THE UNDESIRABILITY OF MANDATORY TIME-BASED SUNSETS IN DUAL CLASS SHARE STRUCTURES: A REPLY TO BEBCHUK AND KASTIEL

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In a 2017 Virginia Law Review article, *The Untenable Case for Perpetual Dual-Class Stock*,[1] Professors Lucian Bebchuk and Kobi Kastiel argued that time-based sunset provisions (the forced unification of shares into one share structure with equal voting rights after a certain period of time) should be a mandatory feature of dual class share structures (classes of common stock with unequal voting rights). This article has recently been used as authority by the Council of Institutional Investors ("CII") to petition to the NASDAQ Stock Market ("NASDAQ") and the New York Stock Exchange ("NYSE") to amend their listing standards.[2] The requested amendments would require companies seeking to go public with dual class shares to include in their certificates of incorporation a time-based sunset provision that would go into effect no more than seven years after the initial public offering ("IPO") unless minority shareholders vote to extend

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

2. Letter from the Council of Institutional Inv'rs, to John Zecca, Senior Vice President, Gen. Counsel North America and Chief Regulatory Officer, NASDAQ Stock Mkt. (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf. The CII sent an identical letter to the NYSE. Letter from Council of Institutional Inv'rs, to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch., Inc. (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf.

it up to an additional seven years.[3] This delayed unification based on a shareholder vote is incorporated in Bebchuk and Kastiel's argument.[4]

This Article, which is based on comment letters I sent in response to the CII's petitions,[5] argues that such a mandatory provision would be extremely unwise and harmful to our most important public companies and their shareholders, current as well as future. As a creation of private ordering, the absence of time-based sunset provisions in dual class share structures serves a significant value enhancing purpose. It prevents the risk that a premature and therefore sub-optimal unification of shares may occur. This risk has so far been ignored by those advocating for the implementation of a mandatory time-based sunset provision. As subsequently discussed, this risk has been ignored because their analysis lacks an appreciation for how the positive skewness in stock market returns negatively impacts the value of mandatory time-based sunset provisions.

I. IN THE FACE OF PRIVATE ORDERING, WHY THE CONTROVERSY?

Market realities do not allow most companies to enter the public markets with dual class shares[6] and not every company with dual class shares is able to omit a time-based sunset provision.[7] This differentiation between IPOs is the result of private ordering. In the words of former SEC Commissioner Troy Paredes, private ordering is the freedom provided by corporate law that "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[8] As several scholars

3. It is important to differentiate between a time-based sunset provision and an event-based sunset provision. The latter is tied to a specific event such as the death or disability of the controller or the departure of the controller from the company.

4. Bebchuk & Kastiel, *supra* note 1, at 623.

5. Letters from Bernard S. Sharfman to John Zecca, Senior Vice President, Gen. Counsel North America and Chief Regulatory Officer, NASDAQ Stock Mkt. (Mar. 21, 2019) and to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. (Mar. 21, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3352177. Please note that this Article shares much of the same textual language as found in these letters. Given that the reader has this upfront knowledge, this Article will not continuously footnote quotes and cites from those letters.

6. In 2017, a banner year for IPOs with dual class share structures, only 19% of total IPOs had such a structure. *Dual-Class IPO Snapshot: 2017–2018 Statistics*, COUNCIL OF INSTITUTIONAL INV. (Jan. 2, 2019) [hereinafter *Dual-Class IPO Snapshot*], https://www.cii.org/files/2018Y%20IPO%20Stats%20for%20Website.pdf. In 2018, only 11% had dual class shares. *Id.*

7. CII reported that in 2018 5 out of 15 IPOs with dual class share structures had time-based sunset provisions. *Id.*

8. Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009),

have noted, "observed governance choices are the result of value maximizing contracts between shareholders and management."[9]

Specific to dual class shares, Adena Friedman, President and CEO of Nasdaq, Inc. has said the following:

> One of America's greatest strengths is that we are a magnet for entrepreneurship and innovation. Central to cultivating this strength is establishing multiple paths entrepreneurs can take to public markets. Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual class structures allow investors to invest side-by-side with innovators and high growth companies, enjoying the financial benefits of these companies' success.[10]

In sum, private ordering creates a strong presumption that the absence of time-based sunset provisions in many dual class share structures is value enhancing and should not be interfered with by regulatory authorities.

Unfortunately, this does not end the story. There are a number of institutional investors, such as public pension funds and investment advisers to mutual funds, as well as corporate governance activists and commentators, who analyze corporate governance arrangements not through the lens of private ordering but through the lens of shareholder democracy or empowerment.[11] This can cause one to lose sight of what is

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http://www.sec.gov/news/speech/2009/spch052009tap.htm.

9. David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

10. Adena Friedman, *The Promise of Market Reform: Reigniting America's Economic Engine*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 18, 2017), https://corpgov.law.harvard.edu/2017/05/18/the-promise-of-market-reform-reigniting-americas-economic-engine/.

11. Shareholder democracy and empowerment are two intertwined concepts. Shareholder democracy was a term coined in the 1940s that "carried the normative message that greater shareholder participation in corporate governance was both possible and desirable." Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1069 (2015). It is currently associated with the idea of one-share, one-vote. *See* Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006). Shareholder empowerment is essentially the leveraging of shareholder democracy by certain institutional investors. How this concept is to be understood in practice has been powerfully articulated by Delaware Supreme Court Chief Justice Leo Strine:

> [T]here is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit.

Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014).

really important: making sure corporate governance arrangements are used to maximize the wealth of shareholders. It also leads to attacks on private ordering and calls for limitations on its use.

In the case of dual class shares, the attacks have been strong and impactful. For example, the two leading index providers, S&P Dow Jones Indices and FTSE Russell, have succumbed to the pressure and have taken steps to exclude dual class shares from their indices.[12] More recently, as found in the CII proposal described above, the attacks on dual class shares have focused on the absence of time-based sunset provisions in IPOs and the call for their mandatory inclusion.

II. THE ARGUMENT FOR MANDATORY TIME-BASED SUNSET PROVISIONS

Zohar Goshen and Assaf Hamdani argue that talented insiders may possess an "idiosyncratic vision" that allows their companies to earn excess returns.[13] Idiosyncratic vision is a term coined by Zohar Goshen and Assaf Hamdani and has two parts:

> First, it reflects the parts of the entrepreneur's business idea that outsiders may be unable to observe or verify. This could be because the entrepreneur cannot persuade investors that she is the best person to continue running the firm or that her business plan will produce superior returns. Second, it reflects the above-market pecuniary return expected by the entrepreneur, which, if the business succeeds, will be shared on a pro rata basis between the entrepreneur and investors. Importantly, idiosyncratic vision need not concern an innovation or new invention: as long as the entrepreneur has a plan that she subjectively believes will result in above-market returns, she has idiosyncratic vision.[14]

Therefore, it is not unreasonable to argue that dual class share

12. *See FTSE Russell Voting Rights Consultation – Next Steps*, FTSE RUSSELL GROUP 3 (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf (explaining that the FTSE Russell bars companies from inclusion in its benchmark indexes unless more than 5% of the voting rights are in the hands of public shareholders)*; see also Minimum Voting Rights Hurdle*, *v1.3*, FTSE RUSSELL GROUP (Nov. 2018), https://www.ftse.com/products/downloads/Minimum_Voting_Rights_Hurdle_FAQ.pdf; Press Release, S&P Dow Jones Indices, S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules (July 31, 2017), https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true (announcing that the S&P Dow Jones Indices has decided to exclude all new dual class share offerings, including Snap, Inc.'s, from the S&P Composite 1500 and its components, the S&P 500, S&P MidCap 400, and S&P SmallCap 600).

13. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

14. *Id.* at 567.

structures add value by protecting talented insiders from the interference and distraction caused by restive and uninformed shareholders.[15] For example, back in 2012, Mark Zuckerberg faced a lot of criticism for his decision to have Facebook purchase Instagram for an expected closing price of $1 billion.[16] This acquisition occurred just one month before the company issued its dual class shares to the public.[17] To add fuel to the fire, Zuckerberg entered into the agreement without informing his board of directors.[18] To make matters worse, the price of Facebook stock fell like a rock shortly after its IPO, down 54% after four months of public trading.[19] As late as July 2015, analysts were still wondering if the acquisition would earn money for Facebook.[20]

During that time period, without a dual class share structure to protect him, Zuckerberg may have felt quarterly pressure to prove that he had made the right decision, thereby leading him into poor decisionmaking.[21] Moreover, the board may eventually have had second thoughts about allowing the very young Zuckerberg to retain operational control of the company.[22] Instagram is now estimated to have a market value of over $100 billion.[23]

Nevertheless, it is reasonable to argue that the value of a leader's idiosyncratic vision erodes over time.[24] Even if it doesn't erode over a leader's lifetime, the leader's mortality will surely put an end to his or her competitive advantage. The point being that once this value approaches zero, the value of the dual class structure will also approach zero. Moreover, if the governance arrangement is simply used to allow the controller to act opportunistically, then the shares would trade at a discount to their unification price.

It is also reasonable to argue that a company leader, who has decided

15. *See id.* at 590 ("Uncontestable and indefinite control provides the entrepreneur with maximum ability to realize her idiosyncratic vision . . . .").

16. Facebook, Inc., Quarterly Report (Form 10-Q) (Sept. 30, 2012), https://www.sec.gov/Archives/edgar/data/1326801/000132680112000006/fb-9302012x10q.htm.

17. Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1, 14–15 (2018).

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. Emily McCormick, *Instagram Is Estimated to Be Worth More than $100 Billion*, BLOOMBERG (June 25, 2018), https://www.bloomberg.com/news/articles/2018-06-25/value-of-facebook-s-instagram-estimated-to-top-100-billion.

24. *See* Bebchuk & Kastiel, *supra* note 1.

to sell most of his or her shares over time and retain only a minority of the company's shares outstanding, may avoid the unification of shares even though the value of the dual class share structure has passed and unification would yield a premium. The purpose of such a strategy would be to retain voting control of the company. To retain control, the controller would sell his or her shares with low voting power but retain shares with high voting power. This gap between share ownership and voting power is commonly referred to as the "wedge."[25]

As Professors Bebchuk and Kastiel explain, the reason for the controller's resistance to unification, even though the benefits of a dual class structure have passed, is "that the controller would capture only a fraction of the efficiency gains [of unification], which would be shared by all shareholders, but would fully bear the cost of forgoing the private benefits of control associated with the dual class structure."[26] And indeed, empirical evidence appears to bear this out,[27] even though Professors Jill Fisch and Steven Solomon have taken issue with the methodologies that are used in these studies.[28] Nevertheless, it would appear that the problem of controllers wanting to delay unification, even though unification would provide a boost to the share price, is a valid concern for those investing in dual class shares without time-based sunset provisions.

In sum, based on the analysis found in this Part, the inclusion of a time-based sunset provision makes some sense. However, to come to the conclusion that they must be mandatory in every single dual class share structure one must go farther and rebut the strong presumption that private ordering is value enhancing for shareholders. To rebut this presumption, strong evidence of some sort of irrationality or market failure must be found when market participants refuse to include time-based sunset provisions in IPOs. As discussed in Part III, such evidence does not exist.

25. *Id.* at 592.

26. Bebchuk & Kastiel, *supra* note 1, at 592–93. The private benefits of control may include the hiring of family members instead of more qualified outsiders, self-dealing, or usurping a corporate opportunity. *Id.* at 603.

27. *See* Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* 35–38 (European Corp. Governance Inst. Fin. Working Paper No. 550, 2018), https://ssrn.com/abstract=3062895; Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Voting* 26 (European Corp. Governance Inst. Fin. Working Paper No. 590, 2019), https://ssrn.com/abstract=3145209.

28. *See* Jill E. Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, B.U. L. REV. (forthcoming 2019) (manuscript at 11), https://ssrn.com/abstract=3305319. According to Professors Fisch and Solomon, "[t]he primary issue with finance studies of dual class stock is selection effects, namely that the companies that select into dual class structures differ, in important ways, from companies that adopt single class structures." *Id.*

III. AN EXPLANATION FOR THE PERSISTENT ABSENCE OF TIME-BASED SUNSET PROVISIONS

It can be assumed that the downside of dual class shares without time-based sunset provisions as discussed in Part II is now common knowledge to market participants. Evidence for this is the recently reported increase in the use of time-based sunset provisions.[29] Yet, dual class share structures without such provisions remain in the majority.[30] For example, the Lyft IPO included a provision requiring unification upon the "death or total disability of the" last of the co-founders (event-based sunset provision), but not a time-based sunset provision.[31] Therefore, there must be something missing in the prior analysis that makes the absence of such a provision appealing to market participants. That missing element can be found in the path-breaking work of Professor Henrick Bessembinder.[32]

Professor Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016.[33] He found that "in terms of lifetime dollar wealth creation" ("accumulated December 2016 value in *excess of* the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns")[34] "the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."[35] His results also showed that the sum of the individual contributions to lifetime dollar wealth creation provided by the top 50 companies represented almost 40% of total lifetime dollar wealth creation.[36] Thus, the returns earned by a relatively small number of best-performing companies were critical to the stock market earning returns above short-term Treasuries.

29. CII reported that in 2018 five out of 15 IPOs with dual class share structures had time-based sunset provisions. *See Dual-Class IPO Snapshot*, *supra* note 6.

30. *Id.*

31. Lyft, Inc., Registration Statement (Form S-1) at 55 (Mar. 1, 2019), https://www.sec.gov/Archives/edgar/data/1759509/000119312519059849/d633517ds1.htm. For an excellent discussion of the sunset provisions found in the Lyft IPO, *see* Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Lyft's Dual-Class Structure*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Apr. 3, 2019), https://corpgov.law.harvard.edu/2019/04/03/the-perils-of-lyfts-dual-class-structure/.

32. Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. FIN. ECON. 440, 440–41 (2018).

33. *Id.* at 440.

34. *Id.* at 454 tbl.5.

35. *Id.* at 440.

36. *Id.* at 454 tbl.5.

The understanding that positive skewness exists in stock market returns means that investors are best served if those select few firms that are *expected* to be the best performers in terms of returns are provided governance arrangements that give them the best shot of reaching their optimum. Governance arrangements can support this objective by making sure that the leadership skills that exist in a company at the time of its IPO are given the maximum opportunity to be utilized. This is likely why only a few select firms are provided dual class share structures without time-based sunset provisions.

While not every company that has a dual class structure without a time-based sunset provision will hit the highest of heights, the results appear to bear out that this private ordering strategy has been highly successful. Included in Bessembinder's top fifty list of wealth creators are four companies with dual class share structures without time-based sunset provisions: Alphabet, Facebook, Berkshire Hathaway,[37] and Comcast. If Bessembinder were to rerun the numbers through 2018, it appears that another such company, Nike, would also be in the top fifty or very close to it. It is also interesting to note that these highly successful companies vary significantly in terms of the number of years from the date when they first went public with dual class shares and that in most cases the number of years out are significantly greater than seven: Alphabet (fifteen years), Facebook (seven years), Berkshire Hathaway (twenty-three years), Comcast (forty-one years), and Nike (thirty-eight years).

As of March 19, 2019, the current market values of these five best performers are quite mind-boggling: Alphabet ($835 billion), Facebook ($461 billion), Berkshire Hathaway ($505 billion), Comcast ($180 billion), and Nike ($110 billion). Together, these five companies have a market value of over $2 trillion. No wonder market participants and investors are willing to provide a small select number of firms with dual class shares that

37. Berkshire Hathaway is unusual in that it created its dual class share structure through the issuance of Class B shares when it was already a public company and constructively controlled by Warren Buffet. *See* Berkshire Hathaway, Inc., Prospectus (Form 424B4) at 3–5 (May 9, 1996), https://www.sec.gov/Archives/edgar/data/109694/0000898430-96-001695.txt [https://perma.cc/L4BN-MCNV]. Prior to the issuance of the Class B shares, Warren Buffet owned 40.2% of the Class A shares and shared voting power over an additional 3.1% of Class A shares. *See* Berkshire Hathaway, Inc., Proxy Statement (Form DEF 14A) at 5 (May 6, 1996), http://pdf.secdatabase.com/2917/0000109694-96-000012.pdf. Over time, Mr. Buffet has used the dual class share structure to reduce his economic interest in Berkshire Hathaway to 16.5% of the common stock outstanding but has retained constructive control by continuing to hold a 31.4% voting interest through his continued investment in Class A shares. *See* Berkshire Hathaway, Inc., Proxy Statement (Form DEF 14A) at 7 (May 4, 2019), https://www.sec.gov/Archives/edgar/data/1067983/000119312519076915/d684203ddef14a.htm?mod=article_inline.

omit time-based sunset provisions. The absence of these provisions are a small price to pay—the lost returns resulting from delayed unification—for helping to make sure that those companies that are expected to be the stock market's best performers are allowed to reach their full wealth creating potential.

Yes, on average dual class shares may persist too long without time-based sunset provisions, creating a situation where eventually a very small number of dual class shares companies that have not failed, been acquired, or have not gone through a process of voluntary unification, may have common stock that trades below their unification price. It is interesting to note that these companies are so few in number that supporters of mandatory time-based sunset provisions can only point to one that is of any significance: Sumner Redstone's control of CBS and Viacom through National Amusements Inc.[38] However, this is not what market participants are interested in when negotiating such a governance arrangement in an IPO with dual class shares. They are willing to take the risk of delayed unification if it provides the maximum opportunity for a leader's idiosyncratic vision to result in that company generating large asymmetric returns.

Finally, the idea of having a mandatory shareholder vote to determine if a dual class share structure should continue for up to another seven years creates new governance problems and does not solve the problem of premature unification. First, such a requirement puts pressure on a company's leadership to make the objective of its decisionmaking the maintenance of its voting control, not the leveraging of the leader's idiosyncratic vision for the economic benefit of its shareholders. This cannot be beneficial for shareholders or the company.

Second, according to Professors Fisch and Solomon, "[a]ny expectation that a vote of existing minority shareholders will function efficiently to identify situations in which there is value to retaining a dual class structure is highly problematic."[39] Shareholders suffer from the problems of asymmetric information and the simple inability to make the proper evaluation of a leader's idiosyncratic vision.[40] This leaves shareholders in the position of having the knowledge that ending the dual class share structure will expose the shares to the market for corporate control and hedge fund activism, an expected positive for the company's

38. Bebchuk & Kastiel, *supra* note 1, at 587–88.
39. Fisch & Solomon, *supra* note 28, at 19.
40. *Id.* at 20.

share price, without being able to evaluate the cost. Since the greater risk to shareholders is cutting off the dual class share structure too soon, assuming it is a company that is still implementing the leader's idiosyncratic vision which will lead to above market returns, this makes a shareholder vote on ending the dual class structure an extremely high-risk proposition for both the company's shareholders and its leadership.

CONCLUSION

How the governance arrangements of IPOs are determined is best handled by market participants through the process of private ordering. If the market is concerned about dual class share structures creating family dynasties, then it will at least include an event-based sunset provision such as unification upon the death or disability of the controller. Consistent with that approach, the argument made by Professors Bebchuk and Kastiel, as reflected in the petitions presented by the CII to the NASDAQ and NYSE, will disrupt private ordering and lead to harmful results for dual class share companies and their investors. Professors Fisch and Solomon articulated these concerns in the following manner:

> [A] one-size fits all approach to sunsets–like that proposed by the CII . . . does not make sense. The time frame necessary for realization of [a] company's goals is likely to vary depending on the company based on factors like the company's maturity at the IPO stage, the duration of its business model, and the time required to develop its products or services and bring them to market.[41]

As provided by private ordering, the omission of a time-based sunset provision in dual class share structures has a defined and obvious benefit, protecting the idiosyncratic vision possessed by those companies that have been identified as possibly turning into one of the stock market's best performers. These are the companies that allow the stock market to generate overall returns that are greater than short-term treasury rates. The cost of delayed unification for a handful of companies may be significant on an individual basis but in terms of the stock market as a whole, the effect appears de minimus. In sum, even if the implementation of a mandatory one-size-fits-all sunset provision only results in inhibiting one company from becoming the next Alphabet or Facebook, it is one company too many.

41. *Id.* at 17.