voting rights is not illegal per se).

It is generally believed that, where vote buying is permitted, each side must bargain in determining a reasonable value at which to consummate the exchange. See Flocos, supra note 10, at 1773-74. See generally Robert Charles Clark, Vote Buying and Corporate Law, 29 CASE W. RES. L. REV. 776 (1979) (suggesting vote buying should be permitted).

24 For example, until 1993, the Magma Copper Company certificate of incorporation authorized 100 million shares of Class A and Class B common stock. The Class A stock had one vote per share and the Class B had four votes per share. The certificate of Incorporation essentially provided that, if a Class B holder transferred shares to a transferee who, following such transfer, directly or indirectly owned 10 percent of Magma's outstanding voting stock, then such shares of Class B stock would automatically convert to Class A. This would result in a serious dilution in the transferee's voting power. The certificate of incorporation additionally provided that the Class A holders would be entitled to elect one board director if they constituted 20 to 40 percent of the outstanding voting common stock, or two directors if they constituted more than 40 percent of the outstanding voting common stock. At the time this structure was devised, no Class A shares had been issued. Through a series of events, Magma shifted from the dual-class structure, originally designed to allow the Newmont Mining Corporation to retain a controlling interest, to a single-class structure, which transformed the preferred stock as well as the Class B stock into a single class of common stock. The stated purpose of the restructuring was to streamline and simplify Magma's capital structure and was triggered by Newmont Mining's subsequent divestment of its interest in Magma. The dual-class structure was originally implemented when Newmont Mining Co., a controlling shareholder in Magma Copper Co., decided prior to a stock distribution that it wished to retain a controlling interest
Thus, conclusions that dual-class structures constitute a permanent alteration in a firm's ownership structure, and have permanent implications on the corporate governance of the firm, are erroneous.

"In jurisprudence, political theory, and economics, voluntary exchange is generally regarded to be a good thing," because, as the Coase theorem implies, bargaining and the legal rules enacted to facilitate it reduce transaction costs. When an exchange has a
more restrictive dual-class regulatory scheme, it imposes unnecessary transaction costs on those firms intending to recapitalize, because such firms are forced to delist and move to an exchange with a more facilitative standard. Restrictions also impose societal costs since they discourage individuals from investing capital and energy in projects that they would have invested in if such restrictions had not existed. Moreover, if the law was designed to facilitate bargaining, the property rights exchange would result in ownership structures that were Pareto-superior improvements in the management of the firm's productive resources. Some shareholders in the firm could be made better off without making others worse off.

Post transaction costs, on the other hand, take several forms; for instance, the setup and running costs associated with the governance structures to which disputes are referred, and the haggling costs incurred if the bilateral efforts are made to correct ex post misalignments. Id. Others believe separating the vote from the underlying share creates an additional, unnecessary agency cost. Easterbrook & Fischel, supra note 2, at 74. Because the American Stock Exchange currently allows firms to undergo a dual-class recapitalization, the transaction costs involved in a delisting are not thought to be extreme.

Entrepreneurs that are not assured of collecting on their firm-specific human and capital investments because of governance structure limitations will hesitate to make these investments. Rules that limit the opportunities for flexible adjustment of governance structures to accommodate their needs weaken the incentives for entrepreneurs to make personal time and energy investment. As such, society as a whole loses.

An allocation of resources is Pareto-superior if it benefits one party without subsequently making another worse off. Richard A. Posner, Economic Analysis of Law 12 (3rd ed. 1986). See Walter Nicholson, Microeconomic Theory: Basic Principles and Extensions 476 (1989); Vilfredo Pareto, Manuale Di Economica Politica (1909). An alternative, Kaldor-Hicks efficiency, also called potential Pareto-superiority, asserts that a transaction is beneficial, even if some individuals are made worse off, so long as those who benefit gain enough to compensate the losses sustained by others. Posner, supra, at 12-13. Whether they actually compensate for such losses is of no consequence. Id. at 13. Because the conditions for Pareto-superiority are almost never satisfied in the real world, the operating definition of efficiency in economics is generally not Pareto-superiority, but Kaldor-Hicks efficiency. Id. As such, it is also a less controversial notion of efficiency. Id. at 13-14. See Ronald J. Gilson, The Law and Finance of Corporate Acquisitions 507 n.6 (1986). See generally B. Lockwood, Pareto Efficiency, in 3 The New Palgrave: A Dictionary of Economics 811 (John Eatwell et al. eds., 1987).

Cf. Hu, Shareholder Welfare, supra note 7, at 1276-86 (discussing corporations' pecuniary goals). There are three primary conceptions of the basic pecuniary goals of the corporation. Id. The first, and traditional conception, is based on the premise that what is good for the corporation is good for the shareholders. Id. at 1279. Consequently, if corporate welfare is furthered, such as through increased earnings per share, shareholder welfare is presumed to be furthered as well. Id. Under the second conception, shareholder wealth maximization is sought directly, rather than as a by-
However, the support necessary to encourage efficient ownership structuring has not been forthcoming. Courts, regulators, and federal and state legislatures have placed various impediments on leveraged buyouts and restructurings, takeovers, and equity restructurings. On the premise of corporate democracy and representations of residual theory, the Securities Exchange Commission ("SEC") and the National Association of Securities product of corporate welfare, by pursuing those actions which increase shareholder dividends and stock prices. Id. at 1282. There is no focus on measures of corporate performance and no concern for the corporation independent of the welfare of the stockholders. Id. The third conception calls for managers to maximize what the shareholders' wealth would be, if the stock market were perfectly omniscient and rational. Hu, Shareholder Welfare, supra note 7, at 1285. Under this theory, managers are asked to ignore blissfully the irrationality and informational problems associated with real stock markets and to decide corporate matters regardless of possible adverse stock market reaction. Id. at 1285-86. The efficiency analysis for dual-class stock and its use in ownership structuring holds true through the three above-mentioned pecuniary goal systems historically applied to the corporation. As Henry Hu has noted, however, "[t]he simple cumulation of different types of interstitial products and multiple classes of securities with maximization rights as well as the increasing part they play in corporate capital structures now put far heavier burdens on a weak tripartite theoretical structure." Id. at 1293; see id. at 1278-86 (extensively explaining these conceptions as goals of modern publicly held corporations).


34 EASTERBROOK & FISCHEL, supra note 2, at 67.

[S]hareholders are the residual claimants to the firm's income. Creditors have fixed claims, and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line. As the residual claimants, shareholders have the appropriate incentives (collective choice problems notwithstanding) to make discretionary decisions. Shareholders are the only voluntary constituency whose relationship with the firm does not generally come up for periodic renewal.

WILLIAMSON, supra note 15, at 304.

Labor suppliers in the intermediate product market, debt-holders, and consumers can negotiate the terms of their relationship when contracts are renewed. Id. Sometimes, however, the contract between shareholders and the firm is adjusted by making changes in the corporate charter. Id. at 305 n.9. But these changes are generally initiated by management. Id.
Dealers ("NASD") have similarly obstructed transactions in voting rights. Currently, two of the three major exchanges have listing standards that reflect almost a complete one-share, one-vote standard. The restrictive listing standard of the NASD (for NMS securities) reversed a long-standing policy of unrestrictive regulation of dual-class stock. Only the American Stock Exchange ("AMEX") has listing standards in place that expressly allow for disparate voting recapitalizations, although prohibitory uniformity exists in regard to nonvoting common-stock issues.

This Article critically analyzes the current policy positions of the SEC, the NYSE, and the NASD (for NMS securities), which administers the National Association of Securities Dealers Automatic Quotation System ("NASDAQ"). In addition, some of the smaller self-regulatory organizations ("SROs") have recently accepted the restrictive dual-class policy proposal advocated by the North American Securities Administrators Association ("NASAA") as their own. For example, the Pacific Stock Exchange has submitted a proposal to the SEC with the intention of implementing listing standards that follow the position of NASAA. Thus, my critique also includes the Pacific Stock Exchange. Relying on data that indicate what type of firms are likely to utilize dual-class common stock, I postulate that the NASDAQ (for NMS securities), the smaller SROs, and the state securities administrators should adopt or accept the dual-class standard recently proposed by the

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35 Two SEC commissioners have asserted: "Voting rights are fundamental rights." Letter from Mary L. Schapiro and Richard Y. Roberts, Commissioners, SEC, to James R. Jones, Chairman, American Stock Exchange (Apr. 9, 1991) (on file with the author).

36 See Lowenstein, supra note 33, at 982. The NYSE has chosen not to strictly enforce its standard, opting instead for a case-by-case system of review. It should be noted that while one share, one vote gives shareholders the ability to monitor managers in direct proportion to their stake in the venture, it has been recognized that a one share, one vote rule does not assign effective votes in direct proportion to shares, since under a majority rule someone with 50.1 percent of the shares has 100 percent of the effective voting power. See Sanford J. Grossman & Oliver D. Hart, One Share—One Vote and the Market For Corporate Control, 20 J. Fin. Econ. 175, 176 n.1 (1988).

37 See National Association of Securities Dealers, NASDAQ FACT Book and Company Directory 4 (1993). NMS securities are traded on the National Market System of the NASDAQ. Id. at 38. These securities are regulated differently than NASDAQ Small Cap Securities. Id. at 143.

38 See Lowenstein, supra note 33, at 979.

AMEX or the principles contained in the draft form of the NYSE proposal as their own. The recommendations that the AMEX and NYSE proposals set forth are further supported by recent developments in corporate finance and corporate governance. For instance, the increasing activism of institutional investors in matters of corporate governance and the increasingly innovative changes regarding debt and equity instruments have made reevaluation a necessity.


41 AMEX Files Proposal With SEC on Disparate Shareholder Voting Rights, 23 Sec. Reg. & L. Rep. (BNA) 906 (June 14, 1991). Under the AMEX proposal, a corporation could issue multiple classes of stock with disparate voting rights provided it obtained either a two-thirds approval of all shareholders or a majority vote of all shareholders unaffiliated with management or other controlling shareholders. Id.

42 See William J. Baumol & J. Gregory Sidak, Toward Competition in Local Telephony 130-35 (1994); J. Gregory Sidak, Review Essay, Telecommunications in Jericho, 81 Cal. L. Rev. 1203, 1216-22 (1993). Deregulation in certain industries may force dual-stock reclassification as well. See, e.g., Baumol & Sidak, supra; Sidak, supra. For example, the seven regional Bell operating companies (RBOCs) traditionally have been prohibited from unregulated markets to avoid predatory pricing and cross-subsidization. Baumol & Sidak, supra, at 130-31; Sidak, supra, at 1216. Predatory pricing will allegedly result if a rate-regulated monopolist enters a competitive market because it will underprice its rivals and drive them out of business. Sidak, supra, at 1216. Cross-subsidization is the predicted result when a RBOC acquires control of an unregulated firm that manufactures telecommunications equipment. Baumol & Sidak, supra, at 131. The RBOC will be tempted to make expenditures that would benefit its manufacturing affiliate, but would be at its own expense. Id. If the regulator is convinced that these expenditures are legitimate costs of the RBOC activity, then he may permit the RBOC to recover the cost by an increased exercise of market power. Id.

However, because of the loss of RBOCs' knowledge and services resulting from the restrictions, a "bifurcation rule" has been proposed. Baumol & Sidak, supra, at 132-34; Sidak supra, at 1217-19.

The RBOCs seek to enter adjacent markets themselves, rather than sharing, through confidential technology-licensing agreements, proprietary information with separate firms that are not local exchange carriers. The RBOCs . . . argue[e] that control by their management is necessary to exploit fully the RBOCs telecommunications knowledge. The bifurcation rule permits an RBOC to enter a currently-prohibited market, but only through a separate, publicly traded corporation having two classes of stock—one with voting rights but with a negligible claim to the affiliated corporation's residual net cash flows, the other with negligible (or no) voting rights but with a claim to virtually all the affiliate's residual net cash flows. While this capital structure permits the RBOC to exercise management control over the unregulated affiliate, it still undermines the RBOC's ability to benefit from cross-subsidization and predation.

Baumol & Sidak, supra, at 132-33.
I. Dual-Class Variations and the Context in Which They Are Used

A. Dual-Class Mechanisms

A dual-class recapitalization begins with a charter amendment that must be approved (as all charter amendments must be) by the voting shareholders. Once approved, an assortment of mechanisms are available to facilitate the voting-rights exchange. Four methods have commonly been used: exchange offers, special distributions, voting-right alterations, and new public offerings. Dual-class common stock that is distributed by way of an IPO, or through a stock dividend to existing shareholders, is generally not considered disenfranchising. Thus, its use is viewed less skeptically and will only be discussed briefly. My focus will instead

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43 See Ronald J. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807 (1987). This article became the basis for many of the solutions recommended by SEC Rule 19c-4. In particular, the SEC followed Gilson's conclusion that there is a major conceptual distinction between nonvoting, or low-voting, shares issued to existing shareholders in exchange for shares already outstanding and the issuance of such shares in an offering to the world at large. Id.

44 See Jeffrey N. Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Cal. L. Rev. 3, 40-42 (1988) (consisting of basis for first three methods described in Part II of this article); George W. Dent, Jr., Ancillary Relief in Federal Securities Law: A Study in Federal Remedies, 67 Minn. L. Rev. 865 (1983) (consisting of basis for fourth method described in Part II of this article).
be on “dual-class recapitalizations,” which are considered disenfranchising.

It should also be noted that dual-class charter amendments sometimes do not call for immediate implementation. Instead, shareholders provide management with the power to install a dual-class capital structure at some future date without the need for further shareholder approval. When implementation is delayed, the dual-class-stock proposal appears closely analogous to poison pills, a popular and effective antitakeover mechanism. Similarly, management can be granted the right to issue preferred shares at will with the prerogative to establish the voting rights when the shares are issued. These so-called ‘blank check preferred’ shares allow enormous voting power to be conveyed to ‘friendly parties’ [or white knights] to prevent existing shareholders from consolidating power.” Because of this similarity and the general effects dual-class stock has on the governance relationships in firms, dual-class-stock use is commonly associated with corporate takeovers and takeover defenses. Thus, this section will also discuss relevant corporate control implications where appropriate.

45 Sander, supra note 13, at 4. These provisions occurred with unprecedented frequency during 1986 when many companies rushed to get authorization in anticipation of Rule 19c-4.

46 The poison pill enables incumbent boards to thwart a potential acquirer’s direct appeal to the shareholders through a tender offer by issuing shareholders certain rights to acquire additional company stock at a significant discount to its market value. Sander, supra note 13, at 4. Poison pills are implemented without a shareholder vote. Id. The rights are triggered when a party acquires or offers to acquire a significant block, usually 20 to 30 percent, of the company’s stock. Id. All shareholders, except the party causing the triggering event, are entitled to exercise these rights. Id. The effect is to dilute massively the potential acquirer’s interest and greatly increase the bidder’s acquisition costs. Id.; see also Jeffrey MacIntosh, The Poison Pill: A Noxious Nostrum for Canadian Shareholders, 15 Can. Bus. L.J. 276 (1989) (providing general discussion and critique of those plans); see Klein, supra note 18, at 137 (discussing use of poison pills). Poison pills are often called “Preferred Share Purchase Rights Plans” and their use as an antitakeover deterrent has been upheld by the Delaware Supreme Court as a legitimate exercise of business judgement. See Moran v. Household Int’l, Inc., 500 A.2d 1346 (Del. 1985) (involving plan adopted as defensive mechanism to ward off possible future advances, not in reaction to specific threat).


48 Id.
1. Exchange Offers

For a recapitalization to be implemented by way of the exchange-offer method, the firm's voting shareholders must first authorize a new class of common stock carrying several votes per share.\(^{49}\) Each shareholder then becomes free to accept or reject the offer on a share by share basis. This is accomplished by voting to exchange existing common shares for low-vote shares (often called Class B) or by electing to keep the preexisting shares now designated as supervoting shares (often called Class A).\(^{50}\) The exchange can also be structured so that shareholders must opt into the higher voting shares.\(^{51}\) Often the supervoting stock receives reduced dividend rights in return for the increase in voting rights, or the low-vote shares simply receive an increased dividend right.\(^{52}\) Generally, the supervoting shares are nontransferable unless the transfer involves family members or trusts of the beneficial owner.\(^{53}\) Impermissible transfers result in a conversion of supervoting shares into ordinary voting shares.\(^{54}\)

Ordinarily, the supervoting common stock votes with the low-vote common shares in traditional matters that come before the shareholders, such as a merger, a sale of substantially all the assets, charter amendments, and director elections.\(^{55}\) Exchange offers, however, may also be structured so that certain specified events may only be voted on by the class of shareholders holding either low-vote Class B or high-vote Class A shares. Such provisions may take the place of increased dividend rights or simply serve to lower the dividend increase incrementally.

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\(^{49}\) Gordon, supra note 44, at 40. A ten to one ceiling in voting rights disparity has been frequently used in modern day dual-class transactions. \(Id.\)

\(^{50}\) See Bainbridge, supra note 39, at 572; Simmons, supra note 26, at 110-11.

\(^{51}\) See Letter from Eli Broad, Chairman of the Board, Kaufman and Broad, Inc. to Shareholders of Kaufman and Broad, Inc. (June 19, 1985) (on file with the author).

\(^{52}\) See Bainbridge, supra note 39, at 573.

\(^{53}\) Id. at 572.

\(^{54}\) Gordon, supra note 44, at 40 n.131. It has been noted that because of the non-transferability of the super-voting shares, agency costs are kept at a minimum because only those who invest the capital necessary to acquire a dominant position in the corporation have a right to control the corporation. Flocos, supra note 10, at 1798; see Zetlin v. Hanson Holdings, Inc., 387 N.E.2d 387 (N.Y. 1979). Others hold that agency costs rise because dual-class stock allows supervoting control shareholders to extract control rents from the firm's cash flows rather than using it to increase the value of the firm, and thus increase the value of all the common shares. See Flocos, supra note 10, at 1798.

\(^{55}\) Cf. 1 GEORGE D. HORNSTEIN, CORPORATION LAW AND PRACTICE § 126 (1959) (discussing voting powers of shareholders).
For example, the E.W. Scripps Company implemented a capital structure that included two classes of common stock, one of which (Class A) is entitled to vote only on matters required by Delaware law, and can only elect the greater of three or one-third of the directors of the company. The other matters are voted on only by the shareholders who hold the Class B stock, which in this instance constitute the high-voting shares. Both classes of stock are held primarily by The Edward W. Scripps Trust.

Incentives to exchange stock may also be provided by firms to holders of existing stock. For example, the exchange offer may designate an exchange ratio greater than one-to-one; that is, one share of supervoting stock may be worth 1.1 shares of limited voting stock. In fact, various types of incentives can be included in the dual-class mechanisms as well, tailoring each restructuring to the specifics required by the parties involved. These incentives

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57 Id.
58 At the end of 1992, The Edward W. Scripps Trust owned 67.6 percent of the Class A common and 79.5 percent of the common voting stock of the company. Id. Another example is supplied by the Fedders Corporation, which has a dual-class structure that includes Class B stock entitling holders to ten votes per share in the election of directors if more than 15 percent of the shares of common stock outstanding on the record date are beneficially owned by a person or a group of persons acting in concert, or if a nomination to the board is made by a person or group of persons other than the board of directors. The Fedders Corporation, 1990 Proxy Statement 1 (1990). The Class B stock has one vote in all other matters. While there is no established public trading market for the Class B stock, the Class A stock is listed on the NYSE and the Philadelphia Stock Exchange. The Fedders Corporation, 1992 Annual Report 12 (1992). The Fedders dual class structure also includes a provision requiring the holders of Class A and Class B stock to vote together as a single class on all matters except those involving business combinations, additional issuances of Class B stock made in connection with stock splits and dividends, and any amendments to the certificate of incorporation. Id. As per corporate distributions, the Class B stock is entitled to dividends 11.11 percent lower than those declared on the existing common stock. Id. The end goal of the Fedders dual class structure is that the Fedders family, holders of 21.12 percent of the existing common stock, receive exclusive post recapitalization veto power over proposed business combinations and other specified transactions.
59 Simmons, supra note 26, at 111 n.32.
60 Id. A company could reclassify the old common shares as an equal number of Class A and B stock and require the stockholder to opt out of Class B. Id. Alternatively, a company could restrict the voting power of shares until they have been owned continuously for a specified period of time. Id. A company could also offer a premium to those who relinquish their voting shares immediately. Id. at 111 n.33.
often compel observers to view the initial shareholder vote on the recapitalization as coercive.\textsuperscript{61}

Exchange offers became increasingly popular after 1984, when they accounted for 46% of the recapitalizations in one sample, as compared with only 18% from 1976 to 1984.\textsuperscript{62} Because of the disenfranchising effects associated with exchange-offer recapitalizations, however, SEC Rule 19c-4 was adopted to prohibit recapitalizations of this type.\textsuperscript{63}

2. Special Distributions

When the firm structures the recapitalization as a special distribution, a charter amendment approved by the shareholders starts the process.\textsuperscript{64} Special distribution supervoting stock will, however, generally receive the same dividend rights as the low-vote common stock. This marks a significant difference from the exchange-offer recapitalization discussed above. Special distribution recapitalizations also do not require any unusual shareholder decision making (other than ordinary decisions to buy, hold, or sell) once the two classes of common stock are authorized. The new common shares are simply distributed to the common shareholders on a one-for-one ratio.\textsuperscript{65} As such, the distribution has no immediate effect on the voting relationships within the entity.\textsuperscript{66} The potential for change lies within the transfer limitations placed on the stock.\textsuperscript{67} The concentration of voting power begins as shareholders dispose of supervoting shares because selling violates the transferability restrictions attached to each share; thus, upon sale, the supervoting stock automatically converts into ordinary common stock. Over time, as public investors adjust their


\textsuperscript{62} Jarrell & Poulsen, supra note 13.

\textsuperscript{63} Id.; see O’Neil, supra note 33, at 1058 n.7. SEC Rule 19c-4 prohibits the “issuance of disparate voting right stocks pursuant to an exchange offer . . . structured as a ‘one time opportunity to receive less than full voting rights stock in exchange for shares of the existing class of common stock.’” See generally infra notes 108-89 and accompanying text (discussing Rule 19c-4 and historical context in which Rule 19c-4 was proposed).

\textsuperscript{64} See Gordon, supra note 44, at 41.

\textsuperscript{65} Id.

\textsuperscript{66} Id. at 41-42.

\textsuperscript{67} Bainbridge, supra note 39, at 572-73.
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portfolios by selling out of the company, the number of supervoting shares held by non-insiders falls. 68

3. Voting Rights Alterations

Under a plan to alter voting rights, two classes of stock each acquire a designation based on the length of time the shares are held — “long term” or “short term.” Long-term shares are defined as those acquired before the date the charter amendment is approved and held continuously thereafter, or shares subsequently purchased and held for a designated period of time, typically forty-eight months. 69 All other shares are considered short term. 70 Both long-term and short-term shares participate equally in dividend distributions. Transfers that violate any stated transferability restrictions convert a long-term designation to short term, thereby divesting shares of their supervoting rights. 71 Thus, rather than an instantaneous transfer of voting power occurring on the date of the amendment, the transfer occurs gradually.

This technique is unique, however, in that shareholders who do purchase after the amendment are not forever prohibited from owning supervoting shares. 72 Rather, shareholders need only purchase and subsequently hold shares for the designated time period to obtain the high-vote designation. 73 As such, the voting rights attached to shares shift back and forth as shares are bought, sold, and held. 74 Because potential suitors must wait for a prescribed period of time before their stock attains supervoting status, they must either acquire an extremely large number of the outstanding low-vote shares to gain control 75 or wait the length of time required to procure the supervote designation. 76 Although

68 Id.; see Gordon, supra note 44, at 41-42 (reviewing special distribution method).
69 Gordon, supra note 44, at 42.
70 Cf. id. (defining “long-term” shares)
71 Id.
72 See id.
73 See id.
74 See Gordon, supra note 44, at 42.
75 Bainbridge, supra note 39, at 574.
76 See Gordon, supra note 44, at 42. Because such shares only have meaningful voting rights after they have been held for the stated period of time, it seems that time based dual class plans may raise some interesting issues under the Williams Act. See Securities Exchange Act of 1934, 15 U.S.C. § 78 (1988). For instance, when does a shareholder meet the 5 percent threshold that triggers disclosure obligations? See id. § 78m(d). In addition, commentators and the D.C. Circuit Court have identified language contained in the Securities Exchange Act of 1934 as harboring potential
this method is not as effective in avoiding hostile takeovers as the exchange-offer or special-distribution recapitalizations, this delay itself is a serious deterrent.

Plans to alter voting rights have been introduced in a multiplicity of formats, often implemented when the firm initially goes public. For example, Roper Industries, Inc., adopted a dual class capitalization whereby the new limited voting shares sold to the public (characterized as “phased-voting common”) were entitled to one vote per share for four years, after which the voting rights would increase to five votes per share. Those holding Roper stock prior to the new offering were immediately vested with five votes per share, thus conferring control to insiders for at least the four-year period immediately following the initial public offering.

Rule 19c-4 expressly prohibited any dual-class transactions under which shares acquire additional voting rights if held for particular periods of time.

4. New Public Offerings

A public company that decides to raise capital by using dual class common stock can simply issue a new class of common stock with limited voting rights, rather than recapitalize. As long as the characteristics of the shares are properly disclosed and any relevant preemptive rights are honored, the issue is unexceptionable. Professor Dent explains:

Potential investors can appraise the new stock as well as any other; they are no more likely to pay more than the stock merits than they would be in any other case. Nor would existing shareholders be injured. If they feel that the offering price of the new stock is too low, they can protect themselves by buying some of it, just as they could with a new issue of preferred stock or debentures . . . Management has no reason to offer the new stock to


77 Ready for Trouble, Mergers and Acquisitions, May/June 1993, at 38.

78 Id.

79 Seligman, supra note 33, at 741. This is the most popular method. Of the 87 firms who announced the creation of dual-class-common stock in the period 1976 through May of 1987, this method accounted for 53 of the issues, followed by 34 by exchange offer, and 8 based on length of time or voting rights alteration. Jarrell & Poulsen, supra note 13, at 135.
the public at an inadequate price or to use the new issue to injure
the corporation . . . . Management would [only] have to be pre-
vented from allotting itself a disproportionate share of the new
stock at an inadequate price. . . .

Similarly, a company can simply create voting and nonvoting
shares rather than accord superior voting rights to one class, un-
less state law requires that at least one vote be attached to each
share. This method of positioning nonvoting stock into public
hands was permitted under Rule 19c-4 but is disallowed by the
exchanges, the smaller SROs, and state securities administrators
because of the nonvoting designation.

5. Initial Public Offerings

Initial public offerings, whereby common stock with limited
voting rights is initially issued to the public or reissued after a
privatizing transaction such as a leveraged buyout, are the chief
mechanisms by which dual-class common stock ends up in the
hands of the general public. For example, the following companies
have recently gone public with two classes of common stock:

Ampex Inc., Automotive Industries Holding, Burlington Indus-
tries, Cone Mills, Finish Line, [Nextel (formerly, Fleet Call)],
Granite Broadcasting, Infinity Broadcasting, International Fam-
ily Entertainment, John Nuveen, Kemet Corp., Lida Inc.,
Meadowbrook Rehabilitation Group, Petroleum Heat & Power,
Quantum Restaurant Group, Reliance Electric, RHI Entertain-
ment, Saga Communications, Scholastic Inc., and Universal Hos-
pital Services.\footnote{Specifically, the SEC}

Rule 19c-4 was based on the processes that created dual-class
stock and not necessarily the end result.\footnote{See Ready for Trouble, supra note 77, at 38.}

\footnote{Seligman, supra note 33, at 741.}
\footnote{Simmons, supra note 26, at 111 n.32. Of note is a recent plan, adopted by Cannon Express (NASDAQ: CANX), in which a dual-class plan was enacted through a two-for-one split, which established a new class of non-voting stock. Cannon Express Board of Directors Approves Dual Class Stock Plan, PR Newswire, Oct. 21, 1992, available in LEXIS, News Library, PRNEWS File. Under the plan, the company's existing common stock was reclassified as Class A voting stock, and one share of non-voting Class B stock was distributed for each share of voting stock outstanding. Id. The plan received the approval of the NASDAQ primarily because the plan does not change the relative voting power or equity position of any existing shareholder. Id.}

\footnote{See Lowenstein, supra note 33, at 987. But see Flocos, supra note 10, at 1787 (“[T]he actual thrust of Rule 19c-4 involves effects, not process, and that with a few narrow exceptions, all processes that create dual class stock are prohibited. Process is in fact ultimately irrelevant in Rule 19c-4 . . . .”).}
believed that the IPO process was not disenfranchising and chose not to place restrictions on dual-class-stock capitalizations. The SEC instead focused on recapitalizations that actually changed the status of current shareholders. Historically, the NYSE listing standards have similarly exempted initial public offerings of limited-voting-rights common stock from the normal prohibitions associated with its use, although, as mentioned earlier, a complete ban on common stock with nonvoting rights has been continually enforced, regardless of the offering process involved.

Putting the dual-class structure in place at the outset allows founding entrepreneurs or family members access to the equity markets without diluting control. The penalty is a lower per-share value for the issued shares than would otherwise be the case if votes were included, thus, the newly public company suffers an increase in its cost of capital. Putting the dual-class format in place at this stage also allows for an effective takeover defense that negates potential overtures from the corporate control markets and the potential control premiums that can follow.

Yet, regardless of the method by which a firm implements a dual class structure, dual-class use is consistently associated with the broader category of takeover defenses. The connection is certainly not inappropriate. As such, this Article shall include a summary of dual-class use and its association with the market for corporate control.

B. Dual-Class Stock and the Market for Corporate Control

Firms constantly evolve as "they change their structure—setting up new divisions, entering or leaving markets, buying or selling plants, acquiring or being acquired, increasing or decreasing leverage, going public or private, selling stock or buying it back (generally or from particular investors) . . . changes [we call] cor-

84 See Adopting Release, supra note 12, at 89, 218-19 (claiming Rule 19c-4 focuses only on process by which disparate voting plans are created and their effect on existing shareholders).
85 See Adopting Release, supra note 12.
86 See Gilson, supra note 43, at 808 n.3.
porate-control transactions." At the same time, the larger corporate control market also evolves.

The influence that corporate-control transactions have on agency costs and efficiencies is widely known. Specifically, if superior managers obtain control of a firm's assets, or if the shareholders alter the incentive structure of existing managers, effi-

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87 Easterbrook & Fischel, supra note 2, at 109. Shareholder voting power can be aggregated into a control block through a purchase of shares by a bidder, who thereby acquires a sufficient economic interest in the firm to make active monitoring worthwhile. If the buyer improves the firm through displacement or other change in management, it reaps a benefit as the stock price rises to reflect the improvement. This is the so-called market for corporate control. Henry N. Butler & Larry E. Ribstein, The Corporation and the Constitution 12 (1994). This market is associated with large benefits to shareholders and firms alike. Merged firms often show significant improvements in asset production relative to their industries which result in higher operating cash flows. Additionally, mergers usually do not lead to cuts in long-term capital or research and development expenditures. There is also a positive relation between postmerger increases in operating cash flow and abnormal stock returns at merger announcements, indicating that expectations of economic improvement underlie the equity revaluations of the merging companies. Paul M. Healy et al., Does Corporate Performance Improve After Mergers? 31 J. Fin. Econ. 135, 137 (1992).

88 The evolution is inevitable because the control market is dominated by forces that are financial (for example, the ratio of value given firms in the marketplace in comparison to book value) and legal (for example, the receptivity of lawmakers—both judicially and legislatively, to takeover activity and innovation), and is chiefly defined by the creativity of the participants because advances in finance theory and takeover law often define the parameters of whom an acquirer or target will be and how well targets can be defended. Each of these attributes is itself characterized by instability.

89 While tender offers, merger bids, and proxy contests enable outsiders to obtain control with the idea of capturing gains from implementing an improved set of investment and financing decisions, this does not mean that all corporate control transactions produce gains. Ronald C. Lease et al., The Market Value of Differential Voting Rights in Closely Held Corporations, 57 J. Bus. 443 (1984). As Easterbrook and Fischel explain,

[Organizational changes come with no more guarantees than do new plants and products. Any innovation may flop. Some changes in control may be attributable to self-aggrandizement rather than to gains in the use of the acquired firm's assets. If one firm wants to squander its money away by paying too much for control, managers have no duty to turn the money away: an auctioneer does not stop the auction at the "right" price in order to protect bidders from paying too much.

Easterbrook & Fischel, supra note 2, at 115. In a dual-class transaction, shareholders will not freely give up their vote; they will expect some value in return. The value can be in the form of dividends, or may be more abstract (for instance, a realization that the firm needs to initiate more investment of firm-specific human capital than is currently possible under the existing structural framework). Managers involved in such an exchange can pay too much, whether it be in the form of dividends, of making their investment in the firm less liquid, or by raising the cost of capital to the firm and thus lowering the values attached to the shares they own.
ciencies as well as decreased agency costs may result. Two transactions that have been designed to meet these ends are leveraged buyouts ("LBOs") and dual-class recapitalizations.

Much of the literature on dual-class recapitalization, however, has focused on its use as an antitakeover device (generally thought to be value decreasing) rather than on its use as a method of achieving Pareto optimalities (value increasing). LBOs, like dual-class recapitalizations, have been discussed under a similar perspective.

Such treatment is inappropriate. Kenneth Lehn, Jeffrey Netter, and Annette Poulson explain that "[b]oth [transactions] are antitakeover devices in that they can be motivated by the threat of a takeover by outsiders. Similarly, both are a form of takeover, since both involve a 'takeover' of voting control." Each transaction also has more tangible similarities. Each consolidates control among a relatively small, well-defined group and alters the relationships within a firm. For our discussion, however, the significance of each transaction lies in the real differences that remain between them. Specifically, the LBO consolidates control in a small group of individuals who immediately end up with the residual claims and the voting rights of the firm. By contrast, dual-class recapitalizations give voting control to a small group of shareholders by increasing the voting rights attached to their common shares without simultaneously increasing their claims to the residual interest. In fact, the residual interest held by the small group often decreases post-recapitalization. Moreover, depending on the format chosen for implementation, the voting power shift in the dual-class transaction may not occur for some time, while the control shift in an LBO is immediate once shares are tendered.

These differences are important because they have consequences for the manager-agent relationship they are designed to disrupt. For example, in an LBO, the capital needed to purchase the outstanding shares comes exclusively from inside sharehold-

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90 Easterbrook & Fischel, supra note 2, at 112.
92 Id.
93 See, e.g., Springs Industries Inc. Proceeds with Stock Offering, BUSINESS WIRE, Feb. 7, 1989. After a secondary public offering of 2 million shares of Class A common stock, the Close family percentage ownership in Springs Industries, Inc. was reduced from 57.7 percent to 46.3 percent. Id.
ers and a vast array of bondholders. In addition, investment banks often supply to the acquiring group "bridge loans," mezzanine financing, and other senior debt. The inside shareholder group holds the voting power, while the bondholders receive protection through explicit promises contained in bond indentures and possibly equity options in the form of warrants. As such, barring any special approval rights bondholders may have specifically contracted for or equity interests banks may have accepted, agency costs are virtually nonexistent in a post-LBO firm. In comparison, agency costs remain in the dual-class firm after the transaction; whether they rise or fall depends on the characteristics of the individual firm and the attributes of the supervoting shareholders.

Important capital-structure differentiations are also evident. While dual-class recapitalizations have no direct effect on leverage, LBOs result in dramatic increases in leverage. Increases in leverage decrease the leveraged firm's decision-making flexibility, although the decision-making process itself becomes streamlined. In dual-class firms, the effects are quite different. By reducing management's accountability to shareholders, high-vote holders enjoy an increased level of flexibility in their decision making.

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94 See Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, 13-15 (1987). Bridge loans are loans intended to serve as interim financing, lasting only until the companies can find more permanent capital. Bridge loans are funded by commercial bank loans, the sale of junk bonds or notes, or the sale of target company assets. See id. Upon obtaining permanent financing, the borrowers repay the loan. See id. Bridge loans led to billions of dollars of losses in the late 1980s. See Caren Chesler, Executive Update; Business Abroad, INVEST°rs Bus. DAILY, Sept. 23, 1993, at 4; Jacqueline Doherty, Bridge Loans, Bane of the '80s, Creep Back, CORP. FIN. Wk., May 10, 1993, at 1.

95 Easterbrook & Fischel, supra note 2, at 6.

96 Research has found a median increase in leverage from 27 percent to 89 percent of the total capital structure following an LBO. Laurentius Marais et al., Wealth Effects of Going Private for Senior Securities, 23 J. Fin. Econ. 155, 155-56 (1989). In addition, debt to equity ratio increases from 0.457 to 5.524 percent (on average) have been reported. See Kenneth Lehn & Annette Poulsen, Free Cash Flow and Stockholder Gains in Going Private Transactions, 44 J. Fin. 771 (1989). If shareholders were entitled to appraisal rights when a dual-class recapitalization is approved by the board and other shareholders, these results might be different. Regulatory models that have included an appraisal right remedy have been suggested. See Flokos, supra note 10, at 1800-14. To date, however, models formulated by regulatory bodies and exchanges have not included an appraisal remedy. The effect of leverage on shareholder optimality of corporate investment is controversial. Hu, Corporate Investment, supra note 5, at 344-46 nn.195-200; see also The Economic Consequences of High Leverage and Stock Market Pressures on Corporate Management: A Roundtable Discussion, J. Applied Corp. Fin., Summer 1990, at 6.
The decision process becomes constrained solely by the state law's fiduciary standards and whatever policing power that product and capital markets can provide.\textsuperscript{97}

Moreover, the dual-class transaction is more easily executed; finding the necessary votes to amend the charter is more palpable to most management teams than raising the large sums of money needed to purchase the firm's outstanding shares. In addition, because of the low costs involved (at least in comparison with LBOs), the dual-class recapitalization is a more practical device when utilized defensively. When implemented at the time of the initial public offering, the cost to the firm is negligible; the effects are only reflected in the lower offering price shares fetch when the value is discounted by the absence of a control premium.

Regardless of what stage of development the corporation is in when the dual-class structure is adopted, the effectiveness of dual-class stock as a takeover defense is widely accepted.\textsuperscript{98} It has been said that nothing else comes close, notwithstanding state antitakeover statutes and poison pills.\textsuperscript{99} While such sentiments are not entirely correct (for example, some of the time-based plans are not ultimate bars to hostile advances), the effect of dual-class stock can be extraordinary. Similarly, the LBO is regarded as an extraordinarily effective defensive technique.\textsuperscript{100}

The effectiveness of the dual-class recapitalization after a hostile advance has been commenced is, however, much weaker. In fact, if instituted after a hostile advance, the recapitalization is likely to receive serious scrutiny from the courts.\textsuperscript{101}

\textsuperscript{97} The inflexibility is a result of the fixed nature of debt obligations.

\textsuperscript{98} Dual-class recapitalizations concentrate the voting power in a group of insiders, which effectively blocks all hostile takeover attempts. To complete a hostile takeover, the "bidder must either replace the target's board of directors or merge with the [target] firm." Richard S. Ruback, Coercive Dual-Class Exchange Offers, 20 J. Fin. Econ. 153, 156 (1988). Both of these avenues are foreclosed by dual-class plans because the voting rules generally follow one of two patterns which ensure insider veto power: (i) plans in which both classes vote together to elect directors, and (ii) plans in which the classes vote separately to elect different directors. . . ." Id. Therefore, dual class plans may be the most effective universal antitakeover device ever invented." Id. Supermajority clauses can further reduce the number of shares required for veto power. Id.

\textsuperscript{99} Lowenstein, supra note 33, at 984; see Gordon, supra note 44, at 4 ("If management and its allies hold the voting stock necessary to elect directors, a hostile bid becomes practically impossible."); RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 147 (Foundation Press Supp. 1991).

\textsuperscript{100} It is also extremely expensive and disruptive by definition.

\textsuperscript{101} See Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (enjoining issuance without stockholder approval of supervoting pre-
The dissimilarities surrounding these two transactions do not end with the structural differences between them. Lehn, Netter, and Poulson, who studied 380 firms that either adopted a dual-class recapitalization or went private through an LBO from 1977 through 1987, found certain defining attributes that distinguish dual-class firms from their leveraged-buyout counterparts and more traditional targets. These attributes include: higher growth rates both before and after recapitalization; significantly higher ratios of research-and-development expenditures to sales-and-advertising expenditures (a result consistent with a growth hypothesis); significantly higher market-to-book ratios; and significantly lower pre-transaction tax liabilities. The last two of these are commonly regarded as antithetical to firms traditionally thought of as being susceptible to leveraged buyouts or takeovers.

Noting the effectiveness of LBOs and dual-class recapitalizations in shielding a firm from takeover and recognizing the increase in LBOs and dual-class use in the 1980s, commentators have frequently regarded each as unnecessary evils, chiefly because of their inherent disenfranchisement. In fact, the availability of other defenses that result in less management control is often held out as evidence that the purpose of the dual-class recapitalization is management entrenchment. In light of this connection, it also has been said that Rule 19c-4 was effectively the first substantive federal regulation of corporate takeover defenses because its design precludes those disparate voting-rights plans that most resemble a takeover defense.

In theory, the takeover rationale is indeed forceful. And while this observation may be theoretically enticing, the empirical evidence indicates that the emphasis is mistaken because, as previously mentioned, firms involved in dual-class recapitalizations

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102 Lehn et al., supra note 91, at 559.  
103 Id.  
104 Simmons, supra note 26, at 114.
generally have characteristics that are not commonly associated with target companies. As such, other reasons must have been behind the resurgence of dual-class common stock use in the 1980s.  

To address those and other issues associated with dual-class stock, it seems wise to put the subject into some form of historical context.

II. A BRIEF HISTORY OF VOTING RIGHTS AND DUAL-CLASS COMMON STOCK

Despite persistent calls for a comprehensive federal corporate statute, or at least federal minimum-standards legislation, and the increasing influence of the SEC on the shareholder-management relationship, voting rights are still generally governed by state law. While a survey of the specific regulation of voting rights under state corporate law is beyond the scope of this article, a brief analysis of the evolution of the one-share, one-vote proposition is appropriate.

Neither common law nor the state corporation statutes addressed the one-share, one-vote issue; corporations were required to follow a system of per capita voting—one vote per person rather than one vote per share. The common-law rule eventually became irrelevant as state legislators in the mid-1800s developed

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105 This is not to say that dual-class recapitalizations are never used as defensive measures; in fact, many companies openly admit such purposes. The Signal Apparel Company, Inc., adopted a plan that was expressly designed and advocated as a way to promote continuity of management by discouraging LBO's or other forms of hostile, non-negotiated takeovers of the company. The SIGNAL APPAREL COMPANY, INC., 1993 PROXY STATEMENT 1 (1993). But the marked increase in their use cannot be explained away by simple reference to takeover activity.


107 See Karmel, supra note 76.


109 For a more thorough examination of the history of one share, one vote, see Professor Joel Seligman's examination, supra note 33, on which my investigation chiefly relies.

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laws recognized as the precursors of today’s enabling statutes. In the beginning, these statutes generally followed a mixed proportionality theory of voting rights that authorized the issuance of a limited number of shares with proportional voting rights, with reduced voting power for the shares that exceeded some statutory minimum. States quickly abandoned the practice of mandated weighted voting, however, primarily because without a one-share, one-vote standard to placate large shareholders, corporations had difficulty raising capital. Thus, after 1860, more and more corporations shifted their voting structures to reflect the concerns of the entrepreneurs and controlling shareholders who were trying to raise capital and the larger stockholders who were not part of the control group but wanted, at a minimum, the theoretical policing power associated with the corporate vote. Eventually, a one-share, one-vote rule became so broadly accepted that as late as 1903, all preferred shares carried votes as well.

State corporation statutes of the period established the one-share, one-vote principle as a default rule. Thus, while dual class stock was not commonplace, its legality made it an accessible format for capital formation. In the twenty years that followed, corporate financiers began to take advantage of that accessibility and dual-class stock gained in popularity. While a variety of reasons have been noted for the preference for nonvoting stock

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111 Enabling codes are “corporation codes that supply standard contract terms for corporate governance, which function as default provisions in corporate charters that firms can tailor more precisely to their needs if they so desire.” ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1 (American Enterprise 1993).

112 See O’Neil supra note 33, at 1062; Kerbel, supra note 110, at 48.

113 See O’Neil, supra note 33, at 1062-63; see also Kerbel, supra note 110, at 48-49 (explaining reasoning behind change).

114 Kerbel, supra note 110, at 48.

115 Id. at 49; WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 85-86 (1927). While preferred shares continued to include voting rights equal to those of common shares in the early part of the century, corporations gradually began granting rights to preferred shares only in the event of certain contingencies (such as non-payment of dividends). See Bainbridge, supra note 39, at 568 n.12; Stevens, Stockholders’ Voting Rights and the Centralization of Voting Control, 40 Q.J. Econ. 353, 354 (1926). Today, it is common practice to grant preferred shareholders voting rights in the event of contingencies. Carey & Eisenberg, supra note 10, at 375-78.

116 Bainbridge, supra note 39, at 568. New York’s General Corporation Law of 1909, for example, entitled each shareholder to one vote per share “[u]nless otherwise provided in the article of incorporation.” Id. at 568 n.10 (citing 1909 N.Y. Laws, ch. 28, § 23, reprinted in J. ARNOLD, NEW YORK BUSINESS CORPORATIONS 39 (4th ed. 1911)).

117 See, e.g., Bainbridge, supra note 39, at 569; Kerbel, supra note 110, at 50 n.35; Stevens, supra note 115, at 353, 355.
during these years, one is quite pertinent even today: the desire of management to raise additional equity capital without diluting the voting position of certain shareholders. As the use of non-voting or limited voting common stock became prevalent, courts generally acquiesced in their issuance on the basis of the concept of freedom to contract. General public policy arguments in favor of a one-share, one-vote rule were not given much credence.

Public reaction, instigated by academics and government officials concerned with the growing power of the voting trusts and the investment banking community, was not nearly so accommodating. More specifically, in reaction to a sale by Dillon, Reed & Company of Dodge Brothers debentures, preferred, and nonvoting common stock (that enabled Dillon, Reed to retain voting control for itself), support for prohibition gained momentum.

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118 Kerbel, supra note 110, at 50 (citing Arthur S. Dewing, The Financial Policy of Corporations 163-64 (5th ed. 1953)). Nonvoting stock was popular in the early 1900s due to:

1. the investor-speculator's dual demand for a share in the huge profits earned by industry during the period and the appearance of security greater than that offered by the common share;
2. the desire of management to raise additional capital when it was easy to do so while retaining full control of the corporation; and
3. a vaguely felt or implied desire on the part of bankers and investors to have something new.

Id.


120 See Bartlett v. Fourton, 38 So. 882 (La. 1905); General Inv. Co. v. Bethlehem Steel Corp., 87 N.J. Eq. 234, 241 (Ch. 1917); St. Regis Candies v. Hovas, 3 S.W.2d 429 (Tex. Comm. App. 1928), aff'd, 8 S.W.2d 574 (Tex. Civ. App. 1928); Shapiro v. Tropicana Lanes, Inc., 371 S.W.2d 237, 241 (Mo. 1963); Benson v. Eleven-Twenty St. Charles Co., 422 S.W.2d 297 (Mo. 1967); Deskins v. Lawrence County Fair & Dev. Corp., 321 S.W.2d 408 (Ky. Ct. App. 1959); Hampton v. Tri-State Fin. Corp., 495 P.2d 566, 569 (Col. Ct. App. 1972); Groves v. Rosemount Improvement Ass'n, 413 So.2d 925 (La Ct. App. 1982), cert. denied, 420 So.2d 443 (La. 1982). "Freedom to contract allows the parties to structure their relations in a manner that ameliorates most of the agency problems inherent in the large corporation. Freedom to contract has guided corporation law since the first truly modern general corporation laws were passed in the late nineteenth century." BUTLER & RIBSTEIN, supra note 87, at 21.

121 Lowenstein, supra note 33, at 982 (providing highly descriptive analysis of influential role played by Professor Ripley). William Z. Ripley, Professor of Political Economy, was the most prominent proponent of equal voting rights and wrote many articles and speeches designed to stop transactions that disenfranchised shareholders. Equating shareholder voting rights with the voting system established by our founding fathers for political government, his crusade eventually caught the attention of federal officials, including President Coolidge. Id. at 982-83; Kerbel, supra note 110, at 57. And while Ripley's plea has been heeded in many quarters since then, at the time federal legislative intervention was never seriously attempted. Flocos, supra note 10, at 1785.

122 Kerbel, supra note 110, at 58.
In response, on January 18, 1926, the NYSE first disapproved an issue of nonvoting common stock.\textsuperscript{123} When the NYSE announced it would consider voting control in future applications for listings, other organizations such as the Interstate Commerce Commission, the New Jersey Public Utilities Commission, and the Industrial Securities Committee of the Investment Banking Association soon followed with changes of their own.\textsuperscript{124} Notwithstanding the momentum against dual-class stock and public pronouncements of its demise,\textsuperscript{125} the NYSE carefully avoided making any definitive policy statement for some time. In its absence, dual-class use continued unabated. Between 1927 and 1932, 288 corporations issued nonvoting or limited voting rights stock.\textsuperscript{126}

On May 7, 1940, however, the NYSE adopted a formal listing requirement relating to the use of dual-class stock.\textsuperscript{127} This standard remained in effect without incident for the next forty years.\textsuperscript{128} Similarly, the NYSE recommended that listed preferred stock have minimum voting rights as well.\textsuperscript{129} Subsequent attempts by listed firms to use dual-class stock were for the most

\textsuperscript{123} Seligman, \textit{supra} note 33, at 697. Specifically, the Fox Theaters Corporation had applied to list 800,000 shares of nonvoting Class A common stock. All voting rights were to be held by the voting Class B common shares owned by the company's president, William Fox. \textit{Id.} at 697 n.68.

\textsuperscript{124} \textit{Id.} at 696. In April and May of 1926, the Interstate Commerce Commission and the New Jersey Public Utilities Commission withheld approval of stock issues that included non-voting common stock. At the same time, the Industrial Securities Committee of the Investment Banking Association decided to discourage member use of nonvoting common stock.

\textsuperscript{125} Ripley had proclaimed the demise of nonvoting common stock as early as 1926, stating "[n]onvoting common stock... bears every appearance of being dead—dead beyond recall." Bainbridge, \textit{supra} note 39, at 570 n.19 (citing \textit{RIPLEY, supra} note 115, at 122).

\textsuperscript{126} Dewing, \textit{supra} note 118, at 161. This number nearly equaled the number of issuances between 1919 and 1926. Bainbridge, \textit{supra} note 39, at 570.

\textsuperscript{127} See Seligman, \textit{supra} note 33, at 699.

\textsuperscript{128} \textbf{NYSE LISTED COMPANY MANUAL}, § 313.00 (A), (C) (1985).

\textsuperscript{129} See Karmel, \textit{supra} note 76, at 817 n.53; \textbf{NYSE LISTED COMPANY MANUAL}, § 313.00 (E) (1985).

For example, the preferred stock should have the right to elect at least two directors in the event of a default on the equivalent of six quarterly dividends. Likewise, 66 2/3\% of the preferred stock, voting as a separate class, must approve any charter amendment materially altering the rights associated with the preferred stock.

Karmel, \textit{supra} note 76, at 817 n.53.
part rejected by the NYSE, and no serious challenges to that policy would occur until 1984.

The reexamination and the debate that resulted were triggered by an issuance of restricted shares by General Motors ("GM") in conjunction with GM's acquisition of Ross Perot's Electronic Data Systems Corporation in 1984. This was ironic because the use of dual-class stock by such a large corporation is a historic anomaly. Prior to 1984 the use of dual-class stock had been confined primarily to small, "going public concerns" or family-owned businesses.

The dual-class debate gained further speed and intensity following the subsequent issuance of disparate voting stock by some forty-six other companies between the time of the GM issuance and June 1987. Between March 1986 and May 1987 alone thirty-four companies had issued disparate voting stock.

130 See Seligman, supra note 33, at 699 n.78. (noting NYSE delisted Cannon Mills in 1962, after company distributed shares of nonvoting common stock to its common stockholders). But see id. (noting that NYSE more commonly enforced its one share, one vote policy simply by threat of delistment). Occasional exceptions have arisen, the most prominent being the 1956 listing of the Ford Motor Company despite its dual-class capital structure. Bainbridge, supra note 39, at 569. The NYSE standards also contained an exception called the "proportionate voting power" exception, whereby the issuance of a second class of common stock with voting rights reasonably related to that security's equity contribution would not warrant a delisting. Karmel, supra note 76, at 817. "Reasonably related" is resolved on a case-by-case basis. Id. at 817 n.5.

131 Only thirty listed issuances of nonvoting or dual-class common stock were registered on U.S. secondary markets between 1940 and 1978, with never more than eleven being made in any single year. Ronald C. Lease et al., The Market Value of Control in Publicly Traded Corporations, 11 J. Fin. Econ. 439 (1983).

132 See Hu, Corporate Investment, supra note 5, at 1294-95. (detailing specifics of Class E common stock used in acquisition). The stock dividend, distribution, and appreciation characteristics of the special class of General Motors stock are designed to be more closely tied to the earnings of EDS, as a GM subsidiary, than to the fortunes of the GM parent or any of its other subsidiaries. Because of the limited nature of the shares, the shareholders have less incentive to monitor the performance of the larger corporate concern. As such, the vote has less value to these shareholders than it would to the shareholders whose shares are tied to the company's overall performance.

133 See Manning Gilbert Warren III, One Share, One Vote: A Perception of Legitimacy, 14 J. Corp. L. 89, 92-93 (1988); O'Neil, supra note 33, at 1064-65.

134 Bainbridge, supra note 39, at 570 n.25 (citing SEC Office of the Chief Economist, Update—The Effects of Dual-Class Recapitalizations on Shareholder Wealth 2 (July 16, 1987) [hereinafter Second SEC Study]). An earlier study by the SEC found 65 dual-class structures created between 1976 and 1986; three-quarters of these were adopted between 1983 and 1986. SEC Office of the Chief Economist, The Effects of Dual-Class Recapitalizations on the Wealth of Shareholders 11-12 (June 1, 1987) [hereinafter First SEC Study]. These listings were allowed to
significance of the GM acquisition was not based on the specifics of the transaction itself. Utilization of dual-class stock in this manner is rare. Rather, its significance was in the explicit challenge to NYSE policy that it represented. General Motors reached back sixty years into the history of corporate finance and devised an acquisitive structure that would move the exchanges, the SEC, Congress, and academia into action.

In retrospect, it seems that only a large corporation such as General Motors could have forced the issue. If a smaller concern, one less important to the NYSE itself, had used a similar acquisition technique, the confrontation to listing policy could have been more easily controlled. With the threat of a number of delistings, however, the NYSE was forced to reexamine its policy.

Other factors were also at work. Specifically, the increased activity in the capital and corporate control markets in the early 1980s and the well-known effectiveness of dual-class stock as a takeover defense would most likely have been enough to elicit a serious policy reexamination—defensive techniques commonly attract attention. In addition, while many prominent firms desired flexibility in fighting hostile advances for control, an increasing number of family-run or insider-controlled companies needed access to capital only available in the public equity markets where share values were at record highs. Dual-class stock was a means of gaining access without the control dilution that is normally associated with new equity issuances. Moreover, the

occur because the NYSE implemented a self-imposed moratorium on delistings. Gail Appleson, NYSE Opens Its Doors With Change in 50 Year Old Rule, REUTERS, July 4, 1986 (reported on wire service); Karmel, supra note 76, at 817 n.57.

135 Gary C. Sanger & John J. McConnell, Stock Exchange Listings, Firm Value and Security Market Efficiency: The Impact of NASDAQ, 21 J. FIN. QUANT. ANALYSIS 1, 22 (1986). The emergence of the over-the-counter market and other computer-linked securities markets as substitute providers of liquidity have deprived the exchanges of any significant market power over listing firms. See id.; see also infra notes 374-83 and accompanying text (discussing effect of emergence of over-the-counter market).

136 Professor Fischel has argued that dual-class stock should not necessarily be regarded as a species of takeover defense. Fischel, supra note 19, at 149-51. Other commentators, however, are virtually unanimous in associating the increase in dual-class use with the increase in takeover activity during the 1980s. See Bainbridge, supra note 39, at 571 n.28 (citing Seligman, supra note 33); Ruback, supra note 98, at 153; Richard M. Buxbaum, The Internal Division of Powers in Corporate Governance, 73 CAL. L. REV. 1671, 1713-15 (1985); Gordon, supra note 44, at 4.

NASD and the AMEX, which had less-restrictive dual-class listing standards, were becoming increasingly competitive in the market for corporate listings.138

In light of those concerns, the NYSE appointed the Subcommittee on Shareholder Participation and Qualitative Listing Standards in June of 1984 to review its dual-class listing standards.139 At the same time, the NYSE imposed a delisting moratorium for dual-class capitalizations and recapitalizations that contravened the NYSE policies on voting rights.140

At the time of the NYSE subcommittee review, it was AMEX policy to accept applications from companies seeking to list two classes of common stock possessing unequal voting rights, provided the issuer observed a ten-to-one limitation on the disparity between the voting rights of the two classes and segmented its board so that at least 25% of the directors were elected by the holders of the lesser voting class; AMEX did, however, forbid the listing of nonvoting common stock.141 At the same time, the NASD did not have an existing voting rights policy.

On January 3, 1985, the subcommittee recommended a new listing standard by which listed corporations would be permitted to issue common stock with unequal voting rights provided that four conditions were met: (1) two-thirds of all shareholders entitled to vote would have to approve the creation of the second class of common stock; (2) if the issuer had a majority of independent directors at the time the matter was voted on, approval by a majority of these independent directors would be required. If the issuer did not have a majority of independent directors, the ap-

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138 Because the NASDAQ and the AMEX were increasingly recognized as effective and efficient exchanges, a listing on either of these exchanges created an alternative that no longer scared away blue-chip companies. Moreover, because the NASD and the AMEX did not adhere to the one share, one vote policy of the NYSE, each became a suitable alternative to the capital structuring limitations of the NYSE. In 1993, NASDAQ, the automated quotation system on which over-the-counter firms trade, attracted a net of 400 new companies, compared with the NYSE's net of 274 new companies. Big Board Claims a Win In Its Battle With NASDAQ, WALL ST. J., Dec. 29, 1993, at C1; see also infra notes 372-95 and accompanying text (discussing competitive situation existing among exchanges).

139 See Seligman, supra note 33, at 701-06 (providing extensive review of process by which subcommittee reached its recommendations).

140 Karmel, supra note 76, at 817. Before this moratorium, the NYSE had delisted five firms for violating the one share, one vote rule. Jarrell & Poulsen, supra note 13, at 131.

141 See AMEX 1991 Proposal, supra note 40, at 4; Seligman, supra note 33, at 703-05 (describing old AMEX listing requirements).
proval of all such directors would be required; (3) the low-vote shares could not have a voting differential of more than ten to one; and (4) the other rights attached to the restricted voting shares must be substantially the same as the rights of the high-vote shares. Special provisions would be made for those firms allowed in during the moratorium.

The subcommittee claimed that its recommendations were strongly influenced by two factors: first, the fact that shareholders should be allowed great latitude in determining the capital structure of their corporation, even if others feel that a decision to adopt dual-class common stock would be destructive in the long run and that those shareholders should not be punished for making that decision; and second, the fact that other safeguards, such as independent directors and the NYSE requirement that corporations have independent audit committees, would prove adequate. Many commentators suggested, however, that the recommendations were primarily based on factors which the committee declined to mention; namely, the new realities of NASD and AMEX competitiveness, as well as member dissatisfaction with the inflexibility of the current rules as related to takeover defenses. The NYSE subcommittee recommendations triggered an almost immediate congressional reaction that ultimately proved unsuccessful.

Following the dissemination of the subcommittee's recommendations, officials of the SEC, NYSE, NASD, and AMEX arranged for a series of meetings aimed at resolving the lack of uniformity among the exchanges. Their discussions proved unsuc-

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142 **NEW YORK STOCK EXCHANGE, INITIAL REPORT OF THE SUBCOMMITTEE ON SHAREHOLDER PARTICIPATION AND QUALITATIVE LISTING STANDARDS** 3 (Jan. 3, 1985).

143 Under the proposed rule change, a grandfather provision would permit listed companies, which have created disparate voting rights since April 1984, two years from the date of effectiveness to achieve compliance with the approval requirements. However, a company requesting to list under the new rules would be required to obtain the requisite approval prior to listing on the NYSE.

Karmel, *supra* note 76, at 818; **AMENDMENTS TO SECTION 313.00 OF THE NYSE LISTED COMPANY MANUAL**, File No. SR-NYSE-86-17 (proposed Sept. 16, 1986).

144 *Id.* at 4-5; see Kerbel, *supra* note 110, at 64.

In fact, shortly after the discussions concluded, the NYSE proposed a new, revised amendment to its Listed Company Manual that proved to be even less restrictive than the original subcommittee recommendations.

The proposed standard for voting rights required delisting only if the recapitalization was not approved by a majority of independent directors and a majority of the shareholders. As was the case under the previously proposed amendment, under this proposal listed companies that created disparate-voting-rights stock during the NYSE moratorium would have two years from the date of the proposal's approval to comply with the amendment. Companies thereafter applying for listing would have to comply with the rule before listing would be approved. In addition, no exchange approval would be necessary if the disparate voting class was outstanding when the company first went public, or if disparate voting stock was distributed pro rata among the distributor's common shareholders in a spin-off transaction in which the distributor was not the issuer.

In response to the second NYSE proposal and the failure of the three SROs to reach a consensus on a minimum rule, the SEC took action itself in June 1987. The commission's efforts produced Rule 19c-4. Rule 19c-4 was designed to prohibit the NYSE, the AMEX, and NASDAQ from listing, or continuing to list, the securities of an issuer that takes action resulting in the nullification, restriction, or disparate reduction of the per-share voting rights of holders of the company's outstanding common shares. The SEC received 1100 comment letters and elicited testimony from seven-

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146 The discussion focused on a mandatory one share, one vote rule that would cover all three of the exchanges. However, such negotiations resulted in little progress or uniformity. Arthur Levitt Jr., chairman of the AMEX, openly advocated a uniform one share, one vote requirement. The NASDAQ followed the recommendations of a review they commissioned from Daniel Fischel, in which it was concluded that there were no reasons to prohibit dual-class stock. The NYSE's view, set forth in testimony before Congress, was that the current competitive environment on the national exchanges precluded the NYSE from retaining one share, one vote unilaterally, although it did note the Exchange's belief that one share, one vote was good policy and that the Exchange still believed in it. AMENDMENTS TO SECTION 313.00 OF THE NYSE LISTED COMPANY MANUAL, File No. SR-NYSE-86-17 (proposed Sept. 16, 1986); Karmel, supra note 76, at 817-19; see also Bainbridge, supra note 39, at 576-77.

147 See Adopting Release, supra note 12, at 89,209.


150 Id. at 89,210.

151 Id. at 89,208.
teen people on Rule 19c-4. Of those comment letters, 1000 supported adopting the rule. Eight hundred were submitted by individual members of the United States Shareholders Association, which advocated a one-share, one-vote standard with no exceptions.152 The SEC adopted Rule 19c-4 on July 7, 1988.153

Rule 19c-4 has often been incorrectly described as a “one-share, one-vote” rule. It clearly was not. In fact, the rule was aimed entirely at those transactions that were deemed to disenfranchise shareholders. The rule expressly prohibited the exchanges and NASDAQ from listing, or continuing to list, the securities of an issuer that takes action resulting in the nullification, restriction, or disparate reduction of the per-share voting rights of holders of the company’s outstanding common shares or resulting in the creation of a ceiling on the voting power of any one individual shareholder. New issues were unaffected and could be listed without exceptional regulation of voting rights.154 The rule also permitted corporations to issue nonvoting common stock or a special class of common stock with limited voting rights, as long as it did not dilute the voting power of existing shareholders.155 Finally, the rule enabled a corporation to issue common stock with lower voting rights when engaging in a business merger or acquisition, as long as the firm made the merger or acquisition for a bona fide business purpose.156

Rule 19c-4 generated debate not only regarding the desirability of dual-class stock, but on the larger issues of shareholder-behavior theory and the proper role of the federal government in corporate governance and securities regulation. Notions of federalism permeated the criticisms of the rule. There was widespread belief that the Commission’s intervention into areas traditionally left to state regulation was improper. Thirty-two of the commentators who expressed opposition to the adoption of Rule 19c-4 during the SEC’s request-for-comments stage questioned the Commission’s authority to adopt a rule in the area of qualita-

152 Id. at 89,210 n.23.
153 The final SEC vote on the Rule was four to one. Jeff Davis, director of the Directorate of Economic Policy Analysis, and SEC Chief Economist, Kenneth Lehn also opposed the rule. O’Neil, supra note 33, at 1065 n.61; see Lowenstein, supra note 33, at 984-85 (summarizing Rule 19c-4).
156 See Adopting Release, supra note 12, at 89,212.
tive listing or authorization standards. The opposition included the ABA and the Business Roundtable.157

The Business Roundtable158 eventually filed suit in the Court of Appeals for the District of Columbia Circuit to vacate the rule on the basis of a theory grounded in corresponding notions of federalism. When the court vacated the Commission's rule on June 12, 1990,159 dual-class stock regulation was once again handed back to the exchanges and the states.

Since the time of the Business Roundtable decision, the NYSE and the NASD have adopted enforced listing standards that embody the spirit of Rule 19c-4, with the NASD doing so only for NMS securities. While the NASD embraced the rule shortly after the Business Roundtable decision, the NYSE actually did so in December of 1989 before the case was heard. The NYSE has not insisted on member compliance with its standard. Instead, the NYSE has only provided issuers with interpretive advice on compliance when requested.160 The lack of enforcement by the NYSE has placed the NASD in a difficult position, because, unlike the other primary markets, most of the blue sky exemptions for NASDAQ and NMS stock are contingent on the continued application of a voting-rights standard analogous to Rule 19c-4.161 Thus, while the NYSE is in a position to change current listing standards in favor of a less restrictive rule, the NASD's ability to change its standard is somewhat restrained. This is precisely what is currently transpiring. On June 9, 1992, the NYSE proposed a new listing requirement that would allow its listed firms to establish unequal voting rights. Institutional Investor Services has summarized this proposal as follows:

The proposal would allow listed companies to adopt dual class voting structures if such a move receives approval from: (1) a ma-

157 Bayley, supra note 155, at 14.
158 The Business Roundtable is an organization of almost 200 leading publicly-held corporations.
161 Id.
majority of directors on an independent committee; (2) a majority of the board; and (3) both a majority of outstanding shares and a majority of affected but disinterested shares. Only in cases when management gains controlling positions as a result of a dual class offer would companies be required to have boards composed of a majority of independent directors. Boards however, are given the right to determine who is independent. In addition, the proposal does not restrict the short-term economic incentives often used in dual class exchange offers.\textsuperscript{162}

Unlike the NYSE, the AMEX had not adopted Rule 19c-4 before the decision by the court of appeals, and unlike the NASD, the AMEX had a preexisting voting-rights policy.\textsuperscript{163} As such, the immediate effect of the Business Roundtable decision for the AMEX was a reinstatement of the original policy before Rule 19c-4 was enacted, a policy commonly referred to as the "Wang formula."\textsuperscript{164} Instead of merely reinstating that policy, however, the AMEX decided to take a fresh look at its listing policy in light of the significant experience acquired by the exchanges during the nearly two years that the principal marketplaces uniformly applied Rule 19c-4.\textsuperscript{165} On September 13, 1990, the AMEX appointed a Special Committee on Shareholder Voting Rights to recommend an appropriate listing standard.\textsuperscript{166}

\textsuperscript{163} AMEX 1991 Proposal, supra note 40, at 4.
\textsuperscript{164} Id. (describing "Wang Formula"). Specifically the Formula: [p]rohibit[s] the listing of nonvoting stock, but generally allow[s] the listing of limited voting stock provided the issuer observes a 10:1 limitation in the voting disparity between the classes and segments its board so that at least 25\% of the directors are elected by the holders of the lesser voting class.
\textsuperscript{165} Id. at 4-5.
\textsuperscript{166} Id. The eleven member Committee was directly charged by AMEX Chairman James R. Jones to recommend the best policy without regard to the competitive position of the Exchange. Jones indicated that he wanted the committee to study the issue of what shareholder voting rights standard the American Stock Exchange should adopt . . . taking into consideration its unique position as the primary U.S. exchange for mid-range and emerging growth enterprises . . . bear[ing] in mind such matters as past practices . . . relating to shareholder voting rights and corporate governance issues in general, the changing structure of corporate America, the experience in applying Rule 19c-4 . . . the appropriate relationships between SRO listing guidelines and state laws governing corporate structure, the impact of Court decision overturning Rule 19c-4 and the role of the SRO's in protecting shareholder interests.

Adopted on April 11, 1991, the proposed AMEX policy (currently awaiting SEC approval) is based on the following four principles identified in the report issued by its Special Committee on Shareholder Voting Rights:

The desirability of flexibility in creating capital structures for listed companies, the effectiveness of shareholder approval in insuring that a proposed multiple class capital structure is fair, the role of independent directors in protecting the interests of public shareholders, and the importance of adequate disclosure in insuring that purchasers of low-vote shares in the secondary markets understand the risks, and benefits of what they are purchasing.\(^{167}\)

The proposed rule seeks to provide a balance between flexible capital structuring and managerial accountability.\(^{168}\) It requires that companies seeking to recapitalize into a multiple-class structure or to issue additional shares of higher-voting-class stock must first obtain favorable votes from two-thirds of their outstanding shares or a majority of shares unaffiliated with management or the controlling group.\(^{169}\) In addition, the AMEX decided that a multiple-class company should have at least one-third of its board composed of independent directors or provide that holders of the lesser voting class be entitled to elect exclusively at least 25% of the board.\(^{170}\)

\(^{167}\) Id.

\(^{168}\) Id. at 3.

\(^{169}\) Id. at 25.

\(^{170}\) Id. at 27. Thus, the AMEX Proposal ensures some independent representation on the board of a multiple class issuer, unlike Rule 19c-4 which compelled no such...
The rule proposed by the AMEX also has a number of exceptions and incorporates the concept of grandfathering for existing dual-class firms. For example, foreign issuers are entirely exempted. In addition, dual-class capitalizations, as opposed to dual-class recapitalizations, receive an exemption from the shareholder voting requirements.\textsuperscript{171} Issuances by way of dividends, splits, acquisitions, financings, and issuances of low-voting or non-voting stock by existing dual-class companies are not subject to additional shareholder approval requirements.\textsuperscript{172}

The proposal also provides exemptions for post-recapitalization issuances of high-vote shares. While such additional post-transaction issuances of high-vote shares are rare, due to the SEC’s existing proxy rules requiring companies to disclose all planned uses of new securities,\textsuperscript{173} the exemption is a thoughtful addition to the regulatory frameworks that historically have been advocated to police attempts of post-recapitalization shareholder dilution.

Rule 19c-4 did not specifically cover subsequent issuances of high-voting shares by firms authorized to issue high-vote shares in the recapitalization. The AMEX proposal does so by constructing a general prohibitory theme, followed by an express exception. Specifically, the proposal provided a twelve-month "window" for high-vote issuances by companies that have just secured shareholder approval to recapitalize into multiple-class structures.\textsuperscript{174} As long as the stock involved and the kind of transaction in which it is to be issued are fully described in the approval proxy, the proposal allows additional issues of high-vote shares to be effected in the twelve months following the original approval.\textsuperscript{175} In addition, the proposal would allow dual-class firms to issue additional high-vote stock constituting up to 2% of their voting power in any one year, subject to an overall cap of 5% in each five-year period, without obtaining shareholder approval.\textsuperscript{176}

\textsuperscript{171} AMEX 1991 Proposal, \textit{supra} note 40, at 28.
\textsuperscript{172} \textit{Id.}
\textsuperscript{174} AMEX 1991 Proposal, \textit{supra} note 40, at 12.
\textsuperscript{175} \textit{Id.} at 13.
\textsuperscript{176} \textit{Id.} at 12.
Finally, the proposed rule provides grandfathering for existing dual-class companies. The rule exempts existing AMEX dual class companies that listed on the exchange before the adoption of the Wang formula in 1976, from the independent director requirement. Additionally, existing Wang formula companies are exempt from any additional shareholder approvals for the issuance of additional high-vote stock.

Questions concerning whether the exchange should require pro-rata sharing of a control premium among all shareholders, or whether purchasers of low-vote shares in the secondary market have adequate notice that they are buying shares with an “impaired” vote, are questions the AMEX has chosen not to answer, choosing instead to defer to legislative action.

This brief illustration of the historical context in which dual-class stock has been used and the regulatory models constructed symbolize the uncertainty and conflict which currently exists in the area of dual-class regulation among SROs and the SEC. The current case-by-case posturing of the NYSE has only exacerbated the uncertainty. For its part, the SEC continues to assert that voting rights are fundamental and that a majority of current shareholders should never be permitted to diminish or eliminate the voting rights of an opposed minority. After the Business Roundtable decision, however, SEC opposition is no longer of paramount importance.

Today, the regulation of voting rights is primarily governed by the rules of the SROs and state law. No state departs from a one-vote, one-share default rule, although state blue sky laws, administered by state securities regulators, often impose restric-

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177 Id. at 14.
178 Id.
180 Letter from Mary L. Schapiro & Richard Y. Roberts to James R. Jones, supra note 35.
181 See Bainbridge, supra note 39, at 574. Exceptions include companies reorganizing under the Bankruptcy Act, registered public utility companies, quasi-governmental agencies (i.e., Student Loan Marketing Association), and certain registered investment companies. Id. at 574 n.42.
182 As of 1991, two states had departed from this default rule. See Bainbridge, supra note 39, at 574. In 1995, both states repealed their respective statutes. See also Mo. ANN. STAT. § 351.180 (Vernon 1991) (permitting limitation or denial of voting rights) (repealed 1995); Neb. Rev. Stat. § 21-2014 (1991) (requiring all holders of voting stock to have right to vote in election of directors, although otherwise permitting variations in voting rights) (repealed 1995); see also Bainbridge, supra note 39, at 574 n.42.
tions on the sale of some shares with disparate voting rights.\textsuperscript{183} Furthermore, eighteen states have adopted regulations prohibiting the issuance of common stock with unequal voting rights.\textsuperscript{184}

As such, it is apparent that state securities administrators represent an important supplement to exchange-based regulation. An interdependency exists between Blue Sky Rules and the exchanges.\textsuperscript{185} State exemptions are the very foundation upon which the use of dual-class stock vests.\textsuperscript{186} Thus, state exemptions granted to the NYSE and the AMEX listed firms are of great importance. Notwithstanding the influence that the states and the exchanges have, the SEC must eventually capitulate and take action on the current AMEX and NYSE proposals being drafted. Should the SEC, and its new commissioner, Arthur Levitt, Jr.,\textsuperscript{187} move toward approving the pending AMEX rule, the NYSE is sure to respond.\textsuperscript{188} Either way, dual-class stock is positioned for serious reevaluation.

III. The Call For a Minimum Voting-Rights Standard

The arguments in favor of a minimum voting-rights standard have been varied and sometimes incongruent. Models advocating complete prohibition of dual-class recapitalizations are rare. Instead, most commentators have focused their efforts on developing a less restrictive minimum voting-rights standard aimed at limiting the disenfranchising effects associated with dual-class recapi-

\textsuperscript{183} See id. at 574 n.43 (listing states that have restrictive legislation). States that have restrictive legislation include: Alabama, Alaska, Arkansas, California, Florida, Indiana, Kansas, Minnesota, Missouri, and Nebraska. Id.

\textsuperscript{184} Seligman, supra note 33, at 713 n.113.

\textsuperscript{185} Id. at 714.

\textsuperscript{186} It has been noted that state administrators, such as those in California, have “a pathological distaste” for certain uses of dual-class stock, and frequently refuse to permit the issuance of this type of security. See Chris Rauber, Meadowbrook Issue Boosts Management, S.F. Bus. Times, Dec. 20, 1991, at 1. For firms listed on the various exchanges, state blue sky law exemptions remain. Periodic reports indicating that state administrators and legislators are preparing to lift exemptions for dual-class firms have thus far been unfounded.

\textsuperscript{187} Arthur Levitt, Jr., has already taken a public stance on the issue. In 1985, he told a House Subcommittee that abandonment of the “one share, one vote” rule by the NYSE would be damaging to the securities markets, and predicted that between 200 to 300 major corporations would adopt dual classes of stock if the NYSE abandoned its long-standing policy. Karmel, supra note 76, at 819-20. He also posited that a significant number of firms would transfer from the AMEX, which he then chaired, to the NYSE. Id.

\textsuperscript{188} Desmond Dodd, Is the Big Board Preparing a New Voting Rights Rule, 18 Corp. Financing Wk. 1 (May 11, 1992).
talizations. The SEC, in formulating Rule 19c-4, reiterated its commitment to that theme by summarizing the primary reasoning behind the rule as follows:

The adoption of a minimum voting rights standard is necessary to ensure management accountability; ... the Rule will protect shareholder interests in connection with contests for corporate control; ... the Rule will protect shareholders from being disenfranchised, while permitting companies to utilize disparate voting rights plans for capital raising purposes; and ... the Rule would prevent a 'race to the bottom' for listing standards among SROs. 189

This reasoning is firmly rooted in the traditional theory of shareholder passivity as originally described by Berle and Means whereby the powerlessness of the shareholder is held to be an inevitable result of the diffusion of ownership. 190 These rationales, as well as others that have been set forth in advocating restrictive listing requirements, can be analyzed distinctly. Such an analysis will best present the arguments against the use of dual-class common stock. This article shall critique those arguments in Part V.

A. The Collective Action Rationale

Shareholder passivity is explained by what is commonly referred to as the collective action problem. 191 The collective action problem in turn is illustrated through certain recurring shareholder behaviors known as "free-riding" and "rational apathy."

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189 Adopting Release, supra note 12, at 89,211. In contrast, the recent AMEX proposal sought to strike a balance between the accountability of management to shareholders and the need for companies to have appropriate flexibility in establishing a capital structure best suited to achieving specific goals and objectives. Id. at 89,210.

190 Shareholders are believed to be powerless to effect the success or failure of proposals that come before the larger shareholder group regardless of their impact on the future prosperity of the firm. Easterbrook & Fischel, supra note 19, at 397. The dual-class recapitalization makes the Berle and Means model a structural reality. Id. But see Flokos, supra note 10, at 1769 n.32 ("The Commission's discussion in the Re- lease of both freerider and rational apathy, collective action problems constitutes one paragraph and footnote; a remarkably small proportion of the 27 page document, and disappointing given the SEC's heavy reliance on these factors as the basis for its important regulation.").

191 See Klein, supra note 18, at 132. Klein states: "Though a change in management may be beneficial to shareholders as a group, the costs for an individual shareholder to gather the required information and communicate that information to other shareholders will generally exceed the benefit to the initiating shareholder. This is a collective action problem." Id. See generally, Mancur Olson, THE LOGIC OF COLLECTIVE ACTION (1980) (discussing collective action problem).
Free riding and rational apathy occur when shareholders remain inactive, yet secure the benefits which result from the activism of other shareholders (typically institutional investors or those seeking to obtain a controlling block of shares). This passive behavior is thought to manifest itself when dispersed shareholders in large corporations realize that the costs associated with agent monitoring are solely incurred, while the returns are shared pro rata. Such behavior is deemed to be rational because the aggregate cost to shareholders of informing themselves of potential corporate actions, independently assessing the wisdom of such actions, and casting their votes will greatly exceed the expected or actual benefits from informed voting. Consequently, since any single shareholder’s vote is unlikely to affect the outcome of a particular proposal, many shareholders choose to take an apathetic approach to corporate voting — they vote without carefully reviewing the proxy materials or by adopting a singular voting approach (that is, they vote for management).

Those who oppose dual-class common stock assert that the use of such stock exacerbates collective action, free riding, and passivity problems that ultimately lead to disenfranchisement. This argument rests on empirical studies which demonstrate that

192 See Robert Charles Clark, Corporate Law 392-93 (1986); see also Flokos, supra note 10, at 1768-69 (providing example of free-riding problem in context of nuisance or pollution case).

193 See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811, 821 (1992) [hereinafter Agents Watching Agents]. Much of corporate law can be read as a response to the intersection of the problem of diverging interests between managers and shareholders and the problem of minimizing agency costs. Rock, supra note 170, at 453. “Boards of directors, derivative suits, and the private enforcement of proxy regulations can be understood as mechanisms for surmounting shareholders’ collective action problems in constraining management.” Id. at 453 n.27. It is often said that “a shareholder who owns 1 percent of a company’s stock must believe that the expected benefits are more than 100 times the cost, before monitoring is worthwhile!” See Bernard S. Black, Next Steps in Corporate Governance Reform: 13(d) Rules and Control Person Liability, in Modernizing U.S. Securities Regulation: Economic and Legal Perspectives 227 (Kenneth Lehn & Robert Kamphias eds., 1992) [hereinafter Next Steps in Corporate Governance Reform].

194 Clark, supra note 192, at 390-91. Moreover, while the shareholder may gain from opposing or affirmatively voting for the transaction, he will gain even more if other shareholders bear the cost of doing so. Flokos, supra note 10, at 1768.

195 Agents Watching Agents, supra note 193, at 821. This is not always unreasonable because it may make sense for a shareholder to vote for a known incumbent (or the ideas they represent) rather than for an unknown or for the views proposed by an unknown. See Grossman & Hart, supra note 36, at 177 n.2.

196 See Gordon, supra note 44, at 44-45.
the ownership composition of firms recapitalizing with dual-class stock is often characterized by large family or management ownership groups and below-average institutional holders. Because of these ownership arrangements, it follows that a large proportion of public shareholders would have to vote against any proposed governance measure for it to be defeated. Moreover, with lower than average institutional holdings, the outside-shareholder group is thought to exhibit a high share turnover rate as well as to suffer the consequences of dispersed holdings. Thus, the costs of opposition are higher than normal because communication and coordination expenses rise in proportion to the extent of shareholder dispersal. According to the SEC and its supporters, because there is no compulsory cost-sharing mechanism, insufficient incentive exists to organize an opposition and the individual shareholder will simply free ride. The hypothesized end result is that the larger shareholder group fails to vote against or

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197 Id.; see also M. Megan Partch, The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth, 18 J. Fin. Econ. 313, 332 (1987) (examining 44 publicly traded firms that created classes of limited voting common stock during 1962-1984). Partch found that "[p]rior to the creation of the limited-voting class, insiders on average own 48.6 percent of the firm's equity. Approximately 21 months later, insider average proportionate ownership of votes is 58.6 percent and the average proportion of equity owned by insiders falls to 48.7 percent." Id. at 332.

198 Studies have shown that in many, if not all, of the recapitalized firms, significant family/management blocs are committed to the recapitalization. In addition, only a handful of these firms have significant stock ownership positions (blocs of 5 percent or more) held by institutions or by individuals not allied with the management group. An OCE study conducted in 1987 reported that the average (mean) institutional ownership for a sample of 87 firms was 19.9 percent. A post NYSE moratorium sample found that this number had increased to 23.9 percent. See SEC OFFICE OF CHIEF ECONOMIST, UPDATE — THE EFFECTS OF DUAL-CLASS RECAPITALIZATIONS ON SHAREHOLDER WEALTH: INCLUDING EVIDENCE FROM 1986 AND 1987, tbl. 4 (July 16, 1987); see also JAMES B. HSARD & HOWARD D. SHERMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM 10 (1987) (indicating such figures are below average).

199 Gordon, supra note 44, at 46 n.149 (suggesting that when small number of institutional investors each owns significant blocks of stock, "[i]t is easy to monitor the level of expenditures of each institutional investor in a particular proxy contest"). "Moreover, since such investors will be 'repeat players' in a successive series of proxy contest, reputation effects and the desire to secure reciprocal assistance of other investors will help overcome free-rider problems." Id. (citing ROBERT AXELROD, THE EVOLUTION OF THE CORPORATION (1984)).

200 Lowenstein, supra note 33, at 989. One study found that when a large number of disaggregated shareholders exists in any given corporation, the chances of a dissident gaining victory in a proxy vote are reduced. John Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. Fin. Econ. 237, 258 (1988).

201 See Gordon, supra note 44, at 46.

202 Flocos, supra note 10, at 1768.
disapprove the charter amendment that ultimately disenfranchises the group. Because opponents of dual-class shares find disenfranchisement to be undesirable, they point to collective action and free-riding problems and the notion of shareholder passivity as reasons for prohibiting dual-class recapitalizations.

Moreover, some have asserted that recapitalization is void notwithstanding shareholder approval because the transaction itself violates management's duty of care. Peter Simmons explains:

By reclassifying the stock, management attempts to retain office in violation of the business judgement rule. The defense enables management to circumvent the usual restraints imposed on it and to gain complete and permanent control over the corporation. Additionally, the plan decreases the value of the corporation to the shareholders by depriving them of... acquisition [premiums] and by subjecting their investment to greater risks. A court should therefore infer that... [the] purpose is... entrenchment and hold the reclassification to be a violation of management's duty of care.\textsuperscript{203}

Because the shareholders more often than not vote to approve a dual-class recapitalization, Simmons maintains that the affirmative vote cannot be fully informed and consequently should not be enforced by a court.\textsuperscript{204} He asserts that the affirmative shareholder vote is really uninformed consent because shareholders undervalue their voting rights and, as a consequence, acquiesce to managerial recommendations regardless of the cost to them individually.\textsuperscript{205} To date, courts have not agreed with such sentiments and have uniformly upheld dual-class recapitalizations.\textsuperscript{206}

Regardless of the judicial treatment of dual-class recapitalization plans, many have accepted the passivity rationale and the conclusions that flow from it. Notions of shareholder passivity serve as the foundation, as well as the common element, on which many of the following rationales rely.

\textsuperscript{203} Simmons, supra note 26, at 112.

\textsuperscript{204} Id. at 118.

\textsuperscript{205} Id. Simmons believes that individual shareholders are unlikely to seek information on the effects of the recapitalization. Id. at 119 n.83.

B. Agency Costs/Managerial Accountability

Rationales for a restrictive regulatory regime are commonly framed in terms of the agency relationship and agency costs. Michael Jensen and William Meckling define the agency relationship as a “contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” The relationship between the stockholders and managers of a corporation perfectly fits the definition of a pure agency relationship.

Because both parties are utility maximizers, the interests of each party do not always correspond. The deviations in the utility functions create agency costs, which have been defined as “the sum of . . . the monitoring expenditures by the principal, . . . the bonding expenditures by the agent, [and] . . . the residual loss. . . .” Agency costs include contracting costs, transaction costs, moral-hazard costs, and information costs. Traditionally, agency costs have been contained through external and internal monitoring mechanisms, such as the voting rights that attach to certain common shares. Therefore, unbundling the voting rights and profit claims has potentially significant consequences on the level of agency costs.

When a firm goes public by way of a dual-class capitalization, agency costs are created. When a firm undergoes a dual-class
recapitalization, however, existing agency costs are dramatically increased.

In principle, the SEC and other adherents to Rule 19c-4 believe that separating the vote from the equity interest (for example by allowing vote buying) or negating the policing power of the vote (by way of debilitating proxy rules or by use of a dual-class capital structure) increase the agency costs involved in share ownership. This result occurs because the consequent loss of managerial accountability causes agency costs to rise. It is said that such plans lead:

to entrenched, inefficient corporate managements acting in their own best interest instead of the best interest of the company and its shareholders. . . . Such management behavior seriously would [sic] undermine investor confidence in the nation's equity markets, which would lead eventually to investors removing their capital from those markets. 214

It is certainly undeniable that after the recapitalization, one distinct group of shareholders controls the voting power within the firm. 215 By definition, shareholders no longer have the ability to express disapproval for managerial misbehavior by voting the directors off the board, although egregious managerial acts are still actionable under state fiduciary duty laws. In addition, the voting power obtained by the control group may negate the independence of any outside board members, who traditionally are held out as the best representatives for the shareholder group at

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214 Adopting Release, supra note 12, at 89,211.

215 In a sample of 45 dual-class firms, managerial super-voting stock holdings were strong enough to give management of the median firm enough votes to elect either the entire board of directors, or a majority thereof, depending on the voting rules for board elections and any preferred stock that may be part of the ownership structure. Harry DeAngelo & Linda DeAngelo, Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock, 14 J. Fin. Econ. 33, 44 (1985). Managers median holdings constituted 58.7 percent of the superior voting stock and 13.4 percent of the inferior voting stock, and mean holding of 59.2 percent and 20.8 percent, respectively. Id. These holdings give officers an average of 54.8 percent of the total voting rights in board elections, but only 27.6 percent of the cash flows. Id. at 45-46. Partch found that within approximately 21 months of the recapitalization, insiders' average proportionate ownership of votes rises to 58.6 percent from 48.6 percent. Partch, supra note 197, at 314.
large. Furthermore, control of the voting mechanism is expected to decrease the number of shareholder proposals presented to shareholders for approval and, in turn, decrease the effectiveness of shareholder proposals as a monitoring mechanism. In light of this, managerial accountability to shareholders supposedly decreases because traditional methods of policing behavior are absent in the firm after recapitalization.

C. Coercion

So, why do shareholders vote affirmatively for a structure that appears to have detrimental consequences to their existing ownership stake, even when those shareholders are institutions that are not thought to suffer from the previously mentioned passive activity problems? One common explanation is that shareholders are coerced to approve the proposal by managerial gimmicks called "sweeteners." The term refers to a situation in which dominant shareholders impose a wealth transfer from public shareholders to themselves by bundling the transaction with an unrelated proposal that shareholders may independently desire, such as an incremental dividend increase or increased marketability for their shares. Gilson explains:

If a public shareholder believes the transaction will succeed, and will thereby effect a wealth transfer from him to the insider group, then obviously it is best for him to participate in the transaction and at least get the ten percent dividend increase. Even if the shareholder believes the transaction will not succeed, he will participate in the transaction anyway so long as the shareholder believes his action will not affect the overall result. By participating, the shareholder gets the ten percent dividend increase; the decision of other public shareholders not to partici-

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216 See, e.g., Seligman, supra note 33, at 721-22. The AMEX proposal and the NYSE recognized this as a substantive issue that had to be dealt with; each decided to require a minimum number of independent directors to be on the board of any listed multi-class issuer firm. Modern dual-class proposals have followed suit and are often structured to alleviate such concerns. See, e.g., supra note 58 (discussing Fedders Plan). The NYSE proposal was criticized, however, because it gives boards the right to make the independent determination. See supra notes 81-86 and accompanying text.

217 See Gilson, supra note 43, at 833-40; Ruback, supra note 98, at 153; Gordon, supra note 44, at 47-54. In addition, Gordon notes that "management can play 'chicken' by credibly threatening to pursue less than optimum strategies for the firm if the recapitalization proposal is defeated . . . [or] management can exploit defects in the regulatory process to increase the likelihood of approval." Id. at 47. Such behavior is likely, however, to violate state fiduciary law standards. See Seligman, supra note 33, at 720.
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pate in an unfavorable transaction can be relied on to prevent
the feared wealth transfer.\textsuperscript{218}

The coercive aspects of the transaction are thought to be success-
ful because a high percentage of the outside shareholders must
vote against the recapitalization to deny implementation. Be-
cause the costs of activism are too high, it is unlikely that the
transaction will be defeated, thus resulting in free-riding and ra-
tionally apathetic behavior.\textsuperscript{219} By putting a "sweetener" in the
deal, success is ensured, even when the deal itself is not in the
best interests of the shareholders.\textsuperscript{220} In effect, rational sharehold-
ers are exchanging a right to a dividend increase for a vote that is
rendered meaningless after recapitalization.\textsuperscript{221}

Proponents of the coercion explanation fail to find solace in
the help that institutional shareholders might offer.\textsuperscript{222} Generally,
this failure has been based on the perceived short-term focus of
institutional shareholders. It is commonly asserted that institu-

\textsuperscript{218} Gilson, supra note 43, at 833-34. As long as shareholders are dispersed, all
shareholders will follow this strategy and the transaction will be approved. In his
study of nineteen firms, Professor Gordon found that the majority of outside share-
holders voted affirmatively for the recapitalization transaction in seventeen of the
nineteen firms. See Gordon, supra note 44, at 80-85.

\textsuperscript{219} Id. at 46. Ownership of 40 percent (and likely significantly less) would give the
dominant group sufficient votes to approve the transaction because five-sixths of the
public shares would have to vote against the transaction for it to fail. Empirical evi-
dence indicates that such figures are often present. For instance, Partch found that
immediately prior to the dual-class recapitalization, the average percentage of shares
controlled by officers, directors, and their associates was 48.6 percent. See Partch,
supra note 197, at 314. In a study by Gregg Jarell and Annette Poulsen, average
insider holdings were 48.7 percent of outstanding shares and the median holdings
were 46.2 percent. For the average firm before the NYSE moratorium, insider hold-
ings were 49.4 percent, with the median equal to 51.5 percent. Jarrell & Poulsen,
supra note 13, at 141.

\textsuperscript{220} Some believe that shareholders in the same circumstances, but acting collect-
ively, would choose not to vote affirmatively for the exchange. Ruback, supra note 98,
at 154.

\textsuperscript{221} "Voting rights have a realizable value only when they can influence the out-
come of an issue, either as a 'swing vote' or as part of a control block of shares." Sim-
mons, supra note 26, at 118 (citing Easterbrook & Fischel, supra note 18, at 402-03).

\textsuperscript{222} See Simmons, supra note 26, at 120. Additionally, dual-class opponents have
asserted that institutions are unlikely to challenge dual-class proposals despite the
fact that institutional shareholders often have the financial stake and voting power to
do so. Id.; see also Edward S. Herman, CORPORATE CONTROL, CORPORATE POWER 146-
54 (1981) (discussing institutional investors and voting); Louis Lowenstein, Pruning
Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 COLUM. L. REV. 249,
tions have no incentive to forego short-term profits for long-term protection against managerial abuses.\textsuperscript{223}

In addition, the systemic failings of the pension-plan managers in the proxy process have been put forward in support of the coercion explanation. Some believe that because managers control the proxy agenda and can often put considerable pressure on corporate and public pension-plan managers to vote for specific proposals, they can coerce large numbers of voteholders into favoring a recapitalization, even when it is against the shareholder's interest.\textsuperscript{224}

As a result of the coercive vote in favor of the recapitalization, dramatic increases in agency costs, resulting from risk increases associated with the lower-voting shares and the loss of policing power, are hypothesized.\textsuperscript{225} The economic prophesy is that the market value of the shares will be substantially reduced once the dual-class proposal is implemented.\textsuperscript{226} The call for regulation is framed in terms of alleviating potential shareholder wealth losses.

D. The Corporate Control Market

Many proponents of Rule 19c-4 and similar regulatory schemes felt that by preventing the inevitable disenfranchisement associated with dual-class recapitalization, they would preserve the opportunity for noninstitutional shareholders to share in potential control premiums at a later date.\textsuperscript{227} The SEC has explicitly stated that "the Rule will protect shareholder interests in connection with contests for corporate control. . . ."\textsuperscript{228}

Theoretically, part of any reduction in the value of a share in a newly recapitalized firm can be attributed to an opportunity cost — the loss of a control premium. Professor Henry Manne explains the concept of the control premium by unbundling the franchise and residual interest contained in a share of stock:

\textsuperscript{223} Simmons, \textit{supra} note 26, at 120.
\textsuperscript{224} Adopting Release, \textit{supra} note 12, at 89,212.
\textsuperscript{225} Simmons, \textit{supra} note 26, at 115-17.
\textsuperscript{226} Id. at 116.
\textsuperscript{227} Adopting Release, \textit{supra} note 12, at 89,211. "[S]hareholders experience large wealth gains as a result of LBOs. In contrast, shareholder wealth is, at best, unaffected by dual-class transactions." Gilson, \textit{supra} note 43, at 822.
\textsuperscript{228} See \textit{supra} note 190 and accompanying text; see also Blair et al., \textit{supra} note 212, at 420 (suggesting marketable voting rights may facilitate value-increasing takeovers thus increasing welfare).
[a]s the price of a voting share declines because of any recogniz-
able inefficiency in the management of the company, the possibil-
ity of capital gains from improved management increases accord-
ingly. Control will be worth more, and the vote portion of the
share package will appreciate at the same time that the price of
the share package is declining. The vote therefore becomes valu-
able largely as a result of the potential for appreciation of the
underlying share interest; when the potential gain in shares is
lowest, the value of the vote will tend towards zero.229

The loss of the control premium befalls shareholders in the dual-
class firm because such a class structure enables management to
prevent all post-recapitalization corporate acquisitions of which
they disapprove, regardless of the decline in the price of voting
shares that often precipitates hostile overtures.230 Because only
common stock with limited voting rights can be sold, acquisition of
a controlling interest becomes improbable after recapitalization
unless participation by high-vote shareholders is ensured.231
Thus, the potential acquisition value or premium is thought to
shift to management when it gains majority voting power. A re-
duction in the likelihood of a takeover is thought to alter manage-
mental incentives. The implication being a reduction in overall non-
controlling shareholder wealth, because managers may deviate
from investment and financing decisions that maximize the value
of the firm.232

The main impact of a firm’s security voting structure will
be in its influence on the market for corporate control.233 Because

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229 Henry G. Manne, Some Theoretical Aspects of Share Voting, 64 COLUM. L.
REV. 1427, 1430 (1964).

230 See Simmons, supra note 26, at 115 n.61. “The value of votes is twofold: they
represent both the value of the right to control management . . . and the present value
of the right to payment from an acquirer that represents the increased value to that
bidder of the ability to obtain corporate control (the control premium) . . . .” Id.

231 See supra notes 29-39 and accompanying text (discussing fact that time-
phased plans make this possibility at a minimum, more probable). Also, it should be
noted that several firms with dual class structures have been acquired. See R. Ferra-
ra et al., Tender Offers: Toughing it Out, in Mergers and Acquisitions in the
dual-class structures have been acquired); William L. Megginson, Restricted Voting
Stock, Acquisition Premiums, and The Market Value of Corporate Control, 25 FIN.
REV. 175, 175-76 (1990) (reporting on study of 152 British firms that had two or more
classes of stock outstanding and noting that forty-three of initial 152 firms were sub-
sequently acquired). See generally infra notes 347-48 and accompanying text (provid-
ing Affiliated Publications, Inc., and McCaw Cellular as examples).

232 Lease et al., supra note 89, at 448.

233 Jarrell & Poulsen, supra note 13, at 132.
most firms undergoing a dual-class recapitalization were controlled by insiders before the transaction, however, the market for control exerts little influence. The insider voting power insulates the firm from hostile control activity.

Some commentators have voiced concern that majority shareholders will expropriate or consume substantial amounts of corporate wealth. For example, large-block or controlling shareholders could pay themselves an excessive salary, negotiate “sweetheart deals” with other companies they control, invest in projects with a negative net present value, or simply withdraw corporate funds. Empirical study, however, indicates that majority shareholders do not use their voting power to expropriate or consume substantial amounts of corporate wealth. Furthermore, firms with majority shareholders survive in large numbers, something that one would not expect to observe if majority shareholders systematically consumed corporate wealth. In part, those conclusions are based on the large shareholdings themselves: “majority shareholders typically hold more of the stock, 64 percent on average, than would be rational if their sole objective were expropriation.”

A discussion of the market for corporate control and dual-class stock would not be complete without briefly considering occasional calls for establishing a market for corporate votes. For instance, in the 1980s, Wall Street professionals suggested the creation of a market in which investors could buy and sell votes separately from shares. The voting rights acquired in such a

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234 ROMANO, supra note 111, at 12 n.33.

One explanation that is consistent with the substantial inside holdings and stock price evidence is that the managers of the [dual-class] firms . . . were able to block takeovers before the recapitalization as well as after . . . . [Hence], these empirical results [obtained by Partch, Gordon, and Jarell and Poulsen], may not be useful in forecasting the impact of a recapitalization on a typical publicly held corporation. Such typical firms have substantially less inside ownership and are subject to takeover bids. Ruback, supra note 98, at 172. Ruback anticipates a decline in the stock price of a typical firm upon recapitalization. Id.


236 Id. at 318.

237 Id.

238 Id. at 344.

239 Id.

240 Blair et al., supra note 213, at 421.
transaction would be temporary; they would revert to the seller after some specified period, not unlike the plans to alter voting rights described in Part II of this paper.\textsuperscript{241} It is argued that such a market would improve the efficiency of the market for corporate control and facilitate certain hostile takeovers.\textsuperscript{242}

\section{Public Policy and the Moral-Political View}

The vague concepts of public policy and moral concerns have also been held out as rationales for restrictive dual-class regulation.\textsuperscript{243} Such proponents base their opposition on a belief that voting rights are non-negotiable, basic, and immutable and thus represent something that cannot simply be voted away.\textsuperscript{244} It has been said that voting rights operate as a "minimal, fail-safe constraint on the integrity, diligence and competence of those who manage publicly traded corporations."\textsuperscript{245} Under this view, the corporation is correlative analyzed as a nation-state or body politic.\textsuperscript{246} As such, it is hypothesized that the legitimacy of the corporate enterprise (like a nation-state) will be undermined if voting rights are permitted to be bargained away.\textsuperscript{247} Michael Jacobs argues that disassociating voting power in elections from economic risk undermines capitalism because the decision-makers are betting with someone else's money, and thus violating the golden rule: He who has the gold sets the rules.\textsuperscript{248}

This notion of voting rights has become an immutable part of our corporate theoretical culture. Nevertheless, the right to vote is generally more highly valued by a certain group of theoreticians than by shareholders.\textsuperscript{249} In fact, many of those who strive to save

\begin{itemize}
\item \textsuperscript{241} Id.
\item \textsuperscript{242} Id. "The efficiency benefits of market-determined assignments of voting rights can be extended [to new firms] as well as existing securities if transactions in voting rights are allowed ... improving the welfare of outside shareholders." Id. at 422.
\item \textsuperscript{243} See Flokos, supra note 10, at 1785-93 (summarizing moral-political basis of one share, one vote).
\item \textsuperscript{244} See, e.g., Lowenstein, supra note 33, at 1007-12.
\item \textsuperscript{245} Id. at 1008.
\item \textsuperscript{246} See Flokos, supra note 10, at 1788-93 (analyzing moral-political view and its relation to contractarian approach).
\item \textsuperscript{247} Id.
\item \textsuperscript{248} Jacobs, supra note 47, at 139.
\item \textsuperscript{249} See Paul W. McCracken, The Corporation and the Liberal Order, in The Corporation: A Theological Inquiry, (Michael Novak & John W. Cooper eds., 1981) (citing Opinion Research Corp., 1978 Shareholder Attitude Survey (1978)). The following chart indicates the primary reasons different classes of stockholders purchase stocks:
the corporate franchise openly admit that the value of corporate voting to shareholders is small and speculative, thus generally going unrecognized.250

Notwithstanding the potential equities that may occur in the bargaining process, advocates for restrictive regulatory measures often base their opposition on concerns of a more grand scale. For example, Joel Seligman has argued that regardless of whether the bargaining process is able to secure a fair deal for shareholders, "if the basic economic effect of dual class voting structures is a loss in management efficiency, a payment to shareholders will not compensate society for that economic cost."251

IV. PUTTING DUAL-CLASS STOCK IN PERSPECTIVE

A. A Theoretical Primer

The process of capital formation clearly benefits from a calculable legal system composed of formal rules. There are two fundamentally different approaches to the nature of the corporation; first, the contractual theory, and second, the concession (or regulatory) theory. These two theories, and derivations of them, continuously battle to decide the content of these rules.252 The conflict is ongoing because enterprises are continuously striving for better forms of organization and more efficient production. The financial

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Id.; see also Securities and Exchange Commission Staff Report on Corporate Accountability for the Senate Committee on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess., 65-68 (Comm. Print 1980) (noting SEC staff report has stated that, "[t]he majority of commentators expressed the view that shareholders have little interest in participating in corporate governance—they are interested primarily in the economic performance of their corporation"). In addition, a 1978 study of approximately 500 dispersed public shareholders reported that 93.3 percent viewed the decision to purchase stock as an investment rather than an ownership decision. See Larry D. Soderquist & Robert P. Vecchio, Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management, 1978 Duke L.J. 819, 835-37; see also Flokos, supra note 10, at 1794-95.

250 Simmons, supra note 26, at 119.
251 Seligman, supra note 33, at 723.
252 See Butler and Ribstein, supra note 87, at 3-43 (describing theories in detail).
innovations that result implicate many of the core principles of corporate law. Since the exchanges are an intricate part of this system and do not enjoy monopolistic power, they must also adapt their rules and be prepared for the consequences their actions have on their own competitive position and the competitive position of the firms they list.

Depending on the individual governance matter at issue, theorists with opposing views of the corporation may or may not be discernably opposed. Regardless of the individual issue, however, predetermined theologies of the corporation tend to drive the analytical process. In corporate governance, academics have historically enjoyed a formidable role in the rulemaking process. As a result, their highly influential role and the dominant themes they create have the potential to shape the corporate governance controversies of the day. For instance, Paul W. McCracken noted over ten years ago that:

> there is a considerable element of scholasticism in the current discussion, much of it stridently polemical in nature, about the basic rightness or legitimacy of the modern corporation. . . . A foundation stone of the case for the view that corporations are somehow “getting away with something” is the assertion that corporations have been created, and accorded certain privileges [i.e., limited liability], by the state. They have received some sort of “concession” from the state, and they should therefore be operated for the public benefit, not “just for the benefit of the owners and managers,” as it is often put.253

Those sentiments identify a theology still commonplace today, a theology that identifies the corporation as a sociological and political institution rather than an economic institution.254 It is a theology in which Orwellian quotations are relevant because the distinction between capitalistic and political institutions is

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253 McCracken, *supra* note 249, at 36-37.

254 *Id.* at 38. The result has been a plethora of rules designed to constrain the amount of harm that can fall on the “other constituencies” as a result of corporate decision making. Scholars buttressed by implicit or explicit reference to market failure have developed a view of corporate governance in which workers and other constituencies with a long term stake in the firm have direct access to governance power structures. For example, such views often advocate express appropriation of seats on the board of directors. For a summary of such views as a background to a discussion of the law and economics of corporate governance, see *Williamson, supra* note 15, at 300.
blurred, a theology in which equality is demanded regardless of the efficiencies and incentives that are smothered.

When differences pervade the debate at this level, compromise on smaller issues becomes a lengthy and difficult process. Because dual-class-stock use implicates so many other areas of corporate governance, the conflict regarding its use has been drawn out and its resolution delayed to an even greater extent than would otherwise be the case.

For example, when voting rights are viewed as immutable, any voting rights exchange not tied to the underlying shares are viewed with skepticism and commonly becomes characterized by notions of lust for power (superbia), lust for wealth (cupiditas), or some other manner of ill-intentioned managerial self-interest, regardless of the other advantages that may represent the realities of the exchange. In the end, such instincts compel one to move toward a heightened legal regime, designed to control such impulses, often with a patchwork set of rules that clearly take into account the interests of those other than managers and owners. Such regimes ignore the real efficiencies and incentives that can result.

In the context of antitakeover laws, current rules are commonly designed to protect corporate constituencies other than shareholders. In the case of dual-class common stock, however,

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255 Michael Jacobs, in his book on investment and shareholder activity, cites to George Orwell’s famous quotation in Animal Farm: “All animals are equal, but some animals are more equal than others” at the beginning of his discussion on unequal voting rights. Jacobs, supra note 47, at 138 (citing George Orwell, Animal Farm (1946)). However relevant to a discussion of political rights quotations from Animal Farm may be, it is entirely inappropriate in a discussion on corporate governance.


257 It is as if entrepreneurs, who are seeking to expand through the use of equity capital, while seeking to avoid control dilution, suddenly can not be trusted; as if success corrupts the moral discipline they needed to build the enterprise in the first place. Id. at 32. And while it is true (particularly with reference to the mid-1980s) that some disparate voting rights plans were proposed by management with dubious intent, such instances are not systematically present over the years. Flocos, supra note 10, at 1768.

258 Michael Jacobs notes “[f]or the most part . . ., corporate governance issues have been debated on the basis of fairness rather than economics. Surprisingly few shareholder activists have put forth a legitimate case for how their corporate governance agenda would be in the economic interests of all owners.” Jacobs, supra note 47, at 73.

259 See Morey W. McDaniel, Stockholders and Stakeholders, 21 Stet. L. Rev. 121 (1991) (noting that some believe constituency statutes are necessary and beneficial); see also id. at 121 n.2 (listing other articles discussing benefits of constituency statutes). But see Henry A. Butler & Larry E. Ribstein, The Contract Clause and the Cor-
the same voices that have supported antitakeover amendments and other corporate rules empirically detrimental to shareholder interests suddenly rise in support of shareholder interests when the topic shifts to unequal voting rights. Others who viewed the shareholder voting process as venerable now seek to substitute their judgement for that of the shareholders on the most momentous vote of all — disenfranchisement. SEC action similarly illustrates this dichotomy. A certain degree of hypocrisy is evident in comparing Rule 19c-4 with the Williams Act and the regulatory system designed to govern proxy use. In recognition of this, the AMEX proposal on dual-class stock queried what may be the fundamental questions of the debate:

If shareholders are incapable of choosing whether and how to exercise their franchise, then what is the rationale for continuing the proxy process and allowing the same shareholders to vote on issues of lesser or greater consequence? If, on the other hand, the proxy process works, then it is the ultimate act of disenfranchisement for a government agency or a self-regulatory organization to administratively determine once and for all what is “best” for shareholders, and to deny them the ability to make that choice for themselves.

As former SEC Commissioner A. A. Sommer, Jr., has noted, the perspective taken by Rule 19c-4 and the one-share, one-vote advocates “smacks of Central American ‘democracy’: if you don’t like the results of the election, stop having the elections.”

B. From Theory to Practice: An Empirical Perspective on the Use of Dual-Class Common Stock

In light of the empirical evidence previously discussed, we know that dual-class recapitalizations are generally implemented in corporations with certain pre-existing ownership characteristics. Successful implementation does not necessarily mean, however, that dual-class use is desirable. Many consider successful implementation to be the result of coercion, which implies a

\[supra\] notes 163-88 and accompanying text (discussing AMEX proposal).

\[AMEX 1991 Proposal, supra note 40, at 24.\]

\[A.A. Sommer, Jr., One Share/One Vote—The SEC Stumbles, DIRECTOR'S MONTHLY, Oct. 1988, at 1, 3.\]

\[See infra note 278 and accompanying text.\]
negative connotation to dual-class stock. Yet, coercion can only exist if the dual-class recapitalization decreases the shareholders’ value despite the shareholders’ affirmative vote for it. Coercion serves as a proxy for explaining how an affirmative vote can take place when the transaction itself is inefficient.

If coercion were a part of the voting process, after recapitalization one would expect decreases in the value of low-vote common stock and increases in the value of high-vote common stock. Because the empirical evidence is at best mixed, the analysis becomes more complicated. The decision whether to regulate the ability of shareholders to amend the voting rights contained in corporate charters turns on surrogate issues. First, are there sound economic reasons for firms to adopt voting structures other than single-class common stock? Second, which firms are likely to use a dual-class stock structure? Third, are policing mechanisms available or incentives present to align the interests of the high-vote group with those of shareholders who hold low-vote shares after a dual-class structure is implemented? Fourth, do the incentives available to the exchanges lead them to adopt efficient listing rules for member firms? Fifth, are the theoretical problems associated with dual-class stock amenable to institutional-investor correction? The answers to these questions should provide a proper framework for analysis, and together they should identify the optimal regulatory model.

1. Are There Sound Economic Reasons for Dual-Class Stock?

As Professor Gilson explains, “[t]he justification offered for . . . [a dual class] recapitalization . . . is Rawlsian: that centralizing control in those receiving the class with superior voting rights somehow will increase the value of the company and, as a result, will increase the value of the shares with limited voting rights.” 264 Theoretically, value increases originate in the economics of the new shareholder/manager relationship and the dynamics of insider control. Empirical studies on dual-class common stock suggest that the Rawlsian hypothesis is not false. 265 In fact, specific

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264 Gilson, supra note 43, at 810. “The philosopher John Rawls has argued that the distribution of income and wealth is just if there is no alternative distribution that would make the worst off people in society better off.” Posner, supra note 31, at 436. (citing JOHN RAWLS, A THEORY OF JUSTICE (1971)).

265 A number of researchers have examined the market valuation of voting rights in dual and multiple share firms. See, e.g., Lease et al., supra note 89; Haim Levy, Economic Evaluation of Voting Power of Common Stock, 38 J. Fin. 79 (1983); De-
theoretical rationales in support of the dynamics of dual-class use have already been identified.

First, it has been stated that a dual-class structure can protect outside shareholders from coercive takeover tactics or from selling their shares at less than value because they lack the information possessed by the inside shareholder group. One difficulty that dispersed shareholders face when confronted with a hostile tender offer is that they are unable to act collectively; this inability hampers their ability to negotiate. By definition, the dual-class capital structure increases the power of inside shareholders or the control group because it forces bidders to deal directly with a collusive group, thus augmenting the power of all shareholders.

Professor Fischel and others have noted that the end result of this bargaining arrangement (which is similar to that resulting from the use of poison pills) is not likely to decrease the number of control transactions but to increase the price paid per transaction. There is some evidence that the implementation of defen-

Angelo & DeAngelo, supra note 215; Partch, supra note 197; Vijay M. Jog & Allan L. Riding, Price Effects of Dual-Class Shares, 42 FIN. ANALYSTS J. 58 (1986); Gordon, supra note 44; First SEC Study, supra note 134; Second SEC Study, supra note 134; Marcia H. Millon & Michael R. Vetsuybens, Voting Rights and Shareholder Wealth: The Issue of Limited Voting Common Stock (1987) (unpublished manuscript, Southern Methodist University) (on file with author); Jarrell & Poulsen, supra note 13; Kenneth Lehn et al., supra note 91; Megginson, supra note 231.


267 See Lea et al., supra note 89, at 448.

268 Fischel, supra note 19, at 138-39; Lease et al., supra note 89, at 448. Strangely enough, "[d]espite the SEC's professed concern with the defensive use of dual-class transactions, the Commission nonetheless specifically exempted from the reach of Rule 19e-4 the two most effective antitakeover tactics in existence today—the poison pill and the corporation's strategic defensive use of control-share acquisition statutes." Flocos, supra note 10, at 1781. This was done despite the fact that poison pills produce a loss averaging 0.34%; 1.51% when adopted by a firm which has been the
sive tactics which allow management to negotiate with hostile bidders may actually increase premiums paid in successful offers. There is also some evidence that benefits can result from increasing managerial voting power while maintaining low marginal vote ownership. Thus, the transfer of negotiating power to the insiders has the potential to maximize value exchanges which would be unattainable under one-share, one-vote structures.

Furthermore, judicial review ensures the participation of the low-vote shareholders in control premiums. As Professor Seligman has explained, "[w]ith dual class capitalization, courts will be aware that a proposal adopted . . . has the collateral consequence of enriching its managers." This factor is likely to inspire skeptical judicial review.

Second, the dual-class transaction eliminates the risk to management that shareholders will terminate their employment or sell shares to a purchaser of control who might change the use of

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269 Jarrell & Poulsen, supra note 13, at 132-33.
270 "Whether [owners] with voting control are free to turn down any bid for the firm, no matter how lucrative, is an interesting fiduciary duty question." Gordon supra note 44, at 4 n.3 (posing that question); see also Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 472 (Cal. 1969) (holding breach of fiduciary duty in transfer of control bloc to holding company, which is then taken public, rather than initiating a transaction in which all shareholders could participate).
271 Seligman, supra note 33, at 720.
272 Id.; see Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (holding shareholder who controlled firm's Class B voting shares and dominated directors, management and affairs of the firm, to rigorous fiduciary standard). The shareholder must prove not only good faith but also "inherent fairness from the viewpoint of the corporation" of a decision to redeem the limited voting rights stock. Id. at 42 (quoting Pepper v. Litton, 308 U.S. 295, 306 (1939)); Judah v. Delaware Trust Co., 378 A.2d 624, 628 (Del. 1977) (noting actions of management which serve to prejudice interests of subordinate security holders will be given close judicial scrutiny); see also Adolf A. Berle, Jr., Non-Voting Stock and "Bankers' Control," 39 Harv. L. Rev. 673, 677-79, 682-90 (1926) (reviewing aspects of older case law suggesting that control of corporations by managing shareholders results in "rendering them analogous to trustees, imposing many of the duties which trustees normally have toward their cestuis que trust"); see also Flocos, supra note 10, 1781-82 nn.93-95, 1784 n.106 (extensively listing case law dealing with supervoting preferred, supervoting common, and reverse recapitalizations whereby firm moves from two classes of stock to one).
the firm’s assets or rid itself of the current management team.\textsuperscript{273} The “idea is that managers, by making [a] firm-specific investment of their human capital, have thus implicitly contracted for future payments.”\textsuperscript{274} The greater the managers’ belief that they may be denied a return on their firm-specific investments, the less willing they will be to make them in the first place.

It has been stated that “[o]ne’s time, energy, strength, and attention are, in a sense, one’s capital.”\textsuperscript{275} In firms characterized by concentrated ownership structures, the firm-specific human capital investment may be considerable. This type of investment is especially significant when entrepreneurs or families who have devoted a significant amount of effort in the developmental stages of the firm’s existence hold control.\textsuperscript{276} Because such investments may not be valuable to other firms, continued association and continued investment with the firm is necessary to induce further firm-specific investment. Corporate governance rules that decrease the likelihood that those entrepreneurs will collect the return on their investments will necessarily weaken the incentives to invest personal time and energy. Enabling those individuals to hold high-voting-rights stock can thus promote and protect entrepreneurial investment while the firms they manage gain access to the capital markets. In the end, society benefits because capital for expansion is supplied to firms and incentives are put in place for management acquisition of firm-specific skills.\textsuperscript{277}

In addition, when a family ownership group is present\textsuperscript{278} both before and after recapitalization, the consolidation of control asso-

\begin{footnotes}
\item[273] Fischel, supra note 19, at 137.
\item[275] Novak, supra note 256, at 43.
\item[276] DeAngelo & DeAngelo, supra note 215, at 34, 63-68 (noting “substantial family involvement” in 30 of 45 firms studied).
\item[277] Notions of firm-specific human capital investment provoked the use of golden parachutes in the event of a hostile control transaction. As Professor Fischel notes, however,

[The difference between insider control and golden parachutes is that insider control protects managers from transfers of control while golden parachutes compensate them in the event a transfer occurs. [While] [b]oth techniques have costs and benefits . . . [g]olden parachutes may be difficult to negotiate, . . . [h]ave enforceability [that] is suspect . . . [a]nd create a moral hazard.

Fischel, supra note 19, at 137-38.
\item[278] See Flocos, supra note 10, at 1778 n.73 (indicating family owned or dominated firms often typify dual-class firms). For example, the Washington Post, Dow Jones &
associated with a recapitalization is unlikely to increase agency costs because of the unique social relationships among the group members.\textsuperscript{279} Intrafamily relationships as a mechanism of oversight within the family management team can be particularly forceful;\textsuperscript{280} it is said that friends and family can apply sanctions that are unavailable to outsiders.\textsuperscript{281} Family monitoring incentives are thought to be "traceable to explicit and implicit contracts that tie family welfare to company profitability, through the quasi rents that relatives earn from employment at a family-controlled firm or through family ownership of common-stock cash flows."\textsuperscript{282}

It was previously suggested that antitakeover methods such as poison pills can achieve the same results as dual-class recapitalization without disenfranchising shareholders. Such comparisons are faulty, however. For instance, one critical difference between the two approaches lies in the character of approval necessary for implementation.\textsuperscript{283} Whereas the board of directors can issue poison pill preferred stock without shareholder approval as long as the corporate charter authorizes the procedure,\textsuperscript{284} dual-class stock issuance requires specific levels of shareholder approval. Moreover, the principal goal of the poison pill (normally instituted before the takeover bid) is to protect shareholders of the target company from a transaction by which the acquiring company secures control and freezes out the remaining shareholders.

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\textsuperscript{279} \textit{Flocos, supra} note \textsuperscript{10}, at 1777; \textit{T. Copeland \& J.F. Weston, Financial Theory and Corporate Policy} 340 (3d ed. 1988).

\textsuperscript{280} \textit{Jensen \& Meckling, supra} note \textsuperscript{208}, at 306; \textit{see DeAngelo \& DeAngelo, supra} note \textsuperscript{215}, at 54 (noting family members who controlled 44% of vote of \textit{Tasty Baking Company} conducted one day proxy fight and replaced one relative with another as Chairman of Board).

\textsuperscript{281} \textit{See Williamson, supra} note \textsuperscript{15}, at 305.

\textsuperscript{282} \textit{DeAngelo \& DeAngelo, supra} note \textsuperscript{215}, at 54; \textit{see also Jensen \& Meckling, supra} note \textsuperscript{208}, at 306-07.

\textsuperscript{283} \textit{Gilson, supra} note \textsuperscript{31}, at 639.

DUAL-CLASS STOCK

at a low price. The goals of dual-class stock are different. Finally, because adoption of a poison pill does not ensure the same degree of protection to those investing firm-specific human capital, dual-class stock becomes a more valuable option.

A third benefit of dual-class stock is that it generally allows holders of the supervoting stock (depending on the ratio of votes per share, and the number of shares held) to diversify their firm-specific stock holdings without losing control. As Professor Gilson notes, "by selling off some of their equity position, a controlling group can reduce the excessive unsystematic (and otherwise potentially undiversifiable) risk that they bear as a result of their large investment in the company." As such, the high-vote shareholders will be less risk averse to investment projects because outside holders have taken on some of the firm's risk through the purchase of the low-vote common shares. Without the added source of funding and the resulting diversification, these projects might have been replaced with less risky projects. Dual-class stock enables the high-vote shareholders to better match their levels of risk aversion with those of the public shareholders.

If a firm characterized by large firm-specific holdings is not permitted to adopt a recapitalization plan, control shareholders may be forced to diversify their capital investment into products whose profit streams are negatively correlated over time with

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285 Gilson, supra note 31, at 639.
286 Id. at 812.
287 Id. Research has shown that, on average, insiders tend to decrease their holdings in the recapitalized firm. See Partch, supra note 197, at 332. One study found that approximately 21 months after the dual-class recapitalization, the average proportional ownership of equity owned by insiders was 43.7%, as opposed to a 48.6% pre-transaction. Id.
288 Thus, if 25 shareholders hold all the voting stock in a corporation, and that stock is reclassified as 50% voting and 50% non-voting, these same shareholders will retain voting power in the same proportions as existed before the transaction, but they will have simultaneously gained liquidity on 50% of their investment.

Gilson, supra note 31, at 124 n.60. While shareholders could, in fact, diversify their portfolios to some degree, they would still have a great deal of investment, both human capital and capital, in the firm. As such, the transaction described above may initiate greater risk taking while at the same time spur human capital investment. Also, overall low vote share liquidity increases because there are more low vote shares in the public domain. Shareholders want riskier projects because they reap the benefits of them; the downside risk is limited to the loss of their investment. Id.
their primary product. In this way control shareholders can avoid the secular variability associated with business cycles and demand or cost shocks, thereby lowering the risk that is tied to the single firm. This type of diversification is costly to noncontrol investors, who can simply diversify their portfolio to receive the same benefits. In addition, such diversification will not always require a shareholder vote.

A fourth reason dual-class transactions may be beneficial is that dual-class use shifts control into the hands of those who value it most, creating a Pareto-optimal exchange. For example, placing voting rights where their value is highest enables exchanging shareholders to realize potential control premiums in the form of current dividends on their low-voting stock, while high-vote holders get the vote which they consider more valuable than dividends. As previously mentioned, because the value of the vote can be tied to a potential control premium, the recapitalization actually implements a control premium exchange that might not otherwise have taken place. The value that passes is the present value of an unknown control premium. The value is unknown because it is uncertain that the current shareholders would have ever realized the gain associated with a future control premium.

Empirical research indicates that the high-voting shares typically increase in value after the recapitalization. One study examining 152 British firms that have two or more common share classes with different voting rights outstanding between 1955 and 1982 found that, on average, the superior voting shares have mar-

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290 Id.


A stock purchase, because it involves shareholders directly, does not require the formality of a vote in most states. The shareholders of the acquiring corporation are not entitled to vote on the purchase. Nevertheless, the Rules of [the NYSE and Amex] require a vote if the acquisition will increase the outstanding shares of the acquiring corporation by 20 percent or more, or if the directors, officers, or major shareholders of the acquiring corporation have an interest in the acquired corporation.

Id. Appraisal rights are not required by most state statutes in stock acquisitions. Id.

292 See Lease et al., supra note 89, at 444. Research has shown that in firms with two outstanding classes of common stock, the class with superior voting rights traded at a premium of about 5 percent of the other. Id. But, in firms that have also included a class of voting preferred stock, the class of common stock with the superior voting rights traded at a significant discount to the class of common shares with inferior voting rights. Id.
ket prices that exceed those of the otherwise equivalent restricted voting shares by 13.3 percent.\textsuperscript{293} This same study noted, in summarizing the results of eight other studies, that “the overall picture that emerges from these studies is that shares of stock with superior voting rights sell at a premium over those with inferior voting rights, and that corporate insiders tend to concentrate their personal holdings in the shares with superior voting rights.”\textsuperscript{294} As Peter Flocos has noted, however:

the fact that fully voting stock generally trades at some premium relative to inferior voting stock indicates that the insider group possesses some sort of realizable value that outsiders do not. Yet this fact alone says nothing about whether the recapitalization transfers wealth to the control group at the expense of public shareholders. As Professor Gordon recognizes, the differential likely reflects the pre-existing control premium of the insider bloc as well as any wealth transfer to that bloc pursuant to the recapitalization. Since the exact value of that premium is not known, one cannot necessarily conclude that the recapitalization transfers wealth to the insiders.\textsuperscript{295}

Another reason given for issuing dual-class shares relates to the perceived time preferences of different corporate shareholders. For example, a firm that issues dual-class shares may be attempting to amplify the voting rights of a distinct group. That group may be more likely to act in the long-term interest of shareholders who are perceived as valuing the firm as an entity.\textsuperscript{296} This amplification (whether empirically beneficial or not) aligns this shareholder group with small portfolio investors who “find it uneconomical to purchase the advice of market professionals . . . and cannot reasonably hope for trading profits . . . [thus] if they are rational, [they] will follow a ‘buy and hold’ strategy.”\textsuperscript{297} Recently, shareholders of the American Family Corporation approved a dual-class recapitalization implemented through a plan to alter voting rights; the express purpose of the recapitalization plan was to reduce the voting influence of “speculative investors.”

\textsuperscript{293} Megginson, supra note 231, at 186-87.
\textsuperscript{294} Id. at 176. But see DeAngelo & DeAngelo, supra note 215, at 57 (finding comparable compensation among multiple common stock classes in twenty of thirty dual-class firms contained in sample of acquired dual-class firms).
\textsuperscript{295} Flocos, supra note 10, at 1780 n.88 (citing Gordon, supra note 44, at 32 n.99).
\textsuperscript{296} Doug Sword, Scripps Offering to Insure Liquidity, Family Control, CINCINNATI BUS. COURIER, Mar. 28, 1988, § 1, at 1.
\textsuperscript{297} MAcEY, supra note 16, at 13.
A dual-class transaction can also decrease the costs involved in supplying firm-specific information to the market itself or to potential bidders in the market for corporate control. As Professor Fischel explains, "[i]n situations of asymmetric information—where managers have information that outside investors do not—managers may have to employ costly signaling devices to communicate their private information."\(^{298}\) We can think of dual-class transactions as a signaling device that shows the market that the firm has valuable opportunities that need to be externally financed. Fischel calls this the "shareholder interests explanation of recapitalizations."\(^{299}\)

2. What Type of Firms Will Use Dual Class Stock?

In light of the increase in dual-class use in the 1980s, we are better able to discern what type of firms are likely to use dual class common stock. Professor Ronald Gilson singularly recognized that the desirability of dual-class stock primarily depends on the characteristics of an individual firm.\(^{300}\) He described two types of firms: "question marks" and "cash cows."\(^{301}\)

Gilson defines "question marks" as companies in an early stage of development that suffer from capital shortages; their markets are growing quickly, they may have only recently gone public, and the founding entrepreneurs still retain a dominant ownership position.\(^{302}\) Generally, such companies suffer from a tradeoff between cost of capital and loss of control; decision makers need capital but do not wish to lose the control that comes with it. Engaging in a dual-class recapitalization before raising additional equity capital allows a dominant shareholder group to secure capital for investments with a positive net present value without forcing

\(^{298}\) Fischel, \textit{supra} note 19, at 138. Examples of this include, dividend payout changes, share repurchases, and high debt to equity ratios. Managers may take an action which will prove costly if future cash flows turn out to be low. From this, investors may infer that the entrepreneur believes that cash flows will be high. The existence of information asymmetries between management and investors has been documented in previous studies of insider trading. See David H. Downes & Robert Heinkel, \textit{Signaling and the Valuation of Unseasoned New Issues}, 37 J. Fin. 1, 2-3 (1982); Jeffrey Jaffee, \textit{Special Information and Insider Trading}, 47 J. Bus. 410 (1975); Myron Scholes, \textit{The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices}, 45 J. Bus. 179 (1972).

\(^{299}\) Fischel, \textit{supra} note 19, at 147.

\(^{300}\) Gilson, \textit{supra} note 43, at 824. Such an explanation is the antithesis of the "management entrenchment" explanation of recapitalizations.

\(^{301}\) Id. at 824, 828.

\(^{302}\) Id. at 827-28.
them to bear a disproportionate amount of the cost or lose proportionate control.\textsuperscript{303}

The Lehn, Netter, and Poulsen study, comparing firms that undergo a leveraged buyout ("LBO") with those that undergo a dual-class recapitalization, supports this "question mark" concept.\textsuperscript{304} Noting a "growth hypothesis" measured both in terms of the average growth rate over the preceding five years and the one year preceding the transaction,\textsuperscript{305} they found that sales growth and employee growth are both significantly higher than before the recapitalization. In addition, they found that dual-class firms spend significantly more on advertising and R&D than LBO firms.

The authors also measured post-transaction growth opportunities by calculating the percentage changes in capital expenditures following the recapitalizations on a one-year-before to one-year-after, two-years-after, and three-years-after format. They found significant industry adjusted growth in capital expenditures, standardized by sales, in all three measurement periods.\textsuperscript{306} Such statistics indicate that, after the transaction, dual-class firms increase capital expenditures significantly more than the firms that have undergone an LBO. The results indicated that 47 percent of the dual-class firms accessed the public equity markets after the transaction, with 41 percent of those issuances occurring within three years after the dual-class recapitalization.\textsuperscript{307} On the basis of those statistics, the authors concluded that, owing to a continuing demand for external financing, growing firms are more likely to consolidate control through a dual-class transaction than an LBO.

Gilson finds further support for the "question mark" explanation based on empirical share price data after the transaction. Specifically, he notes early insignificant price changes result (on

\textsuperscript{303} Id. at 828.

\textsuperscript{304} Lehn et al., supra note 91, at 569-78 (comparing 380 firms that adopted either dual-class recapitalization or went private through LBO during 1977 to 1987 and concluding that choice between dual-class recapitalizations and LBOs is governed by firm attributes that make one organizational form more desirable than another).

\textsuperscript{305} Id. The growth hypothesis included the following: dual-class firms have a higher growth rate than LBO firms, both before and after the transaction, and dual-class firms use the public capital markets after the transaction to raise capital. Id. at 558-59, 564-65. The study measured growth in several ways: average annual increase in sales, employees, research and development costs, advertising intensity, and capital expenditures Id. at 571.

\textsuperscript{306} Id. at 577 tbl. 4.

\textsuperscript{307} Lehn et al., supra note 91, at 576.
average) from dual-class recapitalizations: the impact on shareholder wealth is small, whether positive or negative. He explains:

[T]he market demands of the company's competitive environment already serve to align the interests of management and shareholders. The gain from the dual class transaction . . . should be reflected in an increase in the value of control shares, not public shares. The market price of the preexisting single class of common, however, reflects the value of non-controlling shares so that, consistent with the data, the dual class transaction should have little impact on the value of those shares [the lack of voting power already being accounted for in the share price].

The Partch study adds support to this hypothesis as well. Partch found that "shareholder wealth does not appear to be [significantly] affected by the creation of a class of limited-voting-right common stock." The downside to the expansion is that the firm must bear increased cost of capital; the post-recapitalization issuance will raise less money than it would have had voting rights been attached.

A further negative implication associated with dual-class stock has to do with its use by corporations that Professor Gilson labels "cash cows." Cash cows are characterized as stable companies with high market shares, in slow-growing mature industries. They generally have large positive cash flows. The

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308 Gilson, supra note 43, at 829-30.
309 Because the dominant shareholder group, unlike presumably diversified public shareholders, already bears substantial unsystematic risk, the cost of failing to increase market share falls more heavily on them than on public shareholders. Thus, one would expect the investments to be made regardless of the shareholder vote on the dual class transaction and, as a result, the valuation impact of the availability of positive net value investments already would have been incorporated into the company's stock price.

Id. at 830 n.62.

310 Partch, supra note 197, at 333. The entire Partch sample earned statistically significant positive abnormal returns of 1.237% on the announcement date, and 2.125% over all event days examined. Id. at 326-27 tbl. 4. However, Partch suggests that these are misleading because a positive abnormal return does not fairly describe the sample; only roughly half of the returns are positive, and it is impossible to reject chance as an explanation for the proportion of positive and negative results. Id. at 328. From announcement through approval, the entire sample experience insignificant negative abnormal returns of 1.775%. Id. at 327 tbl. 4.; see also Gilson, supra note 43, at 819-20 (comparing abnormal return event time studies on dual-class common stock transactions of Partch, Jeffrey Gordon, and Gregg Jarrell and Annette Poulsen).

post-transaction economic benefits that this article has previously discussed would be absent if a "cash cow" were to implement a dual-class structure.\textsuperscript{312}

For instance, in the post-transaction "cash cow," the opportunities for managerial misbehavior are greater than in the post-transaction "question mark." Jensen explains:

[C]ash cows are subject to particularly severe conflicts of interest between managers and shareholders. Managers want to increase the amount of assets under their management even if that requires undertaking investments with negative net present value, while shareholders prefer that the free cash flow be distributed to them so that they can then invest the funds more profitably on their own.\textsuperscript{313}

If a manager/shareholder group were to obtain control of this type of company, managerial incentives would become perverted: cost-cutting and self-interested distributions, rather than investments with a positive net present value would result.\textsuperscript{314} If excess capacity exists in the industry,\textsuperscript{315} such managers are apt to resist downsizing and exit.\textsuperscript{316} At best, the decision to initiate shutdown is reached slowly and drains shares of value as product markets ultimately force the manager to act. The removal mechanisms necessary to rid the firm of inefficient management are limited after the transaction, however. Dual-class use in the cash cow context is a cause for concern.

Empirical evidence indicates that "cash cows" do not commonly undergo dual-class recapitalizations. In fact, research has shown that "cash cows" will generally undergo an LBO when a restructuring is to take place if there is not a dominant shareholder group before the transactions. The result of the LBO trans-

\textsuperscript{311} \textit{Id.}

\textsuperscript{312} Agency costs are especially large for entities of this type. \textit{See Jensen, supra note 310, at 323.}

\textsuperscript{313} Gilson, \textit{supra} note 43, at 824 (citing Jensen, \textit{supra} note 310, at 323).

\textsuperscript{314} Gilson, \textit{supra} note 43, at 826-27.

\textsuperscript{315} The world-wide tire industry is an example of this type of industry. Jensen, \textit{supra} note 15, at 847-48; \textit{see also} Peter Huber, \textit{The Telephones, Competition, and the Candice-Coated Monopoly}, 16 REA., 84, 37 (1993) (noting excess capacity also exists in long-distance telecommunications industry). Sprint alone has far more capacity than it could possible hope to utilize in the near-term; it was capable in 1990 of supplying 146 percent of the market. \textit{Id.}

action includes the sharing of gains with public shareholders. In those circumstances, Gilson notes, “[a] dual class transaction simply could not achieve the gain[s]” that come with centralizing control.\textsuperscript{317} Thus, if implemented in the “cash cow,” the dual-class recapitalization would serve only to entrench management, whereas an LBO results in gain sharing with public shareholders.”

The shareholders in typical “cash cows” should avoid such an inefficient and costly control shift. Because management lacks a significant share of the corporation’s voting power,\textsuperscript{318} and the shareholders do not receive any gain from an affirmative vote for a dual-class implementation, the proposal should be blocked for lack of public shareholder support.\textsuperscript{319} If a majority of votes is affirmatively cast in favor of the recapitalization, Gilson believes that some form of coercion must be at work.\textsuperscript{320}

Therefore, it is clear that the benefits associated with a dual-class transaction are tied to the ownership structure in place before the transaction, which, in turn, is often a product of the stage of growth in which a firm finds itself. As previously discussed, the pretransaction corporate entity is thought to have a concentrated ownership structure—large family or insider holdings and high-growth product markets. When this is the case, Pareto optimalities can result from implementing the dual-class structure. When this is not the case, dual-class-stock use will often be detrimental to shareholder welfare.

C. Efficient Markets and Separation Theory

An efficient market—one that quickly incorporates the value of new information about a firm into stock prices—will price, among other things, corporate charter terms.\textsuperscript{321} The weak form of the efficient capital market hypothesis, which has been subject to rigorous empirical scrutiny, has established that current price movements fully reflect any information contained in previous

\textsuperscript{317} Gilson, supra note 43, at 826-27.

\textsuperscript{318} While the average CEO of the 1,000 largest firms (measured by market value of equity) held 2.7% of his or her firm’s equity in 1991, the median holding was only 0.2% and 75% of CEOs own less than 1.2%. KEVIN MURPHY, EXECUTIVE COMPENSATION IN CORPORATE AMERICA (United Shareholders Association, 1992); see also Jensen, supra note 15, at 864 (providing additional statistics).

\textsuperscript{319} Gilson, supra note 43, at 827.

\textsuperscript{320} See id. at 832-40 (analyzing shareholder coercion explanation for dual-class transactions).

\textsuperscript{321} ROMANO, supra note 111, at 72; see also JAMES H. LORIE & MARY T. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-97 (1973).
stock prices, thus the history of securities prices does not yield exploitable trading opportunities.\textsuperscript{322} The semistrong form (similarly tested) tests how much time market prices require to adjust to price-relevant information that is released to the public.\textsuperscript{323}

Because efficient capital markets price securities on the basis of the cash flows that are expected to accrue to them and the riskiness of those cash flows, purchasers of limited-voting-class shares in an IPO would price the shares based on the security’s voting rights, returns, and risk.\textsuperscript{324} In effect, they “price protect themselves.”\textsuperscript{325}

Jensen notes that the owner/manager will bear the wealth effects of those agency costs because of the equity market anticipation. “Prospective minority shareholders will realize that the owner-manager’s interests diverge somewhat from theirs, hence the price they will pay for shares will reflect monitoring costs and the effect of the divergence between the managers’ interest and theirs.”\textsuperscript{326} In addition, because the purchasers in an IPO have no preexisting association with the issuing firm, they cannot be coerced to buy those shares.\textsuperscript{327}

Thus, investors purchasing stock in firms that initially capitalize with dual-class stock will pay less for their shares: a reflection of the security’s voting rights, returns, and risk.\textsuperscript{328} The inves-

\begin{itemize}
  \item \textsuperscript{323} Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 555 n.26 (1984). “These studies typically ask whether trading activity that follows the release of such information can earn investors abnormally high returns and focus on the security’s price history before and after the test period.” Id. The results of these tests indicate “efficient price responses to a wide variety of publicly released information.” Id.
  \item \textsuperscript{324} Ruback, supra note 98, at 169.
  \item \textsuperscript{325} Id. at 170.
  \item \textsuperscript{326} Id. at 313.
  \item \textsuperscript{327} Id.
  \item \textsuperscript{328} Romano, supra note 111, at 87. “Some commentators use imperfect information arguments to advocate a substantial mandatory component in corporation codes. They contend that shareholders are inadequately informed about charter terms compared to manager-drafters and thus will mistakenly invest in firms with disadvantageous charter terms, a situation that could be avoided by prohibiting the offending
tors do not lose wealth because of such discounting. Conversely, this means that founders will bear the cost of retaining voting control. Whether that cost negates the gain intended by the use of the low-vote or nonvoting shares is not certain.

For example, some do not accept the inevitability of the owner/manager wealth loss that Jensen hypothesized.\textsuperscript{329} Applying separation theory,\textsuperscript{330} Ronald Gilson and Bernard Black maintain that founders can gain by going public with a nonvoting or limited voting class of stock.\textsuperscript{331} They assert that when the separation theory applies:

so that proposed corporate action affects shareholder wealth only by its impact on the value of corporate stock, and when markets are informationally efficient, shareholders will not hold their views about a proposed corporate action with different intensities . . . . Cast in terms of public choice the implication is that all voters hold their views with equal intensity, in which event public choice theorists have demonstrated that a majority decisional rule is inefficient.\textsuperscript{332}

Gilson and Black maintain, however, that when a founder or founding group wishes to reserve control because of extensive human-capital investment, but needs access to outside equity markets, the separation theory does not apply. More specifically, they assert that

because a corporate action will impact the founders not only through its effect on the value of the corporation's stock, but also through its impact on the value of the founders' human capital, . . . separation does not apply between the founders and the public, . . . because control has a private value to the founders that it

\begin{itemize}
  \item \textsuperscript{329} See Gilson & Black, supra note 99, at 130-33 (discussing separation theory and voting rules); Gilson, supra note 31, at 510-12.
  \item \textsuperscript{330} Gilson & Black, supra note 99, at 132. The separation theorem states that the determination of an optimal portfolio of risky assets is independent of the individual's risk preferences. See James Tobin, Liquidity Preference as Behavior Towards Risk, 25 Rev. of Econ. Stud. 65 (1958) (originally setting forth separation theorem).
  \item \textsuperscript{331} Gilson & Black, supra note 99, at 133.
  \item \textsuperscript{332} Id. at 130.
\end{itemize}
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does not have to the public. Separation only applies amongst the public shareholder group.\textsuperscript{333} In this situation, the founders may gain by going public with a nonvoting or limited voting class of stock because the public, for whom separation does apply, will not value control as highly.\textsuperscript{334}

Some proponents of the enabling structure of corporation codes and efficient markets, however, are not as vociferous in their support of midstream charter amendments.\textsuperscript{335} For example, some believe that firms should not be permitted to opt out of the code provisions that make management behavior subject to fiduciary standards or preexisting provisions for voting rights.\textsuperscript{336} Generally, those sentiments are based on the perceived decreases in share value associated with the absence of traditional policing mechanisms.\textsuperscript{337} The general proposition appears to be that such decreases tend to effectively fall on a firm’s current shareholders.

D. Industry Specificity

Capital formation does not function uniformly across time or industries. A variety of variables are to blame, some of which are political, others more market-based. For example, with all of the recent talk about price controls by the Clinton administration, debt markets have collapsed for small biotech companies. Equity capital is the only form of capital such firms can obtain.\textsuperscript{338} Recent tax policy is also illustrative.\textsuperscript{339} For example, under the Omnibus Reconciliation Act of 1993, investors who buy stock in some small

\textsuperscript{333} Id. at 133.
\textsuperscript{334} Id.; see Jensen & Meckling, supra note 208, at 305-07 (indicating that founders would bear cost of retaining control and will end up no better off for their efforts at separation).
\textsuperscript{335} It can be said that even in the IPO context, the limited voting rights offering is really a recapitalization, because the transaction would involve an exchange of founding shares of the pre-transaction single class of voting stock for shares of a new class of voting stock and a class of limited voting or non-voting stock. The limited stock would then be sold to the public. GILSON & BLACK, supra note 99, at 132 n.1.
\textsuperscript{336} ROMANO, supra note 111, at 72 (discussing this debate at length); see Lucian A. Bebchuk, The Debate on Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395, 1399-1404 (1989) (discussing debate on contractually opting out of code provisions); Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990) (discussing same debate).
\textsuperscript{337} See supra note 251 and accompanying text (discussing loss of management efficiency in dual class structure).
\textsuperscript{339} Id.
companies (excluding service providers, farms, mineral-extractors, and certain others) and hold it for at least five years can cut their capital gains taxes in half.\textsuperscript{340} Because new, high-technology firms are often the type of companies interested in implementing a dual class structure, tax benefits such as those may spur market interest in equity ownership and thus in dual-class stock.

More theoretical differences between debt and equity use associated with transaction-cost economics are also relevant to this discussion because the asset characteristics of investment projects are often closely associated with specific industry groups. The governance structure attributes of distinct industries and industry segments are similarly distinguishable.\textsuperscript{341}

The transaction-cost approach maintains that some projects are easy to finance by debt and, in fact, ought to be financed by debt: projects for which physical asset specificity is low to moderate.\textsuperscript{342} Where asset specificity is high, equity financing, which affords more intrusive oversight and involvement through the board of directors and, in publicly held firms, permits share ownership to be concentrated, is the preferred financial instrument.\textsuperscript{343}

The conclusion is that asset-specific firms in growth markets, whose structure contains firms with owner/managers with limited resources and an aversion to proportionate control dilution, may find that a dual-class structure is Pareto optimal.\textsuperscript{344} Allowing those firms to use the dual-class option enables them to access capital markets without sacrificing the incentive intensity of the entrepreneurial ownership group.\textsuperscript{345} More restrictive regulatory measures can thus cause harm by decreasing the value of firms in

\textsuperscript{340}I.R.C. § 1202 (1995); see also Saddler, \textit{supra} note 338 (noting that company must not have aggregate gross asset value of $50 million both before stock issuance and immediately afterward).


\textsuperscript{342}Williamson, \textit{supra} note 341, at 168. Debt will be "utilized if the ability to exploit potentially profitable investment opportunities is limited by the resources of the owner . . . . [and] the marginal wealth increments from the new investment projects are greater than the marginal agency costs of debt, and these agency costs are in turn less than those caused by the sale of additional equity." Oliver Williamson, \textit{Corporate Finance and Corporate Governance}, 43 J. FIN. 567, 578 (1989) (citing Jensen & Meckling, \textit{supra} note 209, at 343).

\textsuperscript{343}\textit{Id.}

\textsuperscript{344}\textit{Id.} at 167-68.

\textsuperscript{345}Jensen & Meckling, \textit{supra} note 209, at 305-60.
specific industry groups and causing them to suffer from a competitive disadvantage as compared with competitors who may have originally capitalized with dual-class stock or have chosen to list on an exchange that permits the use of dual-class stock.

Some recent events warrant mention. In the broadcasting, publishing, and telecommunications fields, dual-class stock is frequently used.\textsuperscript{346} Historically, its use has been associated with what is often called editorial integrity. Dual-class stock is also favored by entrepreneurs in high-tech industries, such as cellular, wireless, and cable telephone.

Telecommunications, broadcasting, and media industries are the current leaders in merger and acquisition activity.\textsuperscript{347} Dual-class companies have played a large role in that activity. For example, the \textit{New York Times} recently purchased Affiliated Publications, owner of the \textit{Boston Globe}. Between the two companies there are seven different classes of authorized stock.\textsuperscript{348} The purchase was structured so that Affiliated Class A (low vote) and Class B shareholders received a combination of Class A \textit{New York Times} shares (low vote) and cash. In addition, three Affiliated directors will be given seats on a new eighteen-member \textit{New York Times} board. The acquisition was ratified by 75 percent of the holders of the \textit{New York Times} Class A and Class B shareholders,


\textsuperscript{347} Randall Smith, \textit{AT&T, McCaw Deal Could Spur Others}, \textit{WALL ST. J.}, Aug. 20, 1993, at C1. "[C]ommunications megadeals had already fueled a 29% increase in merger activity over the 1992 level . . . . Counting AT&T/McCaw, U.S. merger activity . . . . is up 64% from last year’s level . . . . [1993’s volume] is the busiest since the record year of 1989 . . . ." \textit{Id.}

\textsuperscript{348} The \textit{New York Times} Class A shares trade publicly and have limited voting power. They can select five of the fourteen members of the Times board and can vote on stock and asset acquisitions and other matters required by law. The \textit{New York Times} Class B Shares, which are not publicly traded, vote on most matters required by law and have the power to select nine members of the Times board. Times Class B shares are freely convertible into Times A shares on a share-for-share basis. \textit{See} Allan Sloan, \textit{Even With Creative Accounting, Free Meals Are Hard to Come By}, \textit{WASH. POST}, Aug. 3, 1993, at B3; \textit{AFFILIATED PUBLICATIONS INC.}, 1992 \textit{ANNUAL REPORT} 21 (1993); \textit{THE NEW YORK TIMES COMPANY}, 1993 \textit{PROXY STATEMENT} 3 (1993).
approximately 80 percent of the Class A Affiliated shareholders, and more than 93 percent of the Affiliated Class B shareholders.

The merger of Infinity Broadcasting and Westwood One, which gives the combined companies a 40 percent share of the U.S. radio-network business, involved no less than five classes of common stock. One of the classes involved, Westwood One Class B stock, was entitled to fifty votes per premerger share compared to Westwood One Class A shares that were entitled to only one vote.\(^{349}\)

On an even grander scale, Bell Atlantic, TeleCommunications Inc. ("TCI"), and Liberty Media recently announced plans to merge into a single dual-class firm.\(^{350}\) The merged company will have a second class of common stock that, for a time, will have lower dividend rights. This Class B Bell Atlantic stock must be converted into Class A Bell Atlantic common stock after a five-year period. This deal has the effect of merging five classes into one, in a two-step process. Both TCI and Liberty Media shares trade publicly.\(^{351}\)

The dual-class capital structures used by TCI and Liberty Media enabled TCI to quickly spin off programming operations to Liberty Media to calm congressional fears that the company was growing excessively powerful with its major holdings in both cable systems and programming.\(^{352}\) Two years later, TCI and Liberty Media merged in a strategic move hastened by an ill-fated bid to merge with Bell Atlantic.\(^{353}\) The structure of these deals provides a case study in the value of creative capital structuring.

\(^{349}\) See 1991 WESTWOOD ONE, INC., ANNUAL REPORT 29 (1992) (noting Westwood One has dual-class structure, one class of which trades on NASDAQ); 1992 INFINITY BROADCASTING CORP., FORM 10-K F-3 (1993) (noting that Infinity Broadcasting, Inc. has three classes of common stock, one class of which trades on NASDAQ); see also David J. Jefferson, Infinity to Merge Radio Network With Westwood, WALL ST. J., Oct. 12, 1993, at A4.

\(^{350}\) Bell Atlantic utilized a NYSE exemption on dual-class prohibition which facilitated the all-equity deal leaving Bell Atlantic with a dual-class structure. Bell Atlantic, TCI, and Liberty Media Announce Merger, BULL. (Investor Relations, Bell Atlantic Corporation), Oct. 18, 1993.


\(^{352}\) Id.

\(^{353}\) Id.; see Laura Landro & Johnnie L. Roberts, QVC Is Near Agreement With BellSouth on $1.5 Billion in Paramount Bid Funds, WALL ST. J., Nov. 9, 1993, at A3. Due to antitrust concerns, Liberty Media ultimately had to sell its stake in QVC to Bell South in order for QVCs bid to move forward). Id.; see also Johnnie L. Roberts & Randall Smith, QVC Wants Liberty Media To Sell Its Stake, WALL ST. J., Nov. 5, 1993,
In the battle for Paramount Communications, a single-class firm, no less than five of the firms involved had dual-class capital structures: TCI, Comcast, Viacom, Liberty Media, and Turner Broadcasting. The complexity of Turner Broadcasting’s capital structure rivals that of TCI’s. It has five classes of stock: three preferred, two common. Viacom, like TCI and Liberty Media, has two classes of common stock that are both publicly traded. The liquidity this affords is extremely useful when there is heavy merger and acquisition activity or when a dual-class firm finds itself in a bidding war. Recent events, triggered by a Delaware court decision that forced new, higher offers from both Viacom and QVC, are illustrative.

Viacom, who initially proposed a friendly agreement with Paramount Communications, Inc., was forced to raise its offer for Paramount a number of times in response to a series of bids by QVC. Viacom has also used its Class B shares in a bid to acquire Blockbuster Entertainment Corp. The combined company eventually emerged as the winner in the battle for Paramount. The use of the Class B low-voting stock in the Blockbuster purchase has enabled Sumner Redstone to maintain a hold on 61 percent of the voting power of the new company.

Cable concerns such as Century Communications, Continental Cablevision, Adelphia, Jones Intercable, and Cablevision Systems are also dual-class companies, some of which have used their dual-class structures for more modest strategic planning.

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at A3. Liberty Media Inc. owned 22% stake in QVC Network, Inc. which had offered to acquire Paramount Communications, Inc. Id.


357 Johnnie L. Roberts & Randall Smith, Viacom Bid Doesn't Appear To Win Paramount Race, WALL St. J., Jan. 10, 1994, at A3. At one time, the tender offer by Viacom included both its Class A shares and its Class B shares. Id. The latest offer, however, only included its Class B shares. Id.


359 Roberts & Smith, supra note 357, at A6.

360 For instance, Century Communications had used their limited voting shares in purchases of independent telephone companies. PETER W. HUBER ET AL., THE GEO- DESIC NETWORK II, 1993 REPORT ON COMPETITION IN THE TELEPHONE INDUSTRY, 2.57 n.202. Comcast, the nation's fourth-largest cable company, recently paid $1.1 billion for Metromedia's cellular interests and acquired a major stake in Nextel. Id. at 2.65
Visionaries in those industries realized early on that capital structuring could be a key part of their strategic planning. Moreover, they realized that successful firms in high-tech, high-growth, and highly regulated industries would require periodic external financing for internal expansion, as well as greater flexibility to engage in strategic acquisitions and consolidations.\textsuperscript{361}

Thus, while dual-class structures add flexibility to a firm's overall decision-making capabilities, dual-class use keeps the key decision makers (such as Sumner Redstone of Viacom, John Malone and Robert Magness of TCI, and Ted Turner of TBS) in control of the firm's voting power. This enables those firms to take advantage of new developments in technology or changes in regulation faster than single-class rivals, whose actions may require a more extended or costly voting process.\textsuperscript{362} In telecommunications, where technology breakthroughs and court decisions create instantaneous opportunities and challenges, entrepreneurs place a high value on control. Thus, firms demand the dual-class option.

1. Policing Mechanisms and Incentives for Wealth Maximization

The separation of ownership from control creates an agency problem: managers will run the firm according to their own interests rather than the interests of the shareholders. Because agency costs must be contained for resources to be allocated efficiently, shareholders have developed mechanisms designed to reduce those costs by policing managers. In addition, corporations...
have also used the forces in various markets to help lower the costs associated with the agency problem. Michael Jensen has noted that, "[t]here are only four control forces operating on the corporation to resolve the problems caused by a divergence [of interest]." These include: capital markets, legal/political/regulatory systems, product and factor markets, and internal control systems headed by the board of directors. While the end goal of reducing costs is constant, the effectiveness of these mechanisms fluctuates over time and across firms.

At the "question mark" stage of firm evolution, the product market plays the most important role in keeping agency costs at a minimum. In theory, product markets exert competitive pressures that force managers to act in their own interest and thus in their shareholders' interest as well. Simply put, if a firm's products are unsuccessful in competitive markets, the firm cannot survive in the long run, and managers end up losing their firm-specific human investment, not to mention any personal capital investment. The presence of shareholder/manager groups in many "question mark" companies is characterized by huge firm-specific human investment as well as substantial capital investment. Because of this presence, the shareholder/manager group's personal interest in the share price appreciation—which is associated with successful products—minimizes the conflict of interest problems normally associated with the shareholder/manager rela-

363 Butler & Ribstein, supra note 87, at 2. These mechanisms may substitute and compliment the legal rules found in state corporation laws. Id. This goal of ensuring managerial accountability was listed by the SEC as one of the primary goals of Rule 19c-4. See supra notes 106-15 and accompanying text.

364 Jensen, supra note 15, at 850. As Michael Jensen has noted, however, "[t]he legal/political/regulatory system is far too blunt an instrument to handle the problems of wasteful managerial behavior effectively . . . . Substantial data support the proposition that the internal control systems of publicly held corporations have generally failed to cause managers to maximize efficiency and value." Id. Moreover, as previously mentioned, the corporate control market itself is not a strong force for policing managerial activity in the dual-class firm. See id. at 852-54 (asserting that corporate internal control systems are ineffective).

365 Id.

366 This role will continue as long as the firm does not have market power, because a firm with market power will not be driven out of business by competition in the product market. See H. Leibenstein, Allocative Efficiency versus X-Efficiency, 56 AM. ECON. REV. 392 (1966); Michael A. Crew & Paul R. Kleindorfer, The Economics of Public Utility Regulation 8 (1986). If the market is contestable, such as the airline industry, then this problem (known as "X-efficiency") may be negated by the threat of entry. See William J. Baumol et al., Contestable Markets and the Theory of Industry Structure (1982).
tionship in large corporations. Public shareholders can rely on this to negate the lack of influence the corporate control markets and labor markets will have on the dual-class firm and thus keep agency costs from increasing. While the problem with product markets is that they are often slow to act—when they take effect it is often too late to save much of the enterprise—their discipline is inevitable.

A corporation's ability to compete effectively in its product markets is related, among other things, to its ability to raise capital. Capital markets serve the function of allocating investor capital efficiently to participating firms. As mentioned earlier, if management is to secure initial and future capital, it must offer attractive terms to investors. The control group in the dual-class firm will have a stake in keeping both the access to capital markets open and the costs of capital down. Misbehavior will raise the cost of capital, lower current share price, and ultimately leave the firm uncompetitive. As such, it is neither in the management's nor the shareholders' interests to see a corporation's ability to raise capital impaired.

Finally, exchange rules and state corporation codes are supported by a system of common law rules designed to balance the shareholder/manager relationship. The fiduciary standards applied to managerial conduct remain applicable in the dual-class firm. In fact, high-vote shareholders who also serve in a management capacity may be held to an even higher standard of care than would normally be the case.

See Flokos, supra note 10, at 1776-77 n.66 (noting empirical studies demonstrate that, "in the average recapitalizing firm, the management insider group's ownership in pure equity terms is very high, on the order of 40% or so... in marked contrast to the usual situation in large public corporations, where median equity ownership of CEO's... is... 0.25%."); see also SECOND SEC STUDY, supra note 134, at tbl. 4; Jarrell & Poulsen, supra note 13, at 141; Lucian Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 HARV. L. REV. 1820, 1842 (1989).

See Jensen, supra note 15, at 850.

See RALPH K. WINTER, GOVERNMENT AND THE CORPORATION 5 (1978). The competition in the capital market, operating through the market for corporate control, may be perceived as less direct and less immediately compelling, leaving great potential for product inefficiency in the long term if the market is characterized as a natural monopoly; the potential is minimized if the market is competitive. See CHEW & KLEINDORFER, supra note 366, at 8.

WINTER, supra note 369, at 5.

Id. at 30.
These three control forces, when combined with the documented characteristics of the management/shareholder group and, to a lesser extent, the interplay of family pressure, can be relied on to influence favorably the agency costs associated with the dual-class firm.

2. Competition Among the Stock Exchanges

In years past, public companies would initially trade on the NASDAQ,\(^{372}\) and then graduate to the AMEX.\(^{373}\) If the company grew large enough to meet the capital requirements of the NYSE, it would eventually decide to list there.\(^{374}\) Each exchange had a distinct market, and competition was weak.

Those conditions have changed dramatically.\(^{375}\) In terms of listings and volume, although the AMEX now runs a distant third to its rivals, it is slowly emerging as the best market for small companies.\(^{376}\) The NASDAQ, on the other hand, is now considered a strong rival to the NYSE.\(^{377}\)

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\(^{372}\) The term “over-the-counter market” traditionally has referred to trading done off the floor of an organized stock exchange. Macey & Kanda, supra note 322, at 1008 n.5.

\(^{373}\) Bill Graham, Should The AMEX Get More Respect?, 10 CFO 53 (Jan. 1994).

\(^{374}\) In the past, new US companies listed on the American Stock Exchange or that were traded over-the-counter often had disparate classes of common stock for reasons cited earlier in this paper. The New York Stock Exchange, as mentioned in Part III, historically forbade the practice, thus companies that grew large enough to be listed on the NYSE restructured into a single class form prior to listing. Jenny Chung, Dual Share Issue Hits Hong Kong Business Today, UPI, July 8, 1987, available in LEXIS, Nexis Library, UPI Files.

\(^{375}\) See, e.g., Graham, supra note 373 (noting NASDAQ provides at least one market maker with vested interest in company, thus giving companies feedback on share price and volume). NASDAQ stocks also trade at wider spreads than stocks on a comparable exchange—spreads that market makers and brokers profit from. Id. Thus, brokers (who may get paid for order flow) have incentive to push a NASDAQ stock. Id. Graham also notes that “the differences between the AMEX and the NASDAQ may dwindle in the wake on a long awaited SEC Market 2000 Report.” Id.; see also Christi Harlan, Market 2000 Sets Its Sights on the Present, WALL ST. J., Dec. 31, 1993, at A15 (discussing SEC Market 2000 Report).

\(^{376}\) Graham, supra note 373, at 53.

\(^{377}\) Id. at 55-56. It should also be noted that comparing NASDAQ volume to that of other exchanges is somewhat deceiving. Bill Graham notes, “[c]omparing volume on NASDAQ to volume on the Big Board or the AMEX is like comparing kiwis and kumquats”. Id. “On an exchange, a specialist matches buyers with sellers; when a buyer takes 500 shares, the volume is 500 shares.” Id. “Buy 500 shares from a NASDAQ market maker, and there is a possibility that volume will jump to 1,500 shares—if the market maker is short the stock and buys it from another market maker, which in turn may also list the trade.” Id.
The NYSE, the AMEX, and the NASDAQ are all profit-making economic organizations; they advertise for listings and provide services that are not limited to the execution of trades. In addition, each exchange has quantitative and qualitative listing standards. Those rules and the reputation each exchange carries in the public domain convey information to investors, such as the size and net earnings of listed firms, and the different listing and accounting standards required of members. As technology has developed, however, the distinction between the over-the-counter securities markets and the organized stock exchanges has become blurred. As such, they should be perceived and regulated as members of a highly competitive industry.

Firms with publicly traded stock typically have shown a strong interest in having their shares traded on an exchange even though they are not required by law to do so. Thus, it stands to reason that exchanges must be offering something of value. Jonathan Macey maintains that organized exchanges provide listing companies with the following benefits: (1) liquidity, (2) monitoring of exchange trading, (3) standard form, off-the-rack rules to reduce transactions costs, and (4) a signalling function that serves to inform investors that the issuing companies’ stock is of high value.

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378 The NYSE, the NASDAQ, and now even the AMEX, are involved in advertising battles for stock market supremacy. Graham, supra note 373, at 55-56. Currently, the NYSE has taken to calling itself the “capital of capital,” while the NASDAQ uses the slogan, “the stock market for the next 100 years.” Id. The AMEX claims to offer companies less volatility than NASDAQ, more protection against short-sellers, a wider variety of services for executives, more useful trading numbers, and better treatment of investors. Id. at 51-55.

379 See Macey & Kanda, supra note 322, at 1040.

[A]n important attribute of listing on the NYSE is the fact that obtaining a listing confers prestige on the listing firm . . . . Because it is costly for buyers to obtain, interpret and verify information about the firms in which they may want to invest, such investors will pay to have “reputational intermediaries” serve as a filter.

Id.; see also Gilson & Kraakman, supra note 325, at 1040 (discussing decline of NYSE as dominant provider of reputational capital).

380 Macey & Kanda, supra note 322, at 1008.

381 Id. at 1010.

382 Id. at 1009. The purpose of a well-developed secondary market is to provide liquidity for investors. See Jonathan Macey & David D. Haddock, Shirking at the SEC: The Failure of the National Market System, 1985 U. ILL. L. REV. 315, 325-27 (noting market liquidity allows investors to dispose of shares quickly and cheaply). In illiquid markets, investors will discount the price they are willing to pay for shares, resulting in a concomitant rise in the cost of capital. MACEY, supra note 16, at 10.
quality. These four functions all serve to reduce the agency costs endemic to the modern corporation.

Firms choose an exchange by determining which one will maximize the value of the firm. They agree to be bound by its rules; these rules decrease costs by supplying terms that form a standard contract between members and shareholders which would otherwise have to be supplied at the firm's expense.

The function of exchange rules also involves what Macey calls "off-the-rack" rules on matters seemingly unrelated to secondary market trading. Often these rules relate to matters of corporate governance. For example, the NYSE requires listed companies to have a minimum of two outside directors and to have an audit committee solely comprised of independent directors. Similarly, the NYSE "require[s] that listed firms review and oversee transactions with related parties on an ongoing basis." In addition, the NYSE has pioneered procedures such as: annual shareholder meetings, requirements in which shareholders are permitted to vote on key corporate issues, such as mergers, and requirements that firms distribute audited financial statements. The NASDAQ has at least ten corporate governance standards to which a company must adhere to qualify for admission.

Because the services offered by exchanges in matters of corporate governance are devised in a competitive environment similar to that seen among states competing for corporate charters, we can expect the conflicts to be similar and many observations to crossover. The key question to be asked is also analogous: does the competitive environment that exists among the SROs resemble a "race to the bottom" or a "race to the top"? The SEC, when formulating Rule 19c-4, was concerned that a "race to the bottom" would occur in the absence of a uniform voting rule.

The success of an exchange depends on the amount of trading that takes place on it. As such, exchanges have incentives to

383 Macey & Kanda, supra note 322, at 1009-10.
384 Id. at 1012.
385 Id. at 1022.
386 Id. at 1022-23.
387 Id. at 1023.
388 THE INSTITUTIONAL SHAREHOLDER SERVICES PROXY VOTING MANUAL, supra note 162, at 7.19.
389 NATIONAL ASSOCIATION OF SECURITIES DEALERS, THE NASDAQ FACT BOOK & COMPANY DIRECTORY, supra note 37, at 37.
390 See supra notes 150-56 and accompanying text.
adopt rules that maximize the value of their listed firms and thus operate to benefit investors. Investor-friendly rules attract more trades, and thus reduce the costs (and increase the profits) of those who run the exchanges.\footnote{EASTERBROOK & FISCHEL, supra note 2, at 294. Exchanges gain, for example, by adopting rules that minimize the amount of deceit committed by listed firms, because investors who are misled are less likely to be repeat players. Id. For the same reason, exchanges have an incentive to adopt rules that require listed firms to disclose the amount and type of information that investors demand. Id.} Competition among organized exchanges and over-the-counter markets for listings, as well as competition between exchanges and the equity interests they represent versus other methods of investing wealth, serves only to augment these incentives.\footnote{Id.}

There is no reason to expect that off-the-rack rules would be designed any differently from the rules more closely related to secondary-market trading once the exchanges were free to do so.\footnote{In fact, recent proposals on dual-class stock and the past rules devised by the exchanges relating to independent directors are clear evidence that this reasoning is sound.} As such, this reasoning would lead us to believe that if dual-class stock maximizes the value of some listed firms, regulations prohibiting its use would eventually be replaced with more facilitative listing standards. As competition among exchanges increases, the exchanges will be forced to respond as any participant in a competitive market would.

Some have hypothesized that changes in the historical voting rights listing standard regime would initiate a significant increase in dual-class use among firms listing on the NYSE and the NASDAQ. Under the current regulatory framework, any firm listed on the NASDAQ or the NYSE that intends to recapitalize with a dual-class capital structure could simply move from its current exchange to the AMEX,\footnote{In 1993, forty-five companies defected to the NYSE from the NASDAQ, marking the highest number of defections since 1988. Big Board Claims a Win In its Battle With NASDAQ, supra note 138, at C1.} but a mass exodus has not occurred. Moreover, empirical research has not found any significant increase or decrease in share price associated with switching exchange membership.\footnote{See, e.g., Gary C. Sanger & John J. McConnell, Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ, 21 J. Fin. Quant. Anal. 1 (1986); Louis W. Ying et al., Stock Exchange Listings and Securities Returns, 12 J. Fin. Quant. Anal. 415 (1977); James C. Van Horne, New Listings and Their Price Behavior, 5 J. Fin. Quant. Anal. 783 (1970). While numerous examples can be
are presumably low. Thus, we can hypothesize that no significant increases in dual-class use will take place (if the NYSE or the NASDAQ allows dual-class recapitalizations) because where its use would be value maximizing, a dual-class structure will have already been implemented. The change in rules will only minimally reduce what are already low transaction costs.

Similarly, because we have the experience of the short-term moratorium that existed on the NYSE during the mid-1980s, we can confidently predict that a mass exodus of funds from capital markets will not occur in response to changes in the voting rights policy.

3. Institutional Investors and Dual-Class Stock

Large shareholders have stronger incentives to monitor management than do small shareholders. The rise of the institutional investor represents this truism. It is now well known that "institutional investors are no longer entirely passive." Forsaking the "Wall Street Rule," large security holder activity has taken the form of "voice," rather than "exit." Changes in the demographics of equity ownership, combined with the absence
given, it is sufficient to note the following: citing investor anguish and volatility, Sunair Electronics, Inc., switched from the AMEX to the NASDAQ in 1985, and then back again to the AMEX in 1992. Graham, supra note 373, at 54-55. Voicing similar concerns, Thermo Electron Corp. has used the AMEX for nine spin-offs after using the NASDAQ for similar spin-offs prior to 1987. Id.


397 Agents Watching Agents, supra note 193, at 817. Such activity is occurring even though the market for shares provides an extremely effective exit option. See A.O. Hirschman, Exit, Voice, and Loyalty: Responses To Decline In Firms, Organizations, and States (1970). Although this market for shares still exists, its effectiveness is limited to large participants such as pension funds, whose sell-offs can disrupt the market. Id.

398 In 1950, pension funds held less than one percent of U.S. equities, while institutional holders as a group held approximately 8%. In 1981, their holdings as a group rose to 38%. By 1989, pension funds alone owned more than 26% of total equity securities and institutions held in excess of 45% of total U.S. equities. Rock, supra note 170, at 447. In 1990, institutional investors held an estimated 53% of outstanding equity instruments with some estimates running as high as 60%. Carolyn Brancato & Patrick Gaugan, Institutional Investors and Capital Markets: 1991 Update, in
of other higher yielding instruments including "junk bonds," are also commonly associated with the increase in activity.\textsuperscript{399} In addition, changes in the market for corporate control have initiated changes in institutional attitudes. Specifically, institutions that were viewed unfavorably by management groups because of their perceived short-term focus on profits have increasingly shifted their focus to long-term share appreciation. Institutional myopia is increasingly a matter of public perception.\textsuperscript{400} For example, the California Public Employees Retirement System ("CalPERS"), with $60 billion in assets, currently owns a portfolio with an average equity holding period of ten years.\textsuperscript{401}

If institutions continue this trend, institutional activism will increase, and monitoring will become a more cost-effective endeavor.\textsuperscript{402} Furthermore, groups such as the United Shareholders Association ("USA"), the Council of Institutional Investors, Institutional Shareholders Services, Inc., the Institutional Voting Research Service, Faulk & Co., and the Investor Responsibility Re-

\textsuperscript{399} Recent trends in yields among debt instruments may serve to further encourage this drift.

\textsuperscript{400} See \textit{Agents Watching Agents}, supra note 193, at 862-65 (describing institutional myopia and managerial myopia). But see Porter, supra note 398, at 70 (opposing Black's position).

\textsuperscript{401} Letter from Dale M. Hanson, Chief Executive Officer, CalPERS, to Jonathan G. Katz, Secretary, S.E.C. 1 (July 29, 1992) (S.E.C. Public Reference File No. S7-15-92); see also Scism, supra note 398 (citing survey findings that 1993 stock holdings of pension funds and other institutional investors had decreased from their peak in 1990).

\textsuperscript{402} A great deal of faith has been put in institutional activism as a means of solving the collective action problem and changing the dynamics of the agency relationship. It has been said that, "[i]nvestor capitalism' would recapture the essential genius of capitalism by restoring primacy to the interests of the suppliers of capital." See Rock, supra note 170, at 448 n.9 (quoting \textit{A Word With Your Owners}, \textit{The Economist}, Jan. 12-18, 1991, at 17); \textit{The End of Casino Society}, \textit{The Economist}, Jan. 12-18, 1991, at 60; Martin Dickson, \textit{Investors Wake Up To Their Power}, Fin. Times, Dec. 3, 1990, at 18.
search Center have served to promote investor communications and access to institutional activity data. These efforts should hasten the pace of institutional activity.\textsuperscript{403}

The Clinton administration, which is more activist in matters of corporate governance than past administrations, may instigate further increases in institutional activity. Setting its sights on corporate pension funds, the Department of Labor is said to be in the process of drafting a plan that would "prod corporate pension funds to set up procedures to govern how their holdings are to be voted."\textsuperscript{404} Corporate pension funds hold more than $2.43 trillion in retirement money.\textsuperscript{405}

Shareholder activism may also occur nonuniformly across governance issue areas. Specifically, because the diversification associated with the large stockholdings of institutions creates economies of scale in monitoring, institutions are more likely to exhibit increased activity in regard to certain processes and structural issues. Dual-class stock is clearly a structural issue.\textsuperscript{406}

Whether or not this is desirable is a question that is part of an ongoing debate,\textsuperscript{407} but the implications of the increased pace of

\textsuperscript{403} See Rock, supra note 170, at 450-51 (extensively discussing shareholder groups); Jacobs, supra note 47, at app. The United Shareholders Association recently disbanded, citing its successes, especially in regard to recent SEC rule changes. Kevin G. Salwen, Shareholder Advocate Group to Close Its Doors, WALL ST. J., Oct. 27, 1993, at C1. This group was characterized as representing individual shareholders. Id. During its lifetime, the association used campaigns of bluster and embarrassment to prod companies to change, often publishing lists of target companies with policies it deemed unfriendly to shareholders. Id.


\textsuperscript{405} Id.

\textsuperscript{406} See Agents Watching Agents, supra note 193, at 818.

\textsuperscript{407} See Bernard S. Black, The Value of Institutional Investor Monitoring: The Empirical Evidence, 39 U.C.L.A. L. Rev. 895 (1992); Rock, supra note 170. Recently, some investors and experts have raised questions about the fairness of institutional ownership when institutions actively press for change. More specifically, recent purchases by two money management firms of Borden, Inc. have raised questions about information disparities between active funds and other shareholders when the institutions make purchases based on how receptive management is to their concerns. Leslie Scism, Borden Activists' Success Raises Fairness Question, WALL ST. J., Dec. 15, 1993, at C1. Such issues may arise more frequently in the future if institutions decide to raise their concerns to management in more private settings than has been the case in the past. In addition, the methods of shareholder activists are changing. Leslie Scism, Bottom-Line Activism of Calpers Pays Off, New Study Indicates, WALL ST. J., Jan. 6, 1994, at C1. This change is often called "relationship investing." Some have forecasted an increase in this type of investing. See Salwen & Scism, supra note 406, at C1; Christi Harlan, Ten Companies Are Target for Action, WALL ST. J., Oct. 6,
activity and the increase in institutional stockholdings have had ramifications on the regulatory debate surrounding the use of dual-class stock.\textsuperscript{408}

To examine institutional investor activity in the context of dual-class stock proposals, it is necessary to examine the data illustrating the likelihood of institutional shareholdings in firms containing the characteristics of the "question mark" firms Ronald Gilson and the Lehn, Netter, and Poulsen study described.\textsuperscript{409} The data on institutional sentiment toward dual-class use in general will then be examined and followed by a short analysis of institutional investors and their influence on the collective action problems normally associated with shareholder voting.

\textbf{a. The Data}

A number of studies reported institutional ownership in firms proposing dual-class recapitalizations. The first was Professor Gordon's 1988 study of nineteen companies listed on the NYSE. He found that only three firms had significant institutional ownership before the recapitalization (blocks of 5 percent or more): General Datacom Industries, Inc., one holder of 5 percent; Kaufman & Broad, Inc., six holders, totaling 31 percent; the North American Coal Corp., three holders totaling 17.6 percent; and Helene Curtis Industries, Inc., one holder of 6.1 percent.\textsuperscript{410} The July 1987 Office of the Chief Economist study reports a 19.9 percent average (mean) institutional ownership for its sample of firms and 23.9 percent for the post-moratorium sample of firms.\textsuperscript{411} Additionally, although institutional holdings as shown by this data appear small, those "holdings greatly increased from about 11 percent before the NYSE moratorium to about 25 percent" afterwards.\textsuperscript{412}

The previously mentioned empirical research describing some common characteristics of firms in which a dual-class structure is potentially beneficial is consistent with the results of studies by...
Professor Gordon and the Office of the Chief Economist. Since institutional ownership generally aggregates in our larger corporations, we would not expect to see a large institutional presence before a recapitalization in firms seeking shareholder approval of a disparate voting rights plan.

Institutional investors' sentiments towards governance proposals in general and supervoting rights stock in particular have also been collected. A 1987 survey by the Investor Responsibility Research Center indicates that although dual-class plans usually pass with a high overall level of voting support—because most companies have a high level of insider ownership—insti- tutions oppose such plans more often than any other antitakeover proposal. In 1986, 88 percent of the institutional respondents stated that they opposed dual-class proposals when presented for vote and, in 1987, 70 percent opposed the authorization of these proposals. When the institutional investors were broken into subgroups, 75 percent percent of investment managers indicated that they opposed the plans, 73 percent of pension funds voted in opposition, and 59 percent of an aggregated group of educational institutions and endowments also voted in opposition.413

A 1990 survey of the Investor Responsibility Research Center, which divided institutional investors into similar subgroups, indicated similar differentiations in subgroup disapproval figures as well as corresponding high levels of opposition for unequal voting right proposals: public pension funds 73 percent, private pension funds 83 percent, investment managers 55 percent, and foundations and church groups 67 percent.414 When those same groups were asked in 1991 how they would anticipate voting if dual class proposals came before them, the answers were again different among the groups:415

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<th>FOR</th>
<th>AGAINST</th>
<th>CASE BY CASE (%)</th>
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<tr>
<td>Public Pension Funds</td>
<td>5</td>
<td>74</td>
<td>21</td>
</tr>
<tr>
<td>Corporate Pension Funds</td>
<td>14</td>
<td>43</td>
<td>43</td>
</tr>
<tr>
<td>Investment Managers</td>
<td>0</td>
<td>62</td>
<td>38</td>
</tr>
<tr>
<td>Colleges, Foundations</td>
<td>6</td>
<td>76</td>
<td>18</td>
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A 1992 survey asked respondents how they would vote on proposals to establish stock with supervoting rights and stock with no voting rights. Thus, the survey split up the single-question format used in prior years. The results were as follows:

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<tr>
<td>Public Pension Funds</td>
<td>0</td>
<td>88</td>
<td>12</td>
</tr>
<tr>
<td>Corporate Pension Funds</td>
<td>0</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>Investment Managers</td>
<td>3</td>
<td>59</td>
<td>38</td>
</tr>
<tr>
<td>Colleges, Foundations</td>
<td>12</td>
<td>41</td>
<td>47</td>
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These statistics reveal that in firms with a large institutional presence, dual-class recapitalizations will most likely fail to win approval unless institutional shareholders find that the proposal increases value. As noted in Part III of this paper, value-increasing recapitalizations will seldom occur unless a company has a significant family or insider shareholder group. In such firms, institutional ownership is generally modest. As such, for the majority of firms on the NYSE, proposals for dual-class recapitalizations should fail to win approval.

In the 1980s, International Business Machines ("IBM") and Merrill Lynch submitted dual-class recapitalization proposals to their shareholders — a group comprised of large institutions. The IBM proposal received the support of only 5 percent of its institutional stockholders; the Merrill Lynch proposal received the support of 19.2 percent of its institutional shareholders. Needless to say, each failed to win overall shareholder approval. In addition, the shareholders of Seagram Co. defeated a recapitalization proposal despite the 40 percent controlling interest held by the Bronfman family, which voted affirmatively for the plan.

In a more recent example of institutional activity in this area, News Corp., whose American depository receipts trade on the NYSE, had to withdraw a dual-class recapitalization plan in the wake of institutional opposition. The plan (a dissemination of supervoting shares to existing shareholders) was said to be proposed in order to allow News Corp. to form strategic alliances through the issuance of shares while preserving the control of its

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biggest shareholder, Rupert Murdoch. Others, however, felt the plan was designed to oust certain family members from the company.

In stark contrast to these three proposals are the results from two recent dual-class proposals that were affirmatively voted for in 1990 introduced by companies illustrating Gilson's "question mark" concept: Crawford, Inc. and Century Telephone Enterprises, Inc. The dual-class recapitalization proposed by Crawford, Inc., was presented to shareholders as a method by which the firm could raise additional capital for investment purposes without diluting the controlling interest of the Crawford family. The proposal won the approval of 94 percent of its shareholders. The Crawford family owned 70 percent of the shares.

The dual-class plan proposed by Century Telephone Enterprises, Inc., received the approval of 97 percent of the votes cast. This plan authorized the company to implement a dual-class recapitalization in the event that Rule 19c-4 was amended or overturned.

b. Collective Action Problems and the Institutional Investor

As mentioned in Part III, the scenario of a horde of rationally ignorant voters, repeatedly misled or coerced by opportunistic managers, has often guided regulatory policy. This has been particularly true on issues involving voting rights, although corporate law and SRO listing standards permit a variety of other transactions that pose similar collective action problems. In addition, while the SEC asserts that such problems are endemic to the shareholder vote on a dual-class proposal, in actuality the

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418 S. Karene Witcher, News Corp. Scraps Its Plan of "Super" Stock, WALL ST. J., Dec. 9, 1993, at A12 (noting institutions hold approximately 40% of News Corp. stock while Mr. Murdoch holds approximately 30%).
419 Id.
420 SANDER, supra note 13, at 41.
421 See ROMANO, supra note 111, at 88.
422 "Going private transactions, their leveraged buyout variants, and freeze out mergers each raise the same sorts of concerns." Bainbridge, supra note 39, at 628; see CLARK, supra note 192, at 504-18; Victor Brudney & Marvin A. Chirelstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1354 (1978). The coercion problems associated with dual-class use have come up in other circumstances as well. For instance, the coercive nature of exchange offer recapitalizations is quite similar to the coercion present in two-tier tender offers. Moreover, the great expense of communication and coordinated action among dispersed shareholders is significantly related to the SEC itself. Flocos, supra note 10, at 1770.
SEC is itself responsible for rules that promote those behavior patterns. Specifically, the Commission's Rule 14a-2(b)(1) and Rule 14a-9 generally raise the costs and the effectiveness of shareholder activism. Under Rule 14a-2(b)(1), most of the SEC's solicitation of proxy rules would apply to any shareholder wishing to contact more than ten other shareholders concerning the recapitalization proxy. Rule 14a-9 is "applicable to any contact among shareholders with respect to the recapitalization proxy vote." The Rule would impose liability on an insurgent shareholder for statements later deemed to be materially false or misleading. Put together, those rules have been cited as "a significant cause of the coercive 'prisoner's dilemma' type of collective action problem to which the Commission [implicitly] points in prohibiting the exchange-offer form of recapitalization."

Recent reforms in the proxy rules may prove helpful in alleviating the burdens of shareholders and the collective problems heretofore mentioned. For example, Jacobs notes:

The new rules exempt all parties, whether shareholders or not, from proxy requirements as long as they do not (1) seek the power to vote others' shares, (2) have a special interest in the outcome of the proxy vote other than as a shareholder, or (3) have a special relationship with the company, such as being a five percent owner. Only shareholders who own over five million of the company's stock have to notify the SEC and any stock exchange on which the company is listed if they disseminate unpublished materials . . . . New rules were [also] adopted to prevent companies from "bundling" unfavorable measures with actions that shareholders desired . . . . A new procedure was adopted to allow disgruntled owners to elect a single candidate to the board without asking fellow shareholders to vote against management's entire slate . . . . And companies will now be required to state in their proxy statement how they tabulate proxies.

Further measures are needed, however, because other rules still exist that discourage cost-sharing, which might otherwise reduce cost burdens and fail to promote more active management.

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423 Id. These proxy rules in turn impose upon the insurgent a host of regulatory and reporting requirements. Id.; see 17 C.F.R. § 240.14a-2(b)(1) (1995).
425 Flocos, supra note 10, at 1770-71.
426 See Jacobs, supra note 47, at 55-58.
427 Id. at 57-58.
monitoring.\textsuperscript{428} For example, the 13(d) rules and the expansive definition of "control" for purposes of control person liability — both of which have a far greater chilling effect on shareholder oversight than the proxy rules ever had — are desperately in need of reform to promote further institutional monitoring of corporate management.\textsuperscript{429}

Moreover, changes in those rules will enhance the ability of institutions (acting collectively) to monitor corporate management's behavior and enable institutions to better oppose unwanted charter amendments. "Ensuring that institutions must act together lets them (imperfectly) watch each other, makes reputation an important constraint on institutional self-dealing, and reduces the downside risk from institutional power."\textsuperscript{430} Even without such widescale regulatory change, the changing role of institutional investors indicates that the collective action problems associated with shareholder activity may be greatly exaggerated. Institutional investors own a large percentage of the shares of most public companies.\textsuperscript{431} "First, most institutional investors are widely diversified . . . . [In addition,] the large public funds that have been particularly prominent in corporate governance matters are largely indexed."\textsuperscript{432} Yet institutions and the votes they cast are not entirely free from influence. Specifically, in support of Rule 19c-4, the SEC cited (what is now well documented) the testimony of institutional investors describing the pressure placed on the managers of corporate pension funds during the voting process.\textsuperscript{433} In addition, others believe that money managers, like

\textsuperscript{428} Agents Watching Agents, supra note 193, at 824; see also Bernard S. Black, Disclosure, Not Censorship: The Case for Proxy Reform, 17 J. Corp. L. 49 (1991) [hereinafter Proxy Reform] (supporting initial 1991 SEC proposals but indicating that proposals themselves do not go far enough).

\textsuperscript{429} Next Steps in Corporate Governance Reform, supra note 193, at 2.

\textsuperscript{430} Proxy Reform, supra note 428, at 51 (discussing what are termed "two-halves" of story); see Rock, supra note 170 (describing first half of story as being that increased concentration of shares makes shareholder activism more rational, making it easier for shareholders to surmount classic collective action problem that forms basis for much of corporate law; describing second half of story as being that, while increased role of institutional investors ameliorates the classic collective action problems, it does so by means of agents — inhouse and outside money managers). With agents come agency costs, and a new version of the agency problem. Id.


\textsuperscript{432} Rock, supra note 170, at 473.

\textsuperscript{433} See Adopting Release, supra note 12, at 89,220; Flocos, supra note 10, at 1771-72. The perceived pressure on corporate pension fund managers is well documented and has heightened the importance of public pension fund managers. See Roberta
outside directors, but unlike the large individual shareholders whom institutional shareholders are thought to resemble, have precious few economic or legal incentives to actively discipline corporate management. Moreover, recent literature indicates that such pressure may not be limited to corporate pension funds, but may pervade the gamut of institutions as well. Such problems and the forecasted increases in their frequency are cause for concern and warrant further study.

Blatant forms of coercion need not, however, be addressed directly by the SEC or the exchanges because they are undoubtedly illegal under existing state law. We can expect institutions to protect their voting rights feverishly as increased holdings make the voice option more cost-effective. In addition, when institutions vote or use less formal forms of persuasion, one can be assured that they will do so with a full understanding of the issues and

Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795 (1993). The problems associated with certain types of institutions may be behind empirical studies reporting mixed results on the correlation between institutional presence and the percentage of no-votes cast. See James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267, 284 (1988); Pound, supra note 200, at 259.

434 Rock, supra note 170, at 452-53.

435 Roberta Romano has noted that, "corporate managers who threaten private fund managers or their employers with loss of business as the price of opposition can just as effectively threaten public funds with economic loss through, for example, local plant closings." Romano, supra note 433, at 796-97. In addition, one can easily contemplate a scenario whereby insurance companies desiring to continue to underwrite a company's insurance, or a bank wishing to continue the provision of financial services to a firm, may decide to vote with management. Klein, supra note 18, at 133-34.

436 It seems the primary area of disagreement over the role of institutional investors in matters of corporate governance is largely over the scope and significance of the agency problems their influence presents to non-institutional shareholders. Ones' view can take a pessimistic or optimistic form. I must admit to being generally optimistic, at least as related to structural issues that implicate the fundamental issues of corporate law. On these issues I believe institutions will protect themselves zealously across the board.

437 Bainbridge, supra note 39, at 630. For example, in Lacos Land Co. v. Arden Group, Inc., [517 A.2d 271 (Del. Ch. 1986)]... a firm's chief executive officer and largest shareholder threatened to block acquisitions of the firm unless the shareholders approved a dual class recapitalization giving him voting control. The Delaware Chancery Court held that he thereby violated his fiduciary duty as an officer and director of the firm.

Moreover, the opinion of Chancellor Allen indicated that future cases would most likely involve review under an entire fairness test. Id.; see also Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1061-62 (Del. Ch. 1987) (enjoining corporation's self tender for its preferred shares in part due to coercive threats by management to delist those shares unless preferred shareholders tendered); Floos, supra note 10, at 1775.
values involved. The end result is that only recapitalizations that increase value will receive adequate shareholder support.

CONCLUSION

The preceding arguments imply that the issuance of limited-voting shares may or may not be in the best interests of stockholders. Dual-class recapitalizations can offer incentives for human-capital investment and decrease agency costs. Decreases will occur when the recapitalization serves to converge management and shareholder interests on matters such as risk-aversion and portfolio diversification. Dual-class recapitalizations can also serve, however, to entrench a specified management group by reducing the influence of the corporate control market. Luckily, empirical evidence offers clear guidelines on when a recapitalization with limited-voting stock will be beneficial to shareholder interests.

Fundamental changes occurring in corporate governance, in addition to empirical evidence gathered since the great dual-class stock debate of the 1980s, indicate that much of the support for a uniform minimum voting-rights listing standard was misguided. This is because its content did not differentiate between good and bad recapitalizations. In particular, the vast array of new equity instruments (which often break apart the traditional components that embody traditional equity interests), and the changing role of the institutional investor have made a reevaluation of the use of dual-class common stock imperative.

The role institutional investors and the exchanges can play (if allowed) is important. Institutional investors and the competitive forces that influence the exchanges can be relied upon to carry the burdens that may result from a uniform change in SEC policy. Faulty dual-class recapitalizations will be rejected, as will an exchange policy whose end result is disadvantageous to shareholders.

Dual-class use should be perceived as an expression of discontent by corporate financiers and entrepreneurs with traditional capital-structuring methods and the restrictions those methods impose on decision making and risk taking. Its use in many of the current equity deals serves to highlight the value limited-voting stock can have.

In response, the SROs and the SEC should support or adopt new forms of dual-class regulation (such as that approved by the AMEX and being drafted by the NYSE), driven not by the theor-
ical implications of its use for traditionally large, listed corporations but for the smaller, start-up firms that largely make use of it.