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SECURITIES OFFERINGS

Companies opting to go public offer investors class A one-vote-per-share stock, while founders and other insiders retain the class B super-voting shares for themselves.

BNA Insights: IPOs in 2016 Increasingly Include Dual-Class Shareholder Voting Rights



BY SPENCER G. FELDMAN

An increasing number of pre-initial public offering companies have set up dual-class share structures. According to public information, more than 24% of the 125 companies that listed their shares on United States stock exchanges in 2015 had dual-class structures. This compared with 15% of companies going public in 2014 and a mere 1% of companies in 2005. Of all technology, media and telecommunications companies going public last year, a staggering 56% choose this structure (up from 11% in 2014). The technology and financial services sectors had the greatest concentrations of companies with dual-class structures, but every sector participated in this trend. So far in 2016, although it has been a slower IPO year, a number of dual-class companies, including Twilio and Reata Pharmaceuticals, have within the last several weeks made IPO fil-

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ings or completed their IPOs. IPO planning now, more than ever, routinely includes a review by the issuer and its advisors of the company's equity capital structure to consider whether a dual-class structure of the company's common equity is in the best interests of the company and its shareholders.

The success of recent well-known IPO companies that have adopted dual-class structures like Facebook (May 2012), Alibaba (September 2014), Shake Shack (January 2015) and Fitbit (June 2015) has had a compelling influence on this increasing trend, especially in higher valuation IPOs. Dual-class IPOs are coming on strong in 2016 across all industries and there does not appear to be any negative impact on IPO pricing or 180-day after-market performance for companies with dual-class structures relative to traditional one-share, one-vote companies. In fact, according to one law firm study, IPOs with dual-class share structures priced shares in or above the offering price range more often than IPOs with a single class of stock.

Interestingly, this trend has occurred in the face of critical comments from parts of the legal community who are concerned about the corporate democracy implications of separating ownership and control and by policies adopted by some large institutional investors such as CalPERS which have said they will not invest in IPOs with dual-class stock. Others have suggested that dual-class share structures are the poison pill of the shareholder activist generation.

Dual-Class Share Structures

Dual-class share structures involve companies that have provided in their certificate or articles of incorporation for at least two classes of authorized common stock: one called class A common stock, limited or low stock, or subordinate voting shares (e.g., one vote per

share), and the other called class B common stock, “super-voting” or high stock, or multiple voting shares (e.g., ten votes per share). Some companies do away with voting altogether for the one-vote shares by having voting and non-voting share structures. State corporate law statutes such as the Delaware General Corporation Law and New York Business Corporation Law explicitly authorize corporations to create classes of shares with differing rights, voting powers, preferences and restrictions as set forth in their certificate or articles of incorporation. This authority goes beyond the primary classifications – common and preferred – to include further divisions of these primary classes.

The capital stock provisions in a company’s certificate or articles of incorporation typically provide that the class A common stock and the class B common stock have the same rights and privileges and rank equally, share ratably and are identical in all respects as to all matters – except that, on all matters upon which shareholders are entitled or permitted to vote, every holder of class A common stock is entitled to one vote in person or by proxy for each share of class A common stock standing in its name, and every holder of class B common stock is entitled to ten votes (or some other number of votes greater than one) in person or by proxy for each share of class B common stock standing in its name. When voting, the holders of class A common stock and class B common stock vote together as a single class so that class B holders control a majority of the combined voting power of the common stock.

On conversion, each share of class B common stock may, at the option of its holder, at any time, be converted into one fully paid and nonassessable share of class A common stock. Additionally, shares of class B common stock would be automatically converted into a like number of shares of class A common stock upon the occurrence of one or more stipulated “events of conversion.” These events differ with each company, but generally include (i) the date specified by a vote of the holders of 2/3 or more of the outstanding shares of class B common stock, (ii) the death or disability of a holder of class B common stock who is a natural person, (iii) a change of control transaction (inclusive of a liquidation, dissolution or winding up of the business) with respect to a holder of class B common stock which is a corporation, partnership, trust or other entity, (iv) transfer of the shares of class B common stock, whether by sale, assignment, gift or otherwise, except for certain transfers including transfers to certain affiliates and for tax and estate planning purposes, (v) the trading day immediately after the earliest date on which the number of outstanding shares of class B common stock represents less than 10% of the aggregate combined number of outstanding class A common stock and class B common stock, and (vi) on the fifth anniversary of the completion of the company’s IPO.

In most instances, the class A one-vote-per-share stock is sold to the public in the IPO and listed for trading on a stock exchange, while founders and other insiders (sometimes late stage private equity or venture capital funds) retain the class B super-voting shares (which are not publicly traded) for themselves.

Regulatory Considerations

Dual-class share structures are an important IPO planning topic. This is because a company’s capital

structure must be established *before* going public, not after trading commences. NYSE and NASDAQ rules provide that the voting rights of existing public stockholders of a company cannot be disparately reduced or restricted through any corporate action or issuance, including by way of the issuance of super-voting stock or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer. Presumably, in theory, the exchanges are of the view that investors in a dual-class company, whether purchasing in the IPO or after-market, should be aware of its structure when they bought its stock and have assumed that risk.

Based on the Securities and Exchange Commission’s recent comments to IPO companies with dual-class share structures, the SEC seems to have settled on the proper disclosure for investor protection, which includes:

- a specific name for each class of shares that is not confusing to readers, with class A and class B common stock being the most popular nomenclature;
- a list of the classes of authorized common stock outstanding, a brief description of the different rights between the classes and, if holders of the outstanding class B super-voting common stock will have voting control over the company, that fact should be stated together with the identity of the holders with control, all of which disclosure should appear on the prospectus cover page;
- one or more risk factors associated with the effect of having a dual-class voting structure such as the limited ability of holders of class A common stock to influence corporate matters and the ability of holders of class B common stock to delay or prevent proxy contests, mergers, tender offers, open-market purchase programs or other purchases of class A common stock that might give public stockholders the opportunity to realize a premium over the then-prevailing market price of those shares;
- an added column in the “Security Ownership of Certain Beneficial Owners and Management” table that discloses the total voting power of each beneficial owner, with narrative or footnote disclosure that discusses the voting rights of each class of shares held by such owner; and
- a description of how each class of shares would be impacted by an acquisition, merger or other change of control transaction.

Pros and Cons of Dual-Class Share Structures

In discussing the benefits of adopting a dual-class share structure, the following considerations should be reviewed by the company and its advisors.

1. For company management and the board, this structure tends to better focus them on long-term strategic decisions. Without the pressure to meet quarterly earnings guidance or other short-term financial expectations due to having a controlling class of shares, management and the board of directors may be better able

to focus on long-term strategic and capital investment decisions compared to making quick fixes and taking disproportionate risks to satisfy short-term investors. Control through a dual-class share structure may be an effective means to protect a company's shareholders from opportunistic traders who may seek to take advantage of quarter-to-quarter price fluctuations that could result from a company's focus on long-term value creation.

2. For entrepreneurs and investors, this structure is more likely to bring entrepreneur-controlled firms into the public capital markets. Because company founders seeking to raise capital for expansion and growth place a premium on retaining control of their companies, they are more likely to access public equity markets only if ownership structures are available that permit them to maintain the company's direction (from an artistic, design or editorial perspective) through voting rather than economic control. Dual-class share structures may provide investors with the opportunity to purchase shares in companies that otherwise might not be publicly available.

3. For minority and controlling shareholders, this structure may more closely align their ownership oversight interests. There have been significant academic studies concerning potential conflicts that exist between management and shareholders at widely-held public companies with one-share, one-vote capital structures given the separation of "ownership" from "control." With dispersed ownership, it may be difficult for shareholders of these companies to effectively monitor management in the absence of committed long-term shareholders or activist shareholders. In a dual-class share company, on the other hand, the interests of super-voting shareholders who have meaningful share ownership (particularly non-executive founders and sponsors) may be more closely aligned with the interests of one-vote shareholders with regard to the ongoing evaluation and oversight of management, and that such super-voting shareholders are better positioned and incentivized to supervise the conduct of management.

In discussing the risks of adopting a dual-class share structure, the following considerations should be reviewed by the company and its advisors.

1. For investors and minority shareholders, this structure may prompt concerns relating to super-voting shareholder self-interest, management entrenchment and passive boards. There may be a fear among new investors that holders of super-voting shares will exert significant influence over a company and award excessive compensation to themselves or family and friends who are appointed officers or employees of the company or waste corporate assets through the approval of self-dealing transactions on a non arm's-length basis. Similarly, dual-class share structures may be said to have the potential of entrenching under-performing management by insulating them from minority shareholder accountability. Further, there could be a fear that directors may, as a practical matter, be bound to follow the views of the super-voting shareholders or risk being replaced on the com-

pany's slate for election to the board, despite the fiduciary duties of directors owed to shareholders. Critics of this view, however, point to SEC and stock exchange governance requirements that apply to public companies such as a majority of independent directors, a separate independent audit committee, related-party transaction review, strict internal controls and procedures, and independent registered public accountants to downplay this effect.

2. For minority shareholders, this structure may cause disproportionate economic risk. While super-voting shareholders have significant power as shareholders, the majority of the economic risk is typically borne by public one-vote-per-share shareholders who do not have the corresponding power to elect the board or exercise fundamental rights.

Conclusion

Family-controlled, dual-class share structures have been a fixture of media companies for decades. The New York Times Company's proxy statement, for instance, reads that the primary objective of the super-voting family trusts that control the company "is to maintain the editorial independence and integrity of the New York Times and to continue it as an independent newspaper, entirely fearless, free of ulterior influence, and unselfishly devoted to the public welfare." Some argue that every company like the Times that determines to adopt a dual-class structure must justify it with valid and significant business purposes. In some cases, that justification may also involve according voting control to a founder with a significant shareholding who has a talent for conceiving products (especially at consumer technology companies) and setting a vision for the company such as at Facebook. These companies and others that are the best performing companies in their sectors will not be hindered by dual-class structures in completing their IPOs, in part because investors make the conscious choice to trade their vote (which is typically limited in any event immediately following an IPO) for a promising new listing. To ameliorate the risk, smart dual-class companies will also adopt strong corporate governance practices to ensure management and directors act in the best interests of all the company's shareholders.

The tougher issue with dual-class share structures is when the super-voting shares are not owned by trusted management or when the original controlling family or visionary founder is no longer running the company, and the company is not performing well. To address the possible perpetuity of the dual-class structure, many companies have included "sunset provisions" in their charters that compel automatic conversion of the super-voting shares after an initial period of time following an IPO. In a perfect world, the duration of this period would be a negotiating point with those IPO investors.

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The views and opinions expressed herein do not reflect the views or opinions of Olshan's Activist Practice with respect to dual-class share structures.