MULTI-CLASS STOCK AND THE MODERN CORPORATION: A VIEW FROM THE LEFT (COAST) ON GOVERNANCE MISALIGNMENT AND THE PUBLIC COMPANY

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I would like to thank Stephen Deane and the SEC for inviting me today, as well as Kurt Schacht and the other members of the Investor Advisory Committee for allowing me to speak on these important issues. I would also to thank my good friend and co-presenter Ken Bertsch, who invited me to discuss similar issues at CII's meeting last year, and I am sure he (and the other speakers here today) will be much more eloquent and informative on these issues than I am.

For more than 25 years I have been advising Silicon Valley based companies on corporate governance issues. Given the general perception (especially on the east coast) of the corporate governance practices of Silicon Valley companies, you may believe that I am simply Ron LaFlamme's corporate governance partner[2], or reading some of the reactions to Snap's governance structure you may have already concluded that "Silicon Valley" and "good corporate governance" is an oxymoron.

However I believe this is not the case—at least thus far no one has asked me to be on TV—and more importantly for our purposes I actually believe many Silicon Valley companies strive to meet the highest standards of corporate governance, and this applies even to many of those companies that have adopted multi-class stock structures. Indeed, I believe it is time to turn the notion of what is "good governance" on its head by asking a simple question: if you assume, as I do, that good governance is important to corporate success, why is the most dynamic sector of our economy—that is the tech sector, best represented by Silicon Valley—

[2] Ron LaFlamme is the corporate lawyer advising the fictional company Pied Piper in HBO's Silicon Valley.

considered to have the poorest corporate governance? One could take this even further and ask why some of the most successful companies in the tech sector—including Alphabet (formerly Google), Facebook, LinkedIn, Square and now Snap—are also among the companies most criticized for their corporate governance structures?

To answer this question I believe one needs to understand the "Corporate Governance Misalignment," that exists in our capital markets today, and that is the focus of my brief discussion. Specifically, changes in who owns stock as well as governance rules (including the power dynamics supporting those rules) that focus exclusively on the needs of stockholders—and are especially favorable to the desires of short-term stockholders—have created a system that is increasingly rejected by technology companies precisely because such companies seek to be measured by more than just their stock price. This does not mean that stock price or shareholder value is unimportant; rather, the governance misalignment exists because we have reached a point where virtually all debates on corporate governance begin and end with what is best for public equity owners. This has led many companies and boards, especially in Silicon Valley, to consider alternative structures so that boards can adopt longer-term strategies, including perhaps sharing some corporate profits more broadly with employees and other constituencies.

By understanding this governance misalignment, including how we got here, the current world we live in, and its effect on tech companies in particular, I think we can better understand why some of our most promising companies go public with dual-class stock (or choose to stay private longer). Equally important, by recognizing the current corporate governance misalignment we may be able to start addressing the problems caused when corporations answer only to today's stockholders without having to consider the impact of their actions on the human investors who actually provide the capital to these stockholders or the human capital that creates the value that grows the corporate enterprise, as well as the many other corporate stakeholders who contribute to the corporation and often take risks that are equal to or greater than stockholders who buy and sell shares in the public market, where the money used to purchase the shares typically does not go to the corporation and the greatest risk for the investor is a decline in the company's stock price.

1. What Incentives Drive Today's Investors?

As Commissioner Stein recently noted, today's markets are dominated by institutional investors; in 2016 institutional investors owned 70% of public shares, and just three money managers held the largest stock position in 88% of the companies in the S&P 500.[3] Thus when individuals do invest in the equity markets today they typically buy mutual funds or ETFs, not individual stocks.[4] Most of this investment is in the form of retirement plans, and because many of these plans give people limited choices over what funds to invest in (and these funds rarely if ever

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[3] *See* The Hon. Kara M. Stein, Commissioner, Securities and Exchange Commission, *The Markets in 2017: What's At Stake*, (Feb. 24, 2017), https://www.sec.gov/news/speech/stein-sec-speaks-whats-at-stake.html.
[4] *See* David J. Berger, *In Search of Lost Time: What if Delaware Had Not Adopted Shareholder Primacy*, in **THE CORPORATE CONTRACT IN CHANGING TIMES** (Steven Davidoff Solomon and Randall Thomas, eds., University of Chicago Press) (forthcoming 2017).

give their investors any choice over what specific stocks the fund invests in), most individuals have very limited investment choices.[5] Additionally, almost half of all Americans have nothing invested in the stock market—they do not own any individual stocks or mutual funds, do not have a pension plan, and do not have an IRAs or 401(k)—and thus have nothing at all invested, directly or indirectly, in the stock market.[6]

As a result, a majority of people—including both those who have nothing invested in the stock market or who's only investment is in various mutual funds or retirement plans—have no direct input into any of the corporate governance issues that are the focus of institutional investors today. This includes issues ranging from proxy fights to staggered boards to proxy access and even the questions of shareholder voting that are the subject of our meeting today.

Given this reality, what incentives drive investors today? "Investors" today are, as Commissioner Stein noted, fund managers, not individuals. These managers, (whether they be hedge fund managers or money managers at institutional investment firms, and whether they call themselves "activists" "quants" or "owners") invest the capital of others rather than taking the actual risks that comes with starting and operating a business. For these managers success is most-often measured by the fund's short-term performance and growth. Because these money managers are incentivized to see stock prices increase they have sought to

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[5] *See* Leo E. Strine Jr., *Who Bleeds When the Wolves Bite?: A Flesh and Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 2, 49-52 (2017).
[6] *Id.* at 4.

incentivize senior corporate leadership—from management, to CEOs to corporate directors—to focus on stock price above all else.[7]

As a result, in today's world the loudest voice that is heard on the issue of corporate governance is that of the equity owner. In contrast, all of the other corporate constituencies—including the voices of the vast majority of people who rely on the corporation for jobs, wages, benefits and long-term growth, as well as consumers who use the corporation's products, communities where the corporation exists and others who rely on the corporation—have virtually no voice in corporate decisions even though these decisions may have a far greater impact on their lives than the fund manager who's focus is simply on whether the company's (or even the broader market's) stock price increases or decreases.

2. Governance Misalignment and the Demise of the Public Technology Company

In addition to the market factors discussed above, existing legal principles contribute to the current governance misalignment. For example, Delaware law today is based upon the concept of stockholder primacy. As a result, directors

[7] While these efforts have led to record stock prices, the costs in terms of decreased investments in employee and management training, lost jobs or harm to communities through plant closings or corporate participation in the community is typically not on the agenda of these investors as there is no incentive for money managers to focus on such issues. Indeed, what is striking is that most funds in a family—whether the particular fund is a "socially responsible" fund, an index fund or an actively managed fund—tend to vote identically on proxy issues, whether the issue involves governance or mergers, for the simple reason that most funds today either establish a centralized voting unit that develops voting policies across all funds or simply "outsources" its voting decisions to one of the major proxy advisory services. *Id.* at 50-54 (discussing voting systems at mutual funds).

cannot take actions to promote other corporate constituencies unless these actions ultimately maximize economic value for stockholders.[8]

At the same time, Delaware law gives directors substantial discretion to take action in the long-term interests of shareholders, and even allows the corporation to adopt structural measures that would provide for longer planning cycles. However in recent years the increased power of institutional investors and activist hedge funds discussed above have led most companies to voluntarily eliminate the types of structural protections that are permitted under Delaware law, and further created a corporate governance system where directors and managers feel under substantial pressure to take actions that have the highest likelihood of raising stock price in the near term, even if these actions may harm the company in the long-term.[9]

The short-term mentality of our public markets has impacted Silicon Valley. Technology has become the sector most frequently targeted by shareholder activists, and the financial characteristics that are most likely to attract activists—including companies with large cash balances, substantial spending on R&D (which has the highest risk of failure or at least not showing near-term results) and high SG&A spending (which includes costs incurred on spending for employee and

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[8] Historically, a variety of countervailing forces often limited the ability of boards to act just in the interests of equity owners. This began changing in the 1980s, as the power of these countervailing forces declined. For a lengthier discussion of these issues, *see generally* Berger, *Lost Time*, supra n. 4.

[9] A recent study by McKinsey found that 79% of executives and directors felt substantial pressure to deliver results in two years or less, despite the fact that 86% of the participants said that using a longer time horizon to set strategy and make business decisions would have a positive effect on both financial returns and innovation. *See* Dominick Barton & Mark Weisman, *Focusing Capital on the Long-Term*, HARV. BUS. REV., Jan-Feb. 2014, https://hbr.org/2014/01/focusing-capital-on-the-long-term.

manager training as well as employee benefits)—are all common to technology companies. Activists are also quick to target technology companies who may have missed a product cycle or technology transition, often with the encouragement of the institutional investors who hold the company's shares, who frequently would rather sell the company and obtain the certainty of a premium for their stock than allow the company to invest and take the risks necessary to try and leap ahead.

Given this environment, it should come as no surprise that in the last several years many successful tech companies have chosen to stay private longer (or leave the public markets entirely) rather than face a public market that has little tolerance for quarterly fluctuations or long-term investments in employee training or management skills[10] or long-term projects that have a significant chance of failing. This has led to an historic low in IPOs, particularly those of smaller private companies (*i.e.* those with market capitalizations that are likely to be less than $1 billion). As Marc Andresson has noted, "in the modern era, public market time horizons have never been shorter and private market time horizons have never been longer."[11]

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[10] Our accounting rules actually disfavor this type of spending, as unlike capital spending there is no line-item for it; instead, expenditures on employees, including training for employees and managers, is generally lumped into SG&A, and such spending is a prime target for activist investors.

[11] *See* Rolfe Winkler & Telis Demos, *Tech Firms Are Notably Scarce in IPO Market*, WALL ST. J. (Sept. 10, 2015), https://www.wsj.com/articles/ipo-parade-continues-without-many-tech-companies-1441929152. For a more detailed discussion of these issues, *see* David J. Berger et al., *Tenure Voting and the U.S. Public Company,* 72 BUS. LAW. ____ (2017) (forthcoming).

3. *One Response to Governance Misalignment: The Multi-Class Stock Alternative*

In the last decade several of the most high-profile technology companies have gone public with a multi-class share structure; Google (now Alphabet), which had its IPO in 2004, is the company most frequently identified as beginning this "trend,"[12] while Snap is the most recent example of such a structure.[13]

The adoption of this structure was a response (at least in part) to several of the factors I have outlined above. As Google explained in its "founders letter" to prospective shareholders at the time of its IPO:

> Google is not a conventional company. We do not intend to become one.... As a private company, we have concentrated on the long-term, and this has served us well. As a public company, we will do the same....If opportunities arise that might cause us to sacrifice short-term results but are in the best long-term interest of our shareholders, we will take those opportunities.
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> Many companies are under pressure to keep their earnings in line with analysts' forecasts...Google has had adequate cash to fund our business and has generated additional cash through operations. This gives us the flexibility to weather costs, benefit from opportunities and optimize our long-term earnings...Our long term focus does have risks. Markets may have

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[12] WSGR represented Google (now Alphabet) in its IPO, and continues to represent Alphabet.

[13] While several prominent technology companies have gone public with a multi-class structure since 2004, including such companies as Box, Facebook, LinkedIn, GoPro, Square, Workday, and Zynga, such companies were a small fraction of the tech companies that went public during this same period. (Again, in full disclosure WSGR represented several of these companies in their IPO). At the same time, according to a recent CII study, the number of "controlled" companies declined from 2012 to 2015, there are less than 100 companies in the S&P 1500 with dual-class stock, and most of those companies went public long before 2004. Historically dual-class structures were most popular among media companies, such as the New York Times and Dow Jones, not technology companies. Today, many non-tech companies, including Nike, Berkshire Hathaway, Comcast, Under Armor and others, have dual- or multi-class stock. *See generally* Edward Kamonjoh Investor Responsibility Research Center Institute, *CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500*, (2016).

> trouble evaluating long-term value, thus potentially reducing the value of our company. Our long-term focus may simply be the wrong business strategy. Competitors may be rewarded for short term tactics and grow stronger as a result. [Yet we] will not shy away from high-risk, high-reward projects because of short-term earnings pressure.
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> We encourage our employees, in addition to their regular projects, to spend 20% of their time working on what they think will most benefit Google. This empowers them to be more creative and innovative. Many of our significant advances have happened in this manner. For example, AdSense for content and Google News were both prototyped in "20% time." [While] [m]ost risky projects fizzle, often teaching us something. Others succeed and become attractive businesses.
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> In the transition to public ownership we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. We understand some investors do not favor dual class structures. Some may believe that our dual class structure will give us the ability to take actions that benefit us, but not Google's shareholders as a whole. We have considered this point of view carefully, and we and the board have not made our decision lightly…we believe the stability afforded by the dual-class structure will enable us to retain our unique culture and continue to attract and retain talented people who are Google's life blood.[14]

As this disclosure makes clear, Alphabet's adoption of its dual-class structure was done at least in part in response to the governance misalignment I have outlined above. Specifically, Alphabet recognized the market pressures that existed at the time often led companies to avoid risk-taking and favor short-term projects over long-term investments.

Since 2004 those pressures have only increased. The continuing growth of the professional money manager class, as individuals increasingly invest in mutual funds rather than individual stocks—what Delaware Chief Justice Strine has called

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[14] The full text of Google's 2004 Founders' IPO letter can be found here: https://abc.xyz/investor/founders-letters/2004/ipo-letter.html.

the "separation of capital from capital"[15] –along with the corresponding governance movement to eliminate structural defenses and pressure to maximize stockholder value, has led companies who want to go public to consider how to withstand these pressures.

As Alphabet's disclosures make clear, there is no guarantee that the dual-class structure will succeed. As the CII's own studies show, dual-class companies (as well as controlled companies) are more successful on some metrics and less successful on others.[16] Yet what is most significant is that the key issues that impact the vast majority of actual human beings who are directly impacted by the corporation—including the development of new products or technology, the actions necessary to recruit and retain the best employees as well as providing the necessary training to allow these employees to excel, or even just creating good corporate citizenship—are all largely ignored by today's narrow focus which gives the greatest influence over corporations to the professional investment class.

The use of multi-class stock by technology companies in recent years has been one response to the problem that the sole definition of "success" for the corporation is how well it performs for stockholders. Of course, companies that go public with multi-class structures remain a very small minority of companies, and given the relative novelty of this structure in the technology sector, it remains to be seen how well this structure will work for technology (or other) companies in the

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[15] *See* Leo E. Strine Jr., *The Delaware Way: How We do Corporate Law and Some of the Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2006).

[16] *See generally* Kamonjoh, *supra* note 11. (showing that, for example, "market capitalization rates of controlled firms was higher than that of the broader market index," while underperforming on other shareholder metrics; no discussion of non-shareholder metrics)

long-term. Further, multi-class stock has been the only alternative to the one-share/one-vote structure, as other potential solutions to the problems discussed above, such as time-based voting, are discouraged by the existing regulatory system.[17]

Yet the leaders of many of our best technology companies will tell you that a corporation is more than its stockholders. More importantly, a governance system that focuses entirely on stockholders—especially when those stockholders are investing other people's money and about half of the people in this country have nothing to invest—ignores the broader interests of the corporation (as well the people who rely on its success).

Until this governance misalignment is fixed—until the broader mission of the corporate enterprise can be considered by directors and other corporate stakeholders have appropriate opportunities to enforce their rights along with stockholders—you will continue to have some of our most innovative corporations consider novel solutions to solve the governance misalignment problem, just as these companies are working to develop novel solutions to other problems that exist.

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[17] For a more extensive discussion of some of the issues involved with time-based voting, *see* David J. Berger et al., *Tenure Voting and the U.S. Public Company,* 72 BUS. LAW. _____,(2017)(forthcoming).