Institutional Ownership in the Twenty-First Century: Perils, Pitfalls, and Prospects

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Abstract

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The recent massive shift by Americans into investment funds and the attendant rise of a core group of institutional shareholders has transformed the financial market landscape. This dissertation explores the economic and policy implications associated with this shift to intermediated capital markets. The underlying assumption has always been that the growing presence of institutional investors in capital markets would improve the corporate governance of their portfolio companies, thereby reducing managerial agency costs and increasing firm value. My research explains why the reality deviates from that ideal. Using two novel perspectives—tax and antitrust—this dissertation reveals the disruptive effects and market distortions associated with the rise of institutional ownership.

Chapter 1 of this dissertation, Common Ownership: A Game Changer in Corporate Compliance, explores the effect of overlapping institutional ownership of public companies by institutional investors on corporate tax avoidance. Leading scholars now recognize that this type of "common ownership" can change company objectives and behavior in a way that may lead to economic distortions. This chapter explores one unexamined peril associated with such common ownership: the effect of this core group of institutional investors on the tax avoidance behavior of their portfolio companies. I show how common ownership can lead to a reduction in those companies' tax liability by means of a newly recognized phenomenon I call "flooding." This term describes a practice by which different companies that are owned by the same institutional shareholders simultaneously take aggressive tax positions to reduce their tax obligations. Due to

the IRS's limited audit capacity, this synchronized behavior is likely to overwhelm the agency and substantially reduce the probability that tax noncompliance will be detected and penalized. This outcome runs counter to the classic deterrence theory model (which assumes that the threat of enforcement deters noncompliance) and demonstrates how common ownership changes the way public firms approach legal risks.

By revealing the systematic compliance distortion and attendant enforcement challenges that ensue when the same investors "own it all," this chapter also highlights a hidden social cost of common ownership. Under the domination of common institutional investors, companies can more easily shirk their taxes, reducing U.S. tax revenues by billions. Ironically, many of these same investors proclaim themselves as socially responsible stewards of the companies they own, attracting millions of individual investors who factor Environmental, Social, and Governance (ESG) issues into their investment decisions. Corporate "flooding" affords an instructive example of the weakness of so-called ESG investment model.

To mitigate the detrimental effect of common ownership on corporate tax compliance, this chapter proposes a double sanctions regime, whereby institutional investors would be penalized along with their portfolio companies for improper tax avoidance. Such a regime may help restore deterrence and may incentivize institutional investors to keep their social promises.

Chapter 2 of this dissertation, The Agency Tax Costs of Mutual Funds, unveils another tax-related pitfall associated with what some scholars term the "separation of ownership from ownership" problem in intermediated markets. In such markets, retail mutual fund investors cede investment and voting decisions to institutional investors who manage the funds. As a result,

actions undertaken unilaterally by financial intermediaries dictate the tax liability of passive individual investors. This chapter argues that the tax decisions of institutional investors are often guided by their own tax considerations rather than by the tax considerations of the beneficiaries who own mutual funds through conventional taxable accounts. Due to the pass-through tax rules that govern investment funds, these beneficiaries, unlike the institutional investors (who are compensated based on pre-tax performance), are tax-sensitive. These diverging incentives give rise to a new type of an agency costs problem.

These agency tax costs arise from the institutional investors' trading decisions, corporate stewardship activities, and their preferences in the mergers and acquisitions (M&A) context. I argue that the structure of M&A deals, the method of payment used in such deals, and even the premiums paid to sellers in such deals are distorted because the votes of passive tax-sensitive retail investors are cast by tax-insensitive institutional investors. As a result, institutional investors not only fail to replicate the tax outcomes that tax-sensitive investors could have achieved had they owned stock directly, but they also distort corporate voting outcomes for all stakeholders—even those with unmediated investments.

This chapter proposes several options for mitigating agency tax costs, including mandatory separation of funds based on the tax profile of the beneficiaries, heightened tax disclosure by mutual funds, decentralization of votes in mutual fund sponsors, and pass-through voting systems. These alternatives would reduce the agency tax costs of mutual funds without imposing new agency costs on tax-insensitive shareholders who also rely on institutional investors for portfolio management.

The agency tax costs problem undermines the traditional assumption that mutual funds and their individual investors have the common goal of maximizing returns. My research reveals

that this underlying assumption is flawed, as it overlooks the tax rules that govern investment funds and the way these rules shape the economic incentives of mutual funds managers and advisors. These incentives create a conflict of interest between institutional investors and their tax-sensitive investors, which has been largely overlooked.

The analysis of the agency tax costs problem also illuminates the ways in which the rise of financial intermediaries has impacted the tax behavior of public corporations, which in turn, has affected the tax liability of investors in capital markets. While this result has significant implications for market participants and society at large, the paths through which these effects occur and their underlying economic rationales have received little attention. This chapter addresses this scholarly gap by examining the role of corporate governance structures as well as the role of tax law and policy in shaping the tax incentives of the most powerful market actors in the U.S. economy.

Chapter 3 of this dissertation, The Corporate Governance Cartel, offers a novel antitrust perspective on a growing phenomenon in capital markets that has accompanied the rise of institutional ownership: institutional investor coalitions. Traditionally, corporate law has regarded such coalitions as desirable, a solution to the well-known collective action problem facing public shareholders. In this chapter, I challenge that view by revealing the anticompetitive risks that investor coalitions pose. This chapter shows how investor coalitions can emerge at the border between firms and markets, affecting not only the intra-firm governance arrangements of the companies held by the coalition members—but capital markets as well. At the firm/market border, cooperation among institutional investors, even around seemingly benign corporate governance issues, provides an opportunity for tacit collusion among these investors in the markets in which they compete.

To illustrate this problem, I use an antitrust lens to analyze the collective efforts of institutional investors to restrict the use of dual-class stock in initial public offerings (IPOs). This original account of the coalition against dual-class structures exposes the significant anticompetitive effects that may arise at the IPO juncture when competing buyers of shares in the primary market coordinate their response to a governance term. Since the members of the coalition collectively possess most of the expected market demand for public offerings, their joint efforts can be seen as an exercise of buyer-side power.

The exploitation of such power effectively creates a cartel of buyers in the primary market, resulting in two potential economic distortions: (1) abnormal underpricing of dual-class offerings, and (2) suboptimal governance arrangements. Both distortions reveal overlooked perils associated with the massive aggregation of power by institutional investors.

In my antitrust analysis of investor coalitions, I also focus on institutional investor consortiums, trade associations that promote governance principles on behalf of their institutional members, which notably are on the rise. In analyzing these consortiums, this chapter draws upon antitrust rules relative to standard-setting organizations and explores how these anticompetitive risks are exacerbated by these investor consortiums.

Finally, this chapter proposes immediate regulatory responses aimed at preventing institutional investors from engaging in collective actions that limit competition. The suggested policies represent a means to resolve the delicate tension between the goal of corporate law to encourage collaboration among shareholders and the goal of antitrust law to restrict cooperation among competitors.

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Dedication

This dissertation is dedicated to my parents, Moshe and Sigal, who always made my education their top priority and provided me with the opportunity to pursue my dreams. Without their support, I would have never made it this far.

Chapter 1: Common Ownership: A Game Changer in Corporate Compliance

Can shifts in the ownership of U.S. corporate equity explain changes in tax compliance? For decades, regulators, scholars, and legal practitioners have assumed that the answer is no. The common view was that corporate tax avoidance[1] should be analyzed through the standard framework for considering an individual's tax avoidance choice.[2] Under such a view, in deciding if and how much taxes to avoid, a company will weigh the potential tax savings against the probability of being caught and penalized (that is, the enforcement probability) and the likely magnitude of the sanction in such case.[3] This chapter argues that in the ever-changing capital market landscape, where public companies share ownership links, the traditional analysis of the determinants of corporate tax avoidance is deficient.

To understand why "common ownership"—the overlapping ownership of public companies by large institutional investors—affects the analysis of corporate tax avoidance, one must consider the fact that the tax agency,[4] like other regulatory agencies, faces constrained budget and enforcement resources. Thus, the agency cannot audit all taxpayers and must decide how to

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[1] The terms "tax avoidance," "tax planning," "tax noncompliance," and "tax aggressiveness" are used interchangeably in this chapter.
In this chapter, corporate tax avoidance is a behavior that causes an explicit reduction in a company's tax burden by exploiting unintended weaknesses in the tax code. *See* Eric. C. Chaffee, *Collaboration Theory and Corporate Tax Avoidance*, 76 WASH. & LEE L. REV. 91, 95-96 (2019). This behavior is identified as existing within a legal gray area; the law does not explicitly proscribe the tax planning position, as opposed to tax evasion, but does not intend to allow it either, so that it violates the spirit of the law.
[2] *See* Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972). The model originally analyzed tax evasion rather than tax avoidance but was later applied to tax avoidance as well. The model of an individual tax avoidance choice has been extended over the past 40 plus years to other variables such as the applicable tax rate (Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. PUB. ECON. 201 (1974)), and other sources of uncertainty were incorporated into it (Alex Raskolnikov, *Probabilistic Compliance*, 34 YALE J. REG. 491 (2017)).
[3] *See* Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25, 35-36 (2007).
[4] For brevity, the terms "tax agency," "tax authorities," and "IRS" are used interchangeably in this chapter.

allocate its collection efforts among taxpayers.[5] Collection efforts that were exhausted in one tax audit would no longer be available for audits of other taxpayers. In the context of corporate tax avoidance, this reality means that a specific company's enforcement probability is dependent not only on its own tax behavior but on the behavior of other companies as well. This, in turn, creates an inherent interdependence between the enforcement probability of different taxpayers that becomes particularly significant when the same investors own multiple companies. The concern is that these companies, which are now tightly tied through common ownership links, will concert their tax avoidance levels to take advantage of the agency's limited audit capacity, thus overwhelming the IRS.

In light of unprecedented levels of tax avoidance by U.S. corporations, the importance of this tax behavior cannot be overstated. Many of the largest companies in the country now take full advantage of dubious tax planning opportunities, reducing U.S. government tax revenues by more than an estimated $100 billion each year.[6] For example, in 2020, approximately sixty companies on the S&P 500 stock index, including profitable giants such as FedEx, Nike, and Salesforce, paid no federal taxes at all on an aggregate of over $40 billion in corporate income.[7] In fact, the number of publicly held companies that zeroed out their federal income taxes has roughly doubled in the last few years.[8]

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[5] *See* Leandra Lederman & Ted M. Sichelman, *Enforcement as Substance in Tax Compliance*, 70 WASH. & LEE L. REV. 1679, 1682 (2013).

[6] *See* Kimberly Clausing, *The Real (and Imagined) Problems with the U.S. Corporate Tax Code*, HARV. BUS. REV. (Dec. 6, 2016), https://hbr.org/2016/12/the-real-and-imagined-problems-with-the-u-s-corporate-tax-code. *See also See* Richard Murphy, *The Cost of Tax Abuse: A Briefing Paper on The Cost of Tax Evasion Worldwide*, TAX JUSTICE NETWORK (Nov. 2011), https://taxjustice.net/2014/04/01/cost-tax-abuse-2011/ (last visited March 1, 2022) (showing that in 2011, the Tax Justice Network estimated the lower bound of tax avoidance at 5.1% of the global GDP).

[7] *See* Matthew Gardner & Steve Wamhoff, *55 Corporations Paid $0 in Federal Taxes on 2020 Profits*, INS. ON TAX'N & ECON. POL'Y (Apr. 2021), https://itep.org/55-profitable-corporations-zero-corporate-tax/.

[8] Matthew Gardner, Robert S. Mclntyre & Richard Phillips, *The 35 Percent Corporate Tax Myth*, INS. ON TAX'N & ECON. POL'Y (Mar. 2017), https://itep.org/wp-content/uploads/35percentfullreport.pdf; *see also* Kathryn Kranhold, *Twice as Many Companies Paying Zero Taxes Under Trump Tax Plan*, NBC News (Apr. 11, 2019), https://www.nbcnews.com/business/taxes/twice-many-companies-paying-zero-taxes-under-tr ump-tax-plan-

The documented surge in corporate tax avoidance has coincided with an increase in common ownership among public companies—itself a result of a shift in corporate ownership.[9] A core group of large institutional investors who oversee mostly passive funds (index funds and ETFs that track benchmark indices) now own significant equity stakes in many companies. In 2020, for example, index funds and ETFs owned approximately 14% of the whole U.S. stock market, up from 7% in 2010.[10] The three largest asset management institutions—BlackRock Group, State Street Global Advisors, and the Vanguard Group (the "Big Three")—are collectively the "single" largest shareholder in 40% of listed companies in the U.S. and nearly 90% of the companies on the S&P 500 stock index.[11] In 2018, the Big Three had at least a 5% equity stake in 2,367, 2,051, and 183 public companies, respectively.[12]

Recent empirical data indeed reveal that this growth in quasi-indexer ownership—a proxy for common ownership[13]—is specifically linked to corporate tax avoidance. According to the data,

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n993046. According to the data presented in these sources, between 2008-2015, two hundred and fifty-eight fortune 500 companies were consistently profitable. One hundred of them paid zero or less in deferral income tax in at least one of these years. Eighteen of them, including General Electric, Priceline.com, and PG&E, did not pay any federal income tax all over this eight-year period.

[9] The rise in common ownership is primarily attributed to the growing popularity of index investing. According to the Bank for International Settlements, "passive funds managed about ... 20% of aggregate investment fund assets as of June 2017, up from 8% a decade earlier, and where passive funds now make up 43% of total U.S. equity fund assets" (see Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, Mar. 2018 BANK INT'L SETTLEMENTS. Q. REV., 114-115, https://ssrn.com/abstract=3139242). A recent empirical study found that the average of passive common ownership measure is approximately twice the active common ownership measure, supporting the idea that common ownership is currently on the rise due to an unprecedented increase in index investing (Erik P. Gilje, Todd A. Gormley & Doron Levit, *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives* 29 (Eur. Cor. Governance Inst., Fin. Working Paper 568/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165574).

[10] Investment Company Institute, 2021 INVESTMENT COMPANY FACT BOOK 50 (2021), https://www.ici.org/system/files/2021-05/2021_factbook.pdf.

[11] Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 18 BUS. & POL. 298, 298-299 (2017).

[12] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COL. L. REV. 2029, 2099 (2019). While the flooding theory introduced in this chapter potentially applies to all large investors with broadly diversified portfolios, not only to passive funds, it focuses on passive funds because they now wield outsized power over hundreds if not thousands of companies, and are likely to affect the tax behavior of their portfolio companies.

[13] *See, e.g.,* Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 119 (2016) ("On average, the ownership stake of each of the Big Three is a third higher for the 250 firms at the top of the Russell 2000 relative to the bottom 250 firms of the Russell 1000, while the likelihood of each

increases in the holdings of these broadly diversified investors led to higher levels of tax avoidance in their portfolios.[14] These findings suggest that as common institutional owners accumulate shares in the public market, companies more aggressively reduce their tax liability through tax planning.

Against this background, this chapter argues that the positive correlation between corporate tax avoidance and common ownership reflects a fundamental compliance distortion that ensues when the same influential investors own the whole market. This distortion, which has thus far been overlooked, is attributed to a newly recognized phenomenon that this chapter terms corporate "flooding."[15] This term describes a practice whereby multiple public companies, all under the direction of a core group of common institutional shareholders, simultaneously avoid more taxes. This across-the-board surge in tax noncompliance inundates the tax agency, making it harder for the agency to counter such noncompliance.

The underlying notion behind the theory of flooding is that given the IRS's limited (and dwindling) enforcement resources[16] and its organizational structure, all public corporations' filings are reviewed by a single division.[17] With a large, synchronized effort of avoidance, this division is quickly swamped with an ever-rising number of noncompliant returns. Under these

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institution owning more than 5% of a firm's shares is two-thirds higher and the likelihood of being a top-five shareholder is 15% higher.").

[14] Shuping Chen, Ying Huang, Ningzhong Li &Terry Shevlin, *How Does Quasi-Indexer Ownership Affect Corporate Tax-Planning?*, 67 J. ACCT. & ECON. 278 (2019); Mozaffar Khan, Suraj Srinivasan & Liang Tan, *Institutional Ownership and Corporate Tax Avoidance: New Evidence* (May 15, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2779809.

[15] The terms "flooding" and "corporate flooding" are used interchangeably in this chapter.

[16] On the continuing shortfall in the IRS resources and personnel see Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential* (Nat'l Bureau of Econ. Research, Working Paper 26475, 2019), https://www.nber.org/papers/w26475.pdf (presenting data regarding the decline in IRS budget, particularly enforcement budget, over the past years); Aaron Grey, *IRS Developments and Examination Strategies*, 5 CONT. TAX J. 45 (2016); John A. Koskinen, *The Challenges Facing the IRS of the Future*, 45 OHIO N. U. L. REV. 561 (2019). *See also* Transat'l Report Access Clearinghouse (TRAC), *Nearly Half of Corporate Giants Escape IRS Audit in 2017*, https://trac.syr.edu/tracirs/latest/507/ (last visited March 1, 2022) ("Congressional cutbacks to IRS's budget have severely trimmed the ranks of available IRS revenue agents, the auditors who examine corporate and high-income individual returns. Last year, there were 5,144 fewer IRS revenue agents employed than there had been in FY 2010. Over the past 7 years, revenue agents have fallen by over a third (34.9%). Fewer auditors mean that fewer audits can be conducted.").

[17] *See infra* note 70 and accompanying text.

circumstances, the effectiveness of at least one of the audit stages (i.e., audit commencement, case development, or deficiency collection) is likely to be compromised.[18] This, in turn, reduces the probability of future enforcement and the "flooding effect" is activated.

The flooding effect has significant adverse consequences. As this chapter demonstrates, flooding reverses the traditional correlation between compliance and enforcement that is necessary for the tax system's proper functioning. Usually, higher levels of tax avoidance are associated with greater enforcement probability as the agency tends to allocate more of its limited resources towards taxpayers who appear to be more tax aggressive.[19] However, when flooding occurs, higher levels of tax avoidance adopted by many companies actually lead to the opposite outcome. Moreover, because flooding reduces enforcement probability, it increases public companies' *optimal* level of tax avoidance.[20] This change in the optimal level of avoidance suggests that the surge in tax avoidance under common ownership is not only triggered by the flooding phenomenon but is also the result of flooding. Because a company knows that it is unlikely to be penalized, it is more likely to seek higher tax avoidance levels. This situation, in turn, creates an independent incentive for public corporations to increase their levels of avoidance, resulting in a new noncompliance equilibrium.

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[18] Enforcement probability can be divided into three components: the probability of detection, the probability of enforcement action, and the probability of liability. *See* Keith N. Hilton & Haizhen Lin, *Optimal Antitrust Enforcement, Dynamic Competition, and Changing Economic Conditions*, 77 ANTITRUST L. J. 247, 254 (2010) (discussing the definition of enforcement probability in the antitrust context). The probability of liability signifies the likelihood that the tax authorities will challenge a tax position (in this chapter, case development) and collect all the tax plus interest plus penalties (in this chapter, deficiencies collection). *See* David Ulph, *Avoidance Policies – A New Conceptual Framework* (Oxford U. Center for Bus. Tax'n, Working Paper No. WP 09/22, 2009), https://core.ac.uk/download/pdf/74367229.pdf.

[19] *See infra* note 38 and accompanying text.

[20] For a more comprehensive discussion on a company's optimal level of tax avoidance, see Jaewoo Kim, Sean Thomas McGuire, Steven Savoy & Ryan J. Wilson, *How Quickly do Firms Adjust to Target Levels of Tax Avoidance?* (U. of Rochester Working Paper (Sept. 2015)), https://pages.business.illinois.edu/accountancy/wp-content/uploads/sites/12/2015/09/Tax-2015-Kim-McGuire-Savoy-Wilson.pdf.

This chapter argues that common institutional owners are the driving force behind the flooding phenomenon and identifies the critical role these dominant market players have in facilitating flooding. Because powerful institutional investors now hold substantial stakes in many companies, they can wield their influence to affect the tax behavior of myriad companies. Thus, these broadly diversified shareholders have the capacity to induce a sufficiently large number of companies to pursue greater tax avoidance. This observation is important because it is only when enough companies participate in flooding that adopting higher tax avoidance levels becomes a profitable choice. In other words, aggressive tax behavior may not pay unless the IRS is sufficiently overwhelmed not to pursue audits or successfully combat aggressive tax behavior.

As this chapter shows, several causal mechanisms can connect common ownership to higher tax avoidance levels, some of which do not entail direct communication between institutional investors and their portfolio companies. The ability to link tax savings to financial profitability, for example, demonstrates how flooding can be triggered at a relatively low cost. Simply increasing pressure on top management to deliver high earnings can lead to more aggressive tax behavior. Indeed, because there is ample empirical evidence that institutional shareholding is positively associated with a firm's performance and rate of return,[21] such a scenario seems highly plausible. Other causal mechanisms that potentially link common ownership and corporate tax avoidance, such as direct engagement with management and the effect on board composition, are also explored. These various mechanisms illustrate how even characteristically passive institutional investors who have a relatively weak incentive to invest in stewardship can lead to an across-the-board increase in tax avoidance without investing many resources or acquiring firm-specific knowledge.

[21] *See, e.g.,* Appel et al., *supra* note 13; Harford, Kecskés, & Mansi, *Do Long- Term Investors Improve Corporate Decision Making?*, 50 J. CORP. FIN. 424 (2018).

In introducing the flooding phenomenon and describing how common ownership distorts corporate compliance incentives, this chapter makes four novel contributions. First, it demonstrates that when institutional investors are "owning it all," they can mitigate firm-specific (so-called, idiosyncratic) risks, specifically tax risks, that public companies may face. Modern portfolio theory contends that since diversification reduces risk at every level of expected return, fully diversified investors in capital markets can smooth out idiosyncratic fluctuations in their portfolios and improve risk-adjusted returns.[22] The flooding phenomenon, however, illustrates that diversification reduces not only the idiosyncratic risk at the portfolio level but also at the individual company level. This is a crucial observation with far-reaching implications for twenty-first century corporate conduct. As common ownership continues to dominate the market, companies are likely to face lower idiosyncratic risk associated with corporate misconduct.

Second, this chapter reveals an overlooked pathway through which concentration in the U.S. capital market harms the economy. Flooding exacerbates the tax agency's difficulties in regulating tax avoidance, allowing public companies to improperly avoid paying their fair share of taxes. And this, in turn, imposes negative externalities on communities. For example, governments are deprived of tax revenues that should have been used for the common good (e.g., education, social programs, and infrastructure repairs). In addition, when governments must cope with lower tax revenues, levels of inequality surge.[23] A growing literature identifies the link

[22] *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); s*ee also* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).
[23] *See, e.g.,* Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data* (Nat'l Bureau of Econ. Research, Working Paper No. 20625, 2014), https://www.nber.org/papers/w20625; Annette Alstadsaeter, Niels Johannesen & Gabriel Zucman, *Tax Evasion and Inequality* (Nat'l Bureau of Econ. Research, Working Paper No. 23772, Sept. 2017), https://www.nber.org/papers/w23772; Frederik Heitmülle, Moran Harari & Markus Meinzer, *Tax Administrations' Capacity in Preventing Tax Evasion and Tax Avoidance* (Oct. 2018), https://ssrn.com/abstract=3300589; Ute Schmiel & Anna-Lena Scherer, *Inequality and Taxation of Multinational Corporate Groups*, Copenhagen Bus. Sch. CBS Law Research Paper No. 20-19 (Aug. 2020), https://ssrn.com/abstract=3678145.

between tax avoidance and inequality, acknowledging that tax revenues, necessary to address inequality, shift the tax burden to other taxpayers.[24] Moreover, since the asset management industry represents relatively high-income investors,[25] wealthy individuals benefit most from public companies' amplified earnings. The costs of tax avoidance, on the other hand, are borne disproportionately by lower-income individuals in their role as citizens consuming public services. The potential distributional implications of common ownership are, therefore, profound.

Third, in analyzing the flooding phenomenon and the role of institutional investors in facilitating this phenomenon, this chapter introduces a new type of agency costs problem—"agency capitalism."[26] This chapter suggests that the actions of the agents—the institutional investors—might be inconsistent with the political preferences of the beneficial owners of the shares. Specifically, although the beneficiaries may benefit from a company's lower tax payments through higher portfolio returns, those same beneficiaries might hold social or political preferences besides maximization of profits. Such beneficiaries may prefer, for example, that companies pay their fair share of taxes.[27] And this type of preference is particularly realistic considering the booming demand for Environmental, Social, and Governance (ESG) investing, a form of sustainable investing that considers not only an investment's financial returns but also its overall

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[24] *See, e.g.,* Grahame R. Dowling, *The Curious Case of Corporate Tax Avoidance: Is it Socially Irresponsible?*, 124 J. BUS. ETHICS 173 (2014) (arguing that non-payment of taxes shifts the tax burden to other and less mobile taxpayers thereby increasing inequalities).

[25] *See, e.g.*, Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* (Nat'l Bureau of Econ. Research, Working Paper No. 24085, 2017), https://www.nber.org/papers/w24085 (showing that in 2016, the top 10% of American households owned 84% of all stocks in 2016, and that while 94% of the wealthiest people in the United States have significant stakes in publicly held companies ($10,000 or more), only 27% of the middle class hold such stakes).

[26] The term "the agency costs of agency capitalism" was first coined by Ronald Gilson and Jeffrey Gordon. *See* Ronald J. Gilson & Jeffery N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance*, 113 COL. L. REV. 863 (2013).

[27] *See, e.g.,* Iftekhar Hasan, Chun-Keung Hoi. Qiang Wu & Hao Zhang, *Does Social Capital Matter in Corporate Decisions? Evidence from Corporate Tax Avoidance*, 55 J. ACCT. RES. 629, 630 n.1 (2017) (arguing that there is a widely shared societal belief that all citizens and corporations hold a civic duty to pay taxes, referring to an annual Taxpayer Attitude Survey which indicates that more than 90% of the taxpayers surveyed either completely or mostly agree that "it is every American's civic duty to pay his or her fair share of taxes.").

impact on society.[28]

However, the welfare of beneficiaries who care about things other than portfolio value maximization, especially those who choose to invest in funds that claim to actively focus on ESG benefits, can only be maximized if those preferences are also considered. Unfortunately, the detrimental effect that large institutional investors have on corporate tax compliance suggests that the social and political preferences of many beneficial owners are often disregarded.[29] To make matters worse, the investment managers who fuel demand for ESG investing and aggressively market their funds as socially responsible are often the same ones that appear to be facilitating flooding.[30] In practical terms, their behavior runs afoul of their social impact promises.

Finally, this chapter offers a novel policy suggestion in the form of a double sanctions regime. Under a double sanctions system, both the tax-avoiding company and its institutional shareholders would be penalized for any illegitimate tax avoidance behavior by the company. Such a regime would allow the taxing authority to recover from both parties without investing more of its scarce resources. More importantly, it could act as a deterrent and break the flooding cycle by providing an incentive for institutional shareholders to push for more tax compliance. Even if the portfolio companies' heightened engagement in tax avoidance is only a byproduct of the institutional investors' demands for better financial performance, the proposed regime might cause

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[28] For an interesting analysis of ESG investing, see John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (Eur. Corp. Governance Inst., L. Working Paper No. 541/2020, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3678197.

[29] *Compare* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value,* 2 J. L. FIN. & ACCT. 247, 251 (2017); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U L. REV. 733, 740 (2005). A somewhat similar concern was also voiced in the context of tax avoidance by Professor Ilan Benshalom (Ilan Benshalom, *Who Should Decide Whether the Apple is Rotten? Tax Disclosure and Corporate Political Agency*, 6 COL. J. TAX L. 86 (2017)). In his article, Benshalom claims that the ownership structure of publicly held companies might give rise to what he calls a "political agency problem" as managers, maximizing value for their shareholders, tend to overlook the political preferences of their shareholders.

[30] For an overview of the rising demand for ESG funds and ranking of the largest ESG mutual funds managers, which suggests that these funds managers are broadly diversified investors that oversee mostly passive funds, see, e.g., Randall Smith, *Which Fund Company is Winning the Race for Socially Responsible Investors?,* WALL ST. J. (Sep. 15, 2021), https://www.wsj.com/articles/socially-responsible-companies-11631539607.

them to sit up and pay closer attention to their companies' tax policies. And this, in turn, could help restore deterrence, reinstate fairness, and help alleviate income inequality.

This chapter proceeds as follows. Part I introduces the flooding phenomenon and its detrimental effect on tax enforcement. Part I also presents empirical support for the theory that common institutional ownership leads to increases in corporate tax avoidance levels. Part II identifies potential causal mechanisms through which common ownership promotes flooding, none of which requires collusion or active coordination between institutional investors and corporate managers or between managers of portfolio companies. Part III proposes an innovative policy to curb the flooding phenomenon and analyzes the potential utility of the recommendation.

1.1 Introducing the Flooding Phenomenon

Over the past two decades, a massive capital shift toward asset management institutions has given rise to a new ownership pattern in the U.S. capital market: common ownership. This emerging trend has interesting implications for corporate behavior, governance, and market outcomes, which are now being intensely investigated.[31] This Part analyzes the tax avoidance repercussions of this ownership structure by introducing the flooding phenomenon.

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[31] So far, the research on common ownership has mainly focused on the product-market behavior of rival firms with common ownership links (see, e.g., José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018); José Azar, Sahil Raina & Martin C. Schmalz, *Ultimate Ownership and Bank Competition* (July 2016), https://core.ac.uk/download/pdf/288289398.pdf). Moreover, scholars have recently explored the effect of common ownership on the labor market (Zohar Goshen & Doron Levit, *Irrelevance of Governance Structure* (Eur. Corp. Governance Inst., Fin. Working Paper No. 606/2019, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3340912), environmental compliance (Madison Condon, *Externalities and the Common owner*, 95 WASH. L. REV. 1 (2020)), investment in Research and Development (R&D) (Miguel Nadal Anton, Florian Ederer, M. Gaseni Gine, Martin Christoph Schmaltz, *Innovation: The Bright Side of Common Ownership?* (U. Navarra Working Paper, 2017), https://ssrn.com/abstract=3099578), and disclosure practices (Jihwon Park, Jalal Sani, Nemit Shroff & Hal Derric White, *Disclosure Incentives When Competing Firms Have Common Ownership*, 67 J. ACCT. & ECON. 387 (2019)).

Section 1.1.1 presents a framework for understanding the underlying theory of flooding by analyzing the interdependence between tax noncompliance levels and enforcement probability. Section 1.1.2 introduces the flooding phenomenon and demonstrates how it distorts the compliance incentives of public corporations. Section 1.1.3 identifies the detrimental effects of flooding on the tax examination process and pinpoints how the process's characteristics make it uniquely vulnerable. Finally, section 1.1.4 supports the hypothesis by presenting preliminary empirical evidence.

1.1.1 Presenting a Framework for Analysis

In the recent past, tax law literature has analyzed corporate tax avoidance through the standard lens of individual choice.[32] According to this model, which is essentially a deterrence model, a taxpayer will choose whether to avoid taxes in the same way a person approaches any risky decision.[33] In deciding if and how much tax to avoid, the taxpayer compares the potential tax savings against the enforcement probability and the expected magnitude of the sanction.[34] When companies apply this model, they generate a target level of tax avoidance that maximizes a company's expected utility.[35]

In the traditional model, enforcement probability generally depends on two principal factors. The first is the tax agency's enforcement capacity. As the IRS has limited resources, it can

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[32] *See supra* note 2. In analyzing an individual tax avoidance choice, the tax literature also analyzed the intrinsic motivation of taxpayers to comply with tax liabilities because of civic duty. *See* Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043 (1997). A young but growing literature has recognized the unique characteristics of corporate tax avoidance (compared to individual tax avoidance), which are mainly attributed to the separation of ownership and control in a corporation. *See* Keith J. Crocker & Joel Slemrod, *Corporate Tax Evasion with Agency Costs*, 59 J. PUB. ECON. 1593 (2005); Jennifer L. Blouin, Alan D. Jagolinzer & David F. Larcker, *Corporate Governance, Incentives, and Tax Avoidance*, 60 J. ACCT. & ECON. 1, 9 (2015). This separation requires that corporate tax avoidance would be explored somewhat differently. In particular, tax law literature has recognized the necessity to incorporate agency predictions into the analysis of corporate tax avoidance and take into account potential agency costs.

[33] *See supra* note 3.

[34] *Id.*

[35] *See supra* note 20.

only audit a fraction of all taxpayers, allowing some noncompliant taxpayers to escape scrutiny.[36] The capacity of the agency therefore impacts the taxpayer's tax planning decisions: greater enforcement resources discourage tax avoidance behavior.[37]

The second factor that affects enforcement probability is the taxpayer's compliance level. The model of tax avoidance assumes that there is an intrinsic positive correlation between noncompliance and enforcement probability. In other words, the model assumes that part of the IRS's decision to audit is based on a suspected level of tax risk and avoidance.[38] Thus, the probability of enforcement normally increases as the level of tax avoidance aggressiveness rises.[39] The correlation between noncompliance and enforcement probability is generally believed to serve as a deterrent mechanism that is desirable from a public policy perspective. Taxpayers would be so wary of audits that they would forego tax avoidance opportunities, even at the cost of paying more taxes.[40]

But what if there is another factor that affects enforcement probability? The next section explores how a simultaneous increase in the number of aggressive filings, which is specifically tied to common ownership by institutional investors, upsets the traditional tax avoidance model.

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[36] *See* Lederman & Sichelman, *supra* note 5. *See also* Michelle Nessa, Casey Schwab, Bridget Stomberg & Erin Towery, *How Do IRS Resources Affect the Tax Enforcement Process?,* 95 ACCT. REV. 311 (2020) (providing more nuanced evidence on how the IRS prioritizes its audit efforts when faced with limited resources during each audit stage).

[37] *See* Jeffrey L. Hoopes, Devan Mescall & Jeffrey A. Pittman, *Do IRS Audits Deter Corporate Tax Avoidance?*, 87 ACCT. REV. 1603 (2012). However, the magnitude of such a deterrent effect is not clear (Lederman & Sichelman, *supra* note 5; Joel Slemrod, *Tax Compliance and Enforcement* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 24799, 2018), https://www.nber.org/papers/w24799).

[38] *See, e.g.,* Slemrod, *supra* note 3, at 8-9; Nessa et al., *supra* note 36, at 6; *see also* James Alm & Michael McKee, *Tax Compliance as a Coordination Game*, 54 J. ECON. BEHAV. & ORG. 297, 298 (2003) (discussing "audit flags" and how they are utilized by the IRS to select returns for audits).

[39] *Id.; see also* Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J. L. ECON. & ORG. 1, 5-6 (1986) (explaining that the IRS adjusts its audit and enforcement strategy in light of the information contained in a taxpayer's tax return); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COL. L. REV. 569, 571 (2006) (claiming that the probability of detection varies among different items on a tax return); Alm & McKee, *supra note* 38 (discussing the variability and endogeneity of audit probability, depending on the behavior of a taxpayer).

[40] Raskolnikov, *supra* note 39, at 593-594 (explaining that many taxpayers look for avoidance opportunities with the lowest probability of detection).

1.1.2 Exploring the Phenomenon of Flooding

The U.S. stock market landscape has changed dramatically over the recent decade. Investors in capital markets have flocked to investment funds, particularly index funds, allowing institutional investors to grow large at the expense of retail investors and become exceptionally concentrated. This market shift has resulted in a situation where institutional investors now hold unprecedented levels of stock ownership in public companies. In fact, institutional investors now collectively own 75% of the entire capital market, [41] representing shares worth over $27 trillion[42] compared to less than 25% during the 1980s.[43]

Among institutional investors, mutual funds, in particular, have experienced a tremendous increase in market share and position sizes due to the extraordinary growth and popularity of investment funds,[44] which can offer low-cost diversification and favorable tax treatment to retirement savers.[45] Index funds, a subset of mutual funds that track market indices, now hold nearly 50% of all U.S. listed companies.[46] The Big Three asset managers, which are mainly known for their broad market index funds, have gained enormous popularity over the past decade.[47] At the beginning of 2021, the Big Three oversaw assets worth over $18 trillion.[48] At least one of those

[41] Azar et al., *supra* note 31, at 1514.
[42] *See* Bd. of Governors of the Fed. Reserve Sys., *Financial Accounts Guide, First Quarter 2021*, Tbl.L.223 Corporate Equities, https://www.federalreserve.gov/releases/z1/20210610/z1. pdf, p. 130.
[43] *See* Azar et al., *supra* note 31, at 1514.
[44] *See, e.g.,* Zohar Goshen & Sharon Hannes, *The Death of Corporate Law,* 94 N.Y.U. L. REV. 263, 304-306 (2019) (discussing the changes in the division of the three main groups of institutional investors: mutual funds, pension funds, and insurance companies). For a general discussion on the growth of mutual funds, see Matthew P. Fink, THE RISE OF MUTUAL FUNDS, AN INSIDER'S VIEW (Oxford U. Press, 1st ed. 2011).
[45] *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 91 (2017).
[46] *See* Jeff Cox, *Passive Investing Automatically Tracking Indexes Now Controls Nearly Half the US Stock Market*, CNBC (Mar. 19. 2019), https://www.cnbc.com/2019/03/19/passive-investing-now-controls-nearly-half-the-us-stock-market.html.
[47] *See* Fichtner et al., *supra* note 11.
[48] BlackRock Funds holds approximately $6.8 trillion, the Vanguard Group holds $8 trillion, and State Street Global Advisors holds $4.1 trillion. *Introduction to BlackRock*, BLACKROCK, https://www.blackrock.com/sg/en/introduction-to-blackrock (last visited March 1, 2022); *Facts and Figures*, VANGUARD, https://corporate.vanguard.com/content/corporatesite/us/en/ corp/who-we-are/sets-us-apart/facts-and-

institutions was the largest shareholder of 88% of the companies included in the S&P 500 stock index.[49]

The growing presence of institutional investors in capital markets was initially welcomed with enthusiasm.[50] Scholars predicted that because institutional investors are sophisticated and well-resourced, they would make informed use of their voting rights and potentially improve firm value.[51] Moreover, given such investors' tendency to support strong corporate governance, some commentators assumed that institutional ownership would likely empower shareholders and constrain managerial agency costs.[52] As a result, policymakers and legal scholars believed that the shift towards greater institutional ownership reflected a positive progression in capital markets.[53]

The reality, however, deviates considerably from this ideal. According to the emerging literature, market distortions ensue under institutional ownership, particularly when the same institutional investors have overlapping ownership in multiple companies.[54] This ownership

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figures.html/ (last visited March 1, 2022); *Who We Are*, STATE ST. GLOBAL ADVISORS, https://www.ssga.com/us/en/institutional/ic/about-us/who-we-are (last visited March 1, 2022).

[49] Fichtner et al., *supra* note 11, at 314-315.

[50] *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (arguing that large institutional investors can help overcome the collective action problem of shareholders and effectively monitor corporate managers); Jeffrey G. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting,* 94 COL. L. REV. 124 (1994) (envisioning a scenario where institutional investors cooperate with each other to institute cumulative voting and campaign with management for charter amendments).

[51] *See, e.g., The Role of Institutional Investors in Promoting Good Corporate Governance*, OECD Series on Corporate Governance (2011), http://www.oecd.org/daf/ca/49081553.pdf.

[52] *See, e.g.*, Black, *supra* note 50 (arguing that large institutional investors can help overcome the collective action problem of shareholders and effectively monitor corporate managers); Jeffrey G. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting,* 94 COL. L. REV. 124 (1994) (envisioning a scenario in which institutional investors cooperate to institute cumulative voting and campaign with management for charter amendments).

[53] In fact, the concern among corporate law scholars is often that institutional investors might lack the capacity and incentive to become adequately involved in the governance of their companies. These scholars have proposed potential market institutions and policy shifts that would improve institutional investors' engagement in stewardship. *See, e.g.,* Gilson & Gordon, *supra* note 26, at 889–95 ("Mutual funds and other for-profit investment managers are almost uniformly reticent"); Bebchuk & Hirst, *supra* note 12 (explaining why passive fund managers have strong incentives to underinvest in stewardship and defer to the preferences of corporate managers).

[54] *See, e.g.,* Azar et al., *supra* note 31; Azar et al., *supra* note 31. Both studies provide empirical evidence that common ownership of rival firms affects the product-market behavior of such firms and leads to price increase); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (laying out a theoretical foundation for the anticompetitive common ownership theory). *See also* Goshen & Levit, *supra* note 31 (showing that common

pattern, known as "common ownership," has become especially prevalent as institutional ownership and index investing have expanded.[55] Common owners are characterized by two main features that, when considered together, are somewhat counterintuitive. On the one hand, common institutional investors are invested in hundreds if not thousands of companies and thus are extremely diversified.[56] On the other hand, because these institutional investors hold sizable stakes in many of their portfolio companies, they are often the largest shareholders.[57] Thus, common owners are also concentrated shareholders.

In light of the unique characteristics of common owners, commentators have recently hypothesized that such common ownership has negative implications for both markets and society. The primary concern is that given their sizable stakes in many companies and their growing involvement in the governance of their portfolio companies, common institutional owners will wield their influence to promote socially undesirable corporate conduct.[58] This chapter supplements that literature by exposing the extensive role that common institutional owners play in distorting the tax compliance incentives of corporate decisionmakers.

Recent empirical studies show that institutional ownership, particularly by quasi-indexer shareholders who are more likely to be common institutional owners,[59] is linked to an increase in the levels of tax avoidance adopted by the portfolio companies. As the ownership of these institutions in U.S. corporations increases, a larger number of companies engage in tax avoidance,

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ownership increases the number of firms with strong governance above the competitive allocation and deters investment by corporate managers in value-creating projects).

[55] *See supra* note 9 and accompanying text. Depending on the measure used, common ownership expanded by either 1,250% or 2,300% from 1980 to 2012. During the 1980s, a typical pair of firms had 1.7 owners in common, but by 2012 this figure increased to 33.6. *See* Gilje et al., *supra* note 9, at 3-4.

[56] On average, the largest asset management institutions hold shares in thousands of companies, while retail investors typically have stakes in significantly fewer companies. *See* Fichtner et al., *supra* note 11, at 299.

[57] Fichtner et al., *supra* note 11, at 311-312 & Tbl.2 (also explaining that institutional investors tend to own exceptionally high equity stakes in the largest companies); Bebchuk et al., *supra* note 45, Tbl.1 at 92.

[58] *See supra* note 54 and accompanying text.

[59] On the correlation between quasi-index ownership and common ownership see *supra* note 13.

an increased number of tax positions are adopted, and more questionable tax avoidance positions are embraced.

This simultaneous increase in tax avoidance behavior of multiple public companies sharing ownership links reflects an overlooked phenomenon that this chapter terms corporate "flooding." The underlying theory of flooding is that, because common ownership leads to abnormally high corporate tax avoidance levels, the resulting barrage of aggressive tax returns overwhelms the tax agency and leads to a reduction in enforcement probability and, ultimately, to even more tax avoidance.

Normally, the IRS decides whether to audit a taxpayer, as well as the amount of resources to be devoted to the effort, based on the likelihood that underreporting will, in fact, be detected.[60] Higher levels of tax noncompliance entail a greater enforcement probability and are thus riskier. Since companies take enforcement probability into account when selecting a tax avoidance level,[61] the level they ultimately adopt is assumed to optimize the aggressiveness of the tax positions, after accounting for the perceived audit risk associated with the tax behavior.[62] Thus, under the traditional model, increasing tax avoidance levels beyond an optimal level would be detrimental as it would subject the firm to unnecessary risk.

Under common ownership, on the other hand, higher levels of tax avoidance can actually mitigate tax risk. When myriad companies concurrently file returns with higher tax avoidance levels, the tax agency—which is flooded with aggressive returns—will not have sufficient resources to adequately audit the returns. Underreporting will remain undetected. The resulting overload faced by the tax agency, which is empirically linked to common ownership, diminishes

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[60] *See supra* notes 38-39; *see also infra* notes 74-75 and accompanying text.
[61] *See supra* note 37 and accompanying text.
[62] *See supra* notes 33-35.

the effectiveness of tax audits and reduces enforcement probability: fewer companies undergo tax audits, fewer positions are detected and challenged during audits, and smaller deficiencies are collected. Thus, in a reversal of the traditional model, more aggressive tax behavior lowers the chance of being audited and penalized.

The reversal of the traditional model illustrates an important point: one company's tax behavior can affect the enforcement probability of not just that company but of other companies as well. Therefore, a core group of institutional investors, each of which holds stakes in multiple corporations, can induce an across-the-board increase in corporate tax avoidance, which would, in turn, diminish enforcement probability. If a sufficient number of companies participate in flooding, they negatively affect the enforcement probability to which they and other commonly owned companies will be subject.

The implications of the flooding phenomenon for twenty-first century corporate conduct are far-reaching. The change in the profitability of tax avoidance demonstrates how common ownership may affect the ways public companies approach tax risks (and perhaps legal risks more generally). According to modern portfolio theory, public shareholders can construct their portfolios in a way that allows them to diversify away idiosyncratic (firm-specific) risks.[63] The flooding phenomenon illustrates that diversification can reduce idiosyncratic risks not only at the portfolio level but also at the level of the individual portfolio company. In other words, by facilitating flooding, the new capital market creature—i.e., the diversified yet concentrated common institutional owner—can cause a reduction in the calculation of a company's expected loss associated with tax avoidance behavior. This important observation suggests that common

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[63] *See* Markowitz, *supra* note 22. The theory identifies two types of financial risks, economy-wide systematic risk and firm-specific risk. *See* Richard A. Brealey, Stewart C. Myers & Franklin Allen, PRINCIPLES OF CORPORATE FINANCE 168-170 (10th ed. 2011); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 200 (2008).

ownership can lead to escalating levels of noncompliant behavior, augmenting the economic incentive of public companies to adopt socially undesirable actions that previously (i.e., pre-flooding) would have been considered too risky or expensive.[64]

Before analyzing the detrimental effect of flooding on each of the tax audit stages, it is worth explaining how the consequences of the flooding theory avoid the critique often aimed at contemporary anticompetitive common ownership theory. According to that theory, common ownership influences product markets by causing price coordination between competing commonly owned companies.[65] Several empirical studies have validated the theory, showing that common ownership is positively correlated with price increases in a particular industry (e.g., airline and banking).[66] Nevertheless, that theory is hotly debated. Critics of the theory point to the fact that second-order implications of such price coordination make such behavior unlikely. Because common owners are extremely diversified, the criticism goes, companies in the upstream or downstream chain, as well as in complementary industries,[67] would be adversely impacted by such behavior. Therefore, common owners with diversified portfolios would have a weak incentive to push for price coordination.[68]

But this criticism does not apply when it comes to flooding. The negative externalities associated with increased tax avoidance levels are not inflicted on other companies that are potentially commonly owned but rather on the government and society at large. In fact, other

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[64] *Contra* Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507 (2019) (claiming that institutional investors that are invested in firms within the same industry have enhanced incentives for monitoring compliance and minimizing macro legal risks). This opinion overlooks the fact that the enforcement agencies' resources are limited, so a high level of noncompliance may affect the legal risk itself.
[65] *See supra* note 54.
[66] *See, e.g.,* Azar et al., *supra* note 31; Azar et al., *supra* note 31.
[67] C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L. J. 1392, 1429-1440 (2020); Thomas A. Lambert & Michael E. Sykuta, The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms 19-20 (U. Mo. Sch. of L. Stud. Res. Paper No. 2018-21, 2018) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173787.
[68] *Id.*

companies might actually benefit from flooding as the abnormal levels of avoidance lower the enforcement probability for other taxpayers. Moreover, the apparent gains associated with "successful" tax avoidance might benefit other commonly owned companies that maintain business relationships with the tax-avoiding companies.[69] Because flooding is harmless (and perhaps beneficial) to other companies, it is a strategy that is likely to flourish under common ownership and one that requires further study.

1.1.3 Identifying Flooding's Threat to Tax Enforcement

To better estimate the potential adverse effect of a concurrent increase in tax avoidance on enforcement, it is necessary to first understand the division of labor within the IRS and the different stages of the tax audit procedure. Within the IRS, a single division known as the Large Business and International Division (LB&I) is responsible for handling all matters related to corporations, including subchapter S corporations and partnerships, with assets greater than $10 million.[70] This division inspects all publicly traded corporations in the country. Given the complexity of the returns, the nature of the examinations that are required for each audit, and the IRS's limited (and shrinking) budget, the LB&I division already faces a continual shortfall in resources, specifically in the number of revenue agents and specialists necessary to support its audit efforts.[71] If one adds to this a simultaneous flood of returns, all of which employ a higher number of aggressive tax positions, one can easily see how enforcement suffers.

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[69] Slemrod, *supra* note 3, at 42-43 (2007) (explaining that tax policy that facilitates tax evasion can benefit costumers through lower prices).

[70] Prior to its reorganization in 1999, the IRS audit and collection offices were divided geographically. Today, the IRS is branched into four operating divisions: Wage and Investment Division, Small Business/Self-Employed Division, Large Business and International Division, and Tax Exempt and Government Entities Division. *See* Edward L. Froelich, United States, in THE TAX DISPUTES AND LITIGATION REVIEW 327 (Simon Whitehead ed., 2nd ed. 2014).

[71] James C. Thorne, *Years Of Budget Cuts Shrink The IRS, and Corporations Are the Big Winners*, CNBC (May 12, 2018), https://www.cnbc.com/2018/05/11/budget-cuts-shrink-the-irs-and-corporations-are-the-big-win ners.html; *see also* TRAC Report, *supra* note 16.

Even if the IRS sets audit priorities and allocates more resources to certain tax-avoiding filers, for example by targeting companies from specific industries or campaigning against certain tax strategies, other tax-avoiding companies will be able to escape detection more easily.[72] And, even if an audit is deemed warranted, a simultaneous flood of aggressive returns means that there are fewer resources available to manage the audit, a multi-stage process that includes commencing the audit, identifying possible return positions, proposing tax adjustments, and finally, collecting amounts due.[73] As the remainder of this section shows, flooding can harm the effectiveness of each of those stages.

a) Audit Commencement

The LB&I selects returns for audit based on several factors, including a company's suspected involvement in an abusive transaction and a computer-based score that predicts the prospect of adjustments to a firm's tax liability.[74] For example, a deduction is likely to raise a "red flag" if it has changed dramatically from one tax year to another or if it is otherwise unusual or "suspicious-looking."[75] These red flags are critical in helping the agency identify aggressive returns.[76]

However, when the general level of tax avoidance surges, red flags lose their meaning. Their growing prevalence makes it more difficult for the IRS to identify which returns deserve

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[72] However, under such circumstances, targeted enforcement towards industries or subject matters might increase the enforcement probability to which firms belonging to the targeted industries, or firms that adopted the "targeted" tax strategies, will be subject.

[73] The LB&I examination process has three stages (assuming that a tax audit has been initiated): planning (the phase which determines the scope of the audit, the issues to be examined and the timeline); execution (the phase in which the audit team determines the facts and applies the law to the facts), and resolution (the phase in which the parties reach an agreement). *See* IRS Pub. 5125, *The LB&I Examination Process* (2018), https://www.irs.gov/pub/irs-utl/p5125.pdf (last visited March 1, 2022). In the following analysis, the first two phases—planning and execution—will be viewed as part of the second phase, which will be termed "case development."

[74] *See* Nessa et al., *supra* note 36, at 6; *see also* U.S. Department of the Treasury, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (July 1999).

[75] Raskolnikov, *supra* note 39, at 589, 590-591.

[76] *Id.*, at 589.

further scrutiny. And, if the levels of avoidance remain high, the IRS's standards for initiating an audit may change. What previously constituted cause for an audit may no longer trigger a tax examination. Flooding can, therefore, diminish the usefulness of a vital audit selection technique.

A recent review of IRS audits demonstrates the negative effect of flooding on enforcement patterns. According to that report, in 2010, the IRS conducted audits of 431 of the largest (so-called "giant") corporations, compared to only 331 audits in 2017.[77] Despite the growth in the number of giant companies during these years,[78] and the escalating tax avoidance behavior adopted by public corporations,[79] the IRS audited significantly fewer companies. This reduction might equate to $9 billion in lost tax revenue as the audit of an average giant company turned up $31.6 million in tax.[80] Moreover, the report shows that even when the IRS did conduct an audit, the time devoted to each audit decreased by more than a half, suggesting that the IRS's thoroughness might also have been affected.[81]

The LB&I is also responsible for the Large Corporate Compliance Program (LCC), pursuant to which selected companies are subject to continual audit and therefore audited each year.[82] Program inclusion is dynamic: companies can be placed in or removed from the program based on the firm's size, the complexity of its return, and tools that classify tax returns as high, medium, or low risk.[83] But, as a practical matter, the number of companies that can be included in

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[77] *See* TRAC Report, *supra* note 16.
[78] *Id.* The report shows that the total number of "giant" corporations grew from 557 in 2010 to 616 in 2017.
[79] *See supra* notes 6-8 and accompanying text.
[80] *See* TRAC Report, *supra* note 16.
[81] *Id.*
[82] Michelle Hanlon, Lillian F. Mills & Joel B. Slemrod, *An Empirical Examination of Corporate Tax Noncompliance* 6-7 (Ross Sch. Business. Working Paper No. 1025, June 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=891226.
[83] LCC assignment is based on a point system involving seven main criteria: (1) gross assets; (2) gross receipts; (3) operating entities; (4) number of industries; (5) total foreign assets; (6) related transactions, and (7) foreign taxes paid. Each criterion has a point value, and a firm is assigned to the LCC program if it has 12 or more points. Firms with less than 12 points can also be assigned to the program. *See* Benjamin C. Ayers, Jeri K. Seidman, Erin M. Towery, *Taxpayer Behavior under Audit Certainty* 7-8 (Sep. 2015), https://www.irs.gov/pub/irs-soi/15rescontowery.pdf.

the program is capped. As more companies take on more aggressive tax planning, however, not all of them can be included in the program.[84] In other words, the escalating tax avoidance levels can also change the benchmark for tax risk that leads to inclusion in the program.

b) Case Development

Once a tax audit is initiated, a case enters the development phase.[85] This stage is critical as the audit team is required to verify the accuracy of the taxpayer's evaluation of its tax liability, reveal illegitimate tax positions on the return, and propose deficiencies. To do so, the audit team must gather and review relevant information about the company and its tax positions. During this stage, the team must also apply the law to the relevant facts and understand the tax implications of the issues at stake.[86] The effectiveness of this stage essentially determines the success of the entire audit procedure.

Building up the case entails a massive information exercise for the agency, and it is the most time- and resource-consuming phase of the audit procedure.[87] Therefore, we should expect that the effect of the escalating levels of tax avoidance, which exhaust the agency's limited resources, would be most discernible during this stage.[88] There is empirical evidence to support

[84] *Compare* Nessa et al., *supra* note 36, at 13-16 (showing that a one standard deviation reduction in the IRS enforcement budget is associated with a 2.3% reduction in audit probability, thereby highlighting the link between tax enforcement resources and audit risk).
[85] At the beginning of the audit, the audit team performs background research on the taxpayer and assesses the overall risk to identify questionable tax positions and determine the scope of the audit. The issues they select are likely to become the focus of the audit. *See* Froelich, *supra* note 70, at 332. In the past, a local team "classified" the return and chose the issues of examination. Today, the issues are centrally selected, developed, and monitored. The addition of other tax issues must receive approval before the scope of the tax examination is extended. *See* Victoria Sherlock, *The Impacts of LB&I's Restructuring and Other Relevant IRS Initiatives,* TUL. TAX INST. (NOV. 9, 2016), https://slideplayer.com/slide/12160446/.
[86] *See* Pub. 5125, *supra* note 73.
[87] *See* Nessa et al., *supra* note 36, at 21-23, 25. During this stage, the IRS issues Preliminary Information and Documents Requests (IDRs) to the audited firm, and it regularly holds meetings and informal conversations with the company if needed.
[88] This is especially true for large publicly held companies that typically have the resources and willingness to aggressively defend and contest tax positions. In that context, see Hanlon et al., *supra* note 82 (attributing the correlation between the size of a firm and tax audit outcomes to the superior ability of large companies to contest IRS proposals); *see also IRS Commissioner Testifies before Senate Committee on Finance on Compliance Concerns*

this analysis. Confidential data collected from the IRS on corporate audits conducted from 2002 through 2014 show that there is a significant and economically meaningful positive relationship between the resources available to the IRS and the incidence and magnitude of proposed deficiencies.[89] For example, one standard deviation increase in IRS resources is associated with a 3.2% increase in the probability of the IRS proposing a deficiency during a tax audit.[90]

The different ways flooding is achieved might have contrasting consequences on the effectiveness of this stage. If, for example, a large number of companies file noncompliant returns or adopt a broad range of tax positions, that type of flooding would likely impair the success of the case development stage. On the other hand, if commonly owned companies take advantage of similar tax planning opportunities, they might make it easier for the IRS to identify and challenge the tax positions.[91] The assumption that commonly owned companies are more likely to adopt similar tax positions corresponds with empirical evidence that shows that a company's tax avoidance policies are positively associated with the proportion of companies held by the same institutional investors employing the same policies.[92]

However, as previously discussed, it could also be the case that when a large number of companies are less compliant, a greater portion of the noncompliant companies will never face an audit due to constrained resources. Moreover, by focusing on these popular tax positions, the audit

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Relative to Large and Mid-Size Businesses, IR-2006-94 (June 13, 2006), https://www.irs.gov/pub/irs-news/ir-06-094.pdf (last visited March 1, 2022).

[89] *See* Nessa et al., *supra* note 36, at 27.

[90] *Id.* at 21. This change was calculated in comparison to the base probability of the IRS proposing a deficiency.

[91] Such a scenario is particularly plausible considering the IRS's transformation towards issue-based examinations and the LB&I compliance campaign, which identifies a selection of prevalent tax strategies that are targeted across-the-board by IRS personnel. The LB&I compliance campaign is based on the view that "compliance issues that present risk require a response in the form of one or multiple treatment streams to achieve compliance objective." *See* IRS, *Large Business and International Launches Compliance Campaigns*, https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns. Widespread adoption of the same strategy can cause that tax position to become the target of a compliance campaign.

[92] C. S. Agnes Cheng, Zeyu Sun & Jing Xie, *Common Equity Blockholders and Diffusion of Tax Avoidance* (Mar. 1, 2018), https://www.lsu.edu/business/accounting/files/ researchseries/Draft-Peer-effect-on-tax-avoidanc e-2018Mar21.pdf.

team might be distracted from other questionable tax positions. There is a limit to the number of issues that the audit team can address during an audit, and agents are more likely to focus on areas where avoidance is more discernible.[93]

The applicable statute of limitations may also play a role in these situations. The IRS has three years from the time a return is filed to assess any additional tax with respect to the return.[94] To avoid extensions, the audit team might complete its examination even if it has not had the chance to fully understand the relevant facts and their tax implications. The higher the level of tax aggressiveness of an audited firm, the longer it takes to conduct an exhaustive and efficient audit.[95] Under such circumstances, the desire to comply with the statute of limitations can jeopardize the thoroughness of the audit, resulting in fewer adjustments.[96]

c) Collection of Deficiencies

At the end of an audit, the IRS proposes adjustments based on its examination and negotiates settlements. If the taxpayer agrees to these adjustments, the tax liability of a taxpayer will be adjusted accordingly. The goal of the deficiencies collection phase is to reach an agreement on the tax treatment of each issue examined.[97]

As a general rule, both sides usually prefer to settle at the examination stage.[98] This would be particularly true when flooding is in effect, when there would be many more noncompliant

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[93] *See* Raskolnikov, *supra* note 39, at 589.

[94] I.R.C. § 6501(a). If there is a year or less remaining on the statute of limitations, the audit team might ask the taxpayer to agree to an extension (usually, no more than a year).

[95] Hanlon et al., *supra* note 82, at 11-12.

[96] If the team is unable to complete the examination, it might issue a protective notice of deficiency that is usually based on prior-year return tax liabilities adjusted upwards (Froelich, *supra* note 70, at 334).

[97] *See* Pub. 5125, *supra* note 73.

[98] *See* Kent W. Smith & Loretta J. Stalans, *Negotiating Strategies for Tax Disputes: Preferences of Taxpayers and Auditors*, 19 L. & SOC. INQUIRY 337, 345 (1994); *see also* Pub. 5125, *supra* note 73 ("LB&I encourages the use of all appropriate issue resolution strategies"). The alternative of going forward to the next level (the IRS Office of Appeals) or the court is burdensome for both parties. If there is no agreement, the case will go to the IRS Office of Appeals. If efforts to resolve the issue within the IRS fail, the taxpayer can file a suit. *See* Froelich, *supra* note 70, at 339-343. In addition to the high litigation costs, the tax-related information and the RAR become public knowledge. This is something that publicly held companies would prefer to avoid, especially given the sensitivity of tax data and

returns awaiting the IRS's attention. Under such circumstances, and considering the resources invested so far by the audit team, the IRS might well decide that it would be better to simply settle the case at that juncture and move on to the next audit.

But the IRS's desire to resolve the case can come at the expense of the amount of collected deficiencies since an audited company might agree to settle only under conditions that are suboptimal from the IRS's perspective. A company might agree, for example, to settle on the most questionable tax positions but refuse to do so with respect to less aggressive positions, which, under other circumstances, would also have been successfully challenged.[99]

Evidence of the detrimental effect of flooding on the collection of deficiencies can be inferred from a recent empirical study that examined the impact of tax uncertainty on dividend payout in companies with varying institutional ownership levels.[100] This study found that dividend payouts among companies with higher levels of institutional ownership remained steady even in high levels of tax uncertainty,[101] suggesting that these tax-avoiding companies are less likely to experience a significant decrease in their cash-flows in the future.

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the perception that tax avoidance is politically charged. From the IRS's perspective, tax litigation in court is resource-consuming since "IRS personnel who were involved during the tax audit phase may, in fact, be assigned to the case or act in some consultative capacity to the IRS trial team."

[99] Nessa et al., *supra* note 36, at 29 (suggesting that when resources are constrained, the IRS proposes adjustments to the weakest tax positions). However, the authors also show that the IRS resources are negatively correlated with proposed deficiencies (there, at p. 23-25). *See also* Hanlon et al., *supra* note 82, at 12 (showing that although the largest companies have their tax returns open for an extended period, "the proposed deficiency rate in those open cases was much less than for smaller companies, just 18.8 percent compared to rates ranging from 25.1 percent to 46.5 percent for the other asset size classes.").

[100] Harald Amberger, *Tax Uncertainty and Dividend Payout*s (WU Int'l Tax'n Res. Paper Series No. 2017–04), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2945877.

[101] *Id.* The coefficient of annual Cash Effective Tax Rates over five prior years was used as a proxy for tax uncertainty, which is itself often used as a proxy for the level of tax avoidance ("Uncertainty in this regard stems from "grey area" tax avoidance, which includes tax positions with ex-ante uncertainty and a high likelihood of being overturned in a tax audit"). *See also* Scott D. Dyreng, Michele Hanlon & Edward L. Maydew, *When Does Tax Avoidance Result in Tax Uncertainty?* 94 J. ACCT. ECON. 179 (2019) (explaining the strong correlation between tax avoidance and tax uncertainty).

The common ownership flooding theory may shed light on these surprising results. Institutional investors shape the link between corporate tax avoidance and settlement negotiations by creating an environment that overwhelms the tax agency. Thus, it makes sense that the impact of IRS audits on the level of tax adjustments and future free cash-flows is less significant in companies owned by these institutional investors. And it means that the IRS is leaving billions of dollars in uncollected revenue on the table when auditing commonly owned companies.

1.1.4 Supporting the Flooding Hypothesis

Over the past decade, tax research has begun to acknowledge the potential effect of ownership patterns on a firm's tax behavior.[102] The underlying assumption is that different shareholders might have distinct trade-off points when it comes to tax avoidance so that changes in ownership structure could explain differences in corporate tax avoidance levels.[103] In accordance with that prediction, several studies have analyzed the cross-sectional variation in the tendency of firms with different ownership structures to engage in tax avoidance.[104]

Following this line of research, a few recent empirical studies have explored the effect of institutional ownership, particularly quasi-indexers, on the tax behavior of their portfolio

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[102] *See, e.g.*, Mihir A. Desai & Dhammika Dharmapala, *Tax and Corporate Governance: An Economic Approach* 10-13 (Apr. 2007), https://ssrn.com/abstract=983563; Michelle Hanlon & Shane Heitzman, *A Review of Tax Research*, 50 J. ACCT. & ECON. 127, 144-145 (2010).

[103] *Id.*; s*ee also* Khan et al., *supra* note 14, at 2. The potential effect of ownership structure on corporate tax avoidance levels is largely the result of the diverse characteristics of different shareholders, such as their attitude towards risk, level of concentration, and investment horizon.

[104] *See, e.g.*, Brad A. Badertscher, Sharon P. Katz & Sonja O. Rego, *The Separation of Ownership and Corporate Tax Avoidance*, 56 J. ACCT. ECON. 228 (2013) (indicating that PE-backed firms avoid more taxes than management-owned firms); Agnes C.S. Cheng, Henry He Huang, Yinghua Li & Jason Stanfield, *The Effect of Hedge Fund Activism on Corporate Tax Avoidance*, 87 ACCT. REV. 1493 (2012) (showing that firms that are targeted by hedge funds experience an increase in tax avoidance after the intervention); Chen et al., *supra* note 14 (indicating that institutional ownership is positively correlated with tax avoidance). For a discussion on the potential difficulties associated with the empirical research of tax avoidance, and particularly on the measurements used to calculate tax avoidance and the limits they impose on the interpretation of the result, see generally Hanlon & Heitzman, *supra* note 102, at 139-143, and *infra* note 114.

companies.[105] These studies found a significant positive correlation between quasi-indexers ownership of public corporations and their corporate tax avoidance levels.[106]

To investigate the relationship between quasi-indexer ownership and tax compliance, these studies utilized two commonly used financial measures that indicate a firm's tax avoidance level: GAAP Effective Tax Rates (GAAP ETR) and Cash Effective Tax Rates (Cash ETR).[107] Using an index reconstitution method to isolate exogenous shock to institutional ownership, the researchers were able to capture fluctuations in the tax burden of companies following index inclusion. Specifically, two studies found that companies at the top of the Russel 2000, where the level of institutional ownership is exceptionally high, have both significantly lower GAAP ETR and Cash ETR compared to companies at the bottom of the Russel 1000. According to Mozaffar Khan and his co-authors, companies at the top of the Russel 2000 have lower GAAP ETR by 5.1% and lower Cash ETR by 7.0% than companies at the bottom of the Russell 1000.[108] Professor Shuping Chen and her co-authors used the same reconstitution index. They documented that GAAP Effective Tax Rate is lower by 3.2% for companies at the top of the Russell 2000 compared to those at the

[105] *See supra* note 14.
[106] Chen et al., *supra* note 14; Khan et al., *supra* note 14. These empirical studies did not examine the direct correlation between common ownership and the level of tax avoidance but rather that of quasi-indexer ownership. Nonetheless, quasi-indexer ownership constitutes a good proxy for common ownership since the index-weighting mechanism creates variation in institutional ownership around the relevant threshold that is presumably exogenous to a firm's tax behavior (compare Appel et al., *supra* note 13, at 119; Yupeng Lin, Ying Mao, Zheng Wang, *Institutional Ownership, Peer Pressure, and Voluntary Disclosures*, 93 ACCT. REV. 283 (2018)). Quasi-indexer ownership is also a good proxy for common ownership as the holdings of large asset management institutions that manage mainly index-based mutual funds and ETFs are greatly affected by index reconstitutions.
A 2013 study found that higher levels of ownership by long-horizon institutional investors are associated with decreased tax avoidance, especially for companies with otherwise poor governance. *See* Inder K. Khurana & William J. Moser, *Institutional Shareholders' Investment Horizons and Tax Avoidance*, 35 J. AM. TAX'N ASS'N 111 (2013). However, these results should be read carefully as they suffer from endogeneity of ownership concentration. This problem has been solved in the more recent studies by using exogenous shock to levels of institutional ownership.
[107] GAAP ETR is the total tax expenses paid per dollar of book income, while Cash ETR is the cash taxes paid per dollar of book income.
[108] Khan et al., *supra* note 14, at 19.

bottom of the Russell 1000, while Cash ETR is lower by 4.8%.[109] Both studies also indicate that institutional investors hold a preference for cash over GAAP tax savings.

Although the documented fluctuations can be attributed to a variety of factors and are not necessarily reflective of abusive tax avoidance,[110] tax researchers have generally viewed incremental tax avoidance following an index inclusion as more likely to come from aggressive tax behavior. The theory is that companies begin by exploiting tax planning strategies that are less aggressive, and as the level of GAAP ETR or Cash ETR increases, they move to a more aggressive segment of the tax avoidance spectrum.[111]

Therefore, the findings in these empirical studies suggest that common institutional shareholding compresses the cross-sectional distribution of tax rates, pushing portfolio companies towards a higher level of tax avoidance.[112] Moreover, The observed increase in tax avoidance levels validates the assumption that common institutional ownership alters the cut-off point of tax avoidance.[113] The flooding phenomenon and its detrimental effect on the effectiveness of tax enforcement can explain the change in the cost-benefit analysis of tax avoidance.

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[109] Chen et al., *supra* note 14, at 286.

[110] On the limitations of ETRs as tax avoidance proxies, see Michelle Hanlon, *What Can We Infer about s Firm's Taxable Income from Its Financial Statements*?, 56 NAT'L TAX J. 831 (2003); Jennifer Blouin, *Defining and Measuring Tax Planning Aggressiveness*, 67 NAT'L TAX J. 875 (2014); Casey M Schwab, Bridget Stomberg & Junwei Xia, *Extreme ETRs: When Effective Tax Rates Capture Something Other than Tax Avoidance* (Kelley Sch. of Bus. Res. Paper No. 18-92, 2019), http://dx.doi.org/10.2139/ssrn.3281289.

[111] *See, e.g.,* Khan et al., *supra* note 14, at 6.

[112] Chen et al., *supra* note 14 (arguing that the positive relationship between quasi-indexer ownership and tax avoidance is the result of these institutions' focus on better overall performance); Khan et al., *supra* note 14 (claiming that quasi-indexers lead to higher tax avoidance levels through their effect on executive pay, while acknowledging that such investors might also be using more "subtle" and less visible ways to increase avoidance levels, such as engagement with management).

[113] Khan et al., *supra* note 14, at 9. In a 2005 study, Professors Mihir Dasei and Dhammika Dharmapala argued that changes in the trade-off point of corporate tax avoidance associated with changes in institutional ownership might be attributed to the fact that these investors engage in monitoring and demand greater tax transparency so that their presence can mitigate the perception of managerial rent extraction from opaque tax avoidance activities, providing managers greater incentive to generate tax savings (Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value* (Nat'l Bureau of Econ. Research, Working No. 11214, 2005), https://www.nber.org/papers/w11241).

1.2 The Role of Institutional Investors: Flooding Mechanisms

The previous Part developed the theory of flooding and reviewed the empirical evidence of the positive relationship between common institutional ownership and increased tax avoidance levels. This Part takes the analysis a step further. It pinpoints specific processes related to institutional ownership that might explain this positive association and incorporates other common ownership predictions into the analysis of corporate tax behavior.

Section 1.2.1 addresses shareholder attitudes towards tax-related monitoring, examines claims regarding the presumed passivity of institutional investors, and explains why it is worthwhile for many of these institutional investors to influence their portfolio companies' tax behavior. Section 1.2.2 depicts two types of monitoring strategies exclusive to common institutional owners that can affect corporate behavior in general and tax behavior more specifically. Both approaches are relatively low cost yet can yield great benefits for common owners. Section 1.2.3 explores certain practices that provide potential causal pathways linking common ownership to higher tax avoidance levels. Section 1.2.4 analyzes how the new noncompliant post-flooding environment formed under common ownership creates an independent incentive for companies to engage in tax avoidance.

1.2.1 Shareholder Attitudes Toward Tax-Related Monitoring

Although the ability to influence a company's behavior is generally associated with shareholders exercising control rights,[114] institutional investors have historically been perceived as shareholders who do not flex their control muscles.[115] In fact, institutional investors have been traditionally viewed as reactive: they regularly vote on management and shareholder proposals,

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[114] Generally, exercising control can be done through either vote or exit. More recently, scholars have begun to acknowledge the option of engaging with corporate management as a third mechanism to exercise control.
[115] *See, e.g.,* Gilson & Gordon, *supra* note 26; Bebchuk et al., *supra* note 45; Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011).

yet they rarely submit or sponsor resolutions or run proxy fights.[116] In recent years, however, this assumption regarding these institutions' passivity has gradually begun to crumble.[117]

The cause of this shift has been attributed to a number of different explanations, including declining costs of stewardship efforts and the prospect of greater marginal benefit. This section shows how those and other theories about the increasing motivation of institutional investors to generally monitor their portfolio companies' behavior may also explain a rise in the specific monitoring of tax avoidance behavior.

First, as institutional investors have increased their equity stakes in many public companies, the marginal benefit of a particular corporate action has grown accordingly. The higher stakes institutional investors now own mean that if they invest resources in stewardship to affect corporate policies that would improve firm value, these investors can substantially increase their portfolios' value.[118] Similarly, by influencing their portfolio companies' tax behavior to encourage greater tax avoidance, these increasingly concentrated investors can reap a considerable benefit in the form of greater portfolio returns, higher dividends, and increased value of their shares.[119] The superior returns would also result in higher revenue from management fees, which are typically a

[116] Kahan & Rock, *supra* note 115, at 1370, 1376, 1430-1431. The relatively small equity stakes that such investors have traditionally owned, combined with the structure of their management fees and the competition in the asset management industry, often do not make it worthwhile for them to invest resources in monitoring. *See also* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism,* 79 GEO. L. J. 445 (1991).
[117] *See, e.g.*, Appel et al., *supra* note 13.
[118] *See, e.g.,* Einer Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It*, 10 HARV. BUS. L. REV. 207 (2020). Moreover, because institutional owners' voting and engagement is often done at the fund-family level by institutions that also have hundreds of billions of dollars in active funds, even low-cost passive funds can influence the governance and policies of public corporations by using their sponsor. However, firm value improvement may also benefit rival mutual funds given the similarity in the portfolio holding among index funds tracking the same market indices. This possibility can potentially discourage institutional investors from investing resources in monitoring as competing institutions will benefit from any intervention without bearing the costs associated with such intervention. *See, e.g.,* Gilson & Gordon, *supra* note 26.
[119] *See, e.g.,* Chaffee, *supra* note 1, at 105.

percentage of assets under management.[120] This would also help attract new investors and improve inflows.

Second, because exiting is not an option for many institutional investors,[121] they may be incentivized to devote resources to actions that could improve corporate profits over the long term. Even if those monitoring costs are high, they can be amortized over time. Similarly, establishing incentives for companies to invest in tax planning can be a long-term investment that can potentially reduce a company's tax payments for many years and positively affect profits.[122]

Third, the shift in monitoring by institutional investors can also be attributed to the presence of activist shareholders.[123] Compared to institutional investors, activist shareholders have a stronger motivation to engage in costly monitoring activities as they invest a large proportion of their wealth in a small number of companies.[124] By piggybacking upon the work of activists, institutional investors can take positions and promote particular actions at a relatively low cost.[125] Large money managers indeed claim to have a positive interactive effect with activist investors,

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[120] Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269 (2004) (demonstrating the positive correlation between portfolio performance and subsequent net-inflows to the fund).

[121] For passive index funds, exiting a firm included in the market index they track is not an option because such funds are required to follow the relevant index. Actively managed funds, due to their equity stakes, might avoid exiting because they can sometimes suffer substantial negative price effect if they sell a large position.

[122] Thomas W. Doellman, Fariz Huseynov, Tareque Nasser & Sabuhi Sardarli, *Do Mutual Funds Consider Tax Avoiding Firms Too Risky?*, 10-11 (Jan. 2018), http://fmaconferences.org/SanDiego/Papers/MFTA%20Jan18.pdf; Scott D. Dyreng, Michelle Hanlon & Edward L. Maydew, *Long-Run Corporate Tax Avoidance*, 83 ACCT. REV. 61 (2008).

[123] *See* Gilson and Gordon, *supra* note 26.

[124] *Id.* This is the result of their relatively large and concentrated stakes in the companies they target, the stronger financial incentive of hedge fund managers to capture a significant portion of the returns, and the lower incidence of "conflicts of interest" within the hedge fund portfolio. *See also* Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS 154, 186-187 (2009)).

[125] *See* Gilson and Gordon, *supra* note 26. The likelihood of such a scenario also incentivizes the activist shareholders themselves to target ex-ante companies with high institutional ownership. *See* Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activist*, 32 REV. FIN. STUD. 2720 (2019) ("Activist shareholders such as hedge funds are more likely to pursue changes to corporate control or influence (e.g., via board representation) and to forego more incremental changes to corporate policies when a larger share of the target company's stock is held by passively managed mutual funds.").

making hedge funds' monitoring efforts more likely.[126] This collaboration allows institutional investors to enjoy spillover of information, which they can use in their stewardship activity.

Likewise, in the tax avoidance setting, tax-inefficient companies are often targeted by hedge funds,[127] which tend to influence the tax behavior of their portfolio companies by suggesting specific tax strategies.[128] Under those circumstances, the costs for other institutional investors associated with generating incentives for portfolio companies to avoid taxes are lower. Moreover, the concern of intervention might induce companies to focus on increasing their tax avoidance levels in the first place, in an attempt to avoid such intervention.[129]

1.2.2 Low-Cost Monitoring under Common Ownership

In recent years, monitoring has become even more economical for institutional shareholders due to the unique advantages associated with their common yet concentrated equity stakes. Specifically, institutional investors can use monitoring and stewardship mechanisms, two of which are detailed below, that have the potential to influence the behavior of a large number of

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[126] *See* Matthew J. Mallow, *Asset Management, Index Funds, and Theories of Corporate Control* 13 (Nov. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3483573.

[127] Cheng et al., *supra* note 104 (showing that firms that are targeted by hedge funds later increase their level of tax avoidance, and that such an effect is empirically associated with the hedge funds' prior record of implementing tax changes, as well as with their interest in tax planning).

[128] *See, e.g.,* Alexandra Stevenson & Chad Bray, *Walgreen Shies Away From Moving Its Tax Base to Britain*, N.Y. TIMES (Aug. 6, 2014), https://dealbook.nytimes.com/2014/08/06/walgreen-to-pay-5-27-billion-plus-shares-for-alliance-boots ("Goldman Sachs Investment Partners and three hedge funds, including JANA Partners LLC, Corvex Management LP, and Och-Ziff Capital Management Group LLC, urged executives of Walgreen Co. to consider moving the company's incorporation outside the United States to reduce its income tax burden."); Kasmira Jefford, *IHG Shareholder Pushes for Tax Inversion Bid*, CITY A.M. (Aug. 5, 2014), http://www.cityam.com/1407198172/ihg-shareholder-pushes-tax-inversion-bid.

[129] *Compare* Gail Weinstein, Warren S. de Wied & Philip Richter, *The Road Ahead for Shareholder Activism*, HARV. L. SCH. FOR. ON CORP. GOVERNANCE & FIN. REG. (Feb. 13, 2019), https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/); Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 BOS. L. REV. 971, 984 (2019). Both papers explain that companies that wish to avoid intervention by activists are likely to take actions in the same direction hedge funds would have wanted them to take in case of an activist's intervention.

their portfolio companies without incurring significant expense and without acquiring firm-specific knowledge.

a) One-Size-Fits-All Approach

Common owners are often asked to vote on the same type of governance matters across their portfolio holdings.[130] By voting horizontally on all such ballots, common institutional owners can spread out the costs associated with researching the issue at stake and exercising their control rights, thus avoiding the necessity of investing resources in acquiring firm-specific knowledge.[131] But this tactic may be especially valuable to institutional investors with a rapidly growing number of portfolio companies, particularly if the resources allocated to stewardship activities do not keep pace.[132] As will be depicted in section 1.2.3, a unified position can facilitate some of the specific mechanisms used by institutional investors to increase corporate tax avoidance levels.

b) Herding Behavior

With common ownership, the ability to affect the behavior of companies in a portfolio is not necessarily contingent on exercising control over that same firm. By influencing the behavior of only a small number of focal companies, common institutional owners can essentially affect the behavior of other commonly owned companies that are likely to mimic such behavior. This so-called "herding effect" has been observed with companies under common ownership.[133] The

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[130] *See, e.g.,* Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEXAS L. REV. 983, 1002 (2020).
[131] The viability of this strategy is limited to cases in which the same governance issue is being voted upon and in which the common institutional owner would want the vote to be cast the same way.
[132] *See* Bebchuk & Hirst, *supra* note 12 (arguing that the stewardship resources of large institutions are inadequate compared to the number of their portfolio companies). However, according to Elhauge, staff for voting and stewardship have recently expanded by 65% at BlackRock, 110% at Vanguard, and 37.5% at State Street (Einer R. Elhauge, *The Causal Mechanisms of Horizontal Shareholding,* 82 OHIO ST. L. J. 1, 68 (2021)).
[133] *See, e.g.*, Michael J. Jung, *Investor Overlap and Diffusion of Disclosure Practices*, 18 REV. ACCT. STUD. 167 (2013) (demonstrating that the disclosure practices of commonly owned intra-industry firms are positively correlated

existence of such herding behavior among commonly owned companies suggests that these companies view the behavior of other portfolio companies held by the same institutional investors as signaling the attitude or preferences of common owners.[134]

In the tax avoidance setting, empirical evidence shows a convergence in companies' ETR following index reconstitution.[135] Indeed, the data illustrate that the level of tax avoidance, measured by different tax avoidance indicators such as ETR and book-tax difference, is correlated with exogenous variation in the tax avoidance of other index companies.[136] These findings support the idea that common ownership creates a new higher benchmark for tax avoidance, to which other companies then adhere. Also, with the new higher benchmark, companies are less likely to be concerned about appearing too aggressive as common ownership pushes up the benchmark for tax avoidance and modifies the IRS's standards for triggering a tax audit.[137] Herding behavior can, therefore, accelerate flooding with minimum effort on the part of institutional investors.

As the herding effect is often associated with mimicking the behavior of large companies and market leaders, these companies are better positioned to influence other commonly owned companies and promote herding. Therefore, institutional investors can target their stewardship

with a higher overlap in large institutional investors, and concluding that higher overlap might function as a communication channel and feedback mechanism to help facilitate the diffusion of disclosure practices); Massimo Massaa & Alminas Zaldokas, *Information Transfers among Co-owned Firms*, 31 J. FIN. INTERMEDIATION 77, 78 (2017) (suggesting that common ownership bondholders are able to use the financial performance of the commonly owned firms as signals from which to draw conclusions regarding the common owners' attitude toward lenders).

[134] *Id.*

[135] Cheng et al., *supra* note 92.

[136] *Id.*

[137] *See* Christopher S. Armstrong, Stephen Glaeser & John D. Kepler, *Strategic Reactions in Corporate Tax Avoidance*, 68 J. ACCT. & ECON. 1 (2019) (explaining that according to game theory, many corporate tax decisions can be characterized as a "strategic reaction" that describes how a firm's decision varies depending on its competitors' anticipated tax behavior). Commonly owned firms are therefore likely to respond to changes in their competitors' tax avoidance due to concerns about being singled out as noncompliant or too complaint. Lower levels of avoidance raise concerns that the firm will appear less efficient or too conservative in its tax policies. Higher tax avoidance levels can cause the firm to be viewed as particularly aggressive and draw unwanted scrutiny.

efforts towards such companies.[138] Moreover, large, well-resourced companies are likely to have a greater ability to gather private information about their shareholders' optimal level of tax avoidance.[139]

1.2.3 Exploring the Practices That Facilitate Flooding

In order to cause an increase in the overall levels of tax avoidance, common institutional owners need not act deliberately or concoct a scheme to flood the agency. As explained in this section, the mere involvement of many corporations in heightened tax planning activity will naturally lead to such an outcome. This section explores the specific pathways that cause such an increase in tax avoidance levels. It proposes several mechanisms that can connect common institutional ownership to tax avoidance behavior. These mechanisms can be divided into three sub-groups: (1) mechanisms that require investor-specific interaction with portfolio companies; (2) mechanisms that are based on a one-size-fits-all approach; and (3) mechanisms that do not require any action on the part of institutional investors.[140] None of these mechanisms involves coordination or collusion, whether tacit or explicit, between institutional investors and corporate managers nor between managers of portfolio companies.

a) Executive Compensation

Compensation contracts are generally perceived as a primary mechanism by which management can be incentivized to choose a tax avoidance level that reflects shareholder

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[138] *Compare* Azar et al., *supra* note 31, at 1550 (discussing the possibility that institutional investors focus their stewardship efforts towards market-leaders). Institutional investors indeed devote more attention to larger companies, primarily because they constitute a higher proportion of their portfolios. *See* Mallow, *supra* note 126, at 30 (explaining that the reason for devoting resources to such firms has to do with the firms' size and influence on the portfolio performance).

[139] *See* Armstrong et al., *supra* note 137, at 30, and compare Martin C. Schmalz, *Common-Ownership Concentration and Corporate Conduct*, 10 ANN. REV. FIN. ECON. 413, 416-17 (2018) ("managers unilaterally act in the interest of their shareholders, and do not explicitly or tacitly coordinate with competitor firms.").

[140] *Compare* Elhauge, *supra* note 132 (discussing the possibility that portfolio companies employ common ownership-related strategies without any prior communication with their institutional investors).

preferences.[141] The potential usefulness of management pay as a mechanism to trigger tax avoidance has to do with the fact that the compensation of managers is often determined based on one or more performance measures, in particular, accounting-based performance metrics,[142] which are directly affected by tax expenses. These performance measures create powerful incentives and extreme sensitivity to levels of firm profits for corporate executives.[143] In some cases, the terms of the compensation contract may also generate "cliffs": if profits cross a certain point, the manager receives a windfall; otherwise, nothing.[144] Since executives often view increasing earnings in order to meet or beat targets as an important goal of tax planning, designing compensation packages with such characteristics is likely to incentivize managers to more aggressively pursue tax avoidance opportunities.[145] Thus, management compensation can explain the incentives of managers to engage in tax avoidance.

In recent years, several empirical studies have examined the relationship between the components and characteristics of compensation packages to companies' levels of tax avoidance. Those studies found a positive correlation between equity-based compensation and pay-for-

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[141] *See, e.g.*, Hanlon & Heitzman, *supra* note 102, at 138 (applying the model of Jensen and Meckling and explaining that shareholders should strive to find a combination of control mechanisms and incentives that influence management to choose a tax avoidance level closer to the target level to minimize agency costs); Christopher S. Armstrong, Jennifer L. Blouin, Alan D. Jagoinzer & David F. Larcker, *Corporate Governance, Incentives, and Tax Avoidance*, 60 J. ACCT. ECON. 1, 2 (2015) (arguing that various governance mechanisms, including managers' incentive compensation contracts, can mitigate agency problems related to tax avoidance); Sonja Olhoft Rego & Ryan J. Wilson, *Equity Risk Incentives and Corporate Tax Aggressiveness*, 50 J. ACCT. RES. 775 (2012) (discussing the potential value of examining the compensation of executives who have a more direct effect on tax policies such as tax directors and managers).

[142] Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* (Eur. Cor. Governance Inst., Fin. Working Paper No. 514/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2992287.

[143] *Id.*

[144] *See* Adi Libson, Taking Shareholders' Social Preferences Seriously: Confronting a New Agency Problem, 9 U.C. IRVINE L. REV. 699, 709 (2019).

[145] *See, e.g.,* Khan et al., *supra* note 14 (showing that tax avoidance is used by management to increase net income margins and to meet or beat earnings expectations); John R. Graham, Michelle Hanlon, Terry Shevlin & Nemit Shroff, *Incentives for Tax Planning and Avoidance: Evidence from the Field*, 89 ACCT. REV. 991 (2014) (suggesting that tax planning strategies are often marketed to public companies as a way to increase earning).

performance sensitivity to tax avoidance, especially for well-governed companies and those with high levels of institutional ownership.[146]

This observed positive association between equity-based compensation and institutional ownership,[147] bolstered by the statements of some of the largest asset management institutions,[148] supports the premise that certain types of executive compensation packages may be linked to higher tax avoidance levels. Indeed, some of the empirical studies that show a positive correlation between institutional ownership and tax avoidance have attributed this correlation to the investors' influence on management pay.[149] That influence would not be a surprise given that many institutional investors claim expertise in evaluating executive compensation and regularly vote on compensation structure in say-on-pay and other votes.[150] According to Professor Jose Azar and his co-authors, institutional investors discuss management pay in almost half of the engagement meetings they conduct every year.[151] And ownership in hundreds of companies provides

[146] *See, e.g.,* Rego & Wilson, *supra* note 141; Hanlon et al., *supra* note 82. *But see* Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-powered Incentives*, 79 J. FIN. ECON. 145 (2006) (documenting a negative relationship between incentive compensation and tax sheltering for companies with weak corporate governance). Desai & Dharmapala also found that this correlation was mediated by institutional ownership and suggested a model in which tax sheltering and rent extraction are complementary activities that decrease when manager incentives are appropriately aligned. Their results were later disputed, and alternative explanations were suggested.

[147] *See, e.g.*, Andres Almazan, Jay C. Hartzell, & Laura T. Starks, *Active Institutional Investors and Costs of Monitoring – Evidence from Executive Compensation*, 34 FIN. MGMT. 5 (2005); Parthiban David, Rahul Kochhar & Edward Levitas, *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200, 200-201, 204 (1998).

[148] For example, State Street Global Advisors has stated in its 2019 Proxy Voting and Engagement Guidelines that it supports management proposals on executive compensation where there is "... a direct relationship between executive compensation and company performance over the long term." It also claims it believes that compensation packages should cause an alignment with shareholder interests. *See Proxy Voting and Engagement Guidelines,* STATE STREET GLOBAL ADVISORS (Mar. 2019), https://www.ssga.com/us/en/institutional/etfs/capabilities/esg/asset-stewardship/asset-stewardship-report-library/world-proxy-voting-engagement-guidelines-2019 (last visited March 1, 2022).

[149] *See* Khan et al., *supra* note 14, at 9; Chen et al., *supra* note 14, at 290-291.

[150] *See* Hemphill & Kahan, *supra* note 67, at 1415.

[151] According to Azar et al., "passive" investors claim to address management pay structure in 45% of engagement meetings (Azar et al., *supra* note 31, at 1556).

institutional investors with the opportunity to gain economies of scale in monitoring compensation policy.

b) Private Engagements

Common owners can communicate their tax-related preferences or bottom-line expectations to management through direct engagements. This communication method, which seems to be a relatively effective way to influence management,[152] is becoming more common among asset managers.[153] According to researchers, asset management institutions now conduct hundreds of engagement meetings every year in the form of direct conversations with companies and through "brief phone calls, email exchanges, or even short meetings."[154] In fact, 63% of institutional investors admitted that they tried to influence corporate managers via direct discussions.[155]

Private engagements can lead to higher levels of tax avoidance in various ways. One possibility is that institutional investors do not actively or consciously push for tax avoidance but rather induce corporate management to focus on bottom-line performance. Hoping to fulfill their institutional investors' financial expectations, portfolio companies will take advantage of more

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[152] *See, e.g.,* Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 N.Y.U. J. L. & BUS. 385 (2016).

[153] *See, e.g.*, Ann Yerger, *Four Takeaways from Proxy Season 2015,* HARV. L. SCH. FOR. ON CORP. GOVERNANCE & FIN. REG. (July 14, 2015), https://corpgov.law.harvard.edu/2015/07/14/four-takeaways-from-proxy-season-2015/ ("Company-investor engagement on governance topics—and disclosure of these efforts in the proxy statement—continues to grow, jumping from just 6% of S&P 500 companies five years ago to more than half of those companies in 2015."). *See also* Sarah Krouse, *At BlackRock, Vanguard and State Street, 'Engagement' Has Different Meanings,* WALL ST. J. (Jan. 20, 2018), https://www.wsj.com/articles/at-blackrock-vanguard-and-state-street-engagement-has-different-meanings-1516449600) (noting that in 2017, BlackRock had 1,603 private engagements with portfolio companies, Vanguard had 954, and State Street Global had over 676).

[154] Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 3 U. ILL. L. REV. 821, 848 (2013).

[155] *See* Elhauge, *supra* note 132.

aggressive tax planning opportunities.[156] In that context, we must remember that poor absolute performance or poor performance relative to peer firms often triggers shareholder engagement.[157]

In this scenario, higher tax avoidance levels are a byproduct of shareholder engagement regarding general performance matters.[158] From the perspective of institutional investors, taxes are just another line-item expense and tax minimization is as good as other corporate strategies aimed to achieve financial goals. Nevertheless, it is important to note that even if these investors do not actively aim ex-ante for higher tax avoidance levels, they can predict (and later observe) that their conduct, driven by their financial performance expectations, will ultimately result in higher levels of avoidance.

Another possibility is that common institutional owners push for improved general tax efficiency. They can do so, for example, by suggesting that the firm's tax liability or ETR is too high. Obtaining and processing information on these financial measures can be done easily and inexpensively,[159] especially by mutual fund managers and their analysts.[160] In this scenario, unlike

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[156] *See, e.g.*, Khan et al., *supra* note 14, at 3 ("Managers [may] "deliver" tax avoidance when institutional ownership increase, without institutional investors explicitly demanding tax avoidance."). The authors showed that tax avoidance is used by management to increase net income margins and meet or beat earnings expectations. *See* also Chen et al., *supra* note 14, at 286 ("Quasi-indexers may directly communicate with the board and managers a desire for improved overall financial performance, and a focus on improving overall performance can motivate managers to achieve better after-tax performance through lower cash taxes and reported tax expense as well."). The possibility that pressure to deliver better performance might trigger tax avoidance was also acknowledged by former IRS commissioner, Mark Everson, *supra* note 88 ("Particularly in the case of public companies, they are driven to show high after-tax profits to shareholders in a very competitive and complex economic environment").

[157] *See* Elhauge, *supra* note 132.

[158] *Compare* Azar et al., *supra* note 31, at 1552 (distinguishing between the claim that common ownership leads to higher prices and the argument that common owners "actively and consciously pursue an anti-competitive agenda, influencing managers of portfolio firms to compete less aggressively against each other, or even incite collusion.").

[159] *See, e.g.,* Novia X. Chen, Sabrina Chi & Terry J. Shevlin, *A Tale of Two Forecasts: An Analysis of Mandatory and Voluntary Effective Tax Rate Forecasts* (Nov. 8, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3271837 (explaining that financial statement users can aggregate year-to-date tax expense and pretax income to infer the mandatory ETR forecast). Moreover, voluntary ETR guidance is explicitly presented during earnings calls in the form of tax rates, making it more salient and easier to process.

[160] *See* Thomas Doellman, Fariz Huseynov, Tareque Nasser & Sabuhi Sardarli, *Mutual Funds' Aversion to Tax-avoiding Firms: An Anomaly?* 3 (Mar. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2956615 (explaining that sophisticated institutional investors are "more capable than an average investor to gather both hard and soft data on factors they perceive important… [and that they] incorporate effective tax rates into their calculation…").

the first one, institutional investors prefer that portfolio companies improve performance by minimizing tax liability.

A third possibility is that investors could take a more active approach by trying to revise the tax policies of their portfolio companies. This type of engagement would likely require the common institutional owners to attain firm-specific knowledge, which can be costly.[161] Because common institutional investors own stakes in many companies and because such investors often have limited resources allocated to stewardship activities, they are more likely to use high-level monitoring to improve performance rather than focus on specific tax issues.[162] Nevertheless, anecdotal evidence suggests that institutional investors that hold large stakes do, in fact, advise companies on their tax avoidance policies.[163]

c) Board Composition

As tax issues often make their way into the corporate boardroom, the board of directors can play a crucial role in dictating the tax policy of a company.[164] For example, a board can approve different tax strategies, structure the compensation of those responsible within the corporation for tax decisions,[165] and allocate more or fewer resources to the tax management department.[166] All such actions can affect the level of tax avoidance.

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[161] *See* Doellman et al., *supra* note 122, at 11.
[162] *See, e.g.,* Bebchuk & Hirst, *supra* note 12.
[163] Cheng et al., *supra* note 92, at 2.
[164] *See* Kristina Minnick & Tracy Noga, *Do Corporate Governance Characteristics Influence Tax Management?,* 16 J. COR. FIN. 703, 704-705 (2010).
[165] Rego & Wilson, *supra* note 141, at 781. Moreover, as tax savings are calculable and easy to measure, directors and other tax personnel that have an influence on tax planning can easily demonstrate how their work positively affected the performance of the company. Compensating tax personnel based on their demonstrated capabilities to reduce the company's tax liability should therefore be a relatively easy task.
[166] Rego & Wilson, *supra* note 141, at 784; Roman Lanis & Grant S. Richardson, *The Effect of Board of Director Composition on Corporate Tax Aggressiveness*, 30 J. ACCT. PUB. POL. 50, 54-56 (2011).

Common institutional owners can influence board members through direct engagement about tax issues, but they can also wield influence by affecting the board's composition. Boards frequently consult with their largest shareholders when selecting candidates, and institutional investors often have a say on whether to put a candidate forward for election.[167] In fact, many public companies have recently adapted their director selection procedures to enhance shareholder influence.[168] Numerous public companies have also adopted a board skills matrix, which highlights each director's specific skill sets.[169] In those circumstances, director candidates may be able to signal their tax orientation. Accordingly, institutional investors can support candidates who are more aggressive when it comes to taxes or who have more tax experience.

d) A Tax-Transparent Environment

Greater information demands from sophisticated institutional investors, particularly during investor conference calls with investors, are a key driving force behind the issuance of tax-related disclosure.[170] In fact, according to Professor Anne Ehinger and her co-authors, "income taxes are mentioned in 82 percent of all conference calls … and taxes are often mentioned during every conference call a company holds during the year."[171] Moreover, an increasing number of public

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[167] *See* Azar et al., *supra* note 31, at 1557; Elhauge, *supra* note 132 (arguing that "even if index funds do not directly communicate about who should be nominated, management has incentives to nominate the sort of candidates for whom index funds are likely to vote," and that all of the Big Three indicate that they utilize the "voting to oppose or support the election of particular board members.").

[168] *See* Brian R. Cheffins, *Corporate Governance and Countervailing Power* (Eur. Cor. Governance Inst. Working Paper No. 448/2019), https://papers.ssrn.com/sol3/papers.cfm? abstract_id=3225801.

[169] According to John C. Wilcox, the Chairman of Morrow Sodali, "The BlackRock team wants companies to provide more detailed and qualitative information about board members on their website and in annual meeting materials." *See* John C. Wilcox, *Getting Along with BlackRock*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 6, 2017), https://corpgov.law.harvard.edu/2017/11/06/getting-along-with-blackrock/).

[170] Anne C. Ehinger, Joshua A. Lee, Bridget Stomberg & Erin Towery, *Let's Talk About Tax: The Determinants and Consequences of Income Tax Mentions During Conference Calls,* 110 NAT'L TAX. ASS'N 1 (2017) (finding a significant positive correlation between analysts' coverage to the issuance of voluntary ETR guidance during earning calls, and suggesting that management usually considers analysts to be helpful in communicating information to institutional investors).

[171] *Id.*

companies now voluntarily provide annual ETR guidance during earnings calls,[172] either during the presentation portion of the conference calls or in the subsequent press release.[173]

Such publicly available data, whether forward or backward-looking, can serve as a channel through which commonly owned companies signal their level of tax avoidance to other companies as well as to their institutional shareholders.[174] Information on public companies' past tax avoidance levels enables other companies to set a tax benchmark keyed to other companies' historical performance.[175] Forward-looking information regarding companies' expected tax performance, on the other hand, helps companies prospectively align their levels of avoidance, and it has an advantage as it precedes the timing of tax-related information in annual statements.[176] That type of forward-looking information can also amplify the herding effect and help companies predict the amount of flooding.

e) Analyst Coverage

Analysts, who obtain and analyze financial information and provide forecasts for other stakeholders in the capital market, can potentially affect a company's tax avoidance level.[177] For

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[172] *Id.*
[173] *See* Martin Haas, *On Effective Tax Rate (ETR) Guidance and the Value-Relevance of Tax-Related Forecasts* 6-7 (Oct. 2013), https://ssrn.com/abstract=2367242.
[174] *Compare* Joel Slemrod, *The Economics of Corporate Tax Selfishness* 26 (Nat'l Bureau of Econ. Research, Working Paper No. 10585 (Oct. 2004)), https://www.nber. org/papers/w10858.pdf (explaining that public disclosure of tax sheltering information may backfire "if it facilitates the benchmarking of corporate tax department performance against the performance of competitors and causes a race to the bottom.").
The prediction that common ownership can facilitate coordination through increased disclosure was empirically tested and confirmed in the anticompetitive common ownership context (Park et al., *supra* note 31; Andrea Pawliczek & Ashley Nicole Skinner, *Common Ownership and Voluntary Disclosure* (June 8, 2018), https://papers.ssrn.com/ sol3/papers.cfm?abstract_id=3002075). Both studies show that the relaxed-competition environment under common ownership increases voluntary disclosure as companies are less concerned about conveying proprietary information that might be used by their competitors.
[175] *See* Slemrod, *supra* note 174; Thomas R. Kubick, Dan Lynch, Michael A. Mayberry & Thomas C. Omer, *Product Market Power and Tax Avoidance: Market Leaders, Mimicking Strategies, and Stock Returns*, 90 ACT. REV. 675, 678 (2015).
[176] Haas, *supra* note 173, at 8.
[177] Chen et al., *supra* note 159, at 2 (arguing that anecdotal evidence suggests that analysts issue ETR forecasts based on management ETR guidance). *But see* Brian Bratten, Cristi Gleason, Stephannie Larocque & Lillian F. Mills, *Forecasting Taxes: New Evidence from Analysts*, 92 ACCT. REV. 1 (2017) (documenting that 73.6% of analyst

example, a cash-flow projection can heighten the focus on cash-flow and induce management to implement tax planning strategies to achieve the projected results. In fact, tax advisors often promote tax planning strategies as a method to increase earnings and free up cash-flow.[178]

It is generally recognized that institutional investors are analysts' most important clients and that analysts are motivated to fulfill their institutional clients' demands.[179] For example, several studies have shown that analysts have an incentive to issue optimistic forecasts for public companies due to their relationships with institutional clients.[180] Following such optimistic forecasts, portfolio companies would be incentivized to find creative ways to increase their earnings, perhaps through tax avoidance.

The presumption that analysts can influence a public company's tax policies and strategies is supported in tax law literature.[181] For example, one study showed that companies lowered their projected Cash ETR from the 3rd to the 4th quarter when they would otherwise have missed the analyst's forecast.[182] Researchers also found that the effect of an analyst's forecast on a company's tax payments was more significant for companies with high institutional ownership.[183] Notably, this finding is also consistent with the empirical evidence discussed above, which documented a robust negative correlation between institutional ownership and Cash ETR.[184]

ETR forecasts differ from mandatory company ETR forecasts by more than 0.5%, suggesting that analysts do not rely only on management when forming ETR forecasts).

178 *See, e.g.,* Graham et al., *supra* note 145, at 994; Benjamin C. Ayers, Andrew C. Call, Casey M. Schwab, *Do Analysts' Cash Flow Forecasts Encourage Managers to Improve the Firm's Cash-Flows? Evidence from Tax Planning*, 35 CONTEMP. ACCT. RES. 767 (2018).

179 Paul A. Wong, *The Influence of Institutional Investors on Analyst Earnings Forecast Properties* (July 31, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2819139.

180 *See, e.g.,* Amitbath Dugar & Siva Nathan, The Effect of Investment Banking Relationships on Financial Analysts' Earnings Forecasts and Investment Recommendations, 12 CONT. ACCT. RES. 131 (1995); Francis, J. & D. Philbrick, Analysts' Decisions as Products of a Multi-Task Environment, 31 J. ACCT. RES. 216 (1993).

181 *See* Graham et al., *supra* note 145; Ayers et al., *supra* note 178; Chen et al., *supra* note 14.

182 Hanlon & Heitzman, *supra* note 102, at 133.

183 Graham et al., *supra* note 145, at 1017.

184 *See* Chen et al., *supra* note 14; Khan et al., *supra* note 14.

1.2.4 Analyzing the Aftermath of Flooding

When many publicly held companies simultaneously engage in tax avoidance, other public companies are likely to reduce their tax payments as well. The explanation is twofold. First, peer firms react to deviations between their tax rates and those of their industry competitors and often mimic the average industry level of avoidance.[185] As Professor Reuven Avi Yonah observed, once "some firms adopted aggressive tax strategies and saw their effective global tax rate plunge and their earning per share increase, management in other firms came under pressure to deliver similar results."[186] Moreover, it is common for companies within the same industry to follow each other by employing the same types of tax planning strategies, such as tax sheltering techniques.[187] And this mimicking effect is most discernible among companies that share institutional ownership links.[188]

Second, because data regarding IRS audit rates are publicly available and companies can easily see the declining audit rate—despite the growing prevalence of tax avoidance schemes—companies that might otherwise have been hesitant to take aggressive positions may now be emboldened to raise their tax avoidance levels.[189] In fact, there is empirical evidence that managers

[185] *See, e.g.*, Kubick et al., *supra* note 174 (showing that companies use the industry average as the primary benchmark for the level of tax avoidance); Vaughan S. Radcliffe, Crawford Spence, Mitchell Stein & Brett Wilkinson, *Professional Repositioning During Times of Institutional Change: The Case of Tax Practitioners and Changing Moral Boundaries*, 66 ACCT. ORG. & SOC. 45 (2018) (confirming that companies focus their tax positions towards "industry norms"); Andrew Bird, Alexander Edwards & Thomas G. Ruchti, *Taxes and Peer Effects* (Rotman Sch. Mgmt. Working Paper No. 2714468, 2017), https://ssrn.com/abstract=2714468 (arguing that peer firms react to negative shocks in the tax avoidance levels of the focal firm, such as significant reductions in its ETR, by reporting lower ETR as well). A former tax director of a Fortune 100 company has confirmed in a private conversation that employees in tax departments indeed calculate the ETR of other firms in the industry and that the firm's tax planning behavior is affected by the results of such comparisons.

[186] Reuven S. Avi-Yonah, *Corporate Taxation and Corporate Social Responsibility*, 11 N.Y.U. J. L. BUS. 1, 24 (2014).

[187] *See, e.g.,* Jennifer L. Brown. *The Spread of Aggressive Corporate Tax Reporting: A Detailed Examination of the Corporate-Owned Life Insurance Shelter*, 86 ACCT. REV. 23 (2011); Jennifer L. Brown & Katharine D. Drake, *Network Ties among Low-Tax Firms*, 89 ACCT. REV. 483 (2014); Kubick et al., *supra* note 175.

[188] *See supra* notes 133-136 and accompanying text.

[189] For example, firms can access annual and monthly audit coverage reports released by the IRS or other organizations that publish information on the IRS's work, such as TRAC reports.

use data provided by the tax authorities to estimate the probability of a tax audit.[190] Companies can also look into trends in government revenues, which can indicate that the IRS failed to substantially raise tax revenues through corporate tax audits.[191] Connections with former employees who currently work for the IRS, as well as informal meetings with IRS officials, can also provide useful insights regarding the enforcement capacity of the agency.[192] All such information can signal weaker enforcement capability and incentivize companies to increase their tax avoidance levels, leading to a vicious cycle of severe levels of noncompliance and drained government resources.

1.3 Proposed Policy: Double Sanctions

The growing concentration in the U.S. market of common institutional owners reveals an overlooked problem associated with the distortive effect that these institutional investors have on their portfolio companies' tax compliance incentives. When profitable corporations inundate the IRS with aggressive tax returns and take advantage of loopholes to avoid paying taxes, they fail to pay their fair share of taxes. By doing so, they shift the tax burden to other taxpayers and impose negative externalities on communities.[193] Governments are forced to cope by limiting services or raising taxes, which can exacerbate existing inequalities.[194] Given the pervasiveness of common

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[190] *See* Hoopes et al., *supra* note 37, at 1605, 1608 (claiming that corporations can gauge the ex-ante threat of an IRS audit in various ways).
[191] *Id.* at 1608.
[192] *Id.*
[193] *See, e.g.,* Dowling, *supra* note 23, at 179 (arguing that corporate tax avoidance is socially irresponsible as it denies governments and states resources that are necessary to fulfill their social obligations); John Christensen & Richard Murphy, *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the Bottom Line,* 7 DEVELOPMENT 37 (2004) (claiming that the payment of taxes is one of the most crucial citizenship duties of corporations since "[t]ax revenues are the lifeblood of the social contract, vital to the development and maintenance of physical infrastructure and to the sustenance of the infrastructure of justice that underpins liberty and the market economy").
[194] *See supra* notes 23-24; *see also* Paul Buchheit*, 6 Facts About Corporate Tax Avoidance,* INEQUALITY ORG. (Oct. 1, 2015), https://inequality.org/research/6-facts-corporate-tax-avoidance (explaining how tax avoidance by large corporations is tightly linked to inequality as it deprives "people all over America… of revenue that should be going to education and infrastructure").

ownership, this problem should sound an alarm for policymakers. An effective, dynamic response to this problem is a must.

As previously explained, a firm's optimal level of tax avoidance depends on its estimation of enforcement probability as well as the expected magnitude of the sanction in case of an enforcement action.[195] One solution, of course, would be to increase the IRS's budget, thereby boosting enforcement probability. Another would be to impose higher penalties on tax-avoiding companies. Nonetheless, since aggressive enforcement will not deter avoidance if pantiles are too low, and given that the imposition of penalties is contingent on aggressive enforcement, each of the potential solutions depends on the other.[196]

Thus, although calls to beef up IRS enforcement and audit capacity, as those coming for Washington, D.C. in early 2021 by the Biden administration[197] are welcomed—particularly as the IRS enforcement capacity has been depleted for years—its usefulness in combating flooding is likely to prove limited. What has become clear is that we need a more radical solution.

This chapter proposes imposing penalties not only on the audited company but also on any institutional shareholder that held at least a 5% equity stake in the company at the end of the tax year in question.[198] The penalty levied on each institutional investor that crosses the threshold would be calculated using the institution's year-end ownership percentage.

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[195] *See supra* notes 33 and accompanying text.

[196] Currently, penalties are levied solely on the tax-avoiding company and often constitute only a small fraction of the unpaid taxes. Thus, unless the penalties are substantially higher than they are today, firms would not be sufficiently deterred. *See* Alex Raskolnikov, *Revealing Choices: Using Taxpayers Choice to Target Tax Enforcemen*t, 106 COL. L. REV 689, 695 (2009); Michael J. Graetz & Louis L. Wilde*, The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355, 358 (1985); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L. J. 1453, 1458-1459 (2003).

[197] *See* Sarah Hansen, *Biden Reportedly Wants Another $80 Billion For The IRS To Crack Down On Tax Evasion And Fund His American Families Plan,* FORBES (Apr. 27, 2021), *https://www.forbes.com/sites/sarahhansen/2021/04/27/biden-reportedly-wants-another-80-billi on-for-the-irs-to-crack-down-on-tax-evasion-and-fund-his-american-familiesplan/?sh=142580f 35b6a.*

[198] The equity stake will be based on the aggregate holdings of the entire investment company so that different funds run by the same management company will be treated as part of the same set of holdings, similar to the proposal of

In the "lighter" version of this proposal, the institutional investor's ownership percentage would be multiplied by the penalties imposed on the company in connection with the relevant tax year. For example, if BlackRock held a 5% stake in Apple at the end of 2020, and Apple was later required to pay a penalty for its unpaid taxes for the year 2020 in the amount of $1 million, then BlackRock would be required to pay $50,000 to the IRS.[199] This penalty would be on top of any amount Apple was required to pay in connection to the audit.

Because penalties levied on taxpayers are often minimal,[200] penalizing institutional investors for only a portion of the penalties might prove toothless. A harsher solution might be necessary. Thus, in the "heavier" version of this proposal, the institutional investor's ownership percentage would be multiplied by the adjustments to the portfolio company's tax liability. In the previous example, if the amount of Apple's tax liability for the year 2020 was increased by $100 million, then BlackRock would have to pay a penalty of $5 million.[201]

Critics of this proposed policy will no doubt note that it departs from a fundamental principle of corporate law: the limited liability of shareholders.[202] While it is true that this proposal would violate this precept, courts have been willing to pierce the corporate veil when public policies or other considerations necessitated such action.[203] Indeed, courts have imposed liability on shareholders in various circumstances, including contractual obligations,[204] tort liabilities,[205]

Professor Eric Posner and his co-authors. *See* Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 Antitrust J. L. 669 (2017).

[199] $1,000,000x0.05=$50,000.

[200] *See supra* note 196.

[201] $100,000,000x0.05=$5,000,000.

[202] Len Sealy & Sarah Worthington, CASES AND MATERIALS IN COMPANY LAW 51 (Oxford University Press, 10th ed. 2013).

[203] For a review on the tendency of U.S. courts to respect the features of limited liability and separate corporate personality, see Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNEL L. REV. 1036 (1991).

[204] *Id.* at 1058 (observing that courts had pierced the veil in forty-two percent of cases related to contract law).

[205] *Id.* (observing that courts had pierced the veil in thirty-one percent of cases related to tort law breaches).

and breaches of various statutes (including tax law).[206] However, in most cases, court's readiness to pierce a corporate veil is contingent upon a shareholder's act.[207]

Under this proposal, on the other hand, institutional shareholders would be sanctioned by virtue of their holdings, even without establishing a direct link between such investors' conduct and the portfolio company's tax avoidance behavior. Viewed in that light, a double sanctions regime would be quite radical.[208] Nevertheless, there are ample reasons that justify this progressive approach.

First, the presumption of liability implied in the proposed policy is necessary given the difficulty in pinpointing the exact ways that investors affect a company's tax policies. As discussed above, some of these causal mechanisms might be carried out away from the public eye, making it challenging to identify clear links between common institutional ownership and tax avoidance. The growing empirical evidence regarding the relationship between institutional ownership and tax avoidance behavior calls for a shift in thinking.[209] The necessity in such a shift is especially profound considering the detrimental consequences of flooding: billions of dollars in lost tax revenues.[210] In that context, one must also consider the fact that the empirical studies that linked

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[206] *Id.* (observing that courts had pierced the veil in forty-one percent of cases related to statutory policy). Thompson also found that in cases involving tax law, courts pierced the veil in 31% of the cases. Several recent cases allowed the IRS to apply the "transferee liability" tool to collect federal income tax liability owed by a corporation from its shareholders (*see, e.g.,* 866 F.3d 1249 (11th Cir. 2017)).

[207] *See Browning-Ferris Indus. of Ill., Inc. v. Ter Maat*, 195 F.3d 953, 955 (7th Cir. 1999) ("[T]he status of being a shareholder does not immunize a person for liability for his, as distinct from the corporation's, acts."); *see also* Nina A. Mendelson, *A Control-based Approach to Shareholders Liability for Corporate Torts*, 102 COL. L. REV. 1204, 1259 (2002).

[208] To ratify the double sanctions regime, Congress would have to pass a statute that allows the government to accord relief from institutional shareholders, in addition to the investee company's tax liability and regardless of the solvency status of the company.

[209] *Compare* Elhauge, *supra* note 132 (claiming that even if one rejected the ample proof on causal mechanisms between common ownership and price increase, it should not matter because "definitive proof on causal mechanisms is not necessary to make enforcement proper or desirable.").

[210] Professors Andrew Bird and Stephen A. Karolyi estimated that an 0.2-0.3 percentage point decrease in Cash ETR following Russell 2000 index reconstitution corresponds to a $9.35 million reduction in cash taxes paid per year for the average company in the sample. Although this article was retracted as it misstated the use of CRSP-based index membership in the main specifications, the study's estimations regarding the amounts of tax revenue losses associated with index reconstitutions can provide a sense of the significant social costs associated with common institutional

institutional ownership and tax avoidance refer to periods when the levels of common ownership were increasing rapidly but were not yet as high as they are today—or as high as they are expected to be in the future.[211] Since implementing new tax strategies can be a long-term process, the adverse effect of common institutional ownership on tax compliance incentives may turn out to be even greater than we envision. Thus, there is a public policy interest in sanctioning institutional shareholders even if all they did was close their eyes to overly aggressive tax avoidance behavior.[212]

Second, institutional shareholders with a 5% or more equity stake at a company would often be the company's largest shareholders. The likelihood (and profitability) of monitoring through engagement and better stewardship is relatively high with respect to companies in which an institutional investor is one of the most dominant shareholders.[213] In fact, the institutional investors themselves admit that they engage more profoundly with companies that represent a larger portion of their assets under management.[214] Accordingly, the tax behavior of public companies whose largest shareholders are institutional investors is likely to reflect the preferences of these dominant shareholders. Moreover, conventional wisdom in corporate law is that institutional ownership is associated with strong corporate governance, which better aligns the incentives of managers and shareholders.[215] Thus, the tax avoidance behavior of companies with

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ownership. *See* Andrew Bird and Stephen A. Karolyi *Governance and Taxes: Evidence from Regression Discontinuity*, 92 ACCT. REV. 29 (2017) [Retracted].

[211] *See* Bebchuk & Hirst, *supra* note 12 (discussing the expected increases in the sizes of prominent money managers such as the Big Three).

[212] According to Khan et al., the fact that certain institutional investors stayed silent even when prompted by media for their comments on tax inverts in their investment portfolio implies some tacit approval on the part of these investors. *See* Khan et al., *supra* note 14.

[213] *See supra* note 138.

[214] *Id.*

[215] *See, e.g.,* Black, *supra* note 50, at 815 ("The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available."); Audra L. Boone & Joshua T. White, *The Effect of Institutional Ownership on Firm Transparency and Information Production*, 117 J. FIN. ECON.

high institutional ownership is assumed to mirror the preferences of their largest institutional shareholders.[216] And the evidence demonstrates that those shareholders prefer corporate behavior that results in more tax avoidance. It is, therefore, reasonable to hold those same powerful shareholders accountable for the consequences of those preferences.

At least two economists have recently expressed a somewhat similar approach. In their article on shareholder liability, Professors Charles Goodhart and Rosa Lastra suggest extending shareholder liability to those who hold power—a group of "insiders who have both the information and capacity to influence corporate decision-making."[217] According to their suggestion, this group would, by definition, encompass all shareholders with a 5% or more equity stake.[218]

Third, imposing liability on large and powerful institutional investors can also be consistent with the purpose of the "controlling persons" provisions under securities laws and regulations.[219] According to these provisions, controlling persons should be held liable jointly and severally for securities violations, along with the controlled company, unless the controlling person establishes one of the defenses provided for under the law.[220] The legislative history surrounding those rules indicates that Congress intentionally refrained from specifying the criteria for determining who

508, 533 (2015) ("quasi-indexers demand greater firm transparency and information production to minimize trading and monitoring costs and that managers and analysts respond to these requests.").

[216] *See, e.g.,* Andrew M. Bauer, *Tax Avoidance and the Implications of Weak Internal Controls*, 33 CONT. ACCT. RES. 449 (2016).

[217] Charles A.E. Goodhart & Rosa M. Lastra, *Equity Finance: Matching Liability to Power* 23–27, 29 (CEPR Discussion Paper No. DP13494, 2019), http://eprints.lse.ac.uk/100058/ 1/Goodhart_CEPR_DP13494.pdf.

[218] *Id.* The authors also discuss the possibility that shareholders, particularly institutional shareholders, that hold between 2%-5% of the company's shares would be able to choose whether to count as an 'outsider' or as an 'insider.' Another alternative is that institutional investors who cross the threshold be given an opportunity to dispute the assumption of liability. Moreover, suppose the portfolio company has a controlling owner-manager that holds a control block of either common shares (or vote-controlling shares in a duel-class structure). In that case, this may constitute a cause to exempt institutional investors with a 5% or more equity stake from liability.

[219] 15 U.S.C. § 78t(a) (1994); 15 U.S.C. § 77o (1994).

[220] *Id.* For an interesting overview of the controlling persons provisions, see Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983).

qualifies as a controlling person.[221] The rationale underlying such abstention was the idea that the term should have broad and flexible coverage, including circumstances that could not be foreseen at the time of the enactment.[222] A new circumstance has indeed arisen. The huge concentration of corporate ownership by institutional investors in the U.S. calls for a reassessment of the conditions under which shareholder liability should be imposed in connection with corporate misconduct, even outside the area of securities compliance. Powerful institutional investors have strong access to information and a demonstrated capacity to influence corporate affairs. It follows that, under certain circumstances, these investors should be held accountable for the noncompliant behavior of their portfolio companies.[223]

Moreover, under Delaware law, a shareholder does not necessarily need to have a majority of votes to qualify as a controlling shareholder.[224] A minority shareholder, or a group of minority shareholders, can be considered as a controlling shareholder if it has "effective control" or "outsized influence" on the board.[225] Thus, if a group of large mutual funds has exercised a

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[221] *See* Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 265, 274 (1997).

[222] *Id.* n. 54 (""Control" is not defined in sections 15 and 20(a). This declination was intentional. Congress announced that "[i]t was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. H.R. Report Number 73-1383, at 26 (1934).").

[223] The Securities and Exchange Commission has defined control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise" (17 C.FR. § 230.405 (1995)). This broad definition may theoretically encompass powerful institutional shareholders that can impose their will on the firms they own, should they choose to exercise it. *See* Paul Hersey & Kenneth H. Blanchard, MANAGEMENT ORGANIZATIONAL BEHAVIOR UTILIZING HUMAN RESOURCES 43 (7th ed. 1996) (defining power as the capacity of its possessor to enforce its will over the object of its power, should it choose to exercise it). *But see* Carson, *supra* note 220, at 274 (explaining that the provisions that impose liability on shareholders under the Securities Act are typically limited to control measures rather than influence).

[224] Roberto Tallarita, *The Limits of Portfolio Primacy* (August 9, 2021) (unpublished manuscript), 43, https://ssrn.com/abstract=3912977 or http://dx.doi.org/10.2139/ssrn.3912977.

[225] *Id.*

significant influence on a company, whether directly or indirectly, such behavior might be scrutinized under the Delaware law controlling shareholder doctrine.[226]

The double sanctions regime offers several significant advantages, chief of which is the increased exposure of institutional investors to tax audit risk. The across-the-board aggressive tax behavior of public corporations, and the lax enforcement environment it creates, benefit common institutional investors. It allows them to capture amplified earnings in their capacity as diversified shareholders while exposing themselves to a very minimal downside tax risk. As a matter of fact, the only risk that institutional shareholders bear is the risk that their portfolio companies will be subject to tax audits in the future and be required to pay additional amounts. From the perspective of institutional investors, however, such risk is negligible both because the enforcement probability is reduced under flooding and because these investors are highly diversified and can more easily diversify away tax risks.[227]

Given the current state of affairs, it is clear that common institutional investors suffer from a moral hazard problem, which could be solved by extending shareholder liability.[228] As Professors Henry Hansmann and Reinier Kraakman explain, extending shareholder liability helps prevent cost externalization by reducing the desirability of actions that create value for shareholders but negative net present value for society at large.[229] A double sanctions regime could therefore

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[226] Such prospect would seem particularly realistic once the voting power of index funds grow, as it is expected. *See* Bebchuk and Hirst, *supra* note 12 (arguing that by 2039, the Big Three are projected to vote 41% of the shares in S&P 500 companies).
[227] This is because of their highly diversified portfolios, as suggested by modern portfolio theory (see *supra* notes 22, 63 and accompanying text). Moreover, even if a tax audit is initiated, the taxes that a company would have to pay following the audit should have been borne anyway. Thus, the repayment of such taxes is not an actual economic loss when compared to the alternative of not avoiding taxes in the first place.
[228] *Compare* Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L. J. 387 (1992); Alessandro Romano, Luca Enriques & Jonathan R. Macey, *Extended Shareholder Liability for Systemically Important Financial Institutions*, 69 AM. U. L. REV. 967, 986 (2020).
[229] *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L. J. 1879, 1883 (1991). In their article, Professors Hansmann and Kraakman focus on risky activities in the context of tort law. However, many of their observations are relevant to the flooding theory as well. A core distinction is that the flooding phenomenon reflects the ability to impose externalities on society through activities

readjust the incentive of institutional investors to reduce tax avoidance levels to more reasonable levels.

Notably, a double sanctions regime could accomplish this result regardless of whether the increased tax avoidance levels are simply a byproduct of the investors' demand for better performance or whether they result from a specific focus on the part of institutional investors on tax minimization. Such a regime might also encourage institutional investors to integrate tax compliance issues into their stewardship activities and institute monitoring and alignment mechanisms to prompt portfolio companies to relax their aggressive tax behavior.[230]

The idea that imposing shareholder liability will be useful in combating flooding is consistent with empirical evidence on shareholder liability in other contexts. For example, several studies have explored the effect of shareholder liability on financial institutions' risk-taking. These studies were able to show that once shareholders were personally liable for the consequences of the company's behavior, the company engaged in activities that were significantly less risky.[231]

Another potential upside to a double sanctions regime is the ability to collect from two entities. This regime constitutes an efficient way to fill government coffers and should thus be appealing to policymakers, given the IRS's scarce enforcement resources and dwindling tax revenues. Moreover, the ability to impose a penalty on institutional shareholders might incentivize the tax agency to allocate more resources towards companies with high levels of institutional ownership. Targeting these companies would make sense since they are known to be more tax

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that normally (in the absence of the flooding effect) would be riskier. Under flooding, such actions are associated with lower risk. This crucial difference further demonstrates the urgency with which policymakers must address the flooding phenomenon.

[230] Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93-101 (1985) (explaining how the incentive of shareholders to monitor managers correlates with the shareholders' risk exposure, which is dependent on the limited liability rule or lack thereof).

[231] *See, e.g.,* Benjamin C. Esty, *The Impact of Contingent Liability on Commercial Bank Risk Taking*, 47 J. FIN. ECON. 189 (1998); Richard S. Grossman, *Double Liability and Bank Risk Taking*, J. MONEY, CREDIT & BANKING 143 (2001).

aggressive, so there is a high likelihood that a tax audit of these companies will reveal problems. In addition, high common institutional ownership is often concentrated in companies at the top of market indices.[232] And these companies are more likely to be market leaders, setting the benchmark for tax avoidance. Devoting greater resources to audits of such companies would likely deter flooding (and aggressive tax behavior) by the company in question, while at the same time, mitigate the herding effect by indirectly influencing the tax behavior of other public companies. Thus, under the double sanctions structure, "specific deterrence" could promote "general deterrence" and encourage compliance.[233]

Finally, a double sanctions regime is also likely to result in a positive change in ownership patterns. This is because it might induce investors to limit their holdings to less than 5%, the proposed threshold for triggering liability. Interestingly, legal scholars and economists such as Professors Eric Posner and Fiona Scott Morton have recently proposed limiting institutional investors' holdings to mitigate the antitrust risks associated with common ownership.[234] Other scholars, like Professors Lucian Bebchuk and Scott Hirst, have suggested limiting investment funds to no more than 5% equity stakes to prevent large asset managers, who are, in their opinion, weak monitors, from accumulating too much power over corporate America.[235] A double sanctions regime could help achieve that same policy goal, thereby mitigating various market distortions associated with the concentrated equity stakes of powerful institutional investors.

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[232] *See supra* notes 57, 106, and accompanying text.

[233] Specific deterrence arises if audited taxpayers become more complaint, while general deterrence is achieved if audits promote compliance by other taxpayers. For an interesting analysis of the two, see Mark C. Stafford & Mark Warr, *A Reconceptualization of General and Specific Deterrence*, 30 J. RES. IN CRIME & DELINQ. 123 (1993).

[234] Posner et al., *supra* note 198, at 678 (suggesting to "limit [institutional investors'] holdings of an industry to a small stake (no more than 1% of the total size of the industry) or hold the shares of only a single "effective firm" per industry.").

[235] Bebchuk & Hirst, *supra* note 12, at 2129-2131.

Chapter 2: The Agency Tax Costs of Mutual Funds

In late 2017, The Walt Disney Company and Twenty-First Century Fox, Inc. announced that Disney was acquiring Fox for $52.4 billion.[236] According to the announcement, the deal would be structured as a tax-free stock-for-stock transaction.[237] This would allow shareholders in Fox, including Rupert Murdoch and his family, who at the time owned 17% of Fox shares, to avoid a large tax liability. A few months later, Comcast Corp. then stepped forward to offer a rival bid: $65 billion in cash.[238] The higher-priced Comcast cash offer, if accepted, would have resulted in a hefty capital gains tax bill for Fox's taxable shareholders, including the Murdochs, because a cash deal would not have qualified for a tax-free arrangement.[239] While several Fox investors publicly voiced their interest in accepting Comcast's higher bid, some of its largest institutional investors—among them BlackRock Funds and Vanguard Investments—refused to comment on the matter.[240] Disney eventually raised its bid price to $71.3 billion, to be paid in either cash or stock at the option of each investor, whereupon Comcast dropped its bid.[241]

The bidding war between Disney and Comcast, and the failure of large institutional investors to disclose their stance on their preferred tax structuring of the deal, raises an important

[236] Press Release, The Walt Disney Co., The Walt Disney Company to Acquire Twenty-First Century Fox, Inc., After Spinoff of Certain Businesses, For $52.4 Billion in Stock (Dec. 14, 2017), https://www.sec.gov/Archives/edgar/data/1308161/000119312517368807/d511050dex 991.htm.
[237] *Id.* For tax purposes, a corporate acquisition can take the form of either an acquisition of assets, an acquisition of stock, or a merger. Acquisitions of assets occur between corporations and, unless a liquidation occurs, have no immediate tax consequences for target shareholders. Therefore, this chapter will not consider acquisitions of assets. In this chapter, a taxable transaction is defined as a transaction in which most of the consideration (more than 50%) is paid with cash. On the conditions for tax-free treatment, see *infra* note 300.
[238] Shalini Ramachandran & Erich Schwartzel, *Comcast Tops Disney with $65 Billion Bid for Fox Assets*, WALL ST. J. (June 13, 2018), https://www.wsj.com/articles/comcast-bids-roughly-65-billion-for-fox-1528920230.
[239] Greg Roumeliotis & Jessica Toonkel, *Comcast's All-cash Bid Could Pit Murdoch Against Fox Shareholders*, REUTERS (May 15, 2018), https://www.reuters.com/article/us-fox-m-a-comcast-murdoch/comcasts-all-cash-bid-could-pit-murdoch-against-fox-shareholders-idUSKC N1IG1CH.
[240] *Id.*
[241] Press Release, The Walt Disney Co., 21st Century Fox and Disney Stockholders Approve Acquisition by Disney (July 27, 2018), https://www.sec.gov/Archives/edgar/data/ 1308161/000119312518229593/d579820dex991.htm. The overall mix of consideration paid to 21st Century Fox stockholders was approximately 50% cash and 50% stock.

question that demands our attention: What, exactly, are the tax incentives of asset management institutions?

In an era of "agency capitalism" where agents hold shares for beneficial owners, understanding the tax motives that guide these financial intermediaries is of critical importance. Nearly half of all U.S. households are now invested in pooled investment vehicles,[242] representing an estimated 99.5 million individual investors.[243] As of 2018, the net assets value of mutual funds in the United States reached $17 trillion, and it is expected to reach approximately $24 trillion by 2024.[244]

As Americans increasingly choose to invest in capital markets through financial intermediaries, they cede investment, portfolio management, and voting decisions to institutional investors. Under the tax rules that govern investment funds, these decisions can have direct tax repercussions for investors in these funds.

Investment vehicles such as mutual funds are treated as pass-through entities for tax purposes. Any income a fund generates is not taxed at the fund level but instead passes through to the beneficial owners. Generally speaking, investors in mutual funds fall into two basic categories: those who invest through conventional taxable accounts and are required to pay taxes on income distributed by the fund ("tax-sensitive shareholders") and those who invest through retirement or deferred accumulation vehicles and are exempt from taxes ("tax-insensitive shareholders"). Accordingly, the goal of tax-sensitive shareholders is to maximize risk-adjusted

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[242] *2019 Investment Company Fact Book*, INV. CO. INST., 2019, available at https:// www.icifactbook.org/.
[243] SEC. INDUS. & FIN. MARKET ASS'N, Q: Who Owns Stocks in America? A: Individual Investors, A Chart Book on Stock Ownership (Oct. 2019) 12, https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Who-Owns-Stocks-in-America.pdf.
[244] MORDOR INTELLIGENCE, US Mutual Funds Industry—Growth, Trends, and Forecast (2020-2025), https://www.mordorintelligence.com/industry-reports/us-mutual-funds-industry.

after-tax returns, while the goal of tax-insensitive fund shareholders is to maximize risk-adjusted pre-tax returns.[245]

Despite these different goals of the two groups of shareholders, the empirical data indicate that the behavior of mutual funds is generally oblivious to the interests of tax-sensitive shareholders. In fact, a recent study shows that a great majority of the assets invested in the asset management industry—nearly 95%—are managed by fund managers who do not appear to be sensitive to the tax consequences of their actions.[246] For example, these fund managers tend to hold stocks with high dividend yield, do not engage in year-end tax-loss selling, and fail to respond to reductions in capital gains tax rates to rebalance their portfolio.[247]

For tax-sensitive investors, these tax-insensitive decisions can take a big bite out of total returns and diminish net accumulations.[248] Given that almost half of the assets invested in the asset management industry are held in taxable accounts,[249] the tax-insensitivity of mutual funds is both puzzling and disconcerting.

It is tempting to explain mutual funds' tax-insensitivity as a natural byproduct of the relative ownership of the two groups of shareholders: tax-sensitive and tax-insensitive shareholders. In other words, because assets held in retirement accumulation vehicles represent a significant (and rapidly growing) proportion of the asset management industry,[250] fund managers' propensity to target pre-tax returns might reflect a deference to the incentives of the

[245] Christopher G. Luck, *Tax-Advantaged Investing*, J. PRIVATE PORTFOLIO MGMT. 3 (Spring 1999).
[246] *See, e.g.,* Jennifer L. Blouin, Brian J. Bushee & Stephanie A. Sikes, *Measuring Tax-Sensitive Institutional Investor Ownership*, 92 ACCT. REV. 49 (2017). Such classification is documented in Bushee's table, available here https://accounting-faculty.wharton.upenn.edu/ bushee/.
[247] *Id.*
[248] Scott J. Donaldson et al., *Tax-efficient Equity Investing: Solutions for Maximizing After-tax Returns,* VANGUARD (Mar. 2015), https://personal.vanguard.com/pdf/ISGTEEI.pdf.
[249] For example, in 2018, 42% of the assets invested in the asset management industry were held in taxable accounts. *See* 2019 Fact Book, *supra* note 242, at 271. These proportions refer to all the assets held by investment companies, not solely those invested in equity funds.
[250] Stock Ownership Chart Book, *supra* note 243, at 6.

dominant group. But a closer examination suggests that this explanation is unlikely—something else is going on.

First, the evidence shows that even during periods when tax-sensitive investors dominated the industry, their fiduciaries ignored their tax interests.[251] Second, mutual funds could have mitigated many of the difficulties associated with the shared ownership of both groups of shareholders but have chosen not to do so. For example, a structural separation between mutual funds based on the tax status of investors, a proposal that has been raised in the past and long embraced by other types of financial intermediaries (e.g., hedge funds),[252] mutual funds have failed to implement a similar approach. Alternatively, fund managers could have adopted a tax approach that adequately balances the interests of tax-sensitive and tax-insensitive shareholders. Instead, they have consistently chosen to favor the interests of the latter.

This chapter offers a novel explanation for mutual funds' tax-behavior by using an agency framework to explore such behavior. While corporate law scholars have traditionally focused on agency costs that flow from the separation of ownership and control in a corporation, a growing literature emphasizes the need to incorporate agency frictions into any exploration of mutual funds' behavior.[253] This chapter is the first to identify the agency costs that emerge from the "separation of ownership from ownership" in intermediated markets due to the diverging tax incentives of institutional investors and their beneficiaries.

The agency tax costs analysis reveals that mutual funds' tax-insensitivity arises from a conflict between the interests of tax-sensitive shareholders—the beneficiaries—and their

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[251] *See infra* note 277 and accompanying text.
[252] *See infra* note 331 and accompanying text.
[253] *See, e.g.,* Leo E. Strine, Jr., Keynote Address, *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. I (2007); Gilson & Gordon, *supra* note 26; Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERS. 89 (2017).

fiduciaries, the institutional investors themselves. The first cause of this conflict is the compensation structure of asset management institutions. These institutions earn management fees that are calculated as a percentage of assets under management (AUM).[254] But the dollar amount of AUM depends on pre-tax returns. Greater pre-tax portfolio performance increases AUM through both portfolio growth and fund flows.[255]

In the past, scholars posited that maintaining tax-efficiency in a mutual fund portfolio would not compromise a fund's pre-tax performance.[256] This perception, however, has recently begun to change.[257] The growing understanding is that a strategy that maximizes pre-tax returns is often different from one that maximizes after-tax returns, suggesting that there is a trade-off between the two. Thus, maximizing pre-tax returns may result in significant tax costs for tax-sensitive shareholders, diminishing their after-tax accumulation.[258]

Moreover, the occurrence of "tax-triggering events"—transactions in a mutual fund portfolio that impose taxes on tax-sensitive fund shareholders—would serve the interests of fund managers for yet another reason. Such events would reduce the fund's so-called tax overhang

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[254] *See, e.g.,* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 46-47 (Oxford University Press, 2016).
[255] *See, e.g.,* Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* (N.Y. Univ. Sch. of Law, Law & Econ. Res., Working Paper No. 18-39, 2019) 10–11, https://ssrn.com/abstract=3295098 (explaining that both actively managed funds and index funds have strong financial incentives to improve the performance of their portfolio firms, and, accordingly, the returns on their portfolios). These incentives are both direct (the management fees of investment funds are calculated as a percentage of AUM) and indirect (the performance of funds is positively correlated with future inflows).
[256] *See, e.g.,* Clemens Sialm & Hanjiang Zhang, *Tax-Efficient Asset Management: Evidence from Equity Mutual Funds* (Nat'l Bureau Econ. Res. Working Paper 21060, 2015), https://www.nber.org/papers/w21060.pdf ("tax-efficient asset management strategies, as practiced by U.S. equity mutual funds between 1990 and 2012, did not have negative performance consequences"). *See also* Clemens Sialm & Laura Starks, *Mutual Fund Tax Clienteles*, 67 J. FIN. 1397, 1402 (2012); Danielle Bergstresser and Jeffrey Pontiff, *Investment Taxation and Portfolio Performance*, 97 J. PUB. ECON. 245 (2013). Both studies empirically showed that tax-efficiency does not harm or even improve pre-tax portfolio performance.
[257] *See, e.g.,* Blouin et al., *supra* note 246, at 51 (showing that tax-sensitive portfolio management results in a -0.35% lower pre-tax return than tax-insensitive portfolio management); Derek Horstmeyer, *Are Tax-Efficient Funds Worth It?,* WALL ST. J. (Jan. 10, 2021), https://www.wsj.com/articles/are-tax-efficient-etfs-worth-it-11610322208 (presenting an empirical study which found that tax-managed funds underperformed similar funds that weren't tax-managed by approximately 0.09 percentage point a year on average).
[258] *Id.*

(i.e., the built-in capital gains in fund portfolios), which often deter prospective tax-sensitive shareholders from investing in the fund.[259] Other factors can further exacerbate the conflict of interest between the fiduciaries and their tax-sensitive beneficiaries. For example, the incentive of mutual funds to minimize portfolio management expenses makes it all the more likely that fund managers will invest very few, if any, resources in promoting tax-efficiency.

Because the benefits of tax decisions often flow to the institutional investors themselves, the concern is that asset managers will exploit their authority to the detriment of their beneficiaries. Such a concern is particularly concerning given the significant degree of information asymmetry regarding a fund's sensitivity to taxes. Investors in mutual funds know very little about the tax behavior of their fiduciaries. Tax-related disclosures that mutual funds are required to make are minimal and are only provided at the end of the year—and after the fact.[260] Moreover, many retail investors are not well equipped to adequately comprehend and analyze these tax disclosures.[261] In the absence of sufficient information, tax-sensitive investors in mutual funds cannot effectively monitor or discipline their fiduciaries for their tax-inefficient behavior.

The agency tax problem identified in this chapter has been aggravated by the growing concentration in the asset management industry. Two primary explanations for the positive correlation between the rise of agency tax costs and the recent changes in the asset management industry are available. First, the evidence shows that as institutions grow more massive, they become less sensitive to the tax consequences of their actions.[262] It is hardly surprising that the

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[259] For a general overview on mutual funds tax overhang, see Ethan Yale, *Mutual Fund Tax Overhang*, 38 VA. TAX REV. 397 (2019).
[260] *See infra* notes 345, 347 and accompanying text.
[261] *See infra* note 346 and accompanying text.
[262] *See* Blouin et al., *supra* note 246, at 54.

behavior of the largest asset management institutions—BlackRock Funds, State Street Global Advisors, and Vanguard Investments, known as the "Big Three"—has been shown to reflect insensitivity to taxes.[263] This finding suggests that the recent emergence of gigantic money managers, which attract both retail investors and retirement savers, may not be good news for tax-sensitive investors in equity markets.

The second explanation, which is linked to the first, is that large fund-families like the Big Three tend to engage in stewardship and voting activities at the family level. Notably, it is now common for such institutions to have a centralized research division that determines the voting policies across all funds within a fund-family.[264] This unified vote system typically reflects the interests of the sponsor—the company that administrates and markets the family's funds.[265] Because these dominant market players fall into the category of tax-insensitive institutional investors, the vote of all the funds within the fund-family is likely to reflect insensitivity to taxes.

After applying an analytical agency costs framework to explore the tax incentives of institutional investors, this chapter focuses on a particular setting where these incentives often arise: mergers and acquisitions (M&A) deals. The M&A sphere provides a useful context within which to explore the agency tax problem. The binary choice between a tax-free and a taxable structure in an M&A deal vividly demonstrates the conflict of interest between tax-sensitive shareholders and institutional investors. A taxable deal is more likely to serve fund managers' interest by improving pre-tax portfolio performance, reducing the fund's tax overhang, and

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[263] *See infra* note 294 and accompanying text. On the limitations of index funds, the primary products offered by the Big Three, to operate with a mindful eye to taxes see *infra* notes 460-461.
[264] *See, e.g.,* Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: TENN. J. BUS. L. 175 (2017).
[265] *Id.* at 192.

increasing its net inflows. This can explain why institutional investors have systematically favored taxable deals over tax-free transactions, despite the significant tax savings the latter could have generated for their tax-sensitive shareholders.[266]

More importantly, because an M&A deal is not just a portfolio-level event but rather a firm-level event that is typically subject to a shareholder vote, the potential impact of institutional investors' tax preferences on the M&A market is substantial. This impact is problematic since mutual funds' tax-insensitivity can skew voting outcomes and impose negative externalities on third parties such as retail shareholders with direct holdings in the target.

In exposing the agency tax problem, this chapter makes several novel contributions and provides a framework for future research. First, it highlights the systematic mechanisms that enhance the propensity of mutual funds to work against the interests of tax-sensitive shareholders. Indeed, this chapter shows that agency tax costs are likely the primary driver of this propensity, affecting decisions made by fund managers that have direct tax consequences for the beneficiaries. Second, this chapter illustrates how mutual funds' tax-insensitivity undermines one of the policy objectives generally associated with investments in mutual funds—the ability to replicate the results that would have been achieved if investors had invested directly.[267] Not only do portfolios managed by financial intermediaries incur higher tax liabilities than if shareholders invested directly, but these intermediaries also fail to replicate voting outcomes in the portfolio companies. Third, this chapter shows that the shift to intermediated markets has made tax-insensitivity a ubiquitous feature in the U.S. capital market, a result that calls for a

[266] *See infra* notes 304-306 and accompanying text.

[267] *Compare* Yale, *supra* note 259, at 399 (arguing that the tax behavior of mutual funds, which have an incentive to accelerate their shareholders' taxes, is incongruent with the policy goal of achieving the same results that shareholders in mutual funds would achieve under direct ownership).

recalibration of the role of taxes in our economy.[268] The long-standing assumption that institutional investors' tax preferences have less market impact than taxable individuals is no longer valid.[269]

Finally, this chapter considers several mechanisms to mitigate the conflict of interest between institutional investors and their tax-sensitive shareholders. The alternatives proposed—separation of funds based on the beneficiaries' tax profile, limitations on centralized voting in mutual funds sponsors, pass-through voting, and heightened tax transparency—would realign such interests, provide an opportunity for tax-sensitive shareholders to express their tax preferences, and reduce information asymmetry.

This chapter proceeds as follows. Part I surveys empirical data on the tax behavior of institutional investors as indicated by their trading, stewardship, and voting activities and refutes possible explanations for the systematic tendency of mutual funds to overlook the tax consequences of their behavior. Part II articulates an agency framework to explore the tax behavior of mutual funds. It offers a novel explanation for mutual funds' tax-insensitivity and illuminates how rational, self-motivated fund managers might be induced to deviate from their tax-sensitive shareholders' interests. Part III focuses on one specific setting that reflects the tax-insensitivity of these institutions—M&A deals—and analyzes how such insensitivity distorts voting outcomes, inflicts negative externalities on third parties, and impacts the market for corporate control. Finally, Part IV proposes necessary steps to help alleviate agency tax costs.

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[268] *See* Blouin et al., *supra* note 246, at 50, 59 (finding that tax-sensitive institutional investors manage only 12.4% of the average yearly total equity in the market, and that assets managed by tax-insensitive institutional investors represent only $539.4 billion).

[269] *See, e.g.,* Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5 (1976) ("It is hard to believe that [tax-exempt investors] have enough impact on the market to outweigh the effects of taxable individuals.").

2.1 The Tax Behavior of Mutual Funds

The tax regime governing mutual funds makes it all but inevitable that the actions of fund managers would determine the tax liability of individuals invested in investment funds. By surveying relevant empirical data from the past few decades, this Part explores how fund managers who invest, trade, and vote on behalf of their beneficiaries integrate tax considerations into their decision-making process, if they do so at all.

2.1.1 The Chronic Blind Eye to Taxes

For tax purposes, financial intermediaries are pass-through entities.[270] In other words, all gains and losses generated by an investment fund flow to the investors on a pro-rata basis and are not taxed at the fund level.[271] Thus, the tax treatment of any income distributed from the fund depends on the tax status of the investor. Only tax-sensitive shareholders—shareholders that hold mutual funds in conventional accounts—are taxed on their pro-rata share of the fund's income.[272] Consequently, even if these shareholders do nothing more than buy and hold mutual fund shares, they can be burdened with significant tax liabilities due to the distribution of gains from their

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[270] Mutual funds are subject to specific tax rules set forth in subchapter M of the Internal Revenue Code, which discusses regulated investment companies ("RITRICs"), real estate investment trusts ("REITs"), and real estate mortgage investment conduits ("REMICs"). Unlike most corporations, investment companies such as mutual funds and ETFs avoid double taxation as they are not taxed on income or capital gains at the entity level to the extent that they meet certain gross income and asset requirements and distribute their income annually. A fund is required to pay out most of its profits (at least 90%) as dividends, which in turn allows the fund a dividends-paid deduction offsetting the fund's taxable income. Unlike partnerships and S corporations, mutual funds cannot pass-through net capital losses and NOLs; these items remain tax attributes at the entity level and can be used against the fund's future income. See I.R.C. §§ 851–860G (2012). Distributions from mutual funds must be reported on a U.S. investor's tax return irrespective of the individual's tax profile.

[271] The income distributed from the fund retains the character it has in the hands of the fund. Generally, the distributed income can be classified as ordinary dividend, qualified dividend, net capital gains (short-term or long-term), or interest.

[272] Even if assets are held in a taxable account, that does not necessarily mean that the beneficial owner would be subject to taxes. For example, investors in taxable accounts might be foreign investors who are not required to pay income on their profits in the United States. Alternatively, a fund shareholder holding a taxable account might be a tax-exempt entity for U.S. tax purposes, such as a tax-exempt university or endowment.

mutual funds.[273] On average, such taxes can account for up to one-third of an average equity fund's annual return, representing one of the most substantial expenses tax-sensitive fund shareholders face.[274]

This problem was recognized nearly three decades ago, in a study on investment strategies for tax-sensitive shareholders in mutual funds. Indeed, the researchers observed that although tax expenses can take a huge bite out of total returns, fund managers often operate "with a blind eye to the tax consequences of the management style."[275] According to the study, this blind eye could result in net pre-tax returns that were not high enough to cover tax expenses.[276]

At the time the study was published, most assets invested in the asset management industry were held in taxable accounts. In 1991, for example, assets held in taxable accounts counted for three-quarters of the industry's total assets.[277] Despite the dominance of tax-sensitive shareholders, fund managers largely failed to factor taxes into their decision-making process.

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[273] For example, in 2018, mutual funds distributed $158 billion in taxable capital gains and $145 billion in taxable dividends. *See* 2019 Fact Book, *supra note* 242, at 274-275.
Ordinary dividend distributions are taxed at the investor's ordinary income tax rate unless they are qualified dividends, in which case they are taxed at a maximum rate of 20%. Long-term capital gains distributions that represent a fund's net gains from the sale of securities held in its portfolio for more than one year are taxed at a maximum rate of 20% as well. Short-term capital gains are taxed at the investor's ordinary tax rate. Certain high-income individuals are also subject to a 3.8% tax on net investment income.
Tax-sensitive shareholders might face different marginal tax rates, which are not always known to fund managers. *See* Steven J. Huddart & V.G. Narayanan, *An Empirical Examination of Tax Factors and Mutual Funds' Stock Sales Decisions*, 7 REV. ACCT. STUD. 319, 320 (2002). Thus, different tax-sensitive shareholders are likely to have different tax incentives (for example, a tax-sensitive investor might have a loss that can be used to offset gains distributed from the fund). This chapter assumes that tax-sensitive shareholders are interested in minimizing taxable distributions from their funds.
[274] *See* Jeffrey M. Colon, *Oil and Water: Mixing Taxable and Tax-Exempt Shareholders in Mutual Funds*, 45 LOY. U. CHI L. J. 773, 808; Sialm & Zhang, *supra* note 256, at 2 ("taxable fund shareholders are estimated to pay investment taxes amounting to 1.12% of their investment value per year.").
[275] Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes*?, 19 J. PORTFOLIO MGMT. 15 (1993).
[276] *Id.* According to a more recent study, under average market conditions, active portfolio management erodes up to 14.5% of profits for high-income individuals. Thus, active strategies must generate an alpha of up to 1.04% per year just to overcome the tax obligations arising from unrealized gains. *See* Stanley Peterburgsky, *Tax Consequences of Active Portfolio Management: A Simulation Approach* (July 14, 2010), https://ssrn.com/abstract=1640183.
[277] *See 2001 Investment Company Fact Book*, INV. CO. INST., 2001, 37 (providing an overview of the holding proportions of the two groups of shareholders which shows that in the years 1991, 1995, and 2000, the share of retirement accumulation accounts represented 25%, 34%, and 36%, respectively, of the assets invested in mutual funds).

This study sparked a policy discussion on the topic of the tax-inefficiency of mutual funds.[278] Congress, regulators, and the popular press began to acknowledge the significance of mutual funds' tax costs. Ultimately, it led to the introduction of H.R. 1089—"The Mutual Fund Tax Awareness Act of 1999"—which required the Securities and Exchange Commission (SEC) to improve disclosure of mutual funds' tax performance.[279] As a result, the SEC subsequently mandated that funds must report their after-tax returns in their prospectuses.[280] The hope was that such disclosure would mitigate tax-inefficiency.[281]

However, the requirement to disclose after-tax returns was limited to a fund's prospectus; the SEC mandate did not insist that funds include after-tax returns in advertisements or other sales materials.[282] Because most investors read ads, not prospectuses, tax scholars and legal practitioners voiced doubts about the new rule's effectiveness.[283]

Their concerns turned out to be well-founded. Indeed, two decades after the disclosure rules went into effect, the tax preferences of most institutional investors are still a great source of mutual funds' tax-inefficiency.[284] As a matter of fact, the data suggest that the general levels of

[278] For a review, see Robert H. Jeffrey, *Tax-Efficient Investing Is Easier Said Than Done*, 4 J. WEALTH MGMT. 9 (2001).
[279] The Mutual Fund Tax Awareness Act of 2000, H.R. 1089, 106th Cong. (2000).
[280] *See* Disclosure of Mutual Fund After-Tax Returns, Exchange Act Release No. 33-7941, 74 SEC Docket 236 (Jan. 18, 2001). 17 C.F.R. § 230.482(e)(4) (2013) describes the reporting requirements. According to the Rule, two types of after-tax returns must be shown: after-tax returns, calculated solely based on distributions (pre-liquidation), and after-tax returns that include both distributions and the sale of the RIC's shares at the end of the measurement period (post-liquidation). Funds were required to show each type of after-tax returns for one-, five-, and ten-year periods.
[281] *Id.* ("[the tax disclosure] could ... caus[e] existing funds to alter their investment strategies to invest in a more tax-efficient manner.").
[282] *Id.* Moreover, not all mutual funds must disclose such information. For instance, a RIC is not required to provide after-tax return disclosure in a prospectus used solely to offer fund shares as investment options in a retirement plan (such as 401(k)).
[283] *See, e.g.,* Jeffrey J. Haas, *Mutual Fund Regulation in the Next Millennium Symposium,* 44 N.Y.U. L. REV. 463, 480 (2001). Fund investors are even more unlikely to read a prosecutes following their initial investments (Mitchell L. Engler, *A Missing Piece to the Dividend Puzzle: Agency Costs of Mutual Funds*, 25 CARDOZO L. REV. 215, 241-242 (2003)).
[284] *See, e.g.,* Robert D. Arnott, Vitali Kalesnik & Trevor Schuesler, *Is Your Alpha Big Enough to Cover Its Taxes? A Quarter-Century Retrospective*, 48 J. PORTFOLIO MGMT. 78, 93 (2018) (arguing that because most managers pay too much attention to unreliable pre-tax returns and too little to the tax costs the fund incurs, these financial intermediaries are doomed to fail their tax-sensitive shareholders); Peterburgsky, *supra* note 276 (showing that the

mutual funds' tax-insensitivity have increased over time and that asset managers today are even less inclined to factor taxes into their decision matrix.[285]

A growing stream of empirical studies analyzed institutional investors' tax behavior to determine whether such investors—who serve both tax-sensitive and tax-insensitive shareholders—consider taxes when making portfolio management decisions. As the remainder of this section shows, these studies prove that mutual funds' sensitivity to taxes (or lack thereof) can generally be reflected in three types of portfolio management activities: trading, corporate stewardship, and corporate M&A deals.

a) Trading Activities

As institutional investors buy, sell, and hold stocks in their portfolios, their actions affect their tax-sensitive beneficiaries' tax liability. The sale of stock for a profit, for example, can result in a capital gain that passes through to the investors in the fund. Another example occurs when an institutional investor continues to hold a dividend-paying stock that generates dividend income that is distributed to fund shareholders at the end of the year. Similarly, institutional investors can affect the tax liability of tax-sensitive investors if they engage in tax-driven trading activities, such as rebalancing a portfolio before a scheduled increase in capital gains tax rate or following a tax rate reduction.

Tax research generally uses institutional investors' observable holding patterns and trading activities to gauge their sensitivity to taxes. Notably, a recent study by Professor Jennifer Blouin and her co-authors created and validated a new and improved measure of institutional investors'

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alpha generated by actively managed mutual funds is generally not high enough to overcome the tax expenses mutual fund investors face); Sialm & Zhang, *supra* note 256, at 30 (finding that mutual funds that impose higher tax burdens on their investors do not offset these tax costs with superior before-tax performance).

[285] Blouin et al., *supra note* 246, at 70. Moreover, Blouin et al. find that "about one-third of tax-sensitive institutions that survive for ten years become tax-insensitive" (there at p. 58). This phenomenon is well illustrated in Bushee's table, mentioned in *supra* note 246.

tax-sensitivity,[286] which was later confirmed in several subsequent empirical studies.[287] Based on specific portfolio characteristics and trading patterns of institutional investors, as well as the legal type of the institution, this study classified institutional investors into two groups: tax-sensitive institutional investors and tax-insensitive institutional investors. The study found that, compared to tax-sensitive institutional investors, tax-insensitive institutional investors tended to hold more stocks with high dividend yields and did not engage in year-end tax-loss selling.[288] Moreover, the study revealed that tax-insensitive investors traded their stocks frequently, with apparent disregard for their investors' tax consequences.[289]

Blouin and her co-authors also found that nearly all investment advisors, a group that encompasses mutual funds and ETFs, fall into the category of tax-insensitive institutional investors.[290] According to the study, a large majority of the assets invested in the asset management industry are managed by tax-insensitive institutional investors. In fact, only 5% of the industry's assets, a startlingly small amount by any measure, are managed by investment advisors who consider the potential tax attributes of their beneficiaries when making trading decisions.[291]

Another interesting finding of this study was a positive correlation between the size of the institution and its level of tax-insensitivity. As institutions become larger, their sensitivity to taxes

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[286] Blouin et al., *supra note* 246. For a discussion on the advantages offered by the Blouin et al. classification see Stephanie A. Sikes, *Capital Gains Lock-in and Share Repurchases* (Aug. 2017), https://faculty.wharton.upenn.edu/wp-content/uploads/2017/07/Sikes_20170816.pdf. Sikes explains that this classification is not based solely on the legal type of the institutions, and that it also takes into account the composition of shareholders as well as the institutional investors' trading variables and portfolio characteristics.
[287] *See, e.g.,* Sikes, *supra* note 286; Michelle Hanlon, Rodrigo S. Verdi & Benjamin Yost, *CEO Tax Effects on Acquisition Structure and Value*, ACCT. REV. (Forthcoming).
[288] *Id.,* at 75-76. Compare Stephanie A. Sikes, The Turn-Of-The-Effect and Tax-Loss-Selling by Institutional Investors, 57 J. ACCT. & ECON. 22 (2014).
[289] Blouin et al., *supra* note 246, at 54. Frequent trading is often viewed as a primary cause for mutual funds' tax-inefficiency (see, e.g., Arnott et al., *supra* note 284, at 87). *See also* SEC After-tax Disclosure Rule, *supra* note 280; House Commerce Chairman Tom Bliley's Statement on Mutual Fund Tax Awareness Act of 1999, 2000 TNT 52-14 (June 3, 2016).
[290] Blouin et al., *supra* note 246.
[291] *Id.,* p.57 Tbl.1.

weakened.[292] Consistent with this observation, the study found that the largest asset management institutions in the country, including the Big Three, which together manage equity worth approximately $16 trillion,[293] are tax-insensitive investors.[294]

b) Corporate Stewardship

Tax-generating events in a portfolio are not limited to a fund's trading and investment activities. Other actions undertaken by portfolio companies can also directly affect the tax liability of fund shareholders. Dividend distributions, asset spin-offs, and stock repurchases are three examples of such activities.

There are reasons to expect that ownership of tax-insensitive institutional investors may result in a higher propensity of corporations to engage in events that impose tax liability on their shareholders. The underlying notion is that corporate managers know who their shareholders are and what they care about, including their tax preferences.[295] Thus, corporate managers are likely to classify their institutional shareholder base as tax-insensitive and act accordingly. Moreover, tax-insensitive institutional investors may also communicate more actively with corporate managers, perhaps through private engagement, enticing them to take on such tax-triggering

[292] *Id.*, at 54, 58.

[293] Introduction to BlackRock, BLACKROCK, https://www.blackrock.com/sg/en/introduction-to-blackrock (last visited Feb. 1, 2021); Fast Facts About Vanguard, VANGUARD, https://about.vanguard.com/who-we-are/fast-facts/ (last visited March 1, 2022); Who We Are, STATE ST. GLOBAL ADVISORS, https://www.ssga.com/na/us/institutional-investor/en/home.html (last visited March 1, 2022).

[294] Bushee's table, *supra* note 246. The authors look at each investment advisor as one entity based on 13F filing and do not distinguish between the different funds within the fund-family. Blouin et al. were also able to survey specific funds based on data obtained from Pensions and Investments. They looked at a sample of 568 mutual funds and were able to identify 88% of the funds as associated with tax-insensitivity. However, note that the data they used in this sample mainly included funds that have a relatively large proportion of Defined Contribution (DC) plans, which might suggest that a broader sample would have resulted in a higher percentage of tax-sensitive mutual funds. Blouin et al., *supra* note 246, Appendix C, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2817914.

[295] *Compare* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1307 (2016) (arguing that "[m]anagers know who their shareholders are and what best serves the shareholders' interests.").

actions.[296]

Several empirical studies validate the prediction that ownership of institutional investors is associated with corporate actions that may trigger shareholders' tax liability. For example, the ownership of institutional investors is positively associated with the chances that a portfolio firm will buy back its shares.[297] The idea is that such tax-insensitive institutional shareholders do not suffer from the "lock-in" effect and would be more inclined to sell their shares for a profit, thereby increasing the supply of shares in the market.[298] Under such circumstances, portfolio companies are more motivated to repurchase their shares. Another recent study has found that firms with low levels of tax-sensitive investors, such as individual investors, are less likely to form a master limited partnership (MLP)—a tax-advantageous entity for tax-sensitive shareholders, but tax-disadvantageous for tax-insensitive shareholders.[299]

c) Corporate M&A Deals

Evidence of mutual funds' tax-insensitivity also emerges in the context of M&A deals. Federal tax law enables parties to an M&A transaction to avoid the realization of capital gains taxes if they meet certain conditions.[300] This prospect makes a tax-free structure appealing for

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[296] Mutual funds' tax-insensitivity is likely to affect engagement with management in another way. A recent study validated the theory that funds belonging to a fund-family that contains a high proportion of DC plans (i.e., a high proportion of tax-insensitive shareholders) may be reluctant to oppose management even if the fund has little DC-plan business. The authors view opposing management as a tax-sensitive behavior because tax-insensitive shareholders would prefer to exit rather than to "stay and fight." In contrast, tax-sensitive shareholders would rather hold the stock and oppose management to avoid capital gains tax. Thus, for mutual funds with tax-sensitive clientele, an increase in the accrued capital gain should increase the probability of "staying and fighting" and decrease the probability of either selling the stock or continuing to hold the stock and support management. *See* Stephen G. Dimmock et al., *Capital Gains Lock-in and Governance Choice* (Nat'l Bureau Econ. Res. Working paper No. 20176, 2014), https://www.nber.org/papers/w20176.

[297] Sikes, *supra* note 286. This study used the classification of Blouin et al. to show that the ownership of tax-insensitive institutional investors increases the chances of share buybacks.

[298] *Id.*

[299] Steven Utke, *The Effect of Shareholder-Level Taxes on Organizational Form and Stock Ownership: Evidence from Equity Carve-Outs of Master Limited Partnerships*, 94 ACCT. REV. 327 (2019).

[300] 26 U.S. Code § 368. For a general overview of the different types of acquisitive tax-free reorganizations see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th ed. 2006).

taxable shareholders in the target since it allows them to postpone the realization of capital gains and possibly avoid taxation altogether.[301] Therefore, such arrangements are likely to maximize after-tax accumulations.[302]

Since M&A deals are generally subject to a shareholder vote, the tax preferences of institutional investors with steadily growing equity stakes in many public companies are likely to play a role in dictating the outcomes of such transactions.[303] These influential investors would support an M&A deal only if it fits their tax incentives.

Available data suggest that institutional investors prioritize taxable deals. For example, one study documented that a target company is more likely to engage in a taxable transaction if its institutional ownership level was high.[304] Another study found that, while higher individual capital gains rates increased the likelihood of a tax-free transaction, the correlation was weaker for target firms with high institutional ownership levels.[305] A more recent study also showed that the

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[301] For example, built-in capital gains in a tax-free transaction will not be taxed in circumstances of death (RC § 1014) or charitable deductions, when the stock received as a consideration in the deal was donated (Treas. Reg. § 1.170A-1(c)(1) ("the amount of the contribution is the fair market value of the property at the time of the gift").

[302] Tony Nitti, *Tax Planning For Mergers And Acquisitions,* FORBES (Apr. 21, 2014), https://www.forbes.com/sites/anthonynitti/2014/04/21/tax-geek-tuesday-tax-planning-for-merge rs-and-acquisitions-part-i/ - 386fb9322519 (explaining that the seller's initial marching orders to its advisors will always be to find a way to structure the transaction as close to tax-free as possible). Certain non-tax considerations might affect the attractiveness of a tax-free deal. Specifically, if target shareholders want to live off their windfall and seek liquidity, they might prefer a taxable cash-for-stock deal. Moreover, cash deals close quicker and more easily than stock deals. *See* David M. Schizer, *Tax and Corporate Governance: The Influence of Tax on Managerial Agency Costs*, Col. L. Sch. Pub. L. & Leg. Theory Working Paper No. 14-415, 28 & n.125 (Sep. 19, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2501660.

[303] Note that a shareholder vote is not always necessary in M&A deals (a prominent example is the case of a tender offer).

[304] Merle Erickson, *The Effects of Taxes on the Structure of Corporate Acquisitions*, 36 J. ACCT. RES. 279, 288 (1998). Note that institutional ownership in this chapter encompasses several legal types of institutions and not only investment funds.

[305] Benjamin C. Ayers, Craig E. Lefanowicz & John R. Robinson, *The Effect of Shareholder-Level Capital Gains Taxes on Acquisition Structure*, 79 ACCT. REV. 859 (2004) (finding that there is a positive correlation between individuals' capital gains tax and the use of a tax-free deal and that such correlation is weaker as the levels of institutional ownership increase). The authors compute tax-sensitive ownership as one minus the percent of shares held by institutional investors—thereby effectively treating all institutions as tax-insensitive. *See also* Benjamin C. Ayers, Craig Lefanowicz & John R. Robinson, *Capital Gains Taxes and Acquisition Activity: Evidence of the Lock-in Effect*, 24 CONT. ACCT. RES. 315, 335 (2007) (finding that in high institutional ownership firms, as opposed to firms with low levels of institutional ownership, there is no significant association between a capital gains tax rate for individual investors and acquisition activity).

presence of institutional investors discouraged managers from choosing a tax-free deal structure.[306] These studies all suggest that institutional investors are not responsive to the imposition of capital gains on their tax-sensitive shareholders.

Institutional investors' failure to consider the interests of their tax-sensitive shareholders is not limited to their tax structuring preferences. Not only do these institutions prioritize taxable deals, but there is empirical evidence that they are willing to accept lower premiums in these deals than those that would have been demanded by tax-sensitive shareholders, if given a choice. [307]

Taxable deals are generally associated with higher premiums that are meant to compensate, at least partially, target shareholders for capital gains that might otherwise have been deferred.[308] This effect has been documented for acquisition premiums in deals involving publicly held targets

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[306] Hanlon et al., *supra* note 287. These findings refer to institutional investors who were classified by Blouin et al. as tax-insensitive institutional investors. This study concentrated on the effect of CEOs' tax attributes on deal structure and premiums and showed that a significant positive correlation exists between CEO tax attributes and the chances of structuring a deal as a tax-free transaction. This correlation, however, is mitigated as the levels of institutional ownership in the target increase ("coefficient on Fed CG Rate is insignificant, consistent with taxes being less crucial for an average firm with considerable institutional investors" (p.18 n.29)). The authors also found that when the CEOs' tax exposure in a taxable deal is relatively small, the effect of capital gains tax rate on acquisition structure is not significant, suggesting that in the absence of considerable institutional ownership, the marginal shareholder is the CEO. Hanlon et al., as opposed to Ayers et al., did not include all institutional investors but rather computed the percentage of the target firm owned by tax-insensitive institutions based on the classification of Blouin et al., *supra* note 246. This classification includes investment advisors who, on average, own 95% of the total yearly equity held by all investment companies. For further discussion on the study of Hanlon et al., see also *infra* notes 428-429.

[307] Ayers et al., *supra* note 309, at 2798; Hanlon et al., *supra* note 287, at 18 (note that according to Hanlon et al., the mitigating effect of institutional ownership on deal premiums is concentrated in firms where CEO ownership or capital gains taxes are relatively high).

[308] *See, e.g.,* Yen-Sheng Huang & Ralph A. Walkling, *Acquisition Announcements and Abnormal Returns*, 19 J. FIN. STUD. 329, 348 (1987) (arguing that "shareholders demand higher premiums in situations that will force them to pay immediate taxes on their gains"); David T. Brown & Michael D. Ryngaert, *The Mode of Acquisition in Takeovers: Taxes and Asymmetric Information*, 46 J. FIN. 653, 657 (1991) (explaining that bidders prefer to use stock consideration rather than cash to avoid the necessity of compensating target shareholders for their taxes). *See also* Lars P. Feld et al., *Taxing Away M&A: The Effect of Corporate Capital Gains Taxes on Acquisition Activity*, CESifo Working Paper Series No. 5738. (Jan. 26, 2016), https://ssrn.com/abstract=2744534 (postulating that target shareholders demand a higher price in taxable deals as they increase tax liability and that as a consequence, such deals become less attractive from the acquirer's perspective): Timothy R. Burch et al., *Taking Stock or Cashing In? Shareholder Style Preferences, Premiums and The Method of Payment*, 19 J. EMP. FIN. 558 (2012) (showing that bid premiums in a stock-for-stock deal are negatively related to target shareholders' tax liabilities).

with dispersed ownership.[309] Sometimes deal premiums can be twice as high as premiums in an equivalent tax-free transaction.[310] Nonetheless, a cross-sectional analysis of the price paid in taxable deals shows that institutional ownership of the target restrains the positive effect of a taxable deal structure in terms of deal premiums.[311] This finding suggests that when the target's median shareholder is an institutional investor, the reservation price—which is the seller's lowest acceptable bid price—is lower than if the median shareholder is not an institutional investor.[312] In other words, these financial intermediaries appear to put a low-price tag on the tax deferment available through a tax-free transaction.[313] By demanding lower compensation in taxable deals, institutional investors act as if they are tax-insensitive shareholders of the target, even though many of their beneficiaries are not.

Given the foregoing empirical data, it is hardly surprising that one study showed that fund managers manage portfolios in a way that creates a higher tax liability than do individuals who

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[309] *See, e.g.,* Benjamin C. Ayers, Craig Lefanowicz & John R. Robinson, *Shareholder Taxes in Acquisition Premiums: The Effect of Capital Gains Taxation*, 58 J. FIN. 2786 (2003); Zhonglan Dai, Edward Maydew, Douglas A. Shackelford & Harold H. Zhang., *Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?,* (Nat'l Bureau Econ. Res. Working Paper 12342, 2006), https://www.nber.org/papers/w12342.
[310] *See* Robert Bruner, *Where M&A Pays and Where It Strays: A Survey of The Research,* 16 J. APP. CORP. FIN. 63, 73 (2004). The author attributes this effect to the notion that target shareholders demand higher compensation as their taxes are due immediately, as well as to the fact that in taxable deals, the buyer is sometimes allowed to take a "step-up" tax basis in the acquired assets, therefore affording a larger depreciation tax shield.
[311] *See supra* note 307.
[312] Benjamin C. Ayers, Craig Lefanowicz & John R. Robinson, *Capital Gains Taxes and Acquisition Activity: Evidence of the Lock-in Effect*, 24 CONT. ACCT. RES. 315, 316 (2007). For a discussion on seller's reservation price see Martin Fedelstein & Shlomo Yitzhaki, *The Effect of Capital Gains Tax on The Selling and Switching of Common Stock*, 9 J. PUB. ECON. 17 (1978). The reservation price of different tax-sensitive shareholders in the same fund would generally be the same because such gains are based on the time in which the fund purchased the target stock and not the time in which the individual investors purchased units in the fund. If, however, the target stock was purchased less than a year prior to the transaction, then different tax-sensitive shareholders would have different reservation prices as the capital gains tax rate will be dependent on the marginal tax rate of each investor (as opposed to a flat tax rate of 20% in case of long-term capital gains). *See supra* note 273.
[313] *Compare* Thomas D. Fields & Thomas Z. Lys, *Optimal Structure Of The Consideration In Mergers And Acquisitions* (Aug. 21, 2000), https://ssrn.com/abstract=239723 (explaining how the tax-insensitivity of institutional investors and the low value they assign to the option to defer taxes, affect bidding strategies).

manage their own portfolios.[314] This finding goes hand in hand with the observation that, as the proportion of household equity invested in mutual funds has increased over the years, capital gains realizations have concurrently increased.[315] Consistent with these findings, in informal conversations, fund managers themselves admit that tax considerations have minimal impact on portfolio management.[316]

2.1.2 Mutual Funds' Tax-Insensitivity: A Balancing Approach?

Mutual funds serve shareholders with heterogenous tax profiles: investors who own mutual funds through taxable accounts and are subject to taxes on income distributed and investors who own mutual funds through tax-qualified accounts and are not required to pay taxes on distributions.[317] Accordingly, tax-sensitive shareholders seek to maximize risk-adjusted after-tax returns, while tax-insensitive fund shareholders seek to maximize risk-adjusted pre-tax returns. Chief among these tax-insensitive investors are individuals invested in mutual funds through retirement accumulation vehicles, such as 401(k) plans and Individual Retirement Accounts (IRAs).[318]

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[314] *See, e.g.,* Matthew Eichner & Todd Sinai, *Capital Gains Tax Realizations and Tax Rates: New Evidence from Time Series*, 53 NAT'L TAX J. 663 (2000); Arnott et al., *supra* note 284 (arguing that many funds do not take full advantage of opportunities to minimize capital gains for their investors).
[315] Eichner and Sinai, *supra* note 314.
[316] *See, e.g.,* Li Jin, *Capital Gain Tax Overhang and Price Pressure* 8 (June 2, 2004), https://ssrn.com/abstract=531244.
[317] Note that in certain accounts, fund managers do not necessarily have the ability to know whether they are held by tax-sensitive or tax-insensitive shareholders. For example, if an investor opens an IRA account at a brokerage house that is invested by the brokerage in a mutual fund, the fund will only see an investment from the brokerage house and, therefore, it is unable to know neither the identity nor the tax profile of the end-user. *See* Colon*, supra* note 274, n.248. Also, ETF shares are often exchanged through a brokerage service and not directly through the firm, as is the case with its conventional index fund shares. *See* Anna Agapove, *Are Vanguard's ETFs Cannibalizing the Firm's Index Funds?,* 1 J. INDEX INVESTING 73 (2010).
[318] A distinction should be drawn between tax-exempt accounts (such as Roth IRAs and Roth 401(k)s) and tax-deferred accounts (such as IRAs and 401(k)s). Investors who own tax-deferred accounts must pay taxes on their realized gains if and when the assets are withdrawn from their retirement plans. At that point, all distributions, stemming from either dividend distributions or capital appreciation, are taxed as if they were ordinary income. However, because taxpayers invest after-tax dollars in Roth accounts, the result is that in either case, the return on investment is de facto tax-free. *See* I.R.C. § 408(e); § 501(a). As of year-end 2018, 5% of all mutual fund assets were held in tax-exempt funds, and 53% were invested in tax-deferred accounts held by households. *See* 2019 Fact

In the past, it was generally accepted in tax research that pre-tax returns are not compromised by tax-efficiency.[319] However, recent empirical evidence shows that tax-sensitive portfolio management constrains investment activity.[320] In particular, it can interfere with fund managers' ability to employ trading strategies that improve pre-tax returns, such as increasing diversification or taking advantage of valuation differentials. Such a stance, therefore, results in inferior portfolio performance measured by pre-tax returns. [321] According to a new study, tax-sensitive portfolio management results in a -0.35% lower pre-tax returns than tax-insensitive portfolio management.[322]

The trade-off between pre-tax and after-tax performance exists when the preferred strategy varies with the tax status. Take, for example, the realization of gains in a mutual fund portfolio. For tax-sensitive shareholders, exiting a position in a stock with accrued capital gain entails tax costs. Therefore, these shareholders would want fund managers to defer the realization of capital gains (by delaying selling appreciated stocks) and accelerate the realization of capital losses (by selling depreciated stocks).[323] Moreover, because mutual funds can pass-through net capital gains but not capital losses,[324] tax-sensitive investors would want fund managers to realize capital gains only if such gains could be offset by capital losses.[325] But taking all of these considerations into account would constrain fund managers' ability to maximize pre-tax returns.

The trade-off between pre-tax and after-tax returns introduces a conflict of interest between

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Book, *supra* note 242. For the purpose of this chapter, owners of both types of plans are considered "tax-insensitive shareholders."

[319] *See supra* note 256.

[320] *See* Blouin et al., *supra* note 246; *see also* Arnott et al., *supra* note 284, at 84 (claiming that the strongest predictor of the tax burden that a fund inflicts on its investors is fund performance).

[321] *Id.*

[322] *See* Blouin et al., *supra* note 246, at 69.

[323] Sialm & Starks, *supra* note 256, at 1402.

[324] I.R.C. §§ 851–860G (2012).

[325] Michael J. Barclay, Neil D. Pearson & Michael S. Welsbach, *Open-end Mutual Funds and Capital-gains Taxes*, 49 J. FIN. ECON. 3 (1998).

tax-sensitive and tax-insensitive shareholders. A Pareto superior move—one which improves the welfare of one group of shareholders without worsening the condition of the other—cannot be achieved when the optimal strategy depends on the tax profile of the shareholder.[326]

Considering this trade-off, a mutual fund's tax-insensitivity might simply reflect the outcome of a balancing process undertaken by its manager. While the empirical findings on portfolio management tax-insensitivity draw a binary distinction between tax-sensitive and tax-insensitive institutional investors, it may be that, in reality, such a distinction is not binary after all. In other words, institutional investors classified as tax-insensitive institutions might have a certain degree of sensitivity to taxes that the studies were unable to capture, and vice versa. Given the challenges faced by tax researchers and the difficulties associated with observing actual tax-related trading activity,[327] it could be that the empirical data fail to identify the full spectrum of mutual funds' tax practices. However, a closer examination of the balancing approach argument undermines its validity.

First, the mere fact that the outcome of such an approach, to the extent it is adopted, disproportionally favors the interests of tax-insensitive shareholders should raise red flags. A true balancing approach would require institutions to provide a rational explanation for their decision to systematically target pre-tax returns while imposing substantial externalities on their tax-sensitive shareholders.

One possible explanation is that the relative holdings of tax-sensitive and tax-insensitive shareholders justify tax-insensitive behavior. After all, assets held in non-taxable accounts have

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[326] For an excellent discussion of Pareto improvement see Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 513 (1980). The Pareto standard was recently analyzed in the context of corporate tax planning. *See* Omri Y., Marian, *Is All Corporate Tax Planning Good for Shareholders?*, 52 U.C.D L. REV. 905, 934 (2018).
[327] *See* Blouin et al., *supra* note 246, at 70.

recently begun to outweigh those held in taxable accounts.[328] But this justification fails if one considers the fact that mutual funds had neglected tax considerations even when tax-sensitive shareholders constituted the majority.[329]

Moreover, any such justification ignores the general principle that fund managers should maximize the aggregate wealth of all fund shareholders. Thus, even managers of funds that are predominantly held by tax-insensitive shareholders must refrain, at least under certain circumstances, from automatically targeting pre-tax returns. Instead, they should consider the tax costs associated with a contemplated strategy and compare it to the benefits that accrue to tax-insensitive shareholders, an action they do not seem to be willing to take.

Second, there are myriad ways for mutual funds to mitigate the conflict of interest—none of which appear to have been implemented or even considered by institutional investors. Legal scholars have suggested, for example, separating mutual funds based on the beneficiaries' tax profile, which would allow fund managers to better serve their beneficiaries without sacrificing the tax interests of one group of shareholders.[330] That type of structural separation has been widely adopted by other financial intermediaries. Hedge fund advisors, for example, often create an offshore fund for their tax-exempt shareholders.[331] The offshore fund is essentially the "sister" fund of an onshore hedge fund under the same advisor, which serves taxable U.S. shareholders. This separation allows hedge fund advisors to maximize their investors' net accumulation based on their tax status.

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[328] *See supra* note 249.
[329] *See supra* note 277 and accompanying text.
[330] *See, e.g.,* Colon, *supra* note 274.
[331] U.S. Securities and Exchange Commission, SEC Staff Report to the United States Securities Commission, Implications of the Growth of Hedge Funds 9 (Sep. 29, 2003), https://www.sec.gov/files/implications-growth-hedge-funds-09292003.pdf (last visited March 1, 2022).

Not only have mutual funds refrained from separating funds, but they have also failed to disclose their tax-management approach. In fact, while institutional investors often disclose their approach on a variety of matters, such as corporate governance policies and stewardship activities, they are almost uniformly vague about their tax strategies. This lapse could be read as an effort to avoid the subject, especially if these sophisticated market players somehow benefit from pushing this topic away from investors' oversight. From a public policy perspective, the absence of such tax disclosure is a problem. Tax-sensitive shareholders deserve to know that fund managers do not care about tax minimization.

2.2 Mutual Funds' Tax-insensitivity As an Agency Costs Problem

The observed tax behavior of mutual funds paints a grim picture for tax-sensitive shareholders in mutual funds. These financial intermediaries consistently fail to adequately represent the interests of these shareholders, even though a significant portion of the assets in the asset management industry are held in taxable accounts. In this Part, I argue that, as in every agency relationship, any action by an agent that fails to advance the principal's interests, particularly if such failure benefits the agent, may be indicative of an agency costs problem.

By developing an agency costs theory of mutual funds' tax behavior, this Part sheds light on the possible motives behind mutual funds' tax behavior. Section 2.2.1 shows that the way that investment funds are compensated, as well as other characteristics and tax features of funds, create an inherent conflict of interest between tax-sensitive shareholders and mutual funds. Due to those characteristics, mutual fund managers and sponsors benefit from their tax-inefficient behavior even if—and perhaps especially if—such conduct is detrimental to their tax-sensitive shareholders. Section 2.2.2 argues that agency tax costs are exacerbated due to an information asymmetry problem, which impairs the ability of tax-sensitive shareholders to monitor and discipline mutual

funds' tax behavior. Section 2.2.3 reveals another factor that exacerbates the agency tax problem: "family loyalty." It explains how the voting pattern of large institutional investors may cause all funds within the fund-family to vote against the tax interests of tax-sensitive beneficiaries. Section 2.2.4 argues that the tax behavior of mutual funds may constitute a breach of institutional investors' fiduciary duties.

2.2.1 The Conflict of Interest

Given the structure of intermediated investment vehicles, shareholders in such vehicles have a limited ability to influence the actions of fund managers. From an agency perspective, this separation between control, which rests with the managers,[332] and the right to cash-flow, which rests almost exclusively with fund shareholders,[333] is particularly problematic.[334] In the tax context, it allows the fiduciaries to employ tax behaviors that would benefit their interests, even if such conduct is counter to the beneficiaries' interests.

This unfortunate result is partly the result of the fact that mutual funds are pass-through investments.[335] Drawing a distinction between the tax rules that apply to mutual funds and those that apply to corporations can help clarify the point. Unlike investment funds, corporations are subject to corporate-level taxes, which can substantially impact a company's net earnings, cash flow, and ultimately, its market value. Thus, corporate managers worry about minimizing corporate taxes. Investment funds, on the other hand, are not subject to any fund-level taxes. As far as taxes are concerned, these financial intermediaries have no skin in the game. Hence,

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[332] *See* Matteo Tonello, *The Separation of Ownership from Ownership,* HARV. L. SCH. FOR. ON CORP. GOVERNANCE (Nov. 25, 2003), https://corpgov.law.harvard.edu/2013/11/25/the-separation-of-ownership-from-ownership/.
[333] *See supra* note 270.
[334] *Compare* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). In their seminal work, Jensen and Meckling introduce the problem of agency costs in a corporation attributed to the separation of ownership and control.
[335] Engler, *supra* note 283, at 229-230.

financial intermediaries have no incentive to factor taxes into their decision making.[336] In fact, as this section shows, their incentive actually runs counter to the interests of tax-sensitive shareholders.

a) Tax-Sensitive Behavior Reduces Mutual Funds' Revenues

It is axiomatic that large asset managers are interested in maximizing their revenue from investment advisory services. This revenue primarily comes from management fees, which are calculated based on a percentage of the value of AUM.[337] Thus, fund managers' primary goal is to increase the AUM through either *portfolio growth* or *net inflows*. Unfortunately for tax-sensitive shareholders, because investment funds are not taxed on income generated by the fund as a distinct entity, this means that fund managers' focus is on improving pre-tax returns.[338]

Since portfolio growth and, therefore, AUM are dependent on higher pre-tax performance, fund managers are likely to make such growth a priority even at the expense of tax-sensitive shareholders. As explained, achieving higher pre-tax returns would often require a fund manager to sacrifice the after-tax returns of the portfolio.[339] When a strategy that maximizes pre-tax returns is different from one that maximizes after-tax returns, the goal of mutual funds to maximize AUM, and thus their own revenue, inevitably clashes with the goal of tax-sensitive shareholders to minimize taxes.

An increase in AUM through net inflows is also likely to be positively correlated with greater pre-tax returns. Pre-tax performance, rather than after-tax performance, is what sells in the

[336] *Id. See also* Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1 (1993) (explaining that an entity tax is optimal from an agency perspective because it reduces the agency costs associated with the taxation of business income).
[337] *See supra* note 254.
[338] *See supra* note 255.
[339] *See supra* notes 257, 320 and accompanying text.

marketplace.[340] Indeed, most discussions about mutual fund performance focus on fund performance measured by pre-tax returns. Pre-tax returns are also reported in advertising materials and are commonly used by investors to compare funds and make investment decisions.[341] Accordingly, the majority of reporting models available today provide only pre-tax performance.[342] Ample literature and academic research on the relationship between pre-tax fund performance and subsequent net inflows suggest that high pre-tax returns attract investors and improve inflows.[343]

It is easy to see why such marketing and disclosure would attract tax-insensitive shareholders. Since such shareholders do not pay taxes on income distributed by the fund, they care only about pre-tax performance.[344] But somewhat surprisingly, it is not only tax-insensitive shareholders who are attracted to funds that target pre-tax returns. The data indicate that tax-sensitive shareholders are also drawn to such funds. There are at least two explanations for this phenomenon.

One reason involves the complexity of mutual funds' disclosures on their after-tax performance. Although disclosures on a fund's after-tax returns are now available for most funds,

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[340] *See, e.g.,* Richard A. Ippolito, *Consumer Reaction to Measure of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J. L. & ECON. 45, 47 (1992) (arguing that investors in mutual funds can easily compare the pre-tax performance of mutual funds); Vincent. A. Warther, *Aggregate Mutual Fund Flow and Security Returns*, 39 J. FIN. ECON. 209, 233 (1995) (surveying studies showing that investors compare the pre-tax performance of mutual funds before making investment decisions).
[341] Feng Chen, Arthur Kraft & Ira Weiss, *Tax Planning by Mutual Funds: Evidence from Changes in the Capital Gains Tax Rate*, 64 NAT'L TAX J. 105, 106 n.5 (2011). The financial press and investment advice platforms also regularly rank funds on pre-tax measures.
[342] *See, e.g.,* Nathan Sosner, Rodney N. Sullivan & Liliana Urrutia, *Multi-Period After-Tax Reporting: A Practical Solution*, 21 J. WEALTH MGMT. 11 (2018).
[343] *See supra* note 340. *But see* Danielle Bergstresser & James Poterba, *Do after-tax returns affect mutual fund inflows?*, 63 J. FIN. ECON. 381 (2002) (demonstrating that failure to consider the tax liability of the beneficiaries might be harmful to the fund because tax-efficiency also impacts net inflows into funds). However, the authors acknowledge that their finding on the positive correlation between after-tax performance and net inflows can be attributed to other factors such as the growth in passive funds.
[344] *See* David Schizer, *Friction as a Constraint on Tax Planning*, 101 COL. L. REV. 1312, 1343 (2001).

they are less common and relatively difficult to interpret.[345] Lacking resources or sophistication, the typical tax-sensitive investor may not understand the after-tax analysis.[346] In addition, even though mutual funds are generally required to disclose their after-tax returns, such disclosure is given only retrospectively, at the end of the year in a prospectus.[347] Pre-tax returns, on the other hand, are updated regularly and reported in the financial press and advertisements.[348] Thus, while some tax-sensitive shareholders might look beyond a fund's pre-tax performance, for most, pre-tax performance is more salient and understandable than after-tax performance.

The second reason tax-sensitive shareholders are drawn to funds that appear to be tax-insensitive may have to do with the so-called tax overhang. Tax-savvy investors who pay attention to after-tax performance (and are typically more sophisticated investors) are also likely to care about a fund's tax overhang: built-in gains in a mutual fund's portfolio. Because of this overhang, an investor who purchases mutual fund shares might be taxed on future capital gains distributions, even if the appreciation occurred before the investor's purchase date.[349] This is because tax law requires that capital gains realized by a fund be distributed to the investors in the fund in proportion to the number of units held by each investor on the distribution date, irrespective of who owned the units when the gain accrued.[350] Consequently, taxable income sometimes passes through to shareholders who had no economic gain, or even a loss, on their mutual fund investment.[351] Given this tax arrangement, the present value of a new investor's tax liability is higher when the fund's

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[345] *See, e.g.,* Engler, *supra* note 283, at 241; Stan Luxenberg, *Mutual Funds: New Rules Don't Make Choices Less Taxing*, WEALTH MGMT. (Apr. 1, 2002).
[346] *See, e.g.,* Engler, *supra note* 283, at 232.
[347] *See, e.g.*, Sosner et al., *supra* note 342, at 21. *Compare* Marian, *supra* note 326, at 969 (arguing that one of the problems associated with corporate-level transactions that have a taxable effect on shareholder-level taxes is that investors learn about such transactions only after the fact).
[348] Sosner et al., *supra* note 342.
[349] Chen, *supra* note 341, at 7.
[350] *Id.*
[351] Yale, *supra* note 267, at 399.

overhang is substantial. Prospective tax-sensitive investors are therefore discouraged from investing in funds with heavy overhang.[352]

Indeed, the research shows that a larger tax overhang is associated with smaller fund inflows from tax-sensitive shareholders.[353] Financial advisors and the institutional investors themselves often inform their clients about impending distributions and advise them to delay investments until after taxable distributions take place.[354]

Because capital gains tax overhang reduces inflows from tax-sensitive shareholders, fund managers are motivated to trigger built-in gains to lower the overhang.[355] In fact, several empirical studies suggest that fund managers often make portfolio management decisions with the purpose of curtailing the tax overhang.[356] While such actions increase the tax exposure of current tax-sensitive shareholders, they help attract new tax-sensitive shareholders.[357]

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[352] *Id.*

[353] *See, e.g.,* Bergstresser & Poterba, *supra* note 343, at 405 (finding that a 10% increase in a fund's tax overhang decreases net inflow on between 107% and 2.3%); Barclay et al., *supra* note 325, at 33 (showing that prospective investors prefer funds with low tax overhang); Woodrow T. Johnson & James M. Poterba, *Taxes and Mutual Fund Inflows around Distribution Dates*, 70 RES. IN ECON. 7 (2019) (documenting that net inflows to mutual funds' taxable accounts are significantly lower in weeks preceding distribution dates than in the weeks following them).

[354] Johnson & Poterba, *supra* note 353 ("financial advisors caution taxable investors against buying mutual fund shares just before distribution dates"); Gjergji Cici, Alexander Kempf & Christoph Shorhage, *Do Financial Advisors Provide Tangible Benefits for Investors? Evidence from Tax-Motivated Mutual Fund Flows,* EFA 2014 LUGANO MEETING PAPERS, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2177401 (explaining the role of financial advisors in advising clients on tax-management and helping them avoid taxable distributions). This advice is often reported in the popular press, especially around year-end distribution season. Somewhat surprisingly, asset management institutions also warn prospective tax-sensitive investors about investing in funds with high tax overhang (see VANGUARD, Learn about Tax-Efficient Investing 18, https://advisors.vanguard.com/iwe/pdf/FAEGTXI.pdf?cbdForceDomain =true.

[355] *See, e.g.,* Colon, *supra* note 274, at 133; Yale, *supra* note 267, at 410.

[356] *See, e.g.,* Barclay et al., *supra* note 325, at 33-34 (finding evidence that managers reduce overhang to attract new investors).

[357] *Id.* Somewhat ironically, once new investors respond to the reduction in tax overhang by investing in a fund with a low overhang, the tax incentives of these shareholders, who are now existing shareholders, might be sacrificed to attract new investors. This paradox results in conflicting preferences of current and prospective mutual fund investors concerning deferred capital gains.

b) Tax-Sensitive Behavior Leads to Competitive Disadvantage

Competition in the asset management industry might also amplify fund managers' incentives to overlook the tax consequences of their behavior. Suppose a fund were to manage its portfolio with tax awareness. In that case, its pre-tax performance is likely to be inferior compared to that of other market participants, risking a competitive disadvantage.[358]

Although higher after-tax performance might be appealing to certain tax-savvy investors, as discussed, most tax-sensitive investors are unequipped to act on information related to a fund's tax behavior.[359] Pre-tax performance is significantly more positively correlated with net inflows from both tax-sensitive and tax-insensitive shareholders. Thus, the net gain to mutual funds from practicing tax-insensitivity would probably outweigh the net losses associated with tax-sensitive shareholder defections (to the extent there are any).

Moreover, in recent years, the cost-benefit analysis of tax-insensitivity in terms of fund inflows has changed for several reasons. First, retirement savers (who by definition are tax-insensitive) have grown in number and size, and the importance that mutual funds attach to them has accordingly risen. Retirement savers are typically long-term shareholders who periodically add to their holdings through items like payroll deductions.[360] Such valuable investors must not be scared away, so improving pre-tax performance becomes even more critical.[361] On balance, then, fund managers would likely be more concerned with the potential loss of tax-insensitive retirement savers over the loss of tax-sensitive shareholders.

Second, the emergence of large institutional investors who seem to pay very little attention

[358] *See supra* notes 257, 320 and accompanying text.
[359] *See supra* note 346 and accompanying text.
[360] *See* Colon, *supra* note 274, at 159.
[361] *Id.* Note that as the proportion of tax-insensitive shareholders in a fund increases, tax-insensitive behavior makes more sense from an agency perspective and is more likely to lead to overall wealth maximization outcomes from the perspective of all fund shareholders.

to taxes inevitably reduces other institutional investors' motivation to minimize taxes. As these dominant market players improve their pre-tax returns—partially by neglecting the interests of tax-sensitive shareholders—they change the pre-tax benchmark for other funds, compelling them to conform to the tax-insensitive approach. Other funds would not want their pre-tax performance to be significantly inferior to that of such market leaders.

Finally, it is not only the incentive to operate with a mindful eye to taxes that is declining with the market presence of large tax-insensitive institutional investors but also the ability to do so. Influential institutional investors with significant equity stakes in their portfolio firms can shape their portfolio companies' behavior through voting, engagement, or threats to exit. When these institutions' tax preferences are reflected in the actions of their companies, they may impact not only the after-tax performance of funds within these institutions but also that of competing funds.[362] Given the power of such institutions, certain tax-generating events that happen at the firm level—such as dividend distribution, share repurchase, or taxable transactions—might be "forced" on other institutions. The implication might then be that the tax-insensitivity of powerful institutional investors results in an across-the-board decline in after-tax portfolio performance.

c) Tax-Sensitive Behavior Increases Mutual Funds' Expenses

Tax-sensitive portfolio management can be a costly process that requires time and resources.[363] For example, the process under which a fund manager considers the tax exposure of tax-sensitive shareholders and attempts to minimize their exposure might be complex and generate coordination costs.[364] Moreover, transaction costs generated by tax-sensitive strategies are likely

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[362] *Compare* Marian, *supra* note 326 (discussing the notion that the tax incentives of certain corporate constituents, such as corporate managers, inflict negative externalities on shareholders with different tax incentives when such incentives affect corporate transactions).
[363] *See, e.g.,* Colon, *supra* note 274, at 125.
[364] *See* Marin Jacob & Roni Michaely, *Taxation and Dividend Policy - The Muting Effect of Agency Issues and Shareholder Conflicts*, 30 REV. F. STUD. 3176, 3180 (2017).

to entail their costs as well.

The incurrence of such expenses would be inconsistent with reducing mutual funds' costs, a goal that has become increasingly salient lately. In recent years, management fees, especially for index funds and ETFs, have declined dramatically.[365] To preserve their fees in such an environment, funds have been engaged in an ongoing struggle to minimize their management expenses. Managing a portfolio with tax-awareness may therefore compromise such efforts to minimize mutual funds' expenses.

Given the costs associated with tax-efficiency, one might argue that investors in a low-cost fund should not expect the fund to factor in taxes. However, it is worth noting that even low-cost funds, such as passive index funds, advertise themselves as suitable for tax-sensitive shareholders.[366] Moreover, tax-insensitivity is found even among high-costs funds.[367] In addition, if such costs were really the issue, large funds could have spread the costs among their many shareholders. Instead, there appears to be a negative correlation between the institution's size and its level of tax-sensitivity.[368]

d) Tax-Sensitive Behavior Reduces Fund Managers' Pay

The compensation of fund managers serves as another constraint on tax-sensitivity.[369] Mutual fund managers are paid based on AUM and pre-tax performance relative to an index that

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[365] *See, e.g.,* FLOWSPRING, *The Game Theory of Fund Price Wars*, *Why Asset Managers Will Soon Pay You to Invest in Their Funds* (Mar. 2019), https://assets.ctfassets.net/t5voto6b6bxs/32RxN0PayX0fSd6H4flifS/9a0defdc96fe2bbf40a8fd54ba526fb5/The_Game_Theory_of_Fund_Price_Wars.pdf.

[366] For example, Vanguard recommends its broad-market stock index funds to taxable shareholders (Vanguard, *Tax-efficient investing*, *supra* note 354, at 13).

[367] *See supra* notes 290-291 and accompanying text.

[368] *See supra* note 262.

[369] *Compare* Schizer, *supra* note 302, at 3 (explaining that a corporate manager whose bonus depends on financial accounting earnings is more likely to take tax-inefficient actions and possibly forego tax planning opportunities). In this scenario, Schizer explains, "agency costs (and accounting rules) are serving as non-tax constraints on tax planning (or "friction")."

is not tax-adjusted.[370] As explained, the desire to increase AUM and improve pre-tax returns could lead fund managers to sacrifice after-tax returns. Thus, their compensation creates a misalignment between the interests of tax-sensitive shareholders and a desire to maximize compensation.

Fund managers are also not required to put a significant portion of their personal wealth into the funds they manage, as opposed, for example, to hedge funds managers.[371] In the absence of any self-investment, they have no exposure to the tax consequences of their behavior. Thus, fund managers gain no pecuniary reward for being tax-savvy, making it even less probable that they would care about tax minimization.

2.2.2 An Information Asymmetry Problem

A fundamental convention in agency theory is that the principal's ability to monitor the agent's behavior mitigates the agency costs problem.[372] To the extent that principals are able to observe the actions of the agent, the agents will have an enhanced incentive to properly fulfill their duties and further the interests of the principals. If an agent fails to do so, the principals could discipline the agent for such misbehavior.

In the context of tax-efficiency, however, tax-sensitive shareholders are limited in their ability to assess the degree to which their fiduciaries integrate tax issues into their portfolio management decisions. As previously noted, tax disclosures regarding after-tax performance are often vague and incomplete.[373] Moreover, most tax-sensitive investors are not well-equipped to understand such disclosures in a way that would allow them to draw accurate inferences about the

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[370] *See, e.g.,* Huddart & Narayanan, *supra* note 273, at 320; Daniel N. Deli, *Mutual Fund Advisory Contracts: An Empirical Investigation*, 57 J. FIN. 109, 115 (2002) (finding that in a sample of 4,833 mutual funds, 93% of them had advisory contracts that were based entirely on a percent of AUM); Edwin J. Elton, Martin T. Gruber & Christopher R. Blake, *Incentive Fees and Mutual Funds,* 58 J. FIN. 779, 780–81 (2003) (explaining that mutual funds rarely use incentives fees).
[371] *See* Mihir A. Desai & Li Jin, *Institutional Tax Clienteles and Payout Policy* 8 (Nat'l Bureau Econ. Res. Working Paper N. 13283, 2007), http://www.nber.org/papers/w13283.
[372] *See, e.g.,* Jensen & Meckling*, supra* note 334.
[373] *See supra* note 345 and accompanying text.

tax awareness (or lack thereof) of particular funds.[374] Thus, information asymmetry likely exacerbates the agency costs risk.[375]

Moreover, even if some fund shareholders can interpret the tax disclosures, the fact that tax-related information is given after the fact makes it very unlikely that investors would be able to act on such information in order to discipline fund managers.[376] The only practical recourse for an unhappy tax-sensitive shareholder is to exit the fund—a decision that can itself have adverse tax consequences. When shareholders sell their units in the fund, the sale price is equal to the per-share net asset value (NAV) of the fund (that is, the market prices of the stocks within the portfolio).[377] Thus, if tax-sensitive shareholders decide to discipline tax-inefficiency by exiting their investment in a fund, they would have to pay taxes on all of the capital gains accumulated in the portfolio. Given the potential for substantial tax liability, these shareholders might be deterred from taking such an action.[378] This lock-in effect makes it unlikely that a mutual fund's tax-inefficiency would lead to a mass exodus of tax-sensitive shareholders. Under such circumstances, the ability of these shareholders to discipline funds for their tax behavior is restricted.

2.2.3 A "Family Loyalty" Problem

In recent years, large conglomerates like the Big Three have created a centralized division that holds direct dialogues with management of portfolio companies and dictates the voting policy of all funds within the fund-family.[379] The existence of this division suggests that the interests of

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[374] *See supra* note 346 and accompanying text.
[375] The understating that information asymmetry can lead to tax-inefficiency was, in fact, the driving force behind the issuance of The Mutual Fund Tax Awareness Act of 1999 (see *supra* note 281).
[376] *See* Engler, *supra* note 283, at 232 n.80-81.
[377] *See* Yale, *supra* note 259, at 407.
[378] *See* Engler, *supra* note 283, at 241-242.
[379] Lipton, *supra* note 264; *see also* Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1170-1172 (2019).

the mutual funds' sponsor will be reflected in the voting pattern of all the constituent funds.[380] Mutual fund sponsors admit that their centralized voting strategy requires the funds to uniformly vote to benefit the fund complex rather than the individual funds.[381]

Under this approach, the tax behavior of a particular fund is not dependent on the fund's idiosyncratic characteristics or the tax profile of its beneficiaries, but rather, on the sponsor's interests. The problem with this approach is that fund managers have a duty to maximize the economic interests of unitholders of their own fund, not those of other funds within the family or those of the asset management institution as a whole.[382]

Different funds within conglomerates are likely to have different tax-related characteristics. For example, some might be "tax-managed" funds or funds advertised to tax-sensitive investors as specifically suitable for them. Moreover, the potential tax exposure associated with a specific strategy is also fund-specific, as it depends on the fund's built-in gains (or losses) in a particular stock. Different funds may also have varying tax considerations due to potential capital gains losses that can be used to offset capital gains. Finally, the proportion of tax-sensitive and tax-insensitive shareholders, as well as the marginal tax rates of tax-sensitive shareholders, also vary among funds.

Despite these fundamental differences, all large investment fund-families, including the Big Three, appear to be tax-insensitive.[383] This may suggest that when it comes to voting, all funds within a tax-insensitive institution will follow the tax-insensitive approach of the advisor, despite

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[380] Griffith & Lund, *supra* note 379, at 1182.
[381] *Id.* at 1173. *See also* Hortense Bioy et al., *Passive Fund Providers Take an Active Approach to Investment Stewardship*, MORNINGSTAR (Dec. 2017), https://www.morningstar.com/lp/ passive-providers-active-approach.
[382] *Compare* Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 IOWA J. CORP. L. 101, 115 (2009).
[383] *See supra* note 294 and accompanying text.

the fundamental tax-related differences among funds.[384] A recent empirical study supports this prediction, showing that funds that are part of large fund-families that have a high proportion of retirement savings accounts tend to vote in a way that reflects insensitivity to taxes even if tax-sensitive shareholders comprise the majority of shareholders in those funds.[385]

This type of lockstep voting in large fund-families presents a particular problem among "tax-managed" funds, which emerged following the introduction of The Mutual Fund Tax Awareness Act of 1999. The management of tax consequences in these funds is allegedly a central part of the investment process.[386] But the ability of "tax-managed" funds to act in a way that minimizes taxes is, by definition, restricted when fund-families coordinate their tax policies and vote in the same way.[387]

2.2.4 Tax-Insensitive Behavior as a Breach of Fiduciary Duties

As fiduciaries, financial intermediaries have a "duty of care" and a "duty of loyalty" to their investors. The duty of care requires the investment advisor to act in the best interests of the client and to "exercise the judgment and care that a prudent person would exercise in the management of his own affairs."[388] To do so, the advisor must collect a range of personal and financial information about the client. The SEC itself has stated that among other requirements,

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[384] *Compare* Griffith & Lund, *supra* note 379, at 1170-1171. The authors observed that the uniformity in voting in 2015 among the large fund-families was extremely high. In State Street, Vanguard, and Blackrock, the percentage of proposals in which certain funds within the conglomerate deviated from the fund sponsor's recommendation was 0.000195%, 0.006%, and 0.018%, respectively.

[385] Dimmock et al., *supra* note 296 (the results of the study show that funds that are expected to be tax-sensitive are more likely to vote with the tax-insensitive—by supporting management rather than "staying and fighting"—if they belong to a fund-family with high DC-plan business).

[386] Arnott et al., *supra* note 284, at 79.

[387] *Compare* Griffith & Lund, *supra* note 379, at 1170-1171 (discussing the conflicting interests of mutual funds and explaining that mutual fund sponsors acknowledge the possibility that there will be variations in view and interests between funds, yet expect that all funds will follow the choice of the fund-family's governance team nonetheless).

[388] Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-35 (2006).

the investment advisor must be mindful of the client's tax status and act accordingly.[389] Thus, in the absence of an explicit disclaimer stating that the fund does not take tax considerations into account, a fund manager's failure to balance the costs and benefits associated with tax-triggering events in a portfolio might well be considered a violation of the duty of care. This would be particularly true for "tax-managed" funds or funds that are specifically recommended for tax-sensitive investors, such as broad-market index funds.[390] In any event, all funds probably have a duty to at least inform themselves about the tax implications of various decisions.[391]

Moreover, as a fiduciary, an investment adviser owes a client undivided loyalty. The duty of loyalty requires the fiduciary "to resolve all conflicts of interest in favor of the beneficiary and to devote its full energies toward enhancing the beneficiary's interest."[392] The interests of the clients must come first; potential conflicts must be identified and mitigated.[393] Thus, to the extent that a conflict of interest between fund managers and their beneficiaries results in behavior unaligned with the beneficiaries' tax interests, fund managers may well be in breach of this fiduciary duty as well.[394]

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[389] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Securities Act Release No. IA-5248 (Dec. 7, 2019) https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf (codified at 17 C.F.R. Part 276).

[390] As will be discussed in *infra* Section 2.4.4, the ability of index funds to take taxes into account is more limited given that they are required to track indexes. Yet, there are still ways in which index funds can minimize tax expenses. Additionally, in all cases, index funds' voting and stewardship activities are capable of minimizing taxes as well.

[391] *Compare* Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 26 (2006) ("Courts normally do not impose liability on a corporate manager simply on the ground that the manager acted without due care. Instead, they impose liability only on the ground that the manager violated a specific obligation that is based on the duty of care, such as the obligation to become properly informed before making a decision.").

[392] Securities and Exchange Commission, General Information on the Regulation of Investment Advisers, (2011), https://www.sec.gov/divisions/investment/iaregulation/memoia. htm.

[393] *See* Fiduciary Interpretation, 84 FR 33669, at 33675-76 ("To meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship…. In addition, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."). Moreover, if a certain action of the fund conflicts with a client's interest, the client's consent is required (*see* Regulation of Investment Advisers, *supra* note 392).

[394] *Compare* Lipton, *supra* note 264, at 184 ("To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.").

Recently, the SEC acknowledged that "family loyalty" could present fiduciary issues since there might be circumstances in which not all funds operating under the same institution will share the same objectives.[395] In such cases, the SEC requires that the investment advisor would consider whether heterogeneous voting is in place (that is, different voting policies for some of the funds within a fund-family).[396] However, mutual funds families continue to cast all their votes the same way, without considering each fund's idiosyncratic tax circumstances and objectives.

2.3 M&A Deals with Agency Frictions

The empirical data indicate that agency tax costs factor prominently in the M&A setting. As previously noted, institutional investors, in their capacity as target shareholders, prioritize taxable deals despite the higher tax burden they impose on their tax-sensitive beneficiaries. Institutional investors also appear to be willing to accept lower premiums in such deals compared to what would have been demanded by tax-sensitive shareholders.

These deal preferences fit the agency costs framework since they benefit the agent (through higher AUM) at the expense of the principal—the tax-sensitive shareholder in the fund. Indeed, taxable deals are more positively correlated with target shareholders' pre-tax returns and are likely to result in higher portfolio growth and net inflows. This is because such transactions are settled primarily with cash and include a higher premium compared to a tax-free deal.[397] Moreover,

[395] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisors, Securities Act Release Nos IA-5325; IC-33605 (Aug. 21, 2019) https://www.sec.gov/rules/ interp/2019/ia-5325.pdf (codified at 17 C.F.R. Parts 271 & 276).
[396] *Id.*, at 13.
[397] *See, e.g.,* Audra L. Boone, Erik Lie & Yixin Liu, *Time Trends and Determinants of the Method of Payment in M&As*, 27 J. CORP. FIN. 296, 299 (2014) (showing that while the average stock price reaction for the target firm is very positive across all payment types, it is much higher for cash consideration (30% for cash deals compared to roughly 20% for the other payment categories)). Huang and Walking, *supra* note 308 (finding that the target shareholders' abnormal returns associated with cash offers are significantly higher than those associated with a stock offer); Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?*, 52 J. FIN. 1765 (1997) (arguing that in the long run, cash deals earn average annual excess returns for target shareholders as opposed to stock-for-stock deals).

taxable transactions reduce a fund's tax overhang, as opposed to tax-free deals, which are not taxable events and usually increase a fund's overhang.[398]

The tax preferences of institutional investors in the M&A sphere is of particular interest for several reasons. First, these preferences undermine the prevailing assumption that, in the context of M&A deals, there is a common interest between fund shareholders (the beneficiaries) and the mutual fund and its managers (the fiduciaries).[399]

Second, unlike portfolio management and trading activities that, at least theoretically, allow fund managers to balance the interests of tax-sensitive and tax-insensitive shareholders, a balancing approach is difficult to implement in an M&A transaction.[400] The Disney-Fox deal illustrates that point. Disney's stock-for-stock offer would probably have made tax-sensitive Fox shareholders happy compared to Comcast's higher cash offer.[401] At the same time, however, Disney's offer would have been less popular with tax-insensitive shareholders. To them, Comcast's all-cash offer was likely superior as it included a higher deal premium and probably would have resulted in higher pre-tax returns.

The third reason institutional investors' M&A deal preferences deserve special scholarly attention is that such transactions are firm-level events that are typically subject to a shareholder

[398] This is because the deal price is typically higher than the pre-deal stock price; there is a premium. Thus, a tax-free deal will increase the unrecognized capital gains tax. To the extent that the deal is taxable but has a boot cash, some part of the tax overhang will be reduced nonetheless as the fund would recognize part of the gain.
[399] *See, e.g.,* Griffith, *supra* note 130 (arguing that all fund beneficiaries and their fiduciaries have a mutual goal when it comes to voting). Moreover, because of the differences in deal preferences between tax-sensitive and tax-insensitive shareholders, the assumption that in the M&A setting there is a common interest among the beneficiaries themselves also does not hold. *See, e.g.,* Paul H. Edelman & Randall S. Thomas, *The Theory and Practice of Corporate Voting at U.S. Public Companies*, Vanderbilt U. L. Sch. L. & Econ. Working Paper N. 15-18, 11, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2650661 (arguing that in corporate contests such as proxy fights and M&A deals, the intermediary can assume a common interest on the part of its investors).
[400] Theoretically, institutional investors can adopt a balancing approach by structuring some of their deals as taxable and others as tax-free, or by structuring the deal as a tax-free deal with boot (that is, cash consideration which is taxable). These alternatives can bring about some degree of balancing.
[401] Unless the deal price offered by Comcast was sufficiently high to compensate for Fox shareholders' capital gains taxes. Regardless, Comcast's offer did not sufficiently compensate the Murdoch family, given their deference to a tax-free deal.

vote. From a policy perspective, this is problematic: the expression of mutual funds' tax preferences through voting suggests that such preferences not only affect investors in mutual funds but other stakeholders in public markets as well. And the magnitude of this problem should not be overlooked. Institutional investors now collectively own the bulk of the equity market and represent key votes in corporate ballots.[402] Therefore, they are capable of skewing the results of contested votes, shareholder proposals, and deal outcomes.

Section 2.3.1 illustrates how mutual funds' tax-insensitivity can distort the outcomes of a shareholder vote, potentially imposing negative externalities on tax-sensitive investors in mutual funds, as well as on other corporate constituencies. Section 2.3.2 explains how the tax preferences of institutional investors can impact the market for corporate control.

2.3.1 Skewed Voting Outcomes

Investors in investment funds delegate rights and responsibilities to financial intermediaries who, in turn, are committed to acting in the best interest of their shareholders.[403] Chief among such delegated duties are corporate voting rights. The delegation of such rights is built on the assumption that the fiduciaries and the beneficiaries share the same interest.[404] If the fiduciary's purpose is somehow opposed to that of the investor, any delegation of voting rights is illogical.[405] However, the assumption regarding a mutual purpose appears to be false in the context of M&A deals.

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[402] For a discussion on the voting power of institutional investors see Griffith & Lund, *supra* note 379, at 1187, 1168; Griffith, *supra* note 399, 1004-1005.
[403] *See* Investment Company Governance, Exchange Act Release No. IC-26520 (July 27, 2004) ("the paramount principle that must prevail, and should animate all decisions directors are called upon to make, is that a fund must be managed on behalf of its investors"). Regardless, both actively managed funds and passive funds are expected to vote on behalf of their shareholders to fulfill their fiduciary to investors (see Investment Company Governance, 69 FR 3472-01, 2004 WL 101604). *See also* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, 68 Fed. Reg. 6564 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274).
[404] Griffith, *supra* note 399, at 989.
[405] *Id.*

The empirical evidence on the deal preferences of institutional investors suggests that the tax purposes of institutional investors do not align with those of tax-sensitive shareholders. As a result, when tax-sensitive beneficiaries cede voting decisions on M&A deals to mutual funds, these funds fail to replicate the voting outcomes that would have occurred under direct ownership. In other words, under circumstances in which votes are cast by institutional investors rather than by the beneficiaries, results may differ from those achieved if the funds' shareholders had voted on an M&A deal based on their individual tax incentives.

This outcome is primarily attributed to the fact that voting—both at the fund and the fund-family level—is done in blocks. A fund casts all of its votes identically. It does not allot some of its shares for the benefit of tax-sensitive shareholders and others for the benefit of tax-insensitive shareholders. Likewise, fund-families tend to cast all their votes the same way, so all funds that operate under the same sponsor typically vote with one voice.[406] Because large fund-families often behave as tax-insensitive investors, deference to the tax interests of fund-families prevents the individual fund from considering the tax interests of its tax-sensitive beneficiaries, even if it would have otherwise done so.[407]

A hypothetical example, in which the ownership structure of the target company mirrors that of many public U.S. companies, can help elucidate this assertion.[408]

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[406] *See supra* notes 379-381 and accompanying text.
[407] *Compare* Dimmock et al., *supra* note 296.
[408] Adriana De La Cruz, Alejandra Medina & Yun Tang, *Owners of the World's Listed Companies*, OECD Capital Market Series (2019), https://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf. In large companies (particularly companies that are included in the S&P 500 stock index), the share ownership of institutional investors is much higher. Smaller firms and firms that are at the bottom of market indices, on the other hand, typically have much lower institutional ownership. However, the distortion in voting outcomes described in this section would occur even if the holding percentage of institutional investors was higher (for example, 70%), as is usually the case with respect to the largest publicly held firms.
In the numerical example, the category of institutional investors does not include pension funds and other public funds that are held solely by tax-insensitive retirement savers. These institutions are included in the "tax-insensitive shareholders" category, alongside other tax-exempt shareholders such as foreign investors. The category of tax-sensitive retail investors includes, among others, strategic individuals and private corporations.

a) Hypothetical Example

Let us assume the following composition of target shareholders:

Table 1: Composition of The Target Shareholders.

Shareholders	Ownership percentage
Institutional investors	50%
Tax-sensitive retail investors	30%
Tax-sensitive insiders	10%
Tax-insensitive investors	10%

Let us also assume that 60% of the assets managed by institutional investors are held in non-taxable accounts (that is, accounts held by tax-insensitive shareholders) and 40% in taxable accounts (that is, accounts held by tax-sensitive shareholders). These proportions appropriately represent the current distributions of assets in the asset management industry.[409] In this situation, the tax status of the beneficial owners of the target company is as follows:

Table 2: The Tax Status of The Target's Beneficial Owners.

	Direct ownership	Indirect ownership	Total Equity stake
Tax-sensitive shareholders	40%	20%	60%
Tax-insensitive shareholders	10%	30%	40%

In an ideal (i.e., frictionless) world, deal outcomes that reflect the 60% majority's sensitivity to taxes would have been obtained. In the M&A setting, that means that if all shareholders could express their deal preferences, a tax-free reorganization would have had a better chance of securing shareholder support. In other words, taxable deals that inadequately compensate target shareholders for their taxes, like the ones institutional investors tend to support, would be less common. But because institutional investors are not necessarily voting in a way that

[409] *See supra* note 249.

mirrors the interests of each group of fund shareholders—tax-sensitive and tax-insensitive shareholders—the outstanding shares of the target held by these institutions (50%) will be voted as if only tax-insensitive shareholders owned them.[410] Under such circumstances, deal outcomes are inconsistent with the preferences of the majority of the beneficial owners of the target (who are tax-sensitive). This observation is critical as it suggests that in intermediated capital markets, voting may no longer function as a reflection of the aggregate preferences of shareholders.[411]

Moreover, this observation illustrates that by investing through financial intermediaries, tax-sensitive shareholders are doing more than merely delegating authority to their fiduciaries. They also enable institutional investors to increase their equity stakes and market power at the expense of certain other shareholders, particularly individual retail investors. In doing so, investors in mutual funds reinforce the influence of these institutions over the firms they own. Consequently, tax-insensitivity becomes further entrenched as a pervasive element in voting outcomes.

b) Rational Apathy

Given the ownership structure in the capital market, more influence is given to the voice of institutional investors at the expense of other shareholders, rendering the deal preferences of institutional investors particularly powerful.[412] The strong impact of institutional investors is attributed, in part, to the fact that retail investors and other shareholders with minor equity stakes

[410] In this example, the underlying assumption is that the distributions of the two groups of shareholders among the different funds are symmetric. However, this may not be the case. The proportions of tax-sensitive and tax-insensitive shareholders can vary from fund to fund. Some funds might be predominantly held by tax-sensitive shareholders, others by tax-insensitive shareholders. *See, e.g.,* Sialm & Starks, *supra* note 256 (showing that the percentage of DC assets in the sample funds varied significantly; the lowest DC ratio quartile was on average 4.6% while the highest quartile was 54%).
[411] *See* Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. R. 11, 16 (2017). *Compare* Edelman & Thomas, *supra* note 399, at 15 (explaining that voting should function as a way to aggregate shareholders' preferences).
[412] Engler, *supra* note 283, at 231.

usually do not invest resources in monitoring their firms or voting in general meetings. In corporate law literature, these shareholders are deemed to be "rationally apathetic."[413]

Considering such circumstances, one might argue that even if tax-sensitive shareholders were to invest directly, rather than through intermediaries, many would not vote their shares anyway. In that scenario, tax-sensitive shareholders' equity stakes would still not make a difference to deal outcomes. Applying that argument to the above hypothetical, even if all tax-sensitive shareholders were direct investors in the target, deal outcomes that maximize the accumulation of tax-sensitive shareholders would still not prevail. This is because if only institutional investors (who are tax-insensitive) and insiders (who are tax-sensitive) vote, more than eighty percent (80%) of the votes actually cast would still reflect the interests of tax-insensitive shareholders.[414] However, that prediction (i.e., that rational apathy will lead to tax-insensitive deal outcomes even with direct ownership of tax-sensitive shareholders) may well be incorrect.

First, while the voting turnout among retail investors is much lower than that of institutional investors, it is still far from zero. According to a 2019 report, on average, 30% of the shares held by retail investors are voted.[415] In fact, in recent years, despite the growing equity holding of institutional investors, retail investors have still been able to pivot voting outcomes.[416]

Second, prior research has shown that although retail investors suffer from rational apathy,

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[413] *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (describing rational apathy problem).

[414] If only institutional investors and insiders vote, then 83.3% ((50:60) x100) of the votes cast would reflect tax-insensitivity, and 16.7% ((10:60) x100) of such costs - tax-sensitivity.

[415] *See* BOARDRIDGE, *2017 Proxy Season Review* 2, https://www.broadridge.com/_assets/ pdf/broadridge-2017-proxy-season-review.pdf.

[416] Fisch, *supra* note 411, at 15. Fisch explains that in many cases, a voting threshold of 20% to 30% can have a critical effect on a company and provides examples of recent cases in which voting outcomes were eventually determined by retail investors, pivoting the votes (such as the DuPont victory in the proxy contest against Nelson Peltz).

corporate managers know who their shareholders are and adjust their behavior accordingly.[417] This assumption was specifically observed in the tax context as the data show that corporate managers consider shareholder-level taxes in their decision-making processes.[418] A broad base of tax-sensitive shareholders, for example, leads to corporate decisions that aim to minimize shareholders' tax liability.[419] Attempts to reduce the tax burden of shareholders are also documented in the context of M&A deals.[420] Corporate managers of target companies have also stated in several instances that it is important for the target to maximize shareholders' value by structuring M&A deals in a tax-efficient manner.[421] When institutional investors such as mutual funds hold significant stakes at a firm, corporate managers often categorize such investors as tax-insensitive and act accordingly. Consequently, managers become less attentive to the goal of shareholders' tax-minimization (inside and outside the M&A deals settings).[422]

Third, managers, who often negotiate the deal and present it to the board, are likely to have significant tax exposure in a deal. This is both because of their relatively substantial equity stakes and because they are typically subject to the highest marginal tax rate.[423] Thus, insiders' tax

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[417] This claim has been voiced in and outside the context of shareholders' tax preferences. *See supra* notes 295, 297-299 and accompanying text.

[418] *See, e.g.,* Michelle Hanlon & Jeffery L. Hoopes, *What Do Firms Do When Dividend Tax Rates Change? An Examination of Alternative Payout Responses,* 114 J. FIN. ECON. 105 (2014) (finding that corporations make decisions related to the distribution of special dividends in response to investor-level taxes, by providing tax benefits to shareholders before dividend taxes increase at the expiration of the Jobs and Growth Tax Relief Reconciliation Act in 2013); William J. Moser, *The Effect of Shareholder Taxes on Corporate Payout Choice,* 42 J. FIN. & QUANTITATIVE ANALYSIS 991 (2007) (showing that firms are more likely to distribute through share buybacks rather than dividend distributions in periods when the dividend tax penalty increases); Utke, *supra* note 299 (finding that firms cater to investors' shareholder-level taxes in making organizational firm decisions).

[419] *See supra* notes 297-299, 304-306 and accompanying text.

[420] *See, e.g.,* Ayers et al., *supra* note 305; *Ayers et al., supra* note 309; Boone et al., *supra* note 296, at 301. These studies provided evidence that cash acquisitions are expedited to close prior to an expected tax rate increase in an attempt to reduce the tax exposure of target shareholders.

[421] *See* Ayers et al., *supra* note 305, at 883-884 for a comprehensive review and examples. *See also infra* notes 428-429 and accompanying text for a discussion of the tax incentives of managers in their capacity as shareholders.

[422] *Compare* Marian, *Corporate Tax Planning, supra* note 326 (arguing that tax-exempt shareholders such as institutional investors may actually cooperate with management in instances of corporate tax planning that impose tax liability on tax-sensitive shareholders).

[423] U.S. executives often have a significant portion of their wealth in their firm's equity (Li Jin & S.P. Kothari, *Effect of Personal Taxes on Managers' Decisions to Sell Their Stock*, 46 J. ACCT. & ECON., 23 (2008)). Moreover, they are

attributes are assumed to have an impact on deal outcomes.[424]

Several recent high-profile cases, such as the acquisition of Fox by the Walt Disney Company and the acquisition of Anheuser-Busch InBev by SABMiller plc, demonstrate this assertion. In each, the tax positions of insiders with substantial equity stakes in the target largely determined the structure of the acquisition and payment method.[425] In the Fox-Disney deal, for example, the Murdoch family's potential tax exposure made the possibility of a cash-for-stock offer extremely unlikely.[426]

These examples are also consistent with a recent empirical study that explored the effect of CEO tax exposure on M&A deal outcomes.[427] That study confirmed that having a CEO with potentially heavy tax liability significantly increased the chance of a tax-free transaction.[428] However, the same study found different results when the target company has high levels of

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typically taxed at the highest ordinary tax rates (Christopher S. Armstrong et al., *The Economics of Managerial Taxes and Corporate Risk-Taking*, 94 ACCT. REV. 1 (2019)).

[424] Hanlon et al., *supra* note 287.

[425] On the Fox-Disney deal, see *supra* notes 238-239. In the InBev-SABMiller deal, the Santo Domingo family, who owned substantial stakes in SABMiller and enjoyed board representation, would not have agreed to accept a cash bid that would have exposed it to a huge tax bill. *See* Michael J. de la Merced, *The Family That May Hold the Key to a Beer Deal*, N.Y. TIMES (Oct. 7, 2015) https://www.nytimes.com/2015/10/08/business/dealbook/the-family-that-may-hold-the-key-to-a-beer-deal. html?_r=0 (explaining that the Santo Domingo family, who had a 14 % stake in SABMiller while one of its members was a board member, was likely to oppose the revised bid made by InBev as it was a cash offer that exposed the Domingos to a huge tax bill).

[426] S*ee supra* notes 238-239.

[427] Hanlon et al., *supra* note 287.

[428] *Id.* Note, however, that this study makes two important observations. The first is that in the absence of CEO tax liability, the deal outcomes are likely to reflect the incentives of tax-insensitive shareholders (higher chances for a taxable deal and lower deal premiums), suggesting that an agency issue exists when the CEO has a low tax liability as she will not try to negotiate a higher premium as compensation for tax-sensitive shareholders. Therefore, under such circumstances, the CEO fails to take outside shareholder-level taxes into account ("potentially [there is] a conflict when CEOs have a low tax liability if they fail to negotiate a higher premium as compensation for shareholder taxes," p. 31, 36). This observation also suggests that institutional investors are even more likely to incur those same costs as they do not fight at all for higher compensation for their tax-sensitive shareholders. The second observation is that another type of agency problem arises when the CEO has a large tax liability. The authors argue that the CEO might then insist on a tax-free deal even if it does not maximize value for target shareholders. This argument is consistent with Schizer, *supra* note 302, p.28 n.127 (explaining that managers may seek to maximize their own tax bill when they negotiate a deal to sell their company and accept a reduced sale price in return for a tax-free structure). Note that Hanlon et al. arrived at their conclusion concerning the existence of an agency problem partially by observing returns for target shareholders. However, they only examined pre-tax, not after-tax returns. By doing so, they overlooked the possibility that the net payout to target shareholders was indeed higher in the tax-free deals promoted by the CEOs.

institutional ownership. Under high levels of institutional ownership, there was a higher probability of a taxable transaction, even if the CEO's tax concerns were significant.[429] The implication is that the alignment mechanisms between tax-sensitive shareholders and managers might cease to function effectively in the presence of institutional investors.

2.3.2 Deal Dynamics in Intermediated Markets

In the past, long-term shareholders with large capital gains taxes were viewed as the price-setting shareholders in M&A deals.[430] Today, it is tax-insensitive institutional investors that largely dictate deal outcomes.[431] Because these powerful investors have a market pricing role above and beyond their percentage interest, their deal preferences are likely to have tangible consequences for deal dynamics and pricing.[432]

As the equity stakes held by institutional investors grow, potential acquirers are better able to know who the target shareholders are and what their deal preferences and valuations are.[433] Acquirers consequently react to these institutions' deal preferences in the bidding and negotiation process. Accordingly, institutional ownership in the target increases the chances that acquirers will offer a taxable transaction to improve their chances of obtaining shareholder support.[434]

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[429] *Id.* These findings mainly focused on firms with institutional blockholdings of more than 5%. In that context, see Bebchuk & Hirst, *supra* note 12 (showing that in 2018, the Big Three had in total 4,601 positions of 5% or more). Hanlon et al. find that in the presence of such institutional shareholders, the chances of a tax-free deal are declining even for targets whose CEOs have a high tax exposure. However, they also show that such circumstances do not deter high-tax CEOs from obtaining higher acquisition premiums in taxable deals. *See* Hanlon et al., *supra* note 287.
[430] *See, e.g.,* Wayne R. Landsman & Douglas A. Shackelford, *The Lock-In Effect of Capital Gains Taxes: Evidence from the RJR Nabisco Leveraged Buyout*, 48 NAT'L TAX J. 245 (1995).
[431] S*ee supra* note 402.
[432] Fields & Lys, *supra* note 313, at 12 (explaining how the tax-insensitivity of institutional investors who "typically place little or no value on the option to differ taxes" affect bidding strategies). *See also* Engler*, supra note* 283, n.76.
[433] Fields & Lys, *supra* note 313.
[434] Note that from the perspective of the acquirer, both advantages and disadvantages are associated with a cash deal. On the one hand, all-cash bids typically result in higher announcement returns (or lower negative returns) for the acquirer than all-equity bids (see, e.g., Burch, *supra* note 308). Cash deals also allow the buyer to take a step-up basis in the target stock (Section 338(h)(10) election). Moreover, cash deals close more easily and are thus quicker; they also do not require acquirer shareholders to dilute their ownership. However, a tax-free deal allows the acquirer, under limitations imposed by the tax law, to carry forward the target firms' net operation loss, as well as unused tax credits due to expire in the short term. It is also more attractive for the bidder if her stock is overvalued.

However, it is important to note that the potential effect of institutional ownership on deal structures is likely to be most discernible in public M&A deals where both the acquirer and the target are public. Because private acquirers do not always have the option of using their stock as currency, they tend to engage in more cash deals, which are taxable, regardless of the presence of tax-insensitive institutional shareholders.[435] On the other hand, public acquirers can pay with either cash or stock. Thus, they are the ones who are most likely to change their bidding strategies—by offering taxable cash deals rather than tax-free stock-for-stock transactions—when the level of institutional ownership in the target is considerable.

The rise of institutional ownership affects deal premiums as well.[436] In all taxable deals, acquirers—public or private—are expected to react to the tax motives of institutional investors by adjusting the tax-compensation component of premiums downwards. Since institutional investors are willing to accept lower compensation for accelerating the capital gains taxes of their tax-sensitive shareholders, acquirers would be able to pursue taxable deals while paying smaller amounts against target shareholders' tax attributes.

These predictions appear to be somewhat consistent with several studies which found that, as levels of institutional ownership have risen substantially in recent years, the number of cash deals has likewise surged.[437] And yet, despite the abundance of taxable cash transactions, deal

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[435] *See* Hanlon et al., *supra* note 287, at 11.
[436] This chapter refers to the effect of institutional ownership on deal premiums in light of their impact on the compensation component for capital gains taxes. Institutional ownership may also affect premiums for other reasons (such as increased levels of monitoring or lower managerial agency costs). Such aspects are beyond the scope of this chapter.
[437] Boone et al., *supra* note 296 (showing that cash payments in M&A deals have soared in the last couple of years); Espen B. Eckbo, Tanakorn Makaew & Karin S. Thorburn, *Are Stock-Financed Takeovers Opportunistic?,* 128 J. FIN. ECON. 443 (2018) (finding that in the period 2001-2014, the average annual number of all-stock bids fell dramatically, while at the same time, the average annual number of all-cash bids increased by one-third); George Alexandridis, Nikolaos Antypas & Nickolaos G. Travlos, *Value Creation from M&As: New Evidence,* 45 J. COR. FIN. 632 (2017) (documenting a significant increase in cash component post-2009).

premiums have not gone up as one would expect.[438] This suggests that taxes no longer inflate the costs of taxable transactions.

Institutional investors' tendency to support taxable transactions with lower premiums can be attributed to another factor. Institutional investors are extremely diversified shareholders and sometimes own hundreds if not thousands of companies.[439] Because they own equity stakes in a large number of companies, they are more likely, on average, to own shares in both target companies and acquiring companies.[440] Therefore, institutional investors might be willing to accept lower prices in their capacity as the target shareholders as that would also mean that, on average, they would have to pay less in their capacity as shareholders of the acquirer. If that is indeed the case, tax-sensitive shareholders do not suffer as much from their fiduciaries' tax preferences. While they are underpaid for their tax exposure as owners of target companies, they are also underpaying as owners of the acquirers.

However, even if that is indeed the case, tax-free transactions are still preferable from the perspective of tax-sensitive shareholders. This is because buyers in tax-free deals are still expected to pay lower premiums than in taxable transactions, while target shareholders in such deals can avoid immediate tax liability. Thus, even for tax-sensitive shareholders who are sometimes on the buyer's side and sometimes on the target's side, a tax-free transaction is still a win-win.

2.4 Policy Proposals

Mutual funds offer many advantages to investors in capital markets. Chief among these

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[438] Alexandridis et al., *supra* note 437, at 636 ("there is no evidence that target shareholders receive higher premia post-2009 than in the past.").
[439] *See, e.g.,* Bebchuk & Hirst, *supra* note 429.
[440] The overlapping ownership of institutional investors in public corporations, known as common ownership, has increased dramatically in recent years. For example, while during the 1980s, a typical pair of firms had 1.7 owners in common, by 2012 this figure increased to 33.6. *See* Gilje, et al., *supra* note 9, 137 J. FIN. ECON. 152 (2020).

benefits are diversification, daily liquidity, the opportunity to obtain economic exposure to various asset classes, and favorable tax treatment.[441] While most of the advantages associated with investing in mutual funds are shared among all investors irrespective of their tax profile, favorable tax treatment is exclusive to one group: retirement savers investing in tax-advantageous accumulation accounts. Investors in conventional accounts are unable to enjoy the tax benefit that these pooled investment vehicles offer. Even worse, tax-sensitive shareholders must pay the price for their fiduciaries' insensitivity to taxes, which is attributed, in part, to the investment of tax-insensitive shareholders in mutual funds.

This Part offers several policy proposals to alleviate agency tax costs. These proposals are ultimately aimed at aligning mutual funds' conduct with the interests of tax-sensitive shareholders without imposing new agency costs on tax-insensitive shareholders.

2.4.1 Separation of Funds

Given the wide variance in strategies that maximize pre-tax returns and after-tax returns, imposing limitations on co-investment in the same fund of both groups of shareholders—tax-sensitive and tax-insensitive shareholders—may be a necessary step.[442] Ideally, taxable funds would focus on delivering higher after-tax returns, while non-taxable funds would maximize pre-tax returns. Accordingly, managers of taxable funds would be rewarded primarily on an after-tax performance basis. Moreover, taxable funds will be required to disclose after-tax returns in their prospectus, advertisements, and any literature they distribute. These after-tax disclosures will be produced regularly and not solely at the end of the year, allowing the investor community to

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[441] *See, e.g.,* Colon, *supra* note 274, at 103; Fink, *supra* note 44, at 7, 54 (OXFORD UNIV. PRESS 2008). Actively managed funds also provide investors exposure to the alpha-enhancing skills of fund managers.

[442] Engler, *supra* note 283, at 244 (discussing the difficulties associated with balancing the interests of different fund shareholders due to the joint investment of shareholders with heterogeneous tax profiles); Colon, *supra* note 274, at 167-168 (suggesting a separation of the funds due to different tax incentives).

properly evaluate taxable funds based on their after-tax performance.

The proposed structural separation would realign the interests of institutional investors with those of their tax-sensitive shareholders.[443] Separating the funds based on the beneficiaries' tax profile will alleviate the managerial burden of reconciling investors' differing tax status and induce mutual funds to employ tax behavior consistent with the tax interests of the underlying shareholders. Moreover, once the funds are separated on a tax status basis, it would become easier to detect agency tax costs.

This proposal, however, presents several difficulties. First, from a practical perspective, such a proposal may be hard to implement and administer given the current composition of mutual funds' investors. Today, mutual funds are co-held by both tax-sensitive and tax-insensitive shareholders. Applying shared ownership restrictions on existing funds would, therefore, require them to split up the funds' assets, a complicated process that would consume both time and resources.[444] A less disruptive proposition might be to apply the division requirement prospectively. Any new mutual fund introduced to the market would serve only one group of shareholders.[445]

Second, if implemented, the proposal is likely to reduce the number of shareholders in each fund, thereby diminishing the economies of scale that large asset management institutions currently enjoy. Today, mutual funds can offer relatively low management fees because their expenses are spread across enormous populations of shareholders.[446] Separating the funds, then,

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[443] It should be noted that while no formal separation is currently in place, one could view the actively managed "tax-managed" funds offered by certain institutions as obviating the need for a more formal separation. However, although the general concept of different outlets may not be entirely new, this chapter has detailed why the current topography of the asset management industry, despite the existence of "tax-managed" funds, is problematic for tax-sensitive shareholders. A more fundamental reform is needed.
[444] *See* Colon, *supra* note 274, at 168.
[445] This solution has another advantage as it gives investors the option to choose a pooled fund (i.e., one that serves both groups of shareholders) if they wish.
[446] *See, e.g.,* Kahan & Rock, *supra* note 255.

may lead to an increase in management fees. Under such circumstances, the net benefit from reducing agency tax costs may be negated by increased management fees.

2.4.2 Decentralization of Votes

Separating funds may not be an adequate solution when decisions are made at the fund-family rather than the individual fund level. As explained, uniform voting tends to reflect the fund-family's interests. All family members vote the same way regardless of fund-specific needs or those of its shareholders. Because of this, even if funds are separated on a tax-profile basis, mutual funds are doomed to fail their tax-sensitive shareholders in instances of voting-based decisions. Decentralization of the funds' votes, an action that would forbid such funds from blindly following the recommendation of the same research division, at least not in connection with tax-generating events—may be an appropriate resolution. Each fund's decisions would be left to its discretion, and each would be required to perform a cost-benefit analysis that would ensure that a fund casts its vote in the interests of the fund shareholders rather than those of the fund complex.[447]

At the very least, even if voting authority cannot be delegated to the individual fund level, oversight of the fund sponsor should be mandated.[448] The fund sponsor would be required to scrutinize the unified voting of the funds and, if necessary, based on the individual funds' specific tax considerations, determine that certain funds be given discretionary voting authority.[449] Although decoupling the votes may not ultimately change voting outcomes, it would at least result in a more transparent snapshot of shareholder attitudes.

This proposal has several drawbacks as well. First, even if the voting were to be

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[447] *Compare* Lipton, *supra* note 264, at 197-201 (suggesting decentralization of voting policies, or an alternative in which research is centralized, but each fund is able to cast its vote independently based on its specific circumstances).
[448] *Id.* at 200 (suggesting that independent directors in the sponsor would oversee the centralized voting and "make fund-by-fund determinations"). *See also* Commission Guidance Regarding Proxy Voting, *supra* note 395.
[449] *Id.*

decentralized, it is doubtful that individual funds would deviate from the fund-family's general policy. Second, it is important to remember that institutional shareholders' preferences can be processed not just through voting but through other actions like private engagements, which are typically undertaken by the fund sponsor rather than individual funds. For example, behind-the-scene communications with corporate managers, a practice that has recently gained popularity among large asset management institutions,[450] can sway management and result in decisions that have immediate tax consequences for shareholders.

Third, even in the absence of centralized voting, corporate managers might continue to classify their institutional shareholders on a fund-family basis. Under such circumstances, if a fund-family is associated with a tax-insensitive approach, managers might categorize all the funds under the same institution as tax-insensitive. This may potentially trigger a broad range of corporate decisions that would result in tax liability for tax-sensitive shareholders. Finally, similar to the previous proposal, vote decentralization may also lead to higher management fees, as the new system would require an independent voting analysis of each fund.

2.4.3 Pass-through Voting

In the late 1970s, the SEC, observing that the institutionalization of equity markets might lead to voting outcomes that do not necessarily reflect the interests of beneficial owners, suggested a pass-through voting system.[451] At that time, however, implementing such a system was administratively challenging, and the initiative was dropped.

[450] *See* Mallow & Sethi, *supra* note 152.
[451] Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, (1978) Securities Exchange Act Release No. 14970, 1978.

The technological development of recent decades has made this suggestion more realistic.[452] Advances in technology, coupled with a growing concern regarding mutual funds passivity and uninformed voting, have resulted in renewed calls for pass-through voting.[453] Moreover, scholars have begun to acknowledge that even in cases of informed voting, pass-through voting can help overcome potential conflicts of interest between financial intermediaries and their beneficiaries.[454]

Mutual funds' tax-insensitivity, particularly as reflected in corporate voting, reinforces the necessity of implementing a pass-through voting system to reduce agency tax costs. As previously explained, given the potential for a divergence in the interest of the beneficiaries and their fiduciaries, the delegation of voting rights to financial intermediaries can lead to voting outcomes that do not mirror the views of the beneficiaries. Because mutual funds are taxed as pass-through entities, fund beneficiaries should have a say on key issues that directly affect their tax liability. Thus, there are compelling justifications for restoring voting rights to the beneficiaries.

In the context of M&A deals, the pass-through voting solution would require fund managers to provide their shareholders with information on the expected long- or short-term capital gains. Based on the information provided, each fund shareholder would make an informed decision that would also factor in her individual tax situation.[455]

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[452] *See* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation,* 52 BUS. LAW. 1195, 1210-13 (1997) (observing that "on the longer-term horizon, there is even the visionary possibility that the Internet can be used to pass-through voting rights in securities held by pension and mutual funds to the fund's own owners or beneficiaries."). Note that in pensions funds, there have been significant developments in the context of pass-through voting (James A. Fanto, *Securities Disclosure, and the Creation and Enforcement of Corporate Governance and Firm Norms,* 48 CATH. U. L. REV. 15, 35 (1998)).
[453] *See, e.g.,* Taub, *supra* note 382, at 888-89; Dorothy Lund, *The Case Against Passive Shareholder Voting*, 43 IOWA J. CORP. L. 493, 530 (2018).
[454] Griffith, *supra* note 399.
[455] To encourage participation, the investment advisor might be required to emphasize in the headline of the notification sent to tax-sensitive shareholders that this is a matter with direct tax consequences.

Pass-through voting is unlikely to promote tax-sensitivity concerning portfolio management activities, as it is limited to corporate voting. However, behind-the-scenes engagement of institutional investors with corporate management may be affected by the roll-back of the votes to fund shareholders. Because mutual funds will know that their beneficiaries would have the option of expressing their preference through voting, this may affect their behavior ex-ante. Moreover, in the M&A setting, given the possibility that a taxable deal may be struck down by fund shareholders, corporate managers, as well as potential acquirers, are also likely to respond to the pass-through voting by factoring taxes into the negotiation process.

Given the low voting turnout rate among mutual fund shareholders,[456] which is even lower than the rate among retail shareholders with direct ownership in stock,[457] pass-through voting might still fail to adequately reflect the interests of fund shareholders. The concern is that since the turnout rate is likely to be higher among wealthier individuals,[458] voting outcomes may become skewed in the other direction by reflecting exceptionally high tax-sensitivity levels.[459]

2.4.4 Mandatory Tax-related Disclosure

Mutual funds share little information about their tax behavior. As a result, despite all the tax dollars at stake, investors lack a clear understanding of how funds are integrating taxes, if at all. For example, with regard to products such as tax-managed funds and broad-market index

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[456] Paul Schott Stevens, *SEC Should Reject Complex, Costly "Pass-Through" Proxy Voting*, Investment Company Institute (Oct. 2, 2018), https://www.ici.org/viewpoints/view_18_passthrough_voting?WT.mc_id=view_18_passthrough_voting&WT.sn_type=FACEBOOKPAGE&hoot.message=The%20SEC%20should%20reject%20complex,%20costly%20%E2%80%9Cpass-through%E2%80%9D%20proxy%20voting%E2%80%94the%20idea%20of%20.
[457] Jill E. Fisch, *The Uncertain Stewardship Potential of Index Funds,* Eur. Cor. Governance Inst. Law Working Paper 490/2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=352 5355.
[458] *Id.*, at 124.
[459] These wealthy individuals are typically subject to the higher marginal tax rate, which might cause them to be more tax-sensitive than other fund shareholders. However, in case the target stock was purchased by the fund over a year prior to the transaction, the applicable tax rate would be fixed for all tax-sensitive shareholders. *See supra* note 273.

funds, which are often recommended to tax-sensitive shareholders by asset management institutions, crucial details remain in the shadows. In particular, there is ambiguity as to the degree to which such funds take taxes into account. Are managers of tax-efficient funds expected to prioritize better after-tax performance, even if that would result in inferior pre-tax performance? Are broad-market index funds recommended to tax-sensitive shareholders due solely to their low turnover, or are index fund managers expected to integrate tax considerations more vigorously?

The tax-efficiency of index funds is of particular importance because, as these funds typically track indices, they are supposedly constrained in their ability to strategize their behavior around tax minimization. However, the evidence shows that index funds that track the same index tend to have varying levels of after-tax returns,[460] suggesting that passive funds have the opportunity to reduce their beneficiaries' tax exposure after all.[461]

Related questions also arise with regard to actively managed funds. Do these funds operate with a blind eye to the tax consequences of their actions? Since they charge high management fees, one could argue that they are expected to consider the interests of tax-sensitive shareholders in their decision-making process. Moreover, actively managed funds trade their shares more frequently. Thus, if their trading activity ignores tax implications, active funds could end up imposing a high tax burden on their beneficiaries due to the sheer volume of activity. The high turnover rate of active funds also emphasizes the dichotomy between the desire of actively managed funds to deliver positive alpha (which inevitably depends on frequent trading activity) and the negative impact of such activity on resulting taxes.[462] Does this mean that actively managed funds only care about generating alpha, even if high alpha will result in significant tax costs borne

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[460] Arnott et al., *supra* note 284 (showing that despite having an almost identical average return, the tax burden generated by funds that tracked the same index ranges from 1.2 to 2.5%).
[461] *Id. See also* Chen et al., *supra* note 341, n.39.
[462] Jeffrey & Arnott, *supra* note 275, at 15-16.

by tax-sensitive shareholders?

These questions are tremendously crucial for tax-sensitive investors in mutual funds, which account for nearly half of the assets in the asset management industry. Even (and perhaps especially) if the answers to these questions portray a grim picture regarding the current state of tax-sensitive shareholders in mutual funds, these shareholders could benefit greatly from improved disclosure on mutual funds' tax-sensitivity.

The absence of explicit disclosure on mutual funds' tax approaches is somewhat counter to the trend of large mutual fund sponsors. These institutions provide the investor community with their policy guidelines and stances on many issues and regularly explain how such policies aim to advance the interests of their clients. It only makes sense that institutional investors would also inform their beneficiaries of the ways in which they consider the tax interests of their clients. Their failure to do so suggests that the current state of ambiguity and the lack of clear measures aimed at defining institutional investors' obligation to consider taxes serve the interests of these institutions.

This chapter proposes new disclosure rules that would compel institutions to disclose their tax approach, including a specific reference to each fund or category of funds. Funds would have to provide more detailed explanations on their tax approach, informing all existing or prospective shareholders about how tax considerations affect their portfolio management, stewardship, and voting activities. Such information would help articulate the duties of fund managers in this context.

While the proposed disclosure may not necessarily alleviate the potential conflict of interest between institutional investors and tax-sensitive shareholders, it would address the information asymmetry issue. In the current situation, tax-sensitive shareholders might reasonably

expect their fiduciaries to be doing something that fund managers systematically fail to do (and, in frank conversations, admit to not doing). Following such a disclosure, at least with regards to funds that declare themselves tax-insensitive, such expectations may not be formed in the first place. As to funds that define themselves as tax-sensitive, their disclosures describing the degree to which they respond to their clients' tax position would allow tax-sensitive shareholders to select funds aligned with their needs. Once investors become better informed about these issues, they can make better investment decisions.

Of course, it is possible that even if tax-sensitive shareholders found out that certain funds are tax-insensitive, those shareholders might decide to invest in those funds anyway. This could be the case, for example, if other advantages offered by such funds, such as the quality of the fund manager or the opportunity to diversify a portfolio, are more critical than taxes. Other investors, however, might decide not to invest if the benefits do not sufficiently offset the potential increase in their tax burdens.

Regardless, all asset management institutions and their constituent funds should be required, in some manner, to inform their clients of a potential conflict of interest that might arise between fund managers (or fund-families) and tax-sensitive shareholders. Such a disclosure would be in line with the SEC requirement that funds must adopt "written policies and procedures that are reasonably designed to ensure" that securities are voted "in the best interest of clients" and "address material conflicts that may arise between" the interests of adviser and clients.[463] A failure to provide such disclosure may thus constitute a breach of fiduciary duties.[464]

As with every mandatory disclosure imposed on entities in the capital market, there is a

[463] 17 CFR 275.206(4)-6(a) (2017).
[464] *See supra* note 393 and accompanying text.

possibility that investors will become overwhelmed by the mess of information.[465] The concern is that if we increase disclosure, investors will need to process an unreasonable amount of information. At some point, such an overload may cause them to make worse decisions than if less information was made available.[466] However, even if that turns out to be true, the mere requirement to disclose their tax approach will likely incentivize mutual fund managers and sponsors to be more attentive to taxes.

Moreover, while individual retail investors in capital markets may experience difficulties in adequately processing the new tax-related information, the role of financial advisors and brokers in this context should not be underestimated. These sophisticated market players, who should be able to process and act on the information contained in the proposed disclosure, are subject to suitability rules and are required to make reasonable investment recommendations to their clients' individual needs.[467] Thus, tax-related information on a fund's sensitivity to taxes can help establish a clearer and more cohesive duty of financial advisors to recommend funds based on their tax disclosure.

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[465] *See, e.g.,* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003).
[466] *Id.*
[467] *See* FINRA rule 2111, "Suitability," http://www.finra.org/rules-guidance/rulebooks/ finrarukles/2111. Under the FINRA suitability rule, a registered representative or broker-dealer is obligated to make a reasonable recommendation regarding the purchase or sale of a security based upon the client's investment objectives, time horizon, risk tolerance, and other securities holdings as disclosed to the firm.

Chapter 3: The Corporate Governance Cartel

Recent years have seen the emergence of a new phenomenon in capital markets: institutional investor coalitions. Powerful institutional investors now march in lockstep on a variety of corporate issues, jointly lead governance initiatives, and support each other in key proxy resolutions.[468] Since these investors collectively account for a large proportion of the shareholder base in public companies, commentators have begun to recognize the capacity of these coalitions to set market-wide governance standards for corporate America.[469]

Indeed, a growing number of companies are voluntarily choosing to follow the governance standards that institutional investors endorse.[470] Companies that fail to do so are often subject to a backlash reaction from these investors, which can lead to governance intervention through engagement with management[471] or activists' campaigns.[472] Moreover, since the stewardship and

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[468] For example, a recent study by Morningstar Inc. analyzed 177 separate proposals related to environmental and social issues from the 2019 proxy season and found that funds owned by the "Big Three," the three largest asset management institutions, voted in lockstep on all 177 proposals. *See* Jackie Cook, *How Can Fund Providers Protect the Future for Worker-Investors*?, MORNINGSTAR (Jan. 9, 2020), https://www.morningstar.com/articles/961552/how-can-fund-providers-protect-the-future-for-worker-investors; *see also The BlackRock Backlash*, WALL ST. J. (Feb. 27, 2020), https://www.wsj.com/articles/the-blackrock-backlash-11582849130 ("One ASA concern is what it calls "groupthink" among asset managers, proxy firms and pension funds. Many now vote in lockstep on environmental, social and governance (ESG) issues."). Moreover, a recent study has found that the stewardship and governance guidelines of many of these institutions are almost identical. *See* Asaf Eckstein, *The Rise of Corporate Guidelines in the United States, 2005-2021: Theory and Evidence* (Oct. 2020) (unpublished manuscript), https://papers.ssrn.com/ sol3/papers.cfm?abstract_id=3705140. *See also supra* notes 511-512.

[469] *See* Edward B. Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* (NYU Law & Econ. Res. Paper No. 18-39, 2019, https://papers. ssrn.com/sol3/papers.cfm?abstract_id=3295098).

[470] *See* Eckstein, *supra* note 468, at 57-61 (describing how companies align their governance arrangements with the guidelines of large institutional investors).

[471] *See, e.g., BlackRock Investment Stewardship*, BLACKROCK, https://www.blackrock.com/ corporate/literature/fact-sheet/blk-responsible-investment-engprinciples-global.pdf (last visited March 1, 2022) ("If we have concerns about a company's approach, we may choose to explain our expectations to the company's board and management. Following our engagement, we may signal through our voting that we have outstanding concerns, generally by voting against the reelection of directors we view as having responsibility for an issue.").

[472] *See, e.g.,* Eckstein, *supra* note 468, at 61-63 (providing examples for instances where shareholders proposals submitted by hedge funds and "corporate gadflies" made specific references to guidelines published by institutional investors); *see also* Appel et al., *supra* note 13 (explaining how passive institutional investors facilitate activism by other investors).

proxy guidelines of many institutional investors are almost identical, voting outcomes increasingly reflect the mutual views of dominant market actors.[473]

The unusual cooperation among institutional investors has been boosted by the emergence of institutional investor consortiums—advocacy groups and trade associations that represent their members' collective interests. Chief among these organizations is the Council of Institutional Investors (CII), a trade association that represents asset managers, pension funds, and union funds with combined assets of over $40 trillion.[474] Another prominent investor consortium is the Investor Stewardship Group (ISG), a coalition of more than 70 institutional investors with combined assets worth over $32 trillion.[475] These powerful groups now actively promote governance principles that their members view as "best practices."[476] In fact, these groups not only urge uniformity among their institutional members[477] but also pressure corporations to conform to the designated principles,[478] further amplifying the collective governance power of institutional investors in today's capital markets.

From a corporate law perspective, the recent development of investor coalitions is generally viewed as a positive trend.[479] For over a century, one of the most significant challenges

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[473] *See supra* note 468; *see also* Alon Brav, Wei Jiang, Tao Li & James Pinnington, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* (Eur. Corp. Governance Institute, Finance Working Paper No. 601, 2019), https://papers.ssrn.com /sol3/papers.cfm?abstract_id=3101473 (demonstrating the pivotal role that institutional investors play in initiating and dictating the outcomes of proxy contests).
[474] COUNCIL INSTITUTIONAL INV., https://www.cii.org/about (last visited March 1, 2022).
[475] *About Us*, INVESTOR STEWARDSHIP GROUP, https://isgframework.org (last visited March 1, 2022).
[476] *Id.* ("The ISG was formed as a sustained initiative to establish a framework of basic investment stewardship and corporate governance standards for U.S. institutional investors and boardroom conduct. The result is the framework for U.S. Stewardship and Governance comprising of a set of stewardship principles for institutional investors and corporate governance principles for U.S. listed companies.").
[477] *Id.* ("The ISG encourages institutional investors to be transparent in their proxy voting and engagement guidelines and to align them with the stewardship principles.").
[478] *Id.* ("The ISG encourages shareholders' elected representatives—company directors—to apply the corporate governance principles at the companies on whose boards they serve. The ISG will evaluate companies' alignment with these principles, as well as any discussion/disclosure of alternative approaches that directors maintain are in a company's best interests.").
[479] *See, e.g.,* Black, *supra* note 50 (explaining how the rise of major institutional investors can help overcome the collective action problem of shareholders, providing more incentive for these investors to become involved in governance affairs and monitoring); Marco Becht, Patrick Bolton & Ailsa A. Röell, *Corporate Governance and*

corporate law scholars have faced is the collective action problem of public shareholders, which leads to rational apathy.[480] In fact, much of corporate law can be seen as a system of mechanisms designed to escape this collective action problem.[481] Cooperation among shareholders whose combined equity stakes provide an adequate incentive for them to engage in stewardship may be the ultimate solution. By acting in concert, these shareholders can compel corporations to align their practices with the investors' governance preferences. Ideally, these joint efforts would help discipline management and control managerial agency costs.[482]

This chapter takes a novel approach to this issue by offering a different perspective on institutional investor coalitions, through an antitrust analysis.[483] It argues that the traditional corporate law analysis of shareholder coalitions overlooks the fact that these investors are not merely co-owners in public companies but also competitors in primary and secondary capital markets. In the primary market, institutional investors are the potential buyers of shares who compete on share allocation. In this market, institutional investors are not even co-owners, but rather, mere competitors. In the secondary market, institutional investors compete as asset managers, using their relative portfolio performance to attract retail investors and large sponsors.

In the paradigmatic corporate governance context, the coordinated actions of investors are tied to the companies in which they are co-owners, rather than to the markets in which they

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Control (Oct. 2002), https://ssrn.com/ abstract=343461 (reviewing the theoretical and empirical research on the main mechanisms for the resolution of the collective actions of shareholders); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 2 J. FIN. 737 (1997) (discussing the common approaches for corporate governance and explaining that ownership by large investors helps reduce agency costs).

[480] *See* Berle & Means, *supra* note 413 ("[T]he normal apathy of the small stockholder is such that he will either fail to return his proxy vote, or will sign on the dotted line, returning his proxy to the [management] of the corporation.").

[481] *See* Edward B. Rock, *Corporate Law Through an Antitrust Lens,* 92 COL. L. REV. 497, 501 (1992).

[482] *Id.* at 502.

[483] Note that this chapter assumes that antitrust laws apply to capital markets as well as to corporate law and governance.

compete. Under that circumscribed lens, no anticompetitive risks emerge.[484] In the antitrust context, on the other hand, investors' collective actions might be used to secure a competitive advantage in markets in which institutional investors compete with each other.

As this chapter shows, the coordinated push by institutional investors for governance standards affects not just the public companies in which investors own stock. Often, it will affect markets, as well, potentially disrupting competition in these markets and causing the same economic harm that antitrust laws are designed to prevent. In such circumstances, the collaboration among institutional investors—even if it revolves around governance issues that are seemingly innocent from a corporate perspective—provides an opportunity for collusive behavior.

To develop the antitrust analysis of investor coalitions with a clear example, this chapter focuses on the coalition against dual-class structures—share structures that have two classes of stock with unequal voting rights.[485] In recent years, a large group of institutional investors, including prominent asset management institutions, pension funds, and union-related funds—have joined forces against issuers of dual-class stock. With the help of their consortiums, they called upon the Securities and Exchange Commission (SEC) and the stock exchanges to ban the listing of dual-class stock. They also successfully persuaded index providers to exclude dual-class stock from leading market indexes. Moreover, they sent open letters of condemnation to companies contemplating going public with a dual-class structure. The goal of those efforts was, of course, to restrict, or at the very least discourage, the use of such structures in initial public offerings (IPOs).[486]

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[484] *See* Rock, *supra note* 481. In his article, Rock identified the borderline between firms and markets, at which cooperation between shareholders should be analyzed under antitrust law rather than corporate law.
[485] In this chapter, the terms "dual-class structure" or "dual-class stock" refer to a share structure with multiple, not necessarily two, classes of stock, each carrying different voting rights compared to their cash-flow rights.
[486] *See, e.g.,* Bernard S. Sharfman, *A Private Ordering Defense of a Company's Rights to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1, 9 (2018).

These collective responses to the dual-class arrangement increase institutional investors' capacity to act in concert as competing bidders in IPOs. By coordinating their stance on this corporate governance arrangement, institutional investors, who collectively possess most of the expected market demand for public offerings,[487] can leverage their bargaining power against issuers. As in the case of a classic cartel of buyers, this allows the cartel members to negotiate better price and non-price terms with issuers.

In turn, the coalition against dual-class structures is expected to have two remarkable distorting effects: the price effect and the governance term effect. The price effect suggests that the coalition artificially inflates the penalty paid by issuers of dual-class stock, leading to abnormal underpricing of such stock in IPOs. In particular, the coalition creates a collective understanding that a dual-class structure is flawed (by claiming, for example, that it imposes a governance risk or that it deviates from the institutional investors' best practices). As such, dual-class shares should be priced significantly lower than single-class shares. Since the price of an offering reflects a negotiated valuation,[488] the collective view of institutional investors against dual-class structures would indirectly influence the ultimate issuance price, undermining the competitive process in IPOs.[489] Due to the macrostructure of the primary market and the critical role that institutional

[487] *Understanding the IPO Share Allocation Process*, FIDELITY, https://www.fidelity.com /learning-center/trading-investing/trading/ipo-share-allocation-process (last visited March 1, 2022) (explaining that institutional investors usually receive the lion's share of shares of any IPO and that the split between institutional investors to retail investors is 90/10).

[488] *See, e.g., Investing in an IPO*, U.S. SEC. & EXCH. COMMISSION, https://www.sec. gov/files/ipo-investorbulletin.pdf (last visited March 1, 2022) ("Whether you have an opportunity to participate directly in an IPO or are buying shares in the open market, it is important to realize that the offering price reflects a negotiated estimate as to the value of the company. The offering price may bear little relationship to the trading price of the securities, and it is not uncommon for the closing price of the shares shortly after the IPO to be well above or below the offering price.").

[489] *Compare* Dennis W. Carlton & Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION 107-110 (Pearson Addison Wesley 4th ed. 2005). Carlton and Perloff explain the economics of monopsony, according to which buyers with significant market power are able to force the price of an input below its competitive level. As this chapter shows, the coalition creates a monopsony power in the primary market.

investors play in public offerings,[490] this anticompetitive price effect is highly likely.

The governance term effect signifies the capacity of the coalition to push issuers into adopting a share structure that is in line with the institutional investors' preferences, such as a single-class structure or a dual-class structure that eventually sunsets. In any antitrust analysis, a process in which competitors collaborate to create a market standard is subject to zealous scrutiny, particularly if the procedure involves competitors who possess a significant degree of market power on the buying side.[491] The main concern is that collaborative standard-setting would be used to unlawfully affect the price or quantity of an output or exclude market actors.[492] As this chapter shows, all of these concerns are likely to materialize in the wake of the coalition against dual-class structures.

The novel use of an antitrust-based framework to analyze the coalition against dual-class structures makes several contributions to contemporary literature. First, it reveals a tension between two competing goals: the goal of corporate law to solve the collective action problem of shareholders and the goal of antitrust law to frustrate the collective action of cartelists.[493] By forming investor coalitions, institutional investors solved their collective action problem in their capacity as co-investors but have also created a new anticompetitive problem in capital markets heretofore unidentified.

To the extent that investor coalitions affect markets—and not just the companies that the

[490] *See, e.g.,* Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues,* 24 J. FIN. ECON. 343 (1989) (describing the role of institutional investors as providers of pricing feedback that is most necessary for the purpose of determining the offer price); *see also infra* Part III.
[491] *See, e.g.,* David J. Teece & Edward F. Sherry, *Standards Setting and Antitrust*, 87 MINN. L. REV. 1913, 1927-1928 (2003).
[492] *See Policy Roundtable on Standard Setting*, OECD Report 10 (2010), https://www.oecd.org/daf/competition/47381304.pdf (last visited March 1, 2022) (explaining that collusion in the context of standard-setting can lead to market exclusion, output restraints, and higher prices).
[493] *Compare* Rock, *supra* note 481, at 501 (arguing that at the firm/market borderline, the goal of corporate law to solve the collective action problem of shareholders inevitably clashes with the antitrust law purpose to frustrate the ability of competitors to communicate with each other).

members of the coalitions jointly own—these coalitions may function as cartels in disguise. This concern is particularly profound when a coalition emerges at the IPO stage, considering that such a coalition functions solely as a competitor coalition rather than a shareholder coalition. In these circumstances, corporate law—which emphasizes the importance of cooperation between shareholders as means to enhance firm value—offers an inadequate conceptual framework within which to analyze the coalitions. In other words, corporate law's historical bias in favor of collective action may be misplaced since collaboration in capital markets can be used to undermine competition.

Second, the identification of an anticompetitive problem in the IPO setting reveals a monopsony power in capital markets that was never recognized before. In the past, scholars have suggested that IPO prices might be affected by the monopsony power of underwriters—the investment banks that manage and sell the IPO for the company.[494] However, this chapter shows that monopsony power actually exists on the investors' side, distorting prices and terms of shares sold in public offerings.[495] Ultimately, this distortive effect will have the typical allocational and distributional inefficiencies associated with a cartel of buyers.

Third, the observation that institutional investors can depress competition in capital markets suggests that the focus of antitrust research on the anticompetitive consequences associated with the rise of institutional ownership has been too limited. The existing literature concentrates on the potential effect of the overlapping ownership by institutional investors in public companies (i.e., "common ownership") on product markets.[496] Antitrust researchers argue

[494] *See, e.g.,* Jay R. Ritter, *The 'Hot Issue' Market of 1980*, 57 J. BUS. 215 (1984) (suggesting that gross underpricing may be attributed to the monopsony power of underwriters in issues of common stocks of small firms).
[495] While traditionally, a monopsony is defined as an oligopsony limited to one buyer, this chapter will use both terms interchangeably, in consistency with contemporary antitrust literature and case law. *See also infra* note 642.
[496] *See* Azar et al., *supra* note 31 (empirically showing how common ownership leads to price increases in the airline industry). For a general review of the theories underlying the anticompetitive effects of common ownership, see Hemphill & Kahan, *supra* note 67 (2020).

that, due to common ownership, potent institutional investors may cause price increases in concentrated markets. However, this chapter postulates that the anticompetitive harm may actually emerge in a completely different dimension: the markets where institutional investors compete with *each other*, rather than the markets where their portfolio companies compete.

This chapter unfolds as follows. Part I explores the evolution of institutional investor coalitions and reveals the oft-neglected antitrust concerns they impose. Part II presents the orchestrated attack of institutional investors and their consortiums against dual-class share structures, particularly against prospective dual-class issuers. Part III analyzes the coalition against dual-class from an antitrust perspective. It argues that the coalition facilitates a buyers' cartel in the primary market, leading to bargaining inefficiencies between issuers and investors. Part III also assesses the focal market effects of the coalitions and their social welfare implications.

Finally, Part IV discusses the policy implications that can be gleaned from the antitrust analysis of the coalition against dual-class structures. It argues that public officials should scrutinize institutional investor coalitions and restrict collective actions that affect markets in which institutional investors compete. This Part also maintains that special antitrust attention should be given to investor consortiums, considering their demonstrated ability to facilitate collaboration among their members and create credible mutual commitments, which are most necessary for cartel formation. Applying antitrust standards to such associations, which are currently on the rise, is a necessary step. In particular, since these organizations attempt to set market-wide governance standards and best practices on behalf of their members, they should be viewed as standard-setting organizations (SSOs) for antitrust purposes. Accordingly, to the extent that they fail to include policies or procedures to ensure a competitive standard selection

process prescribed by antitrust laws, these consortiums and their members should be subject to antitrust liability.

3.1 From Collective Action Problem to Collective Coalition Problem

Historically, retail shareholders of public corporations faced a well-known collective action problem: Due to each shareholder's relatively small ownership percentage, that shareholder had a marginal incentive to pursue activities that would benefit the larger group of shareholders. This Part shows how the reconcentration of share ownership in the hands of institutional investors has helped overcome that collective action problem. At the same time, it contends that this situation represents an antitrust failure. Section 3.1.1 traces the evolution of institutional investor coalitions and describes the unusual cooperation observed among these powerful institutions in recent years. Section 3.1.2 reveals a darker side of these coalitions: in light of the institutional investors' role as competitors, these coalitions can be used to facilitate anticompetitive behavior.

3.1.1 The Rise of Institutional Investor Coalitions

In their seminal work, *The Modern Corporation and Private Property*, written nearly a century ago, Adolf Berle and Gardiner Means identified one of the main concerns associated with modern corporations in the United States: the separation of ownership from control.[497] They argued that given the dispersed ownership in large public corporations, the typical shareholder is uninterested in undertaking monitoring and stewardship activities that would benefit the entire group of shareholders. This passivity, they argued, would allow corporate managers to operate companies without meaningful shareholder scrutiny.[498] Berle and Means' thesis emphasized the collective action problem of shareholders and illuminated related principal-agent issues.

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[497] *See* Berle & Means, *supra* note 480.
[498] *Id.*

Over the years, these issues have occupied the minds of legal scholars, economists, and policymakers who have attempted to develop institutional arrangements necessary to resolve this collective action problem and protect investors from managerial opportunism.[499] Proxy regulations, class actions, attorneys' fee provisions, and even regulatory guidance that make shareholder voting by certain financial intermediaries a fiduciary duty, can all be seen as attempts to increase the incentive of public shareholders to monitor managers, thereby evading their collective action problem.

In the last few decades, however, there has been a dramatic shift in the composition of shareholders. The classic Berle and Means corporation, owned by thousands of dispersed shareholders, has given way to corporations with substantial shareholdings held by institutional investors.[500] Sophisticated institutional investors now collectively own approximately three-quarters of the entire U.S. capital market,[501] representing shares worth over $27 trillion.[502] Moreover, the asset management industry became highly concentrated. A group of twenty-five institutional investors holds more than 30% of the entire U.S. capital market,[503] and the largest ten institutional investors hold the vast majority of those assets.[504] The three largest asset management institutions—the BlackRock Group, the Vanguard Group, and State Street Global Advisors (known as the "Big Three")—collectively oversee over $18 trillion in Assets Under Management (AUM).[505]

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[499] *See supra* note 479 and accompanying text.
[500] For an overview of the rising ownership of institutional investors, see Fichtner et al., *supra* note 11.
[501] Posner et al., *supra* note 198.
[502] *See* Bd. of Governors of the Fed. Reserve Sys., *Financial Accounts Guide, First Quarter 2021*, Tbl.L.223 Corporate Equities, https://www.federalreserve.gov/releases/z1/20210610/ z1.pdf, p. 130.
[503] *See* Marcel Kahan & Edward B. Rock, *Anti-Activist Poison Pills* 20 (N.Y. Univ. Sch. L, L. & Econ. Res. Paper Series, Working Paper No. 17-08, 2017), https://ssrn.com/abstract=2928883.
[504] Itzhak Ben-David et al., *The Granular Nature of Large Institutional Investors* 1 (Nat'l Bureau Econ. Res Working Paper No. 22247, 2017), http://www.nber.org/papers/w22247.pdf.
[505] BlackRock Funds holds approximately $6.8 trillion, the Vanguard Group holds $8 trillion, and State Street Global Advisors holds $4.1 trillion. *Introduction to BlackRock*, BLACKROCK, https://www.blackrock.com/sg/en/introduction-

The shift to concentrated capital markets in which institutional investors own significant blocks of stock in their portfolio companies should change the way one analyzes the collective action problem of shareholders. As institutional investors began to take large stakes in public corporations, the benefit to each shareholder from collective action increased since they received a greater proportion of any collective benefit. Moreover, the significant equity stakes held by institutional investors make their vote and voice count, resulting in a higher likelihood that such investors will be able to influence corporate actions. These circumstances have made it more worthwhile for institutional investors to undertake the costs of monitoring.[506]

A natural byproduct of this change in the capital markets landscape was that institutional investors became more involved in the governance affairs of their portfolio companies. Institutional investors now regularly vote their shares and have become increasingly engaged in

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to-blackrock (last visited March 1, 2022); *Fast Facts About Vanguard*, VANGUARD, https://corporate.vanguard.com/content/corporatesite/us/en/ corp/who-we-are/sets-us-apart/facts-and-figures.html/ (last visited March 1, 2022); *Who We Are*, STATE ST. GLOBAL ADVISORS, https://www.ssga.com/us/en/institutional/ic/about-us/who-we-are (last visited March 1, 2022). *See also* Fichtner et al., *supra* note 11(documenting the power of the three largest asset management institutions); Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 55 (2013) (explaining how three mutual funds complexes oversee significantly more assets than other institutional investors).

[506] *See, e.g.,* Black, *supra* note 479; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992) (surveying the empirical evidence on the value of large institutional shareholder oversight of corporate management). Another important regulatory change that helped mitigate the collective action problem of corporations is the SEC and Department of Labor regulatory guidance that made shareholder voting a fiduciary duty (see Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) (codified at 17 C.F.R. §§ 275.204-2, 275.206(4)-6)). Following this change, institutional investors, including investment advisors and retirement plan managers, began viewing voting as an obligation and started casting their votes on nearly all issues subject to a shareholder vote. *But see* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights,* 113 COL. L. REV. 863 (2013) (discussing how many institutional investors are evaluated based on their relative performance compared to that of their competitors, and how this state of affairs reduces their incentive to invest resources in monitoring that will eventually benefit their competitors as well).

direct dialogues with public companies.[507] In fact, commentators now recognize the capacity of these dominant market actors to set market-wide governance standards for corporate America.[508]

The increased involvement of institutional investors in governance affairs has revealed an unusual similarity in the views of these influential investors. Such similarity can be gleaned, for example, from the institutions' voting records, public statements, and stewardship guidelines.[509] Recently, these parallel views have given rise to the formation of institutional investor alliances. Institutional investors now vote in lockstep on various issues,[510] support each other in proxy fights,[511] and lead corporate initiatives to promote their mutual governance preferences.[512] This behavior is believed to reflect a "groupthink" among institutional investors,[513] which leaves very little choice for public companies but to conform.

Another phenomenon that accompanied the rise in institutional ownership is the emergence of institutional investor consortiums—nonprofit trade associations and advocacy groups that

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[507] *See, e.g.,* Lund, *supra* note 453 (arguing that mutual funds now cast all their votes); Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 724 (2019) (showing that the "Big Three" collectively cast approximately a quarter of the votes of S&P 500 companies); Mallow & Sethi, *supra* note 152 (describing the increasing tendency of asset management institutions to engage in direct dialogues with corporate management).
[508] *See supra* note 469 and accompanying text.
[509] *See supra* note 468 and accompanying text.
[510] *Id.*
[511] *See The BlackRock Backlash*, *supra* note 468 (discussing the support of large asset managers such as State Street Global Advisors and other pension funds in BlackRock's initiative to vote against directors who serve on boards of companies that fail to disclose ESG risks).
[512] *See, e.g.,* Joann S. Lublin, *Big Investor Group to Push for End to Dual-Class Shares*, WALL ST. J. (Jan. 31, 2017), https://www.wsj.com/articles/big-investor-group-to-push-for-end-to-dual-class-shares-1485817380?mod=article_inline (describing the campaign of large institutional investors such as BlackRock, State Street, and Vanguard, as well as large public pension systems in California, Florida, and Washington state against dual-class); Sarah Krouse & Joann S. Lublin, *Big Investors Want Directors to Stop Sitting on So Many Board,* WALL ST. J. (Sep. 26, 2017), https://www.wsj.com/articles/big-investors-want-directors-to-stop-sitting-on-so-many-boards-1506418201 (describing how major institutional investors, followed by proxy advisors, have recently cracked down on so-called "overboarding," trying to ensure that directors do not overstretch themselves in a way that prevents them from adequately monitoring management); Saijel Kishan, *Vanguard to Push Companies on Racial Diversity Next Year*, BLOOMBERG (Dec. 15, 2020), https://www.bloombergquint.com/markets/vanguard-to-push-companies-on-racial-diversity-next-year (describing how Vanguard joined BlackRock and State Street Global Advisors in their efforts to press companies for more data on their metrics to boost racial diversity within their ranks).
[513] *See The BlackRock Backlash*, *supra* note 468.

represent the interests of institutional investors.[514] These umbrella associations primarily focus on coordinating governance initiatives and promoting corporate governance policies and principles to be endorsed by their institutional members and adopted by their members' portfolio companies. Over the years, these consortiums gained substantial power, resources, and access to policymaking.

A prominent example is the CII, which was founded in 1985 with the goal of expanding the shareholder voices of pension funds and union funds and leading to "a collaborative effort by members to compel corporate managers to step up efforts to improve performance."[515] The CII currently has over 140 voting members with combined assets of approximately $4 trillion and associate members with over $40 trillion in AUM.[516]

Since its foundation, the CII has established a high profile as a corporate monitor and initiator of successful coordinated governance initiatives. Notably, the CII has a record of targeting companies that are performing poorly and companies that the CII views as having poor corporate governance, in some cases by issuing a "Focus Listing" of such companies.[517] Moreover, the CII has successfully lobbied for several policy reforms regarding corporate governance and securities regulation. For example, the CII has pushed for changes in shareholders' ability to engage in firm-level collective action. These efforts led the chairman of the SEC to announce that the commission would undertake a major review of the proxy rules.[518] Notably, this announcement was made at

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[514] On the rise of institutional investor consortiums and their role in solving the collective action problem of shareholders see, e.g., Black, *supra* note 479, at 846; Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective* (Eur. Cor. Governance Inst., Law Working Paper No. 393, 2018), https://papers.ssrn.com/sol3/pape rs.cfm?abstract_id=3157708, 24-25.
[515] Gary L. Caton, Jeremy Goh & Jeffrey Donaldson, *The Effectiveness of Institutional Activism*, 57 FIN. ANALYSTS J. 21, 21 (2001).
[516] *See supra* note 474.
[517] Jill A. Brown, Scott D. Graffin & Andrew J. Ward, *Under the Spotlight: Institutional Investors and Firm Responses to the Council of Institutional Investors' Annual Focus List*, 7 STRATEGIC ORG. 107 (2009).
[518] 56 Federal Register 28987 (June 25, 1991).

the CII 1990 annual meeting.[519] Two years later, the rules were amended to provide greater opportunity for communication between investors—without prompting a regulatory burden.[520]

Another powerful consortium is the ISG, a collective of over seventy of the largest U.S.-based and global institutional investors, with combined assets worth over $32 trillion.[521] Over the years, the ISG has developed several consensus positions on corporate governance matters.[522] In 2019, it issued a Framework for U.S. Stewardship and Governance (the "ISG Framework"), which contains a set of corporate governance best practices for corporations.[523] The ISG Framework also includes a set of principles for institutions, one of which states that "institutional investors should work together, where appropriate, to encourage the adoption and implementation" of those best practices.[524]

There is no doubt that investor consortiums have helped institutional investors overcome the collective action problem of shareholders. Their formation confers a shared identity, provides a springboard for collective action, and offers economies of scale, especially when it comes to shareholder activism.[525] The cooperation among the members of the consortiums also grants members a better opportunity to influence voting outcomes and disciplinary power over corporate

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[519] Gerald F. Davis & Tracy A. Thompson, *A Social Coalition Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141, 153 (1994).
[520] Regulation of Communication Rules, Exchange Act Release No. 30,147 (Jan. 6, 1992); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326 (Oct. 16, 1992); s*ee also* Robert Rosenbaum, *Big Investors' Push for Power*, CONN. L. TRIB. Dec. 16, 1991, at 16.
[521] *See supra* note 474. Another initiative that was launched on similar grounds is the United Nations Principles for Responsible Investment (PRI). Sixty-three investment companies with $6.5 trillion in AUM signed a commitment to incorporate Environmental, Social, and Governance (ESG) principles into their stewardship activities and voting decisions. By 2018, the number of signatories had increased to 1,715, repressing $81.7 trillion in AUM. *See What Are the Principals for Responsible Investment*, https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment (last visited March 1, 2022).
[522] Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229, 1277 (2019).
[523] *Corporate Governance Principles for US Listed Companies*, INVESTOR STEWARDSHIP GROUP, https://isgframework.org/corporate-governance-principles/ (last visited March 1, 2022).
[524] *The Principles,* INVESTOR STEWARDSHIP GROUP, https://isgframework.org/stewardship-principles/ (last visited March 1, 2022).
[525] Tim C. Opler & Jonathan Sokobin, *Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors*, Dice Center for Res. in Fin. Econ., Working Papers Series 95-5, 4 (1995), https://ssrn.com/abstract=46880; *see also* Davis & Thompson, *supra* note 519, at 163-164.

managers.[526] Moreover, because members can observe whether others are contributing to the provision of the collective good, free-riding is discouraged, and the enforcement of the alliance becomes simpler and cheaper.[527]

A good illustration of these consortiums' capabilities to solve the collective action problem of shareholders and effectively influence corporate affairs can be seen in the recent efforts of the ISG. When the ISG Framework was first released, the ISG issued a public statement that corporations "should recognize that some of their largest investors now stand together behind these principles."[528] The publication of those principles, coupled with the fact that the ISG specifically pointed out that some of its largest members were behind the effort, could be read as a veiled threat.[529] In other words, even though corporate governance principles are not mandatory, companies would have difficulty ignoring them, knowing that they were backed by the largest institutional members of the ISG.

The upshot of the rise of institutional ownership and their coalitions is that we now have a group of investors with enormous influence and market power who seem to think, talk, and vote the same way.[530] And, until now, the broad market implications associated with this homogeneity have escaped scholarly attention.

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[526] Opler & Jonathan, *Id.; see also* Manuel A. Utest, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition,* 44 EMORY L. REV. 71 (2010) and compare Jiekun Huang, *Coordination Costs, Institutional Investors, and Firm Value*, U. Ill. Working Paper (2013) (showing that the ease of coordination between institutional investors enhances the governance role of institutional investors).
[527] *See* Huang, *Id.*
[528] A*bout the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INVESTOR STEWARDSHIP GROUP, https://isgframework.org/ (last visited March 1, 2022).
[529] *See* Eckstein, *supra* note 468, at 28 ("The ISG's position reflects a threat that if corporations choose not to follow the principles perceived by investors to be good corporate governance, they should have good reasons.").
[530] *See supra* note 468 and accompanying text; *see also* Annie Massa & Emily Chasan, *BlackRock, Vanguard Voting Habits Show Why Some Fear Their Power*, BLOOMBERG (Feb. 28, 2020), https://www.bloomberg.com/news/articles/2020-02-28/blackrock-vanguard-voting-habits-show-why-some-fear-their-power.

3.1.2 The Dark Side of Investor Coalitions

The previous section demonstrated how recent changes in the composition of shareholders in public companies, coupled with the high levels of equity market concentration, led to the development of institutional investor coalitions. As explained, such cooperation has been traditionally viewed as a desirable phenomenon. The general perception is that institutional investors are sophisticated market players who promote governance principles that help protect public shareholders from managerial agency costs and are therefore value-enhancing.

However, that positive view on investor coalitions fails to consider the fact that the members of such coalitions are not merely co-owners in public companies but also *competitors*.[531] For example, in the primary market, these same investors are potential buyers of newly issued shares who compete over allocation. In the secondary market, institutional investors compete as asset managers, using their relative portfolio results to attract retail investors and large sponsors.

Given their status as competitors, the concern is that institutional investor coalitions might also function as competitor coalitions (rather than simply as shareholder coalitions). In other words, these powerful investors, who now increasingly act through alliances, can effectively form cartels in markets where they compete by using mechanisms designed to solve the shareholder collective action problem.

The notion that shareholders are also competitors and that their cooperation on governance arrangements may introduce antitrust concerns has been largely overlooked in both the antitrust and the corporate law literature.[532] This oversight is likely due to the notion that governance

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[531] *Compate* Rock, *supra* note 481. In his article, Rock provides several examples for circumstances where institutional investors are competitors and not merely co-investors, while focusing on joint bargaining agreements among target shareholders in tender offers. He explains that in the case of a tender offer, shareholders compete to sell shares in the secondary market.

[532] An exception is Professor Edward Rock's article, written nearly three decades ago, which identified the potential anticompetitive risks that emerge when shareholders coordinate their response to a tender offer. Rock explained that

arrangements are generally assumed to be confined to the portfolio company's domain and are unlikely to affect markets. In the absence of market outcomes, the thinking goes, competition laws should have very little reason to worry.

This chapter challenges the assumptions that underlie that logic—specifically the assumed benign nature of the governance arrangements promoted by investor coalitions. It shows that, under certain circumstances, these arrangements can affect not just portfolio companies but also markets. When the affected markets are markets in which institutional investors compete, investor coalitions can function as a well-coordinated cartel, distorting competition in such markets.

In particular, by coordinating their positions on a governance matter, institutional investors can effectively use their mutual demands as a bargaining chip to secure better terms when dealing with suppliers of shares. That type of collective action increases the capacity of institutional investors to depress the *prices* of securities sold in capital markets or secure more favorable *governance* arrangements. These anticompetitive outcomes are particularly profound in primary markets where, as discussed below, institutional investors have significant buyers' power. The exercise of their collective buyers' power, coupled with their status as providers of valuable pricing feedback in public offerings,[533] makes it almost inevitable that their mutual governance preferences will affect IPO stock prices, the governance terms attached to the stock, or both.

The possibility that joint action of institutional investors will provide an anticompetitive edge against other market participants demands an antitrust lens. This chapter uses precisely such a lens to analyze one particular type of investor alliance that emerges in the primary market: the coalition against dual-class share structures.

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such agreements between potential tenderees could inflate the price a bidder would be required to pay to buy shares in secondary markets, in violation of competition laws. *See* Rock, *id*.

[533] *See supra* note 490; *see also infra* notes 682-683 and accompanying text.

3.2 The Coalition Against Dual-Class Share Structures

Recent years have seen an orchestrated attack of institutional investors on companies with dual-class structures, particularly IPO companies that choose to go public with this structure. Section 3.2.1 describes the dual-class structure and presents the different scholarly views on this structure. Section 3.2.2 describes the development of the coalition against dual-class and highlights the main joint actions taken by the coalition, while arguing that some of these actions may satisfy the concert of action requirement under antitrust laws.

3.2.1 The Dual-Class Structure

A dual-class structure provides that all the shares of an issuer have equal cash-flow rights—and thus, are deemed to be "common" shares—but that one class of stock has "super-voting" rights. The class with superior voting rights is often held by founders or other insiders, and the class of stock with inferior voting rights is usually sold to the public. This share structure allows the holders of the super-voting common stock to effectively control the company without owning a majority of its shares.

Although dual-class structures have been around the United States since the 19th century, until recently, only a small fraction of U.S. corporations opted for this capital structure.[534] During the past decade, however, an increasing number of IPO companies have used some variation of the dual-class structure to create two or more common stock classes.[535]

One generally accepted explanation for this trend is the increasing concentration of public stock in the hands of institutional investors and the concurrent rise of activist investors. These market shifts have prompted founders to limit the intervention power of these influential investors

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[534] Andrew Winden & Andrew Baker, *Dual Class Index Exclusion*, 13 VA. L. & BUS. REV. 101, 108 (2019).
[535] Investing in an IPO, *supra* note 488.

by retaining control through a dual-class structure.[536] And this trend has been exacerbated by the surge in IPOs in the technology sector, which made the need for isolation from outside shareholder pressure even more pronounced. Technology companies, especially in the first years following an IPO, tend to have high levels of information asymmetry, and founders worry that outside investors will try to discipline management if they are unsatisfied with the company's short-term performance.[537]

The increasing number of dual-class IPOs has sparked a heated debate among scholars on the merits and drawbacks of dual-class. On one side is a group of scholars, including Professors Lucian Bebchuk and Kobi Kastiel, who oppose dual-class structures, citing governance risks and management entrenchment.[538] These scholars focus primarily on private benefits of control and raise concerns that dual-class structures will shield management from accountability. Accordingly, they advocate for a ban or, to the very least, a sunset limitation on the use of dual-class.[539]

On the other side of the debate are scholars such as Professors Zohar Goshen and Dorothy Lund, who recognize the potential benefits of dual-class structures and advocate against regulation

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[536] *See, e.g.,* Claire A. Hill & Alessio M. Pacces, *The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance* (Eur. Cor. Governance Inst., Law Working Paper No. 492/2018, 2019), https://ecgi.global/sites/default/files/working_papers/documents/ finalhillpaccess.pdf, 66 (noting that in the U.S., dual-class shares "may be the only effective defense against activists, and are regarded by activists as a major hurdle.").

[537] *See, e.g.,* Armen A. Alchain & Harold Demsetz, *Production, Information Costs, And Economic Organization*, 5 AM. ECON. REV. 777 (1972) (discussing the advantage of dual-class structures under circumstances in which public shareholders are less informed than the controlling shareholders).

[538] *See, e.g.,* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights in Concentrated Corporate Ownership*, 310–11 (Randall K. Morck ed., 2000) ("[T]he agency costs associated with [controlling-minority-structure] firms increase very rapidly as the fraction of equity cash-flow rights held by controllers declines"); Lucian Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 Geo. L. J. 1453 (2019) (analyzing the perils of small-minority controllers and explaining how they generate considerable governance costs and risks, which are likely to exacerbate as the controller's stake decreases); see also Charles Elson & Craig Ferrere, *Unequal Voting and the Business Judgment* Rule, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Apr. 7, 2018), https://corpgov.law.harvard.edu/2018/04/07/unequal-voting-and-the-business-judgment-rule/ (arguing that the surge in dual-class companies is likely to result in a growing number of companies that are unaccountable to shareholders, the markets, and the courts).

[539] *See, e.g.,* Lucian Bebchuk & Kobi Kastiel, T*he Untenable Case for Perpetual Dual-Class Stock*, 4 VA. L. REV. 585 (2017); Elson & Ferrere, *supra* note 538.

that would restrict this structure.[540] Supporters of dual-class also point to the fact that many of the most successful companies in the country—including Alphabet and Facebook—have dual-class share structures.[541]

The empirical evidence on the performance of dual-class stock, however, is inconclusive.[542] While several empirical studies indicate that dual-class companies perform worse than single-class companies,[543] especially as they age,[544] many studies indicate the contrary. Notably, a line of empirical studies shows that the financial performance of dual-class companies is actually superior and that compared to fundamentals, these companies are traded at a discount.[545] Moreover, because the market over-discounts dual-class stock, investors in dual-class corporations receive higher stock returns than those who invest in single-class companies.[546] Thus, some scholars have hypothesized that the markets are "systematically discounting dual-class

[540] *See, e.g.,* Goshen & Hamdani, *supra* note 180, at 591 (maintaining that under the dual-class structure, the entrepreneur's uncontestable control provides her with the freedom to pursue her idiosyncratic vision); Dorothy S. Lund, *Non-Voting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 717 (2019) (suggesting that dual-class shares can be used by management to incentivize informed investors to buy stock with super-voting rights, thereby reducing agency costs); *see also* Bobby Reddy, *More than Meets the Eye: Reassessing the Empirical Evidence on US Dual-Class Stock*, 23 U. PA. J. BUS. L. 955 (2021) (surveying empirical studies which show that dual-class firms often outperform single-class firms both in terms of buy-and-hold stock returns and financial performance and concluding that a presumption that dual-class stock is harmful to outside stockholders should not guide policy formulation).
[541] *See, e.g.,* Sharfman, *supra* note 486, at 32-33.
[542] *See, e.g.,* Zohar Goshen & Richard Squire, Essay, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COL. L. REV. 767, 815-816 (2017) (summarizing the empirical literature on the performance of dual-class and explaining that "while some studies have linked the dual-class share structure to lower firm value, others have found no correlation once firm-specific attributes are taken into account, as principal-cost theory predicts.").
[543] *See, e.g.,* Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010); Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009).
[544] *See, e.g.,* Martijn K. J. Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation*, (Eur. Corp. Governance Inst. Fin. Working Paper No. 550/2018, 2020), https://ssrn.com/abstract=3062895 (finding empirical support for the claim that as firms age, valuation premiums for dual-class firms dissipates, and attributing these findings to the widening wedge).
[545] For e comprehensive overview of these studies, see Reddy, *supra* note 540, at 994-1004. Reddy surveyed numerous empirical studies and found that while dual-class firms are generally valued less than similar one-share-one-vote firms, they perform as well as, and, in many cases, outperform, such firms in terms of operating performance.
[546] *Id.* at 986-993.

corporations in anticipation of future poor performance that does not actually emerge."[547]

The SEC's view of dual-class structures likewise signifies two different approaches. Dual-class structures were always permitted by the SEC, although for a short period during the 1990s, the SEC amended the rules of self-regulatory organizations (such as stock exchanges) to prohibit "the ability of public companies to undertake actions having the effect of nullifying, restricting, or disparately reducing the per-share voting rights of existing common stock shareholders of the company."[548] However, this prohibition was quickly overturned by the United States Court of Appeals for the District of Columbia, which invalidated the rule on the ground that the SEC had exceeded its statutory authority.[549]

Since then, the SEC has been reluctant to regulate dual-class structures, despite rising calls from institutional investors to restrict the use of dual-class.[550] Among other reasons, the SEC has noted that the empirical evidence regarding the wealth implications of dual-class structures was unclear or inconclusive.[551] In addition, the SEC has acknowledged that dual-class stock has legitimate uses.[552]

3.2.2 The Coalition's Opposition and the "Concert of Action" Requirement

Although the regulatory and scholarly views, as well as the empirical evidence on dual-class, are far from conclusive, institutional investors have always expressed, at least publicly, a solid objection to dual-class structures.[553] They argue that dual-class structures exacerbate agency costs and entrench control in the hands of the founders.[554] And the recent surge in dual-class IPOs

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[547] *Id.* at 960.
[548] Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L. Q. 565, 578 (1991).
[549] Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).
[550] *See infra* notes 560-565 and accompanying text.
[551] *See* Bainbridge, *supra* note 548, at 578.
[552] *Id.*
[553] *See* Reddy, *supra* note 540.
[554] *See Dual-Class Stock*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclass_stock (last visited March 1, 2022).

has only intensified this opposition. As depicted in the remainder of this section, a large group of institutional investors, together with their advocacy groups and proxy advisors, have orchestrated an organized, synchronized public attack on IPO companies that opted to utilize the dual-class structure.

From an antitrust perspective, the practice by which institutional investors as competing buyers of shares in the primary market coordinate their position on a governance term is problematic. As will be elaborated below, many of the coalition's initiatives and actions depicted in this section can be viewed as agreements among competitors, either implicit or explicit, that satisfy the "concert of action" requirement under Section 1 of the Sherman Act, which proscribes every "contract, combination … or conspiracy, in restraint of trade or commerce…"[555]

In that context, it is important to emphasize that antitrust law requires far less than a formal agreement to establish a violation. In fact, it is almost always the case that courts infer an agreement from conduct.[556] For example, in the Supreme Court's Socony decision, a violation of Section 1 of the Sherman Act was established due to the Court inference of an informal "gentleman's agreement" between competing oil companies, according to which each would purchase an unspecified quantity of oil from other specified suppliers.[557] In *Strobl v. New York Mercantile Exchange,* the court concluded that the "unusual parallel conduct" of competitors

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[555] 15 U.S.C. § 1 (1988). This Part of the chapter solely analyzes the "concert of action" requirement, while the following Part shows how such actions are capable of restraining trade, in violation of Section 1 of the Sharman Act.
[556] *See, e.g.,* United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (a violation of Section 1 of the Sherman Act was established under circumstances in which the Court inferred that the defendants had formed an informal "gentleman's agreement" between competing oil companies that each would purchase an unspecified quantity of excess "distress" oil of other specified suppliers); Strobl v. New York Mercantile Exch., 582 F. Supp. 770 (S.D.N.Y. 1984) (upholding verdict of antitrust conspiracy on the basis of "unusual parallel conduct"); In re Petroleum Prods. Antitrust Litig., 906 F.2d 432 (9th Cir. 1990), cert. denied, 500 U.S. 959 (1991) ("[W]e believe that the evidence concerning the purpose and effect of price announcements, when considered together with the evidence concerning the parallel pattern of price restorations, is sufficient to support a reasonable and permissible inference of an agreement, whether express or implicit, to raise or stabilize prices … [A]t the very least, a jury could conclude that the appellees implicitly agreed to engage in practices that they knew and hoped would lead to greater price coordination.").
[557] United States v. Socony-Vacuum Oil Co., *Id.*

satisfies the concert of action requirement.[558] Thus, even implicit arrangements that fall short of an actual contract, such as those described in the section, may violate Section 1 of the Sherman Act.[559]

a) Regulatory lobbying Efforts

Recently, institutional investors have engaged in intense lobbying activities to ban dual-class structures or restrict the listing of dual-class stock. Most of these initiatives were undertaken by the CII on behalf of and with the express endorsement of its members. For example, in 2017, the CII lobbied the SEC to foreclose IPO listings of dual-class stock.[560] In response, the SEC's Investor Advisory Committee decided to hold a hearing on the topic of unequal voting rights among common stockholders.[561] At the hearing, the CII claimed that it was "time for the SEC to revisit … the rules on new offerings of multi-class common structure with differential voting rights."[562]

Although this initiative did lead Professor Robert Jackson, then the SEC Commissioner, to empirically evaluate the performance of dual-class companies with differing sunset provisions,[563] these lobbying efforts ultimately did not bear fruit. The SEC refused to change its rules or restrict

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[558] Strobl v. New York Mercantile Exch., *supra* note 556.
[559] *See infra* notes 623-624.
[560] *See, e.g.,* Blair Nicholas & Brandon Marsh, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 17, 2017), https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequenc es-of-depriving-institutional-investors-of-corporate-voting-rights/ ("In the wake of the Snap IPO, CII Executive Director Ken Bertsch and other investors met with the SEC Investor Advisory Committee. They encouraged the SEC to work with U.S.-based exchanges to (1) bar future no-vote share classes; (2) require sunset provisions for differential common stock voting rights; and (3) consider enhanced board requirements for dual-class companies in order to discourage rubber-stamp boards.").
[561] The video webcast of the IAC meeting on Mar. 9, 2017, is available at https://www.sec. gov/news/sec-webcasts (last visited March 1, 2022).
[562] *Remarks to The Sec Investor Advisory Committee,* COUNSEL INSTITUTIONAL INV. (Mar. 9, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_09_17_IAC_ test imony.pdf (last visited March 1, 2022).
[563] *See* Public Statement, Robert J. Jackson, Comm'r, *Perpetual Dual-Class Stock: The Case Against Corporate Royalty,* U.S. SEC. & EXCH. COMM'N (Feb. 15, 2018), https://www.sec. gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

the ability of companies with dual-class structures to list their stock. In fact, at one of the CII's annual conferences, the former SEC chairman Jay Clayton stated that regulating dual-class stock structures was not at the top of the SEC's priority list.[564] Clayton also expressed his opinion that the exclusion of dual-class stock from market indexes, another initiative that institutional investors promoted against dual-class, which will be discussed below, did not "sit really well" with him.[565]

Besides lobbying the SEC, institutional investors and their organizations tried to lobby the U.S. stock exchanges. In 2012, following Facebook's IPO, the CII petitioned Nasdaq and the NYSE to amend their listing requirements by instituting a one-share-one-vote policy for newly public companies.[566] The CII also asked the exchanges to bar a listing if the company had two or more classes of common stock with unequal voting rights.[567] But both exchanges effectively refused. Nasdaq explicitly rejected the calls for stricter rules regarding multi-class stock and acknowledged the importance of the structure in terms of encouraging innovators to access public markets.[568] The NYSE simply chose not to respond to the calls from the investor community.[569]

Six years later, following Snapchat's unprecedented IPO, which offered non-voting common shares, the CII again petitioned Nasdaq and the NYSE. This time, the CII asked the exchanges to amend their listing standards and accept newly listed companies with a dual-class

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[564] *See* Public Statement, Jay Clayton, Chairman, *Remarks to the SEC Investor Advisory Committee*, U.S. SEC. & EXCH. COMM'N (Mar. 8, 2018), https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8.
[565] *See* Andrea Vittorio, *FTSE Russell to Revisit Voting Power One Year After Snap IPO*, BLOOMBERG L. (Mar. 13, 2018), https://news.bloomberglaw.com/business-and-practice/ftse-russell-to-revisit-voting-power-one-year-after-snap-ipo.
[566] *See* Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Edward S. Knight, Exec. Vice President, Gen. Counsel & Chief Regulatory Officer, NASDAQ OMX Group, (Oct. 2, 2012), http://www.cii.org/files/is sues_and_advocacy/correspondence/2012/10_02_12_ cii_letter_to_nasdaq_dual_class_stock.pdf; *see also* Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Claudia Crowley, CEO & Chief Regulatory Officer, NYSE Regulation (Oct. 2, 2012), https://www.cii.org/files/issues_and_advocacy/correspondence /2012/10_2_12_cii_letter_to_nyse_dual_class_stock.pdf.
[567] For a thorough review of past attempts to limit the listing of dual-class companies, see Lund, *supra* note 453540, at 702-703.
[568] Winden & Baker, *supra* note 534, at 114.
[569] *Id.*

structure only if their governing documents included a mandatory seven-year sunset for any unequal voting rights.[570] The CII's press release claimed to have endorsements from several large asset managers, such as BlackRock and T. Rowe Price, as well as the largest institutional pension funds, such as California Public Employees' Retirement System (CalPERS) and California State Teacher Retirement System (CalSTRS).[571] But once again, the exchanges refused to support the CII's proposal and rejected its request to impose any restrictions on dual-class structures.

In 2019, the CII tried again, this time submitting letters to the Delaware Bar and the American Bar Association ("ABA") requesting amendments to the corporate law in those jurisdictions which would ban multi-class share structures that extend beyond seven years following an IPO.[572] Both the ABA and Delaware Bar rejected the CII's petition.[573]

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[570] *See* Letter from Ash Williams, Chair, Kenneth Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to John Zecca S. Knight, Senior Vice President, Gen. Counsel North Am. & Chief Regulatory Officer, NASDAQ Stock Market (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024% 20NASDAQ %20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf; Letter from Ash Williams, Chair, Kenneth Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Elizabeth King, Chief Regulatory Officer, NYSE Regulation (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/ 2018/20181024 NYSE Petition on Multiclass Sunsets FINAL.pdf.

[571] *See* Press release, *Investors Petition NYSE, NASDAQ to Curb Listings of IPO Dual-Class Share Companies*, COUNSEL INSTITUTIONAL INVESTORS (Oct. 2, 2018), https://www.cii. org/files/issues_and_advocacy/correspondence/FINAL%20Dual%20Class%20Petition%20Press%20Release%20Oct%2024, %202018.pdf.

[572] *See* Letter from Kenneth Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Laurie A. Smiley, Chair, Am. Bar Ass'n Corp. L. Committee, (Sep. 13, 2019), https://www.cii.org/files/issues_and_advocacy/correspondence/2019/September 13 2019 Final MBCA letter.pdf; Letter from Ken Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Henry E. Gallagher, Council Chair, Corp. L. Sec. Del. State Bar Ass'n (Sep. 13, 2019), https://www.cii.org/files/issues_and_advocacy /correspondence/2019/September%2013%202019%20Final%20DGCL%20letter.pdf.

[573] *See* Letter from Laurie A. Smiley, Chair, Am. Bar Ass'n Corp. L. Committee to Kenneth Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs (Dec. 13, 2019), https://www.cii.org/files/issues_and_advocacy/ correspondence/2019/ABA Response to CII request to reform MBCA.pdf; Letter from Henry E. Gallagher, Council Chair, Corp. L. Sec. Del. State Bar Ass'n to Kenneth Bertch, Executive Director & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs (Jan. 28, 2020), https://www.cii.org/files/1-28-2020%20Letter%20to%20CII%20(05512328xCCC1C).pdf. In its response letter, the Delaware Bar expressed concerns regarding the possibility of applying "a mandatory rule to a subset of Delaware corporations with a particular voting structure."

The regulatory initiatives described so far reflect the mutual understanding of institutional investors regarding dual-class structures, as conveyed by the most prominent investor consortiums. Because these efforts are primarily targeted against issuers in the primary market, a market in which institutional investors compete, they should be seen as de facto agreements between competitors. As the following Part shows, these regulatory efforts can lead to anticompetitive distortions.

According to the Noerr-Pennington doctrine, antitrust laws do not prohibit joint lobbying activities undertaken in an attempt to influence the passage of laws.[574] However, while this doctrine might shield lobbying of the SEC—a government agency—it does not necessarily shield the lobbying of self-regulated organizations such as the stock exchanges.[575] Moreover, even protected lobbying activities must meet certain safeguards aimed to ensure that these activities do not spill over into unlawful competitor coordination.[576] For example, several types of communication with a governmental body on behalf of a group of competitors may still face antitrust scrutiny. In fact, in the Noerr case itself, the Supreme Court stated that "there may be situations in which a publicity campaign, ostensibly directed toward influencing governmental action, is a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor and the application of the Sherman Act would be

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[574] Eastern Railroad Presidents' Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1965).

[575] For a general discussion on the reasons for and against the classification of securities industry self-regulatory organizations, such as stock exchanges, as government agencies, see Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies*, 14 STAN. J. L. BUS. & FIN. 151 (2008).

[576] *See, e.g.,* Clipper Express v. Rocky Mountain Motor Tariff Bureau, Inc., 690 F.2d 1240, 1261 (9th Cir. 1982); Eastern Railroad Presidents' Conference v. Noerr Motor Freight, Inc., 365 U.S. 127, 144 (1961). The Federal Trade Commission (FTC) has also interpreted case law to provide "ample room to conclude that, outside of the political arena, a pattern of repetitive petitions filed without regard to merit and for the sole purpose of using the government process, rather than the outcome of the process, to harm marketplace rivals directly and suppress competition should be subject to antitrust liability without the requirement that each underlying filing meets PRE's standard for objective baselessness." *See* Enforcement Perspectives on the Noerr-Pennington Doctrine, An FTC Staff Report 35 (2006), https://www.ftc.gov/sites/default/ files/documents/reports/ftc-staff-report-concerning-enforce ment-perspectives-noerr-pennington-doctrine/p013518enfperspectnoerr-penningtondoctrine.pdf.

justified."[577] Given the potential anticompetitive consequences of these petitions, they may fail to meet the threshold for exemption. Moreover, even if these petitions are exempt from antitrust enforcement, other joint efforts of institutional investors and their consortiums described in the remainder of this section, are likely not exempt.

b) Calls for Index Exclusion

Having failed to convince regulators and stock exchanges to restrict the issuance of dual-class stock, institutional investors, acting through their consortiums, focused their advocacy efforts on index providers. In 2017, the CII pushed prominent index providers, such as the S&P Dow Jones Indices, MSCI Inc., and FTSE Russell, to exclude companies with multi-class share structures unless such companies had corresponding sunset provisions.[578]

According to the CII, index exclusion was necessary to provide public shareholders "a viable mechanism, outside of litigation, to protect against insider entrenchment and the associated risk to long-term performance."[579] The Corporate Finance Institute (CFI), another organization that represents investment professionals, weighed in as well, stating that "indexed investors would largely be relieved of the requirement to own companies with what would be deemed to be poor governance practices as sub-optimal shareholder rights."[580]

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[577] Eastern Railroad Presidents' Conference v. Noerr Motor, *supra* note 576.
[578] *See* Letter from Kenneth Bertch, Executive Director, Council of Institutional Inv'rs, to FTSE Russell Governance Board (Mar. 24, 2017), https://www.cii.org/files/issues _and_advocacy/correspondence/2017/03_24_17_letter_ ftse.pdf; Letter from Kenneth Bertch, Executive Director, Council of Institutional Inv'rs, to MSCI Equity Index Committee (Mar. 29, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_MSCI_ letter_request_for_consultation.pdf; Letter from Kenneth Bertch, Executive Director, Council of Institutional Inv'rs, to S&P Dow Jones Indices (Apr. 27, 2017), https://www.cii.org/files/ 20170426 CII comment S&P no vote share(1).pdf.
[579] *Id.*
[580] *See* Letter from James Allen, Head, Capital Mkts. Policy & Matt Orsagh, Dir., Capital Mkts. Policy, Corporate Finance Institution to S&P Dow Jones Indices, CORP. FIN. INST., (June 29, 2017), https://www.cfainstitute.org/Comment/20Letters/20170629.pdf. The CFA Institute suggested that companies with no voting rights could be placed in a new "governance light" index, but not "commingled with issuers who adhere to full governance/shareholder accountability standards."

Because index providers are beholden to their institutional clients—institutional investors comprise the vast majority of their potential client base when it comes to licensing indices—index providers have an economic incentive to accommodate the preferences of such institutions.[581] Thus, it should come as no surprise that the most prominent index providers decided to change their inclusion standards in response to their institutional clients' demands.

The S&P Dow Jones, for example, announced that it would no longer add companies to its S&P Composite 1500 and its component indexes if they had a multiple share class structure.[582] Existing index constituents with a dual-class structure would be grandfathered and would not be affected by the exclusion.[583] FTSE Russell announced that beginning in 2017, it would exclude dual-class stock from the Russell 3000 indexes if less than 5% of the company's voting rights are held by unrestricted, public shareholders.[584] Notably, unlike the S&P Composite 1500 rule, this new restriction would not grandfather existing companies.[585]

The MSCI index, however, was less responsive to the calls for exclusion. At the beginning of 2018, MSCI published a consultation paper that concluded that "unequal voting shares should be eligible for inclusion in indexes because they meet the definition of equity."[586] A few months later, MSCI slightly changed its stance, recognizing that low-voting shares cause a dilemma for

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[581] *See* Hirst & Kastiel, *supra* note 522, at 1242.

[582] *See S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, S&P DOW JONES INDICES, (July 31, 2017), http://press.spglobal.com/2017-07-31-S-P-Dow-Jones-Indices-Announces-Decision-on-Multi-Class-Shares-and-Voting-Rules.

[583] *Id.* Other S&P and Dow Jones branded indexes, such as the S&P Total Market Index, continue to include companies with multiple share structures.

[584] *See FTSE Russell Voting Rights Consultation Results – Next steps*, FTSE RUSSELL (July 2017), https://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_ Next_Steps.pdf. Given the low threshold set by the FTSE Russel, the exclusion does not affect most dual-class companies.

[585] *See FAQ: Minimum Voting Rights Hurdle*, FTSE Russell, 4 (Nov. 2018), https://research.ftserussell.com/products/downloads/Minimum_Voting_Rights_Hurdle_FAQ.pdf. However, a five-year grace period was given to existing constituents to comply with the new rules.

[586] *See Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?,* MSCI, 3 (Jan. 2018), https://www.msci.com/documents/1296102/8328554/ Discussion+Paper_Voting+rights.pdf/d3ba68f1-856a-4e76-85b6-af580c5420d7.

index trackers. Thus, MSCI suggested that it would adjust the weights of dual-class stock in its indexes to reflect the level of voting power in the hands of outside shareholders.[587] However, this change in index weighting was soon abandoned by the MSCI, apparently because it was a polarizing issue among international institutional investors.[588]

In their article on governance by indexation, Professors Scott Hirst and Kobi Kastiel argue that the effort to exclude dual-class structures from the various indices—although purportedly carried out by index providers, almost certainly was imposed at the behest of their institutional clients.[589] Hirst and Kastiel provide three pieces of evidence as support for that conclusion. First, they explain that this proposal did not reflect the index providers' views or their fundamental business goal of covering the whole investable market.[590] Second, there is anecdotal evidence that only a few years before the coalition made its public opposition, some larger index providers had no problem adding dual-class stock to their indices. For example, in 2014, S&P Dow Jones allowed Google to include both its Class A and Class C shares in the S&P 500 index.[591] Similarly, S&P indices also agreed, in the years preceding the coalition's efforts, to include two classes of shares of two well-known media companies (Fox and Comcast).[592] And third, the CEO and chairman of

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[587] *See Consultation on the Treatment of Unequal Voting Structures in The MSCI Equity Indexes*, MSCI (June 2018), https://www.msci.com/documents/1296102/8328554/Consultation_ Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339.

[588] *See* MSCI Will Retain the MSCI Global Investable Market Indexes Unchanged and Launch a New Index Series Reflecting the Preferences of Investors on Unequal Voting Structures, MSCI, (Oct. 30, 2018), https://www.msci.com/documents/10199/238444/PR_Voting_Results.pdf/ 0b548379-fbe7-71c7-b392-7140b2215cc9.

[589] *Id*.

[590] *See* Hirst & Kastiel, *supra* note 522, at 1242-1246. Following the change in the index inclusion rules, several prominent institutional investors stated that although they oppose dual-class structures, the index exclusion sanction is problematic for that exact reason (see, e.g., Letter from Barbara Novick, Vice Chairman, BlackRock to Baer Pettit, President, MSCI, Inc. 1 (Apr. 19, 2018), https://corpgov.law.harvard.edu/2018/05/03/open-letter-regarding-consultation-on-the-tre atment-of-unequal-voting-structures-in-the-msci-equity-indexes/). The other two largest index fund managers, Vanguard and State Street Global Advisors, echoed this view.

[591] *See* Hirst & Kastiel, *supra* note 522, at 1246.

[592] *Id.*

MSCI basically admitted as much when, in speaking directly to institutional investors, he said, "you pushed it on us."[593]

Putting aside the genesis of the exclusion effort, it is important to note that the negative financial impact of dual-class stock cited by the indices as the reason for exclusion has not been borne out by the data. Several recent studies have actually shown that the returns of several major indexes would have fallen significantly over the last decade if dual-class companies had been excluded from the indexes.[594] Moreover, the study utilized by the CII in its advocacy to ban dual-class share structures in IPOs was later described as "sloppy in design, amateurish and misleading in its statistics, and biased in its interpretation."[595]

Unlike lobbying activity before a governmental authority that can enjoy the Noerr protection, lobbying activity around index exclusion is not exempt from antitrust scrutiny. As a matter of fact, in light of the emergent view that index investing is essentially a form of delegated management—whereby index fund managers (the principals) empower the index providers (the agents) to make decisions on their behalf and for their benefit[596]—antitrust scrutiny is demanded. Putting pressure on index providers under the described circumstances to use their products as an enforcement device against issuers may well constitute an antitrust violation. Given the potential anticompetitive impact of the index exclusion initiative on price

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[593] *Id.*
[594] According to Melas, excluding dual-class shares from indexes would have reduced the indexes' total returns by approximately 30 basis points per year over the ten-year period starting in 1997. *See* Dimitris Melas, *Putting the Spotlight on Spot: Why Have Stocks it Unequal Voting Rights Outperformed?,* MSCI (Apr. 3, 2018), https://www.msci.com/www/blog-posts/putting- the-spotlight-on/0898078592. Another study sponsored by State Street Global Advisors found that excluding dual-class firms from indexes during the years 1996-2006 would have reduced the returns on such indexes from 86.5% to 84.6% (see Winden & Baker, *supra* note 534, p. 150 n.175).
[595] *See* Sharfman, *supra* note 486, at 17 n. 87.
[596] *See* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and Index Investing*, 36 YALE J. REG. 795 (2019).

and non-price terms of securities sold in IPOs, as described in the following section, an antitrust violation is particularly likely.

c) A New Blacklist: "Dual-Class Enablers"

Recently, the CII published a list of "Dual-class Enablers."[597] The list is updated regularly and includes the names of all board members who were involved in IPOs of companies that went public with an open-ended dual-class structure (that is, a dual-class structure that does not include a sunset provision).[598] As the CII itself stated, the goal of this list is to sanction dual-class enablers "by voting against them or withholding support from these same individuals at other, single-class boards on which they sit." [599]

This initiative carries significant implications for board members of IPO companies, as it negatively affects their reputation and may even limit their career opportunities. By using their collective power, institutional investors were able to put in place mechanisms that effectively deter board members from supporting a dual-class offering, even if the members would have otherwise endorsed it. These likely outcomes are precisely what motivated the CII to come up with this initiative in the first place. As Kenneth Bertch, then the executive director of the CII, explained, one of the impacts of such a list is that it will "cause directors of private companies that are considering an IPO to think more carefully about the benefits and costs of adopting a dual-class structure."[600]

The dual-class enablers initiative constitutes a clear use of market power by the CII on behalf of its members. Essentially, institutional investors, acting through the CII, used their

[597] *Dual-Class Enablers*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclassenablers.
[598] *Id.*
[599] *Id.*
[600] Hazel Bradford, *CII Identifies Directors of Companies with Dual-Class shares,* PENSIONS & INVESTMENTS (Aug. 7, 2019), https://www.pionline.com/governance/cii-identifies-directors-companies-dual-class-shares.

collective power to sanction individual directors only because they supported a voting structure that they viewed as worth-adopting.

d) Widespread Backlash Against Dual-Class Companies

In recent years, some of the largest institutional investors in the United States have publicly voiced their opposition to dual-class structures. Leading asset management institutions such as the Big Three, as well as T. Rowe Price and Fidelity, all adhere to the one-share-one-vote share structure in their corporate governance guidelines[601] and have stated on several occasions that all companies should have shares with equal voting rights.[602] Moreover, the proxy guidelines of these asset management institutions specifically state that they expect new public companies to refrain from going public with a dual-class structure.[603] A spokesperson for Vanguard, for example, commented: "We are increasingly troubled by the rise of nonvoting and low-voting shares. These structures contradict our fundamental belief that shareholders' economic interest and voting rights should be aligned."[604] In addition, T. Rowe Price has revealed its intention to vote against independent directors and against nominating and corporate governance committee members at

[601] *Proxy voting guidelines for U.S. securities*, BLACKROCK, https://www.blackrock.com /corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; *Proxy Voting and Engagement Guidelines: North America*, STATE STREET GLOBAL ADVISORS, https://www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guideli nes-us-canada.pdf; *Summary of the proxy voting policy for U.S. portfolio companies*, Vanguard Funds, https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020 _proxy_voting_summary. pdf; Proxy Voting Guidelines, FIDELITY, https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Full-Proxy-Voting-Guidelines-for-Fidelity-Funds-Advised-by-FMRCo-and-SelectCo.pdf; *Proxy Voting Guidelines*, T. ROWE PRICE, https://www.troweprice.com/content/dam/trowecorp/Pdfs/50356_TRP_Proxy_ Voting_Guide _UK_1119%20FINAL.pdf.
[602] Alicia McElhaney, *Investor Group Pushes for 'One Share, One Vote' Policy at Stock Exchanges*, INSTITUTIONAL INVESTORS (Oct. 24, 2018), https://www. institutionalinvestor.com/ article/b1bjdfmdfjxh6h/Investor-Group-Pushes-for-One-Share-One-Vote-Policy-at-Stock-Excha nges.
[603] *See supra* note 601.
[604] Richard Teitelbaum, *Index Firms Take Issue with Nonvoting Rights*, WALL ST. J. (Apr. 9, 2017), https://www. wsj.com/articles/index-firms-take-issue-with-nonvoting-rights-1491739227.

dual-class companies.[605] The two largest U.S. pension funds, CalPERS and CalSTRS, also objected to the structure in their public statements.[606] Both of them called for eliminating stock with unequal voting rights and threatened to ban any dual-class company in which a minority shareholder controls the majority of the votes.[607]

Investor advocacy groups and proxy advisors have also voiced opposition to the dual-class structure. The CII, as discussed, has publicly led the charge against unequal voting rights, maintaining that stock with inferior voting rights should be barred. The opposition to dual-class structures was also incorporated into the set of consensus governance principles developed by the ISG. The ISG Framework asserts that newly public companies should adopt a single-class structure.[608] According to the framework, dual-class voting is not a best practice, and directors of existing dual-class companies should phase out that controlling structure.[609] These investor consortiums, the CII and the ISG, have also emphasized that their institutional members stand together behind the objection to the dual-class structure.[610]

From an antitrust perspective, such statements and threats are problematic as they confirm the power of the coalition, thereby imposing effective threats on issuers of dual-class stock. Moreover, by reducing the uncertainty surrounding the institutional investors' approach towards dual-class, these practices and public statements make it easier for institutional investors to coordinate their behavior in an anticompetitive way. Since uncertainty among competitors is a significant impediment to cartel-like results, the reduction of such uncertainty makes tacit

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[605] Ross Kerber & Jessica Toonkel, *Exclusive: T. Rowe Price to Oppose Key Directors at Super-Voting Share Companies*, REUTERS (Mar. 6, 2016), https://www.reuters.com/article/us-troweprice-directors/exclusive-t-rowe-price-to-oppose-key-directors-at-super-voting-share-comp anies-idUSKCN0W90F2.
[606] *See* Lund, *supra* note 453, at 710 & n.118.
[607] *Id.*
[608] *See, e.g., Corporate Governance Principles for US Listed Companies*, INVESTOR STEWARDSHIP GROUP, https://isgframework.org/corporate-governance-principles/ (last visited March 1, 2022).
[609] *Id.*
[610] *See supra* note 528 and accompanying text.

coordination of price and other terms associated with dual-class offerings more probable. Thus, the described practices can be viewed as facilitating practices, which help ensure that institutional investors adhere to the consortiums' stated position, reducing the chances of shirking.

In a similar spirit, the two leading proxy advisory firms—Institutional Shareholder Services ("ISS") and Glass, Lewis & Co., which collectively advise asset managers that account for ninety-seven percent of the asset management industry[611]—issued statements opposing dual-class structures.[612] The ISS included an objection to dual-class structures in its guidelines,[613] labeling it "an autocratic model of governance."[614] Glass Lewis announced that it would vote against directors of companies with dual-class structures unless their charters include a reasonable sunset provision.[615] Glass Lewis further stated that it would generally recommend voting against all board members of an IPO company that went public with a multi-class share structure unless the company had a sunset provision.[616]

Although the process by which proxy advisory firms came to oppose dual-class is not transparent, ample evidence indicates that institutional investors are often involved in the process by which those firms develop their voting guidelines.[617] And the input received from institutional investors likely affected the proxy advisors' attitude towards dual-class. To the extent that the

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[611] *See* Eckstein, *supra* note 468, at 20.
[612] *See, e.g., United States Proxy Voting Guidelines*, INSTITUTIONAL SHAREHOLDER SERVICES, https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.
[613] *Id.*
[614] Shayndi Raice, *Advisory Service Slams Facebook's Dual-Class Share Scheme*, WALL ST. J. (Feb. 13, 2012) https://www.wsj.com/articles/SB10001424052970204883304577221942476996 760.
[615] *2020 Proxy Paper Guidelines*, GLASS LEWIS, https://www.glasslewis.com/wp-content/uploads/2020/11/US-Voting-Guidelines-GL.pdf?hsCtaTracking=7c712e31-24fb-4a3a-b396-9e8568fa0685%7C86255695-f1f4-47cb-8dc0-e919a9a5cf5b. Glass Lewis also announced that it would refrain from voting against the board members if the board commits to submitting sunset provisions to a shareholder vote at the first shareholder meeting following the IPO.
[616] *Id.*
[617] Enriques & Romano, *supra* note 514, at 15-16 (arguing that the proxy advisors' policies tend to reflect institutional investors' corporate governance preferences); Eckstein, *supra* note 468, at 58 ("Interestingly, institutional investors not just design their own guidelines, but also involved in the process in which proxy advisory firms develop their voting guidelines.").

concerted efforts of institutional investors entice proxy advisors to toughen their stance on dual-class structures, such efforts can also run afoul of antitrust laws. Here, again, institutional investors use their power to influence the policies of for-profit private companies—companies that vote millions of votes on behalf of these investors each year and largely shape the corporate governance of public companies. Thus, harnessing proxy advisors to the coalition can also be seen as a clear use of market power.

The backlash reaction of institutional investors and their advocacy groups against dual-class structures was not just an abstract, general concern but also firm-specific, often targeting IPO companies that planned to go public with a dual-class structure.[618] It has now become almost routine for the CII to write open letters to issuers, calling upon them to abandon a proposed dual-class IPO or include sunset provisions.[619] Companies such as Snap, Airbnb, Blue Apron., Dropbox, Roku, Lyft, Pinterest, and Levi Strauss have all been targeted by such letters.[620] These letters emphasize the power of the CII, explicitly mentioning the number of institutional investors that the CII represents and the collective value of the members' assets under management. As these letters are sent expressly on behalf of the members of the CII, they should satisfy the concerted action requirement under the Sherman Act.

Moreover, prominent institutional members often publicly line up behind the CII following the issuance of the open letters.[621] Notably, several institutional members even implied that a

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[618] *See, e.g.,* Ronald Orol, *Activists Urge Exchanges to End No-Vote IPOs Like Snap*, THE STREET (Feb. 28, 2017), https://www.thestreet.com/markets/mergers-and-acquisitions/activists-urge-exchanges-to-end-no-vote-ipos-like-snap-14019899; Hazal Bradford, *Investors Intensify Fight Against Dual-class Shares*, PENSIONS & INVESTMENTS (Apr. 1, 2019), https://www.pionline.com/article/20190401/PRINT/190409984/investors-intensify-fight-against-dual-class-shares.
[619] For the list and links to all the letters sent by the CII to IPO companies since 2017 see COUNCIL INSTITUTIONAL INV., https://www.cii.org/old_correspondence.
[620] *Id.*
[621] *See, e.g.,* Stephen Foley & Hannah Kuckler, *Snap's Offer of Voteless Shares Angers Big Investors*, FIN. TIMES (Feb. 3, 2017), https://www.ft.com/content/17db65c0-e997-11e6-893c-082c54a7f539.

decision to issue shares with inferior voting rights would have significant pricing implications.[622] These types of public statements should also face antitrust scrutiny. Antitrust regulators and scholars have already recognized the possibility that competitors may make public announcements as a means to send signals to their rivals and chill competition.[623] For example, in the *Petroleum Products* antitrust litigation, the court viewed price announcements of competing oil companies as forming an agreement to raise or stabilize prices.[624] Likewise, the FTC decision in the Dupont case challenged unilaterally adopted practices such as advance announcements as conduct that may facilitate anticompetitive ends.

According to this view, the problem is that even a vague understanding between competitors on a common course of action, which can be implied from public announcements, involves both collective decision-making and some degree of express mutual assurance of compliance with that joint decision.[625] The main concern is that such public statements may indicate the desired direction of future price movements and pricing strategies in the market. Thus, while public statements against dual-class structures may not be illegal per se, they might still be unlawful if they have anticompetitive effects.[626]

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[622] *See infra* notes 649-650.
[623] *See, e.g.,* Thomas A. Piraino, Jr., *The Antitrust Implications of "Going Private" and Other Changes of Corporate Control*, 49 B.C. L. REV. 971, 1005 (2008), at 1005 (acknowledging the possibility that private equity firms send subtle signals to each other about their competitive intentions, in a way that allows them to "establish a pattern in which they take turns bidding for companies, thus reducing the purchase price each firm has to pay in a particular transaction."). Piraino mentions interesting anecdotal concerning the DOJ investigation of the competitive practices of private equity funds in the context of going-private transactions as well as a New York Times article by Andrew Ross Sorkin, which referred to letters directed to four large private equity firms. Sorkin suggested that "[w]hile it was never asked directly, the letters could have been only one sentence long: 'Are you colluding to drive down buyout prices?'." Similarly, the FTC decision in the Dupont case also challenged unilaterally adopted practices as advance announcements as conduct that may facilitate anticompetitive ends (E.I. du Pont de Nemours & Co. v. FTC (Ethyl), 729 F/2d 128 (2d Cir. 1984)).
[624] Petroleum Prods. Antitrust Litig., *supra* note 556.
[625] *Id.*
[626] *Compare, e.g.,* Nicholas Walter, *Antitrust and Corporate Law: Revisiting the Market for Corporate Control*, 15 U. PA. J. BUS. L. 755, 777 (2013) ("Even if private equity bidders do not agree explicitly to collude in a bid, they are able to signal to each other that they do not wish to bid against each other. Such signaling is not illegal per se, but would still be illegal if it had an anticompetitive effect.").

In sum, the coalition's efforts against dual-class help create an across-the-board understanding among institutional investors—some of which are the most influential investors in the country—that dual-class stock is worth less and that issuers should either conform to the one-share-one-vote standard or bear a price tag. As the following Part shows, this collective understanding undermines competition in the primary market.

3.3 An Antitrust Analysis of the Coalition Against Dual-Class

The previous Part described the joint efforts of institutional investors and their consortiums against companies with dual-class structures and suggested that some of the initiatives could be viewed as implicit agreements between competitors that satisfy the concert of action requirement under antitrust law. This Part analyzes these concerted efforts through an antitrust lens and demonstrates how they distort competition in violation of competition laws.[627] Section 3.1.1 maintains that the actions of the coalition members help facilitate a cartel of buyers in the primary market and explores the ways in which the coalition affects the environment within which issuers and investors bargain. Section 3.1.2 pinpoints two of the coalition's distorting effects: the price effect and the governance term effect. Section 3.1.3 explores the distributional and allocational inefficiencies created by these two market effects.

3.3.1 The Coalition as a Buyers' Cartel

Although antitrust laws have been traditionally more focused on the market power of *sellers*, a core principle in economic theory is that powerful *buyers*, whether acting individually or in collusion with other buyers, are capable of causing the same economic harm that antitrust laws are designed to prevent.[628] This view has been articulated by the U.S. courts in several well-known

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[627] The standard of review adopted in this chapter is the "rule of reason" analysis, which requires an analysis of the relevant market, the market power of the parties and the existence of anticompetitive effects.

[628] *See, e.g.,* Roger D. Blair & Jeffrey L. Harrison, *Cooperative Buying, Monopsony Power, and Antitrust Policy*, 86 NW. U. L. REV. 331, 331 (1992). The authors further explain that "there is little reason to believe, at least as an

cases[629] and manifested in the Antitrust Guidelines.[630] According to the guidelines: "The exercise of market power by buyers has wealth transfer and resource misallocation effects analogous to those associated with the exercise of market power by sellers."[631]

Antitrust experts recognize that to induce an anticompetitive outcome, a buyer or a group of buyers need not possess the mirror image of monopoly power. Instead, the monopsony must have "significant market power as a buyer in the form of bargaining power that it can exert against the seller of the input."[632] Stated another way, a buyer's power becomes problematic if the buyer has the ability to obtain a "concession from another party by threatening to impose a cost, or withdraw a benefit, if the party does not grant the concession."[633]

As this section shows, both necessary elements—the possession of sufficient market power in the form of bargaining power and the capacity to obtain concession by threatening to impose a cost on the other party—characterize the coalition against dual-class. Thus, the concerted actions of the coalition are capable of inducing the same anticompetitive harms typically associated with a monopsony.

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initial proposition, that the inefficiencies and misallocations resulting from monopsony are any less damaging than the harm flowing from monopoly." *See also* John B. Kirkwood, *Buyer Power and Exclusionary Conduct: Should Brooke Group Set the Standards for Buyer-Induced Price Discrimination and Predatory Bidding?* 72 ANTITRUST L. J. 625 (2005).

[629] For example, in Vogel v. American Soc'y of Appraisers, 744 F/2d 598, 601 (7th Cir. 1984), the court explained that "[j]ust as a sellers' cartel enables the payment of monopoly prices, a buyers' cartel enables the charging of monopsony prices; and monopoly and monopsony are symmetrical distortions of competition from an economic standpoint." *See also* Fashion Originator's Guild of Am., Inc. v. FTC, 312 U.S. 457 (1941); FTC v. Morton Salt Co., 334 U.S. 37, 44 (1948); Nat'l Macaroni Mfrs. Ass'n v. FTC, 345 F.2d 421 (7th Cir. 1965); NCAA v. Bd. of Regents of the Univ. of Okla., 468 U.S 85 (1984); Balmoral Cinema v. Allied Artists Pictures, 19 885 F.2d 313 (6th Cir. 1989).

[630] U.S. Dep't Just. Merger Guidelines, 49 Fed. Reg. 26, 823 (1984).

[631] *Id.*

[632] Kirkwood, *supra* note 628, at 635-636.

[633] *Id.* at 638-639.

a) The Market Power of the Coalition

In the primary market, institutional investors, which control the coalition, are the main buyers of shares.[634] On average, approximately 90% of IPO shares are allocated to institutions.[635] In fact, the vast majority of IPOs are offered through an "underwriting syndicate," which is comprised of a small, select group of broker-dealers,[636] many of whom do not even have retail investors as their clients.[637] In "hot" IPOs, where the demand significantly exceeds the supply, it is almost impossible for retail investors to acquire shares since underwriters in those offerings usually allocate shares only to institutional investors.[638]

The recent changes in ownership patterns in capital markets, particularly the shift of retail investors to the asset management industry, have potentially amplified the buyers' power of several institutional investors. As recent data show, the largest twenty-five institutional investors hold more than a third of all U.S. corporate shares.[639] When considered in combination, the Big

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[634] This chapter takes the approach that the relevant market in which the coalition operates is the IPO market—the market in which private companies first sell their shares of stock to the public, and does not differentiate between the market for single-class stock and the one for dual-class stock. Such an approach is consistent with contemporary literature on monopsony power in the IPO market (see, e.g., Ritter, *supra* note 494).

[635] *See supra* note 487. This disproportional allocation is also attributed to the change in the investment style of retail shareholders. Instead of investing in individual firms, retail investors now invest in mutual funds. Consequently, individual retail shareholders today constitute only a tiny fraction of the shareholder base of public corporations. *See* Lund, *supra* note 453, at 717. Note that the high allotment to institutional investors in IPOs is not limited to issues of single-class shares and seems to be true for dual-class issues as well. *See, e.g.,* Benjamin Robertson & Andrea Tan, *Why Dual-Class Shares Catch On, Over Investor Worries*, BLOOMBERG (Mar. 4, 2021), https://www.bloomberg.com/news/articles/2021-03-04/why-dual-class-shares-catch-on-over-inv estor-worries-quicktake-klwbtryg. Thus, even if the relevant market in which the cartel facilitated by the coalition operates is the market for dual-class IPOs rather than the general IPO market, its members collectively possess significant market power in such market as well.

[636] *Initial Public Offerings*, *Why Individuals Have Difficulty Getting Shares*, U.S. SEC. & EXCH. COMMISSION, https://www.investor.gov/introduction-investing/investing-basics/glossary/initial-public-offerings-why-individuals-have.

[637] *Id.*

[638] *Id.; see also* Beatrice Boehmer, Ekkehart Boehmer, and Raymond P. H. Fishe, *Do Institutions Receive Favorable Allocations in IPOs with Better Long-Run Returns?,* 41 J. FIN. & QUANTITATIVE ANALYSIS 809 (2006); Tim Loughran & Jay R. Ritter, *Why Don't Issues Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. FIN. STUD. 413 (2002) (arguing that there is a quid-pro-quo that underwriters receive from buy-side clients in return for allocating underpriced IPOs to these investors).

[639] *See supra* note 503.

Three are the single largest shareholders in 88% of the companies in the S&P 500.[640] Given such high concentration levels, one can reasonably expect that IPO share allocations would mirror that concentration, providing large equity stakes to large institutional investors.[641] In this scenario, the IPO macrostructure resembles an oligopsony, where a small group of large buyers dominates the demand side of the market.[642]

In light of the current macrostructure of the capital market, it is fair to say that the coalition effectively aggregates the power of buyers who together possess significant market power. The largest and most influential institutional investors are part of the coalition and have been more than willing to publicly voice their opposition to the dual-class structure. As shown below, this substantial collective buyers' power allows the coalition members to leverage their mutual opposition as a bargaining chip against issuers of dual-class stock, thereby imposing a cost on such issuers. Sellers are forced to price the issue at a price that is below the level that would have emerged in a competitive market or to adjust the rights attached to the stock in favor of the buyers. Both potential effects lead to inefficiencies in the market for dual-class stock

b) Bargaining in the Shadow of the Coalition

In the context of negotiating a capital structure, bargaining power is crucial. As Professors Zohar Goshen and Assaf Hamdani explain, investors and issuers can choose different structures

[640] *See* Fichtner et al., *supra* note 11, at 298-299.
[641] Note that among the S&P 500 firms, the shareholdings of index funds are exceptionally high given the large sums invested in funds that track the S&P 500 stock indices. The proportions of IPO allocation to institutional investors that track these indices are expected to be somewhat lower than their holding proportion in the S&P 500 firms because companies that become public do not usually enter major market indices during the first years following their IPOs. Nonetheless, it should be noted that many of the asset management institutions that oversee index funds manage actively managed funds as well, and are profoundly invested in IPO firms as well.
[642] The coalition may be seen as either monopsony or oligopsony. Historically, monopsony was defined as an oligopsony limited to one buyer (see monopsony, Merriam-Webster.com, https://www.merriam-webster.com/dictionary/monopsony). However, in the antitrust literature and case law, monopsony is often used to describe a group of buyers as well (similar to oligopsony). *See, e.g.,* Blair & Harrison, *supra* note 628; NCAA v. Bd. of Regents of the Univ. of Okla., *supra* note 629.

that balance the founders' interest to maintain control and pursue their idiosyncratic vision and the investors' need for protection against agency costs.[643] The ultimate structure that the parties ultimately agree to, they argue, reflects the outcome of that negotiation, which largely depends on each party's relative bargaining power and the competition in the market.[644]

This chapter argues that by acting through a coalition, institutional investors can extract significant bargaining power over issuers. Such power can then be used by these investors to control competition for the prices and terms governing IPOs and perhaps even limit the supply of certain stocks (i.e., dual-class stock) in capital markets.[645] The ability of institutional investors to extract power over issuers is attributed to several factors.

First, as explained, institutional investors—and particularly a sub-group of these investors—dominate the demand side of the primary market (for both dual-class and single-class stock). These key investors, however, not only receive a substantial portion of the shares allocated in IPOs, but they also play an essential role in the IPO price discovery process. In practice, the IPO pricing process is "an intricate exercise" in which different players, with different information and incentives, interact with each other in an attempt to arrive at a price at which the security can be put on the market with reasonable assurance of success.[646] Institutional investors, as informed

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[643] *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560, 585-586 (2016) (the authors mainly refer to entrepreneurs in their capacity as managers of the issuer); *see also* Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1272 (1999) (arguing that the contractual provisions that will be shaped "depend[s] on the outcome of the bargaining process that takes place between the contracting parties.").
[644] *See* Goshen and Hamdani, *Id.*
[645] Regardless of capital structure choice, issuers are generally at a disadvantage considering how the IPO process has evolved in recent decades. This is mainly because, unlike institutional investors as a class, "many pre-IPO shareholders… are not repeat players in the IPO market. They depend on experts (law firms and investment banks) to advise them about the conventions and effects of governance term choices," whose interests may diverge from those of issuer (see John C. Coats, *Explaining Variation in Takeover Defenses: Failure in the Corporate Law Market* (Harv. L. & Econ. Discussion Paper No. 297 (2000), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=237020, 16. Consistent with that view, the literature concludes that the IPO allocation process tends to be biased towards institutional investors. *See, e.g.,* Supriya Katti & B.V. Phani, *Underpricing of Initial Public Offerings: A Literature Review,* 4 UNIVERSAL J. ACCT. & FIN. 35 (2016).
[646] United States v. Morgan, 118 F. Supp. 621, 654 (S.D.N.Y. 1953).

participants, provide valuable pricing feedback in this process, during marketing activities and the "book-building" process—a process in which prospective investors submit flexible bids within a pre-determined price range.[647]

If these investors *collectively* send negative signals on a governance term attached to a security sold in an IPO, they can more easily pressure issuers.[648] The unspoken but very real threat is that a failure on the part of the issuers to align with the institutions' preferred governance standards will cause these investors to drive the IPO stock price down. In fact, prominent institutional investors have explicitly tied the decision to go public with a dual-class structure to having a lower offering price. For example, in a recent whitepaper, BlackRock emphasized that "deviations from the proportionality principle can negatively impact the value of shares," and that investors tend to apply a discount of up to 30% on dual-class stock.[649] In a similar spirit, a director at the CalPERS publicly stated that the IPO valuation of Snap was lower than initially hoped for because of its proposed share structure.[650]

Second, because institutional investors are informed investors who acquire information about the issue and report price signals to the underwriters, the ability of sellers in IPOs to switch to less informed retail investors is limited.[651] Replacing too many informed investors with less-informed investors will impair the underwriters' ability to receive sufficient information about the

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[647] *See, e.g.,* Katti & Phani, *supra* note 645.
[648] *See, e.g., Dual-Class Stock*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclass _stock ("CII has pressed dual-class IPO companies to include reasonable time-based "sunset" provisions in their charters.") (last visited March 1, 2022).
[649] *Key Considerations in The Debate on Differentiated Voting Rights*, BlackRock, https://www.blackrock.com/corporate/literature/whitepaper/blackrock-the-debate-on-differentiate d-voting-rights.pdf (last visited March 1, 2022).
[650] *See* Orol, *supra* note 618 ("We and others noticed the slide in the potential valuation for Snap's IPO, some of that is your price tag for not allowing [outside] votes.").
[651] *See, e.g.,* Ann E. Sherman & Sheridan Titman, *Building the IPO Order Book: Underpricing and Participation Limits with Costly Information*, 65 J. FIN. ECON. 65, 16-17 (2006). In addition, because underwriters want to encourage the participation of informed institutional investors in public offerings, they must compensate these investors in the form of favorable IPO allocation. *See, e.g.,* Benveniste & Spindt, *supra* note 490, 343-362.

offering. Therefore, institutional investors are likely to receive substantial share allocation even if they provide less favorable (and perhaps intentionally inaccurate) signals during marketing activities.[652]

Finally, members of the coalition against dual-class structures have a very weak incentive to *shirk*, making it easier for the coalition members to secure a competitive advantage over issuers. This weak motivation is mainly attributed to (i) the unique characteristics of the IPO pricing and allocation process and (ii) the stabilizing and monitoring role of institutional investor consortiums.

The IPO pricing and allocation process—Flexible bids received by institutional investors affect the ultimate offer price, which is the *same* for all buyers in the IPO. This, in turn, means that to the extent that an institutional bidder shirks by failing to "properly" discount dual-class stock—such an action would intrinsically impact all buyers. Moreover, unlike most cartel settings in which the defecting party is expected to gain higher market share, in the case of an IPO, a defecting bidder who bids higher will not necessarily enjoy higher share allocation. This is because underwriters take into account many factors when allocating shares, and the bidding price is only one of them.[653] Thus, it is not guaranteed that a defecting bidder will get more shares in an IPO. It is also important to flag that due to considerations related to diversification, liquidity, and disclosure requirements,[654] institutional investors are often limited in the number of shares and percentage equity stake they can own. Thus, receiving more shares in an IPO may not necessarily serve the interest of institutional bidders.

The important role played by investor consortiums—Institutional investor consortiums, such as the CII and the ISG, play a critical function in facilitating and stabilizing the cartel of

[652] *Id.*
[653] *See* Benveniste & Spindt, *supra* note 490; *see also supra* note 638.
[654] *See*, *e.g.,* 15 U.S.C. § 78p (1964) regarding limitations on stock ownership by institutional investors. Section 16 of the Exchange Act also establishes mechanisms for a company to recover "short-swing" profits.

buyers in the primary market. Notably, these consortiums provide an opportunity for communication and interaction among institutional investors, allowing these investors to share opinions and coordinate their actions.[655] In addition, by centralizing decision-making on best practices at the organization level, institutional investors who belong to a consortium can overcome the hurdle of agreement that ordinarily inhibits cartel formation.[656] More importantly, investor consortiums often require their members to endorse the governance views that these organizations promote.[657] Indeed, many of the largest and most potent institutional investors have incorporated the views of these consortiums, such as the condemnation of dual-class structures, in their proxy guidelines and other publicly available statements.[658] This type of behavior helps signal the institutional investors' allegiance and stabilize the cartel.

The foregoing analysis suggests that in the absence of solid collective opposition, issuers could have enjoyed a better bargaining position. For example, one could have expected that at least some institutional investors would be more tolerant of dual-class structures. And that tolerance would have been consistent with the empirical evidence on the superior financial performance of dual-class companies,[659] and with recent studies that show that dual-class companies often outperform single-class companies (ironically, some of which were sponsored by prominent asset managers themselves[660]). Such a scenario would have also conformed with the fact that many institutional investors who have spoken against dual-class structures are the largest investors in many dual-class companies.[661]

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[655] *See supra* notes 525-527 and accompanying text.
[656] *Compare* Aaron Edlin & Rebecca Haw, *Cartels by Another Name: Should Licensed Occupations Face Antitrust Scrutiny*, 162 U. PA. L. REV. 1093, 1133 (2014).
[657] *See supra* note 529 and accompanying text.
[658] *See supra* note 601 and accompanying text.
[659] *See supra* note 545 and accompanying text.
[660] *See supra* note 594 and accompanying text (referring to a study that was performed and cited by State Street Global Advisors).
[661] Robertson & Tan, *supra* note 635.

However, by guaranteeing that all members of the coalition are on the same page, the coalition forecloses that possibility, undermining the notion of a fair auction embodied in antitrust law. The coalition allows its members, in their capacity as bidders in IPOs, to buy dual-class stock for a lower price than if they had bid independently and without regard to each other's views about dual-class stock.[662]

From an antitrust perspective, such practice, which can be seen as a form of joint bargaining on a governance tern, stands in opposition to what courts describe as Congress's preference for "unorganized individualism in bargaining" over "the danger, real or fancied, which may attend any efforts to control [bargaining] by concerted efforts."[663] The suspicious view on joint bargaining agreements reflects the prevalent notion that such agreements are "the most effective means of coordinating pricing, preventing cheating, and preventing nonprice competition by cartel members."[664] The main concern in the context of the coalition against dual-class is that the joint bargaining would cause issuers to lose the benefit of competition, such that they will no longer be able to play one bidder against another.[665]

3.3.2 The Market Effects of the Coalition

As the previous section demonstrated, the coalition against dual-class structures undermines the competitive process in IPOs, creating an environment that strengthens the bargaining position of institutional buyers in primary markets. This section demonstrates how those distortions translate into market outcomes, directly affecting the ultimate allocation of gains

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[662] *Compare* Mark A. Lemley, *Intellectual Property Rights and Standard-Setting Organizations*, 90 CALIF. L. REV. 1889, 1940 (2002) (explaining how the standard-setting process allows competing buyers to reduce prices below their competitive level).
[663] *See, e.g.*, Live Poultry Dealers' Protective Ass'n V. United States, 4 F.2d 840 (2d Cir. 1924).
[664] *See* Rock, *supra* note 481, 526 n.123
[665] *Compare* Edward Rock, *Antitrust and the Market for Corporate Control*, 77 CAL. L. REV. 1365, 1373 (1989) (explaining that an agreement among bidders competing for control results in the seller losing the chance to play one bidder against others).

between institutional investors and issuers. In particular, this section analyzes the two distorting market effects of the coalition—the price effect and the governance term effect—and argues that these effects may constitute an unreasonable restraint of trade within the meaning of the Sherman Act.[666]

a) The Price Effect

During the IPO process, underwriters, acting as intermediaries, advise the issuer on pricing. This advice is rendered both at the time of the issuance of a preliminary prospectus, which includes a *file price range* ("P1"), and at the pricing meeting with the issuer, when the *final offer price* is determined ("P2").[667] Notably, P1 is determined before marketing activity takes place, while P2 is determined after the marketing efforts involved in the book-building process are concluded. It is generally accepted that both P1 and P2 are affected by the market's perceptions, especially the perceptions of informed institutional investors.[668]

a. P1: the initial price range

The broad aversion of institutional investors to dual-class structures sends a strong message to issuers, underwriters, and investors. Namely, that shares with limited voting rights deviate from what is a best practice and are therefore inferior. Thus, under the pretense that dual-class structures

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[666] 15 U.S.C. § I (1988).
[667] SEC Securities Act Release No. 6383, 47 Fed. Reg. at 11,395 (1982). Regulation S-K requires companies pursuing an IPO to file a "bona fide estimate of the range of the maximum offering price" before circulating a preliminary prospectus to investors. This filing kicks off the roadshow period, in which the issuer's managers typically go on a blitz campaign of one-on-one meetings with large institutional investors and other important potential purchasers of the issuer's stock. At the end of the marketing activities, the underwriters, with the issuer, set the final offer price. This final offer price determination is based on "indication of interests" received from institutional investors. Such price determination includes "receiving the bids from the investors belonging to various classes, recording the price and quantity demanded, tracking the payment and changes in case the bids are revised."
[668] *See* Katti & Phani, *supra* note 645; *see also* Fabio Braggion & Mariassunta Giannetti, *Changing Corporate Governance Norms: Evidence from the Dismissal of Dual Class Shares in the U.K.*, (Eur. Corp. Governance Inst. Fin. Working Paper No. 375, 2013), https://papers. ssrn.com/sol3/papers.cfm?abstract_id=2138949.

impose principal-agent risks, institutional investors foster a generally negative image of dual-class structures, skirting the anticompetitive aspects of the coalition's efforts.[669]

This bias against dual-class that institutional investors nurture drives the price of such shares down. As noted, certain institutional investors have explicitly stated that a decision to issue dual-class stock should come with a price tag.[670] Thus, it is fair to assume that the general concerns expressed by institutional investors about dual-class offerings and the institutions' attempts to discourage the use of this structure are likely to impact the underwriters' perception as to the price at which the offering of dual-class stock is likely to succeed.

Moreover, it is not just the institutional investors' general views about dual-class stock that affect P1, but their issuer-specific comments as well. Although the empirical research on the interaction between underwriters and investors during pre-marketing activities is scarce,[671] it is clear that buy-side (the institutional investors) and sell-side (the underwriters) interact and exchange information even prior to marketing activities.[672] This interaction between institutional investors on one side and issuers and underwriters on the other is even more probable following the enactment of the 2012 Jumpstart Our Business Startups Act (JOBS Act).[673] The JOBS Act permitted certain emerging growth companies (EGCs)—which today account for nearly 90% of

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[669] The fact that the negative view of the coalition is backed by scholarly views strengthens the coalition's stance and inadvertently makes the coalition appear more innocent.
[670] *See supra* notes 649-650.
[671] For a theoretical discussion on pre-marketing interaction, see Tim Jenkinson, Alan D. Morrison & William J. Wilhelm Jr., *Why Are European IPOs So Rarely Priced Outside the Indicative Price Range?,* 80 J. FIN. ECON. 185 (2006).
[672] *See, e.g.,* Patrick M. Corrigan, *Why Do IPO Issuers Systematically Underestimate Initial Maximum Pricing Range Estimates? An Underwriter Agency Cost and Passive Manager Explanation* (unpublished manuscript).
[673] The JOBS Act amended Section 5 of the Securities Act (15 U.S.C. § 77e) to provide that an EGC, or any other person, such as an underwriter that it authorizes to act on its behalf may engage in oral or written communications with QIBs and institutional accredited investors to gauge their interest in a proposed offering, whether before or after the first public filing of any registration statement, subject to the requirement that no binding orders can be solicited or accepted at that time.

all IPOs[674]—to engage in "testing-the-waters" communications with sophisticated institutional investors. Thus, issuers can now determine P1 following discussions and consultations with large institutional investors regarding their valuation assessments and demands for information.[675] Since institutional investors are likely to convey their opposition to dual-class stock at this juncture, their input is expected to affect P1.

Similarly, the joint efforts of the coalition to exclude dual-class stock from market indexes may also have a negative effect on P1. Since many investors in the secondary market, particularly passive funds that track market indices, will not purchase excluded dual-class stock, the exclusion sanction is likely to decrease the pool of potential buyers. This, in turn, increases the cost of capital for excluded companies.[676] In other words, the low expected future demand in the secondary market will depress the price that investors will be willing to pay for dual-class stock at the IPO.[677] Moreover, because index exclusion is generally associated with limited liquidity, the restriction on inclusion may increase investors' required rate of return, resulting in lower prices even at the IPO stage.[678]

b. P2: the final offer price

The coalition's efforts are also likely to exert downward pressure on the final offer price of dual-class stock. First, because P1 is depressed by virtue of the coalition's efforts, P2 will almost certainly decline. This is because P1 and P2 are correlated. If P1 is set at a low range in light of

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[674] *EGC IPOs and IPO Registration Statement Trends in 2019*, MAYER BROWN (2019) https://www.freewritings.law/2019/11/egc-ipos-and-ipo-registration-statement-trends-in-2019/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration (showing that depending on the year, from 2014-2019, between 86 to 97 percent of IPOs in the U.S. were of EGC companies).
[675] Corrigan, *supra* note 672.
[676] *See* Hirst & Kastiel, *supra* note 522, at 1252-1253 (finding that index inclusion increases the demand for a stock, which subsequently leads to significant positive abnormal returns).
[677] Cf. Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*?, 41 J. FIN. 579 (1986). Note that although firms are not automatically added to indexes as they become public, their price at the IPO is likely to integrate potential future expectations regarding demand from index funds.
[678] Hirst & Kastiel, *supra* note 522, at 1253.

the institutions' views, it would be difficult to push towards a higher price.[679] In other words, a low P1 affects the behavior of underwriters and investors in a way that makes it sticky, inevitably reducing P2.[680]

Moreover, as soon as marketing activities begin, underwriters collect information and solicit indications of interest from institutional investors—non-binding statements of intent to buy the securities from prospective shareholders. This book-building process allows the underwriters to factor in the collective information available—namely, the intrinsic value as perceived by investors—before arriving at a final sales price.[681] In this process, underwriters are mainly affected by feedback received from institutional investors.[682] In fact, institutional investors, particularly a small group of key institutions, are the primary source of information extracted in the course of these marketing efforts.[683]

Considering their public statements against dual-class structures, the reasonable expectation is that institutional investors will express their negative views in roadshows and during the book-building process as they place their bids. As Professor Scott Smart and his co-authors note, "it is hard to imagine that firms going through the IPO process fail to hear, either from their investment bankers or from institutional investors on the roadshow, that issuers pay a price for insulating managers through a dual-class equity offering."[684] Indeed, the evidence on prices of dual-class stock indicates that institutional investors' progressive domination of the landscape over

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[679] Corrigan, *supra* note 672.
[680] *Id.*
[681] *See* Katti & Phani, *supra* note 645.
[682] *See, e.g.,* Benveniste and Spindt (1989), *supra* note 490.
[683] *See, e.g.,* Alexander P. Ljungqvist & William J. Wilhelm, Jr.*, IPO Allocations: Discriminatory or Discretionary?*, 65 J. FIN. ECON. 167, 178 (2002); *see also* David C. Brown & Sergei Kovbasyuk, *Key Investors in IPOs* (Paris Dec. 2015 Fin. Meeting), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2657394, at 13-14 (explaining that key investors' industry expertise and information is particularly important to IPO pricing).
[684] *See, e.g.,* Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values,* 45 J. ACCT. & ECON. 64, 105 (2008).

time, coupled with their aversion to dual-class, may have affected how dual-class companies are valued.[685]

Because institutional investors, as competing buyers of stock in IPOs, share a mutual interest in depressing the price paid for the issue, they have an incentive to collaborate to underprice dual-class stock. If they all cooperate, perhaps underrepresenting their true estimation of the issue by overvaluing voting rights, they increase their chances of being able to force a low offering price for dual-class stock. In that type of collusive equilibria, the optimal strategy from the institutional investors' perspective would be to shade their bids—rather than place bids that more accurately reflect their valuation of the shares. Due to the underwriters' constraints associated with switching from institutional investors to retail investors, deliberately overrepresenting a negative view is the optimal strategy from the perspective of the colluding institutional investors.[686] The tacit collusion between bidders can therefore lead to the systematical over-discount of dual-class offerings.

Indeed the data suggest that institutional investors often succeed in forcing deep underpricing in IPOs of dual-class stock.[687] According to one study, an important indicator of severe underpricing—the "first-day bump," which is the price increase in the first day of trading—

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[685] *See* Reddy, *supra* note 540, at 14.
[686] *Compare* Ljungqvist & Wilhelm, *supra* note 683, at 182-183 (explaining that if there are constraints on the underwriter's ability to switch to retail investors, then misrepresenting positive views is an optimal strategy from the perspective of institutional investors).
[687] Although IPO underpricing is a common phenomenon in IPOs, many of the traditional explanations offered in the literature for IPO underpricing are less relevant in the case of dual-class shares, particularly in the U.S. capital market, making the severe underpricing of dual-class shares particularly puzzling. For example, according to one hypothesis, severe underpricing generates excess demand for the offer, allowing issuers to ration shares in order to create a more diffused ownership structure. This, in turn, would reduce the incentives of outside shareholders to monitor managers (Thomas Jason Boulton, Scott B. Smart & Chad Zutter, *Acquisitions, Strategic IPO Underpricing, and Firm Survival*, 39 FIN. MGMT. 1521 (2006)). Such an explanation for underpricing is not applicable to dual-class shares as control will continue to reside with insiders nonetheless. For a comprehensive review of the literature on IPO underpricing and its causes (including the motives of underwriters in this regard), see Katti & Phani, *supra* note 645.

is almost twice as large for dual-class companies compared to single-class companies.[688] This bump implies that as soon as dual-class shares enter the broader market for securities, where institutional investors do not have as much market power as they had at the IPO stage, the price of such shares immediately increases towards what is likely to be their actual market value.

The recent IPOs of dual-class companies provide a useful illustration of the adverse pricing effect of the coalition. While most of these offerings were subject to criticism from the investor community, many of them were significantly oversubscribed and severely underpriced, as indicated by the "first-day bump." For example, Snap's decision to issue nonvoting rights encountered robust resistance, and yet, Snap made one of the biggest one-day pops for a U.S.-listed IPO raising at least $1 billion.[689] The order book was more than ten times oversubscribed.[690] As Professor Dorothy Lund noted, "investors, including some of the large institutional investors that vocally opposed the dual-class structure, did not seem to be deterred from purchasing nonvoting shares."[691]

Another example is Airbnb, whose stock shot up 112% on its opening day, suggesting it could have raised over double the money in its IPO.[692] Ultimately, Airbnb left approximately $4 billion on the table in its IPO—the second-largest first-day profit received by investors who were

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[688] Roberto Tallarita, *High Tech, Low Voice: Dual-Class IPOs in the Technology Industry (*Harv. L. Sch. Discussion paper 2018), http://www.law.harvard.edu/programs/olin_center/Prizes/ 2018-2 .pdf. The author finds that the average first-day "price bump" is 41% for dual-class firms and 24% for single-class firms. However, when looking at the variation between the offer price and the market price one week and four weeks (rather than a day) after the IPO, the difference between dual-class and single-class companies becomes less significant. According to an earlier study from the beginning of the 2000s, the underpricing for dual-class shares was actually smaller (Scott B. Smart & Chad J. Zutter, *Control as a Motivation for Underpricing: A Comparison of Dual and Single-Class IPOs,* 69 J. FIN. ECON. 85 (2003)).
[689] *See* Maureen Farrel, Corrie Driebusch & Sarah Krouse, *Snapchat Shares Surge 44% in Market Debut*, WALL ST. J. (Mar. 2, 2017), https://www.wsj.com/articles/snapchat-parent-snap-opens-higher-in-market-debut-1488471695.
[690] *See* Lauren Hirsch, *Snap's Shares Pop after Year's Biggest IPO*, REUTERS (Mar. 2, 2017), https://www.reuters.com/article/us-snap-ipo/snaps-shares-pop-after-years-biggest-ipo-idUSKBN 1690I7.
[691] Lund, *supra* note 453, at 707.
[692] *See* Kevin Stankiewicz, *Cramer Calls IPO Pricing 'Broken' and 'Embarrassing' after Airbnb, Doordash Debuts Skyrocket,* CNBC (Dec. 11, 2020), https://www.cnbc.com/2020/12/11/ jim-cramer-calls-ipo-pricing-broken-after-airbnb-doordash-debuts.html.

allocated shares at the offer price.[693] Airbnb's decision to issue dual-class stock potentially contributed to this huge underpricing, given that its share structure had also drawn criticism from the investor community.[694]

Relatedly, a recent study identified a core group of key institutional investors that are associated with the most underpriced IPOs.[695] This list of investors includes many large institutional investors who are active participants of the coalition, such as the Big Three, T. Rowe Price, and Fidelity.[696] According to that study, those investors persistently participate in the most underpriced offerings, suggesting that they force prices down to a lower point than the intrinsic value of the shares.[697] Moreover, there appears to be a strong positive relationship between those key investors' participation in the IPO process and the frequency of offer price revisions.[698] Such findings confirm that underwriters adjust offer prices after receiving information from key investors.

The existence of deep underpricing of dual-class can also be gleaned from the fact that most institutional investors who ultimately invest in IPOs of dual-class stock are not passive investors whose investment options are typically limited to the indices they track. Rather, these

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[693] *See* Jay R. Ritter, *Money Left on the Table in IPOs by Firm* (Dec. 18, 2020), https://site.warrington.ufl.edu/ritter/files/Monnew.pdf.
[694] *See, e.g.,* A Letter from Kenneth Bertch, Executive Director, Council of Institutional Inv'rs, to Angela Ahrednts, Director at Airbnb, Ken Chenault, Director at Airbnb & Ann Mather, Director at Airbnb (Sep. 20, 2020), https://www.cii.org/files/Airbnb.pdf.
[695] *See* Brown & Kovbasyuk, *supra* note 683. Using institutional investors' 13F filings to proxy for IPO participation, the authors were able to identify investors who are associated with statistically significant abnormal underpricing. According to the study, key investors' participation explains 42% of the variation in underpricing, more than any other control variable in univariate regressions. Economically, a one-standard-deviation increase in key investors' participation (about nine key investors) is associated with a 26% increase in underpricing (from the average underpricing of 21% to 47%). The study classified, on average, 11% of institutional investors as key investors, including the "Big Three" (BlackRock, State Street, and Vanguard), Fidelity, T. Rowe Price, and J.P. Morgan. Those key investors continue to be associated with abnormal underpricing over long periods. For example, 38% of key investors in a given year are classified as key investors in the following year.
[696] *Id.,* tbl.3.
[697] *Id.*
[698] *Id.*

are stock-pickers and information investors (often described as value investors) who are heavily invested in dual-class companies.[699] The fact that these value investors decide to invest in dual-class IPOs implies the existence of a substantial undervaluation of the shares, which may well be the result of the coalition's efforts.

Because institutional investors receive most of the shares in IPOs, particularly in underpriced offerings,[700] and are being favorably treated by underwriters,[701] they are the primary beneficiaries of the systematic underpricing of dual-class stock. By flipping dual-class stock in the secondary market soon after the IPO for a quick profit or enjoying the abnormal stock returns often associated with dual-class companies,[702] investors in dual-class IPOs can make big profits.

This price effect of the coalition also emphasizes how the coalition allows powerful institutional investors to gain a competitive advantage over retail investors, to whom these IPO profits are unavailable. If IPO allocation were less biased in favor of institutions, retail investors would have been able to buy dual-class stock in IPOs, perhaps mitigating the bargaining distortions facilitated by the coalition. In addition, greater participation of retail investors might have forced institutional investors to purchase the shares in the secondary market where they have no bargaining power, probably for higher prices than if they were able to buy the shares in the primary market. Instead, the coalition amplifies the advantages institutional investors have over retail shareholders in today's capital markets

[699] *See* Sharfman, *supra* note 486, at 19-20.
[700] *See, e.g.,* Ljungqvist & Wilhelm, *supra* note 683.
[701] *See supra* note 638 and accompanying text.
[702] According to Smart and his co-authors, relative to fundamentals, dual-class trade at lower prices than do single-class firms, both at the IPO and for at least the subsequent five years. *See* Smart et al., *supra* note 687.

b) The Governance Term Effect

The idea that a group of buyers may take advantage of their market power to depress the price of critical inputs lies at the heart of competition laws. However, it has already been recognized that a group of companies collectively possessing monopsony power may also conspire to influence a non-price term.[703] This would be the case, for example, if the attempts of a monopsonic group to affect non-price terms indirectly affect prices, reduce quantity, or exclude market participants.[704] Under such circumstances, coordinated attempts to affect non-price terms may also be seen as an antitrust violation.[705]

The process facilitated by the coalition, pursuant to which institutional investors with substantial buyers' power collectively oppose a governance arrangement, indeed causes a non-price term effect—a governance term effect. By bringing together a large number of market participants in IPOs and allowing them to coordinate their efforts against a particular governance arrangement, the coalition provides institutional investors with the opportunity to negotiate in lock-step on a substantial governance term. This, in turn, deprives issuers of the ability to negotiate on this term fairly.[706]

These efforts of the coalition's members are analogous to the *standard-setting* process—a process by which different market actors develop standards for products or services through industry collaboration.[707] The standard-setting process is often scrutinized under antitrust law, as

[703] *See, e.g.,* Roger D. Blair & Jeffrey H. Larrison, *Antitrust Policy and Monopsony*, 76 CORNELL L. REV. 297, 308 (1991). The most prominent example is the collaboration of buyers in a standard-setting process. For a general review, see Teece & Sherry, *supra* note 491.
[704] *Id.*; *see also supra* note 492.
[705] *Id.*
[706] *See* Primetime 24 Joint Venture v. NBC, Inc., 219 F.3d 92 (2d Cir. 2000) (in this case, the Second Circuit held that a conspiracy between copyrights owners not to settle with infringement defendants might violate Section 1 of the Sherman Act, while noting that "copyrights holders may not agree to limit their individual freedom of action in licensing future rights to such an infringer.").
[707] *See* Teece & Sherry, *supra* note 491.

it traditionally raises anticompetitive issues. Such issues result from several reasons, which also apply to the coalition against dual-class structures.

First, because the standard-setting process involves communication and deliberation among competitors, the concern is that competitors will use this process to achieve anticompetitive ends in restraint of trade.[708] Indeed, SSOs—industry groups that create standards to ensure that products are interoperable, compatible, or safe to use—have traditionally been seen as "continuing conspiracies of their members when agreements have related to areas in which they compete."[709] Accordingly, antitrust law will "condemn facially neutral product standards where the very purpose of the standards is to facilitate anticompetitive conduct."[710]

When the largest buyers in the industry are involved in the process, as in the case of the coalition against dual-class, their buyers' power allows them to favor the demand side of the market over the supply side.[711] In such circumstances, the competitive disadvantage is imposed on actors in the downstream chain, and the SSO is viewed as a buyers' cartel.[712]

In that context, it is crucial to emphasize that competition law may view the standard-setting process as a collusive practice that restrains trade regardless of the reasonableness of the promoted standard.[713] For example, in *Fashion Originator's Guild of America, Inc. v. FTC*, the Supreme Court denounced the "well-intentioned" activities of a trade association to eradicate the counterfeit clothing market, viewing it as an attempt to become an extra-governmental agency.[714]

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[708] *See* U.S. Dep't of Justice and Fed. Trade Comm'n, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition (2007), at 33-35.
[709] *See* Rock, *supra* note 481, at 508.
[710] *See* Sean P. Gates, *Standards, Innovation, and Antitrust: Integrating Innovation Concerns into the Analysis of Collaborative Standard Setting*, 47 EMORY L. J. 583, 619 (1998).
[711] *See* Teece & Sherry, *supra* note 491, at 1927-1928.
[712] *See* Lemley, *supra* note 662, at 1940.
[713] *See* Gates, *supra* note 710, at 621.
[714] Fashion Originator's Guild of Am., Inc. v. FTC, *supra* note 629. The Fashion Originator's Guild of America ("Guild") consisted primarily of textile manufacturers, garment designers, manufactures, sellers, and distributors. Other manufacturers copied and sold versions of the Guild member products at a lower price. Because the original

Using that rationale, the standard-setting process by investor consortiums, whose members are competitors in capital markets, should sound an alarm ball even to those who view equal voting rights as an appropriate governance standard. In other words, even under the perception that dual-class structures are inferior (a view that, as explained, is controversial and not necessarily backed by empirical evidence), the mere attempt of institutional investors to use their market power against dual-class issuers and set a market-wide governance standard, is legally problematic.

Second, the standard-setting process can be the means by which companies with buying power in some markets reduce their buying price. A prominent antitrust case from the 1960s illustrates this concern.[715] In this case, the Seventh Circuit analyzed the attempt of the National Macaroni Manufacturers Ass'n ("NMMA"), a group of macaroni manufacturers who produced almost three-quarters of the nation's macaroni, to set an industry standard. Due to a shortage of durum wheat, which was considered high quality and customarily used to make pasta, the NMMA had decided that durum millers, who were all members of the NMMA, would no longer offer pure durum wheat. Instead, they would sell blends of durum and hard wheat, which was considered lower quality. The goal was to prevent a sharp increase in the price of durum wheat. In that case, the FTC ruled that the new standard violated section 5 of the Federal Trade Commission Act. As the FTC stated, "where all of the dominant firms in a market combine to fix the composition of their product with the design and result of depressing the price of an essential raw material, they violate the rule against price-fixing agreements." On appeal, the Seventh Circuit affirmed that decision, also finding that the macaroni industry had used the product standard to suppress prices

designs were not protectable under copyright, the guild members set up a private IP system, under which designers registered their creations with the Guild. The Guild was able to detect violations, and retailers that copied the originals were boycotted by Guild members. Despite the "well intentions" of the Guild to fight forgeries, the Supreme Court found that these actions violated Section 1 of the Sherman Act and constituted an illegal restraint of trade.

[715] National Macaroni Manufacturers Ass'n v. FTC (345 F.2d421 (7thCir. 1965)). For an excellent review of this case, see Gates, *supra* note 710, at 619-620.

in the industry.

By the same token, governance terms that are imposed via sanctions by a coalition of institutional investors can depress stock prices. As mentioned, some of the coalition members have explicitly flagged the "price tag" associated with the decision to use a dual-class structure.[716]

The third and perhaps most frequently cited problem related to the joint setting of standards is that the standard may be used to unlawfully *exclude* participants from the market. As the Supreme Court has noted, an "agreement on a product standard is, after all, implicitly an agreement not to manufacture, distribute, or purchase certain types of products."[717]

Applying that logic to the coalition's equal voting rights standard, one can see how that guideline enables institutional investors to push from the public market issuers that do not meet the standard. Private companies that want to avoid the heavy sanctions imposed on dual-class issuers are effectively precluded from going public or forced to raise equity in other ways. Thus, by setting a standard that pertains to corporate governance, institutional investors can limit the supply of shares, or at least a specific type of shares such as dual-class stock, in the public market.

Moreover, the coalition's standard has the explicit capacity to push public dual-class companies from a subset of the public market—the index market. The index exclusion of dual-class stock allows institutional investors to successfully create a voting rights hurdle for access to equity markets and eligibility for benchmark equity indexes. In fact, considering that investor consortiums have pushed for the exclusion of firms from indexes solely based on their voting rights, such an act may constitute per se exclusion, against which the courts and the antitrust

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[716] *See supra* notes 649-650.
[717] Allied Tube & Conduit Corp. v. Indian Head, 486 U.S. 492, 500 (1988). Such an agreement may also be viewed as a boycott, which generally involves an agreement among competitors to refuse to do business with another firm, including another competitor, a supplier, or a purchaser.

authorities tend to guard vigorously.[718] The fact that this market exclusion is done by market players with monopsony characteristics, such an act may well provide early warnings of collusion risk and can be seen as a form of cartelization that requires antitrust enforcement.[719]

3.3.3 The Welfare Implications

As in the case of a classic cartel, the coalition's market effects have significant distributional and allocational ramifications. These welfare-reducing consequences are primarily attributed to the coalition's disruption of the private ordering between issuers and investors, which is a process that provides for the implementation of market-driven corporate governance arrangements.[720] The underlying notion is that market forces are considered efficient in allocating control and cash-flow rights through different ownership structures.[721] Thus, the bargaining process between issuers and investors would identify the optimal corporate governance arrangement for a particular company.[722] Any interruption to this process, for example through the collective action of investors that is oriented towards issuers in IPOs, may result in inefficiencies. In particular, the bargaining leverage that institutional investors secure through their coordinated attack on dual-class structures reduces the contractual freedom available to issuers. And in those circumstances, companies are likely to adopt suboptimal financing and make value-reducing investment and governance decisions.

It is important to note that under certain circumstances, the bargaining power of founders tends to be relatively robust. Usually, that is the case when there is greater availability of private

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[718] *See* David M. Schneck, *Setting the Standard: Problems Presented to Patent Holders Participating in the Creation of Industry Uniformity Standards*, 20 HASTINGS COMM. & ENT. L. J. 641, 647 (1997).
[719] *Compare* Nolan E. Clark, *Antitrust Comes Full Circle: The Return to the Cartelization Standard*, 38 VEND. L. REV. 1125, 1152 (1985).
[720] *See, e.g.,* Sharfman, *supra* note 486.
[721] Goshen & Hamdani, *supra* note 643, at 587 n. 85.
[722] *Id.; see also* Sharfman, *supra* note 486, at 486.

funding or when "more money is chasing deals."[723] Thus, at least theoretically, the coalition might function as a countervailing power that can help mitigate the bargaining power of founders.[724] As a matter of fact, legal scholars who oppose the dual-class structure have suggested that a scenario in which a broad group of shareholders would develop common strategies against dual-class structures can serve as an effective mechanism to deter IPO companies from adopting a dual-class structure.[725] However, given the anticompetitive risks associated with the practice of joint bargaining described above,[726] this argument collides with antitrust policy.

As the remainder of this section shows, the coalition leaves certain private companies that, in the absence of the alliance, would have gone public with a dual-class structure, with three possible courses of action. Each of these courses of action may result in distributional distortions, allocational inefficiencies, or both.

a) Staying Private

Because dual-class structures are often viewed as a tool to help maintain a founder's control and preserve a founder's idiosyncratic vision, they can be a prerequisite to persuading founders to list their companies.[727] For that reason, the coalition's opposition to the structure may make it more

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[723] *See, e.g.,* Dhruv Aggarwal et al., *The Rise of Dual-Class Stock IPOs* (Sep. 2021), https: //papers.ssrn.com/sol3/papers.cfm?abstract_id=3690670, 4 ("VC firms do not appear, on average, to be averse to founders' voting rights exceeding their economic rights."). The same might also be true in hot IPOs in which investors suffer from a "fear of missing out." In that context, an observation made by Josh Korff, a legal practitioner, following Snap's IPO, is particularly relevant. Korff has noted that the very nature of hot IPOs "allows issuing companies to effectively do what they please, despite rising levels of shareholder objection." He attributed this outcome to the "fear of missing out," explaining that "[e]veryone is going to invest in Snap's IPO, whether you like their no voting rights policy or not." The explanation is that if certain institutional investors abstain from investing in dual-class shares, but some defect and invest, the defecting investors might outperform the others if the dual-class company does well. *See* John Crabb, *Blue Apron's no-vote shares IPO concerns investors*, INT'L FIN. L. REV. (June 28, 2017), http://www.iflr.com/ Article/3728513/Blue-Aprons-no-vote-shares-IPO-concernsinvestors.html.

[724] For an interesting discussion on countervailing power under competition law, see Zhiqi Chen, *Defining Buyer Power*, 53 ANTITRUST BULL. 241, 244-245 (2008).

[725] *See* Hirst & Kastiel, *supra* note 522, at 1276-1277; *See also* Crab, *supra* note 723 ("if a few of the big investors get out in front of [the dual-class structure] and say, we don't want to do it, then that would provide cover for others.").

[726] *See supra* notes 663-665 and accompanying text.

[727] *See supra* note 568 and accompanying text.

likely that private companies will decide to forego or delay their entry into the public market. From the founders' perspective, listing with a single-class structure means that they would either risk losing control or retain control but lose their ability to diversify their personal wealth, as they would have to own the majority of the company stock.

Not only does the coalition's opposition limit the equity options available to companies, but it also adversely affects other investors in capital markets. By deterring companies from listing, the coalition may deny investors in capital markets the ability to invest in dual-class stock, and accordingly, the opportunity to earn the high premiums associated with many dual-class companies.[728] Notably, other investors that are not limited to the public markets, such as private equity funds and actively managed funds—financial intermediaries who typically manage the wealth of America's wealthiest citizens—will be able to continue investing in such companies even if they remain private. This consequence clearly has troubling distributional implications.

The decision to stay private may also entail inefficiency implications, creating a deadweight loss and reducing firm value. Because private funding is more expensive,[729] private companies might be more likely to forego funding for growth and innovation. The coalition may also push companies to incur debt (rather than equity), even when debt is s suboptimal choice that reduces the company's ability to take a necessary risk for innovation.[730] Thus, by impeding a company's path to public markets, the coalition potentially reduces growth, innovation, and profitability.

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[728] Adena Friedman, *The Promise of Market Reform: Reigniting America's Economic Engine*, HARV. L. SCH. FORUM. CORP. GOVERNANCE (May 18, 2017) https://corpgov.law.harvard. edu/2017/05/18/the-promise-of-market-reform-reigniting-americas-economic-engine/.
[729] *See, e.g.,* Thomas J. Chemmanur & Paolo Fulghieri, *A Theory of the Going-Public Decision*, 12 REV. FIN. STUD. 249 (1999).
[730] *See* Lund, *supra* note 453, at 693 n.27.

b) Listing with a Single-Class Structure

In the face of the coalition's opposition, the second option available to founders is to take their companies public without a dual-class structure. Concerned about price reduction and dilution, as well as the possibility of an IPO failure, issuers may reasonably conclude that the negative consequences associated with dual-class structures (i.e., the increased cost of equity) outweigh the positive benefits (i.e., preserving control after the IPO).[731]

And this view might be shared by other insiders and stakeholders involved in the IPO process, such as the board of directors and other pre-IPO investors. For example, it is not difficult to see how a board might conclude that a single-class structure presents the greatest likelihood of a successful IPO or that such a structure will maximize proceeds from the offering.[732] Similarly, because of the penalty imposed by the coalition members on dual-class issuers, pre-IPO investors such as Venture Capital (VC) funds are also likely to push for a single-class structure. Because an IPO presents an exit opportunity for these funds, they have an incentive to maximize the value of the offer price at the IPO. Accordingly, VC funds are likely to oppose dual-class offerings. Thus, in the wake of the coalition's efforts, the shareholding of these funds—which often have a say at the IPO as they typically control several board seats pre-IPO and participate in the selection of management—reduces the likelihood of a dual-class offering.[733][734]

[731] *See* Winden & Baker, *supra* note 534, at 119.

[732] Moreover, since directors are also concerned about their reputation, the recent "dual-class enablers" initiative can further diminish directors' incentive to support a dual-class IPO.

[733] *See, e.g.,* Smart, Thirumalai & Zutter, *supra* note 684; Tallarita, *supra* note 688. Interestingly, Founders are more likely to support a dual-class structure after all because founders typically believe in their idiosyncratic vision and the possibility that their firm will prosper under their guidance. Their vision can also explain why they rarely sell their shares during the IPO. However, depending on the VCs' bargaining position against founders, the objection of such funds may lead to the adoption of a single-class structure, even if the latter opposes this structure. *See* Asma Fattoum-Guedril, Frédéric Delmar & Mike Wright, *The Best of Both Worlds: Can Founder-CEOs Overcome the Rich Versus King Dilemma after IPO?,* 39 STRT. MGMT. J. 3381, 3385 (2018) (explaining that founders' implementation of a dual-class structure is an outcome of a bargaining process involving other stakeholders such as VCs and board of directors).

[734] Interestingly, VC funds are generally accepting of dual-class structures when investing in private companies. However, at the IPO juncture, perhaps due to the inflated penalty imposed by investors in IPOs, VC funds tend to

The role of underwriters in choosing a governance structure must also be considered. Underwriters are expected to "engage in a continuing conversation with the company concerning the feasibility of a dual-class IPO (with or without sunset provisions), the preliminary 'indications of interests' received from investors, and the trade-off of the dual-class structure against the discounted price that investors would be ready to pay."[735] Underwriters' lawyers are also likely to alert their clients on terms that entail price effects.[736] The coalition's very public opposition to dual-class structures and the collective view among institutional investors that a dual-class structure is not a best practice make it inevitable that law firms flag the issue.[737]

If a company ends up listing with a single-class structure, founders face two alternatives. Under the first alternative, they can maintain control through a single-class structure by owning most of the outstanding shares. The problem with this decision is that it will limit the founders' ability to diversify their wealth, potentially resulting in suboptimal levels of risk-taking.[738] Moreover, under this scenario, founders might forgo efficient investment opportunities as new outside financing would likely further dilute their voting power. Under such circumstances, companies will not issue sufficient equity for further growth, resulting in inefficiencies. Under the second alternative, founders will give up control in a single-class structure to enjoy diversification. However, in this scenario, founders will likely be concerned about disciplinary forces and the possibility of being fired. Consequently, they would be much less inclined to execute innovative

push for a single-class structure or a dual-class structure with a sunset provision. *See, e.g.,* Aggarwal et al., *supra* note 723, at 4-7.

[735] *See* Tallarita, *supra* note 688, at 22.

[736] *See* Coats, *supra* note 645, at 21.

[737] *Id.; see also* Eckstein, *supra* note 468, at 66-68 (explaining how law firms often use proxy guidelines as a reference point and urge corporations to review and pay close attention to those guidelines).

[738] *See, e.g.,* Eugene F. Fama, *Agency Problems and the Theory of Firm*, 88 J. POL. ECON. 288 (1980).

projects or projects with a long-term payoff.[739] Overall, this analysis illustrates how restricting governance options to a single-class structure may also constrain companies from pursuing the opportunities necessary to maximize their value.

It should be noted that under the view that dual-class structures present a governance problem,[740] these inefficiencies should be weighed against managerial agency costs and private benefits of control which may be extracted by founders of dual-class companies. Thus, scholars who oppose the dual-class structure may argue that despite its anticompetitive effect, the coalition may result in net social benefit after all.

c) Listing with a Dual-Class Structure

If a private company decides to go public with a dual-class structure in the face of opposition from the coalition, such a decision is also likely to have adverse distributional consequences. First, because the coalition artificially inflates the cost of capital for dual-class companies, significant sums of money are left on the table in IPOs.[741] In effect, this is a wealth transfer from one side of the market—the issuers and possibly pre-IPO shareholders—to the other side of the market—investors in the IPO.[742] The issuers realize less capital from their IPO, and pre-IPO shareholders who sell their shares at the IPO do so for a lower amount.[743]

Second, excluding dual-class companies from major market indexes reduces the size of the potential investment pool in capital markets. In this scenario, certain institutional investors,

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[739] Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, 151 (1990) (arguing that due to the complexity of long-term projects, corporate managers that want to please their shareholders might be inclined to pursue short-term projects, which are easier for outsiders to evaluate).
[740] *See supra* note 538 and accompanying text.
[741] *See supra* note 688 and accompanying text.
[742] *See* Boulton et al., *supra* note 687.
[743] Moreover, the underpricing that characterizes dual-class IPOs might cause an increase in the demand for the stock at the IPO. When the demand is that high, average investors lose because they are unable to get shares in an oversubscribed offering, an outcome which entails distributional consequences as well. *See, e.g.,* Gerard Hoberg, *Strategic Underwriting in Initial Public Offers* (Yale ICF Working Paper No. 04-07, 2004). *See also supra* note 638.

including actively managed mutual funds and pension funds, will be able to invest separately in non-indexed companies, as many of them have traditionally done and continue to do. At the same time, investors in passive funds will be deprived of the opportunity to invest in dual-class companies. To access dual-class stock, they would have to switch to actively managed funds, which charge much higher management fees. This outcome is particularly unfortunate given that the size and number of investors in passive funds have steadily grown in recent years and are expected to grow even more over the coming decades.[744]

According to several recent empirical studies, excluding dual-class companies from leading market indexes would have significantly diminished the indexes' returns over the last decade.[745] Moreover, recent data from 2020 vividly illustrate this point, as some of the year's best-performing companies, such as Zoom (up more than 400%) and Pinterest (up more than 270%), have dual-class structures.[746] In light of these findings, the implications of the dual-class index exclusion initiative appear to be profound.

In addition to the distributional consequences that the coalition is likely to have with respect to dual-class issues, it is also expected to result in allocational inefficiencies, which are mainly attributed mainly to the high cost of capital that dual-class companies face. The institutions' approach towards dual-class structures and the associated underpricing of dual-class offerings will likely harm the ability of IPO companies to grow as fast as they need, resulting in deadweight loss.[747] In particular, the funding for innovative projects in dual-class companies may become too expensive, leading them to forgo profitable projects. Moreover, to the extent that a public dual-

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[744] *See, e.g.,* Bebchuk & Hirst, *supra* note 12.
[745] *See supra* note 594.
[746] Tom Bailey, *Why The S&P 500 Was Not the Best Way to Track the US Market This Year*, INTERACTIVE INVESTOR (Dec. 18, 2020), https://www.ii.co.uk/analysis-commentary/why-sp-500-was-not-best-way-track-us-market-year-ii514537.
[747] *See* Hoberg, *supra* note 743.

class company subsequently requires equity funding for growth, the continued high costs of capital could force it to unify the capital structure to a single-class structure at an inopportune time—when it would have been beneficial for the company to continue with a dual-class structure.[748]

The capacity of the coalition to artificially depress the prices of dual-class stock also presents another form of inefficiency: informational inefficiency. Pricing of a new capital asset is a critical element in capital markets, and price informativeness is considered a crucial component of any welfare analysis.[749] Ideally, the book-building method should help achieve such a goal by evaluating the intrinsic worth of a security based on its underlying fundamentals. However, in the context of dual-class offerings, institutional investors, as informed and sophisticated market players, are likely to transmit misleading signals to the market. And, because their views and public announcements are built on a self-serving and anticompetitive agenda—rather than on legitimate governance concerns—the market is likely to be distorted.

In sum, this section showed how the coalition can harm the capital markets and lead companies to choose suboptimal governance arrangements, distorting their investment and financing decisions. The harmful consequences of these effects are particularly alarming in light of a recent study which found that the net gain for the U.S. stock market between 1926 and 2016 can be attributed to only *four* percent of all listed companies, including dual-class companies such as Alphabet and Facebook.[750] As Professor Bernard Sharfman observed, forcing companies to join the market under standardized governance arrangements "may inhibit one company from

[748] *See* Reddy, *supra* note 540, at 34; *see also* Jill E. Fisch & Steven Davidoff Solomon, *The Problem of Sunsets,* 99 B.U. L. REV. 1057, 1080-1083 (2019) (arguing that a one-size-fits-all approach to sunsets—like the one adopted by the CII and the index providers—may lead to inefficiencies).
[749] On the relation between price informativeness and welfare, see, e.g., Jennie Bai et al., *Have financial markets become more informative?*, 122 J. FIN. ECON. 625, 627 (2016) (explaining that independent, market-based component of price informativeness contributes to the efficiency of capital allocation, which generates an improvement in welfare).
[750] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills*?, 129 J. FIN. ECON. 440, 440-441 (2018).

becoming the next Alphabet or Facebook."[751] The main concern is that institutional investors are damaging the stock market as a whole in order to maximize profits in the IPOs. From a public policy perspective, this is something we cannot afford.

3.4 The Future of Investor Coalitions: Implications for Regulators

The preceding antitrust law analysis of the coalition against dual-class demonstrates how investor alliances on governance matters can help facilitate coordination among investors in their capacity as competitors in capital markets. This Part argues that the potential misuse of market power by institutional investors in their capacity as members of investor coalitions requires an immediate policy response. Section 3.4.1 advocates in favor of regulating investor coalitions, particularly those which emerge at the firm/market borderline. Section 3.4.2 proposes classifying investor consortiums as SSOs and applying the same antitrust principles that are generally applied to such organizations.

3.4.1 Regulating Investor Coalitions

As this chapter illustrates, there is a significant difference between shareholders coordinating a vote in an attempt to increase firm value and competitors coordinating a governance stance for the purpose of gaining a competitive advantage over other market actors. While corporate law provides justifications for encouraging shareholder cooperation, namely solving the shareholder collective action problem and mitigating managerial agency costs, there is no equivalent legal or policy justification for allowing competitors in capital markets to collaborate. To the contrary. These competitor coalitions operate in a way that directly opposes the collective good. Thus, the assumption upon which corporate law favorably views these coalitions is no longer valid—and without that justification, these coalitions need to be re-examined through an antitrust

[751] Bernard S. Sharfman, *The Undesirability of Mandatory Time-Based Sunsets in Dual Class Share Structures: A Reply to Bebchuk and Kastiel*, 93 S. CAL. L. REV. PS1, 10 (2019).

lens.[752]

Identifying investor coalitions that raise antitrust concerns is not an easy task. The boundary between firms and markets is often vague as a variety of collective actions that affect companies may have spill-over effects to markets and vice versa. Due to this uncertain borderline between firms and markets, the determination as to the appropriate framework within which to analyze certain investor coalitions is fairly challenging. The main concern is that hurrying to apply antitrust scrutiny to investor coalitions will have a chilling effect on the incentive of investors in capital markets to cooperate on issues that are benign from an antitrust perspective and are potentially welfare-enhancing. However, a failure to use an antitrust framework when such a perspective is appropriate may result in substantial market distortions.

The test that this chapter proposes to apply is the following. If an investor coalition emerges at a stage in which the coalition members are not shareholders, the preliminary assumption should be that such coalition is a competitor coalition. Accordingly, an antitrust analysis should apply. If, on the other hand, an investor coalition involves investors who jointly own the company at issue, corporate law should come to the fore, but with one important exception. Under circumstances in which the coalition has the capacity to directly affect markets in which the members of the coalition compete,[753] a preliminary analysis is required. The relevant question that should be asked is whether the collaboration among these shareholders is likely to provide them with a competitive advantage over other market participants in markets in which these shareholders compete? If the answer is yes, competition laws offer the appropriate framework within which to analyze such a coalition.

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[752] *Compare* Rock, *supra* note 481, at 503 ("absent additional normative arguments regarding stakeholders' entitlements, one cannot conclude that stakeholder collective action problems are market failures rather than market successes.").

[753] *Id.* at 524-544 (offering antitrust perspective on joint bargaining agreements in the context of tender offers).

Consistent with these distinctions, this chpater analyzed the coalition against dual-class—which emerges at the primary market, where the coalition members are mere competitors—from an antitrust perspective. With respect to these types of coalitions, which are essentially competitor coalitions, there are several potential policy responses.

First, this chapter proposes restricting investor coalitions among competing bidders in public offerings by limiting the freedom of such bidders to engage in collective action. Under this proposal, in the context of stock issuance, institutional investors should only be allowed to express their views individually and privately—even if the opinion relates to a seemingly innocent governance term such as the voting structure of the issuer. To the extent that a potential investor is dissatisfied with a particular governance term, such an investor may object privately or simply avoid participating in the offering.[754]

By the same token, the practice of "negotiating" governance terms through trade associations should also be prohibited. In particular, the routine of sending open letters to prospective issuers of dual-class stock on behalf of the institutional members must be subject to antitrust scrutiny. Because institutional investors can use these letters to coordinate positions, stabilize the buyers' cartel, and reduce the chances of shirking, this practice raises significant anticompetitive risks.

In addition to the restriction on collective action, this chapter proposes to ban any communication between institutional investors aimed at facilitating concerted efforts against other market actors.[755] In that sense, this proposal would change the existing rules under which

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[754] *Compare* Drew Hasselback & Barbara Shecter, *From Cara Operations Ltd. To Shopify Inc: Why Dual Class Shares Are Suddenly Cool Again*, FIN. POST (May 5, 2015), https://financialpost. com/news/fp-street/from-cara-to-google-why-dual-class-shares-are-suddenly -cool-again (citing a legal practitioner who called institutional investors that opposed dual-class shares to simply not buy them).

[755] The view that mere discussions among competitors may lead to anticompetitive results was discussed in Esco Corp. v. United States, 340 F.2d 1000, 1007 (9th Cir. 1965). The Ninth Circuit posed a hypothetical in which competitors met to discuss their problems. Each said in turn that it would not fix prices with the others but that it would set its own

institutional investors as potential investors in IPOs are allowed to communicate freely on firm-specific matters without triggering any disclosure or filing requirements. Given that the ease with which competitors can communicate with each other is an important factor in cartel formation, the lack of any limitations on investor communication in this setting is problematic.

And, it is not solely direct communication between investors that it is proposed to ban, but also communication through public statements. As antitrust regulators have already acknowledged, competitors might issue such statements to send signals to each other in an attempt to relax competition.[756] For example, in the context of dual-class offerings, investors' public statements can signal a meeting of the mind and an intent to sanction dual-class issuers per the coalition's agenda, which help facilitate the buyers' cartel.

Finally, even if collective action and communication at the IPO stage will not be restricted, such practices should at least trigger disclosure requirements. Outside the IPO setting, securities regulations already impose filing requirements on institutional investors that collaborate with each other if they qualify as a "group" under Section 13(d) of the Securities Exchange Act.[757] To the extent that the collaborating investors collectively own 5% or more of the issuer's voting equity, they automatically fall within the SEC filing requirement and become subject to elaborate

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price at X dollars on the following Monday. Each then did so. The Court concluded that: "We do not say that the foregoing illustration compels an inference in this case that the competitors' conduct constituted a price-fixing conspiracy, including an agreement to so conspire, but neither can we say, as a matter of law, that an inference of no agreement is compelled. As in so many other instances, it remains a question for the trier of fact to consider and determine what inference appeals to it (the jury) as most logical and persuasive, after it has heard all the evidence as to what these competitors had done before such meeting, and what actions they took thereafter, or what actions they did not take."

[756] *See supra* notes 623-624 and accompanying text.

[757] 15 U.S.C. § 78m(d)(3) (2012). According to Section 13(d)(3) of the Securities Exchange Act of 1934, "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person.'" According to this Section, "two or more persons [who] act as a ... group for the purpose of acquiring, holding, or disposing of securities of an issuer are deemed as a 'person.'"

disclosure requirements.[758]

The potential anticompetitive risks associated with investor coalitions that emerge in IPOs provide compelling justifications for extending these filing requirements by applying them to prospective investors in the primary market. This view can also be seen as consistent with the general tendency of courts to acknowledge that, for the purpose of securities regulations, a "group can be formed informally, without written documentation, and its existence can be proved by circumstantial evidence."[759]

3.4.2 Investor Consortiums as Standard-Setting Organizations

Institutional investor consortiums play an important role in facilitating institutional investor cartels. As this chapter demonstrates, these consortiums allow their members to communicate freely on issues that affect competition in markets where the institutional investors compete and coordinate their stance. Moreover, by centralizing decision-making on governance practices at the consortium level, these organizations help their members avoid the hurdle of agreement which often inhibits cartel formation. And, perhaps even more importantly, since investor consortiums require their members to adhere to the governance standards and best practices developed by the consortiums, they help ensure compliance with mutual commitments. In fact, to ensure adherence to the standards they promote, investor consortiums push their members to increase transparency regarding their governance policies.[760] All these actions are vital for cartel formation and stabilization.

Despite the anticompetitive risks associated with investor consortiums, antitrust authorities

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[758] *Id.* Relevant questions in this regard, which are beyond the scope of this chapter, are whether there should be a holding percentage threshold that triggers the disclosure requirement, and if so, how such threshold should be calculated (for example, based on the bids submitted, the IPO allocation, etc.).
[759] *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 543 (1990) (also citing court cases that acknowledge the possibility of an informal nature of a group for the purpose of securities regulation).
[760] *See supra* note 477 and accompanying text.

have thus far failed to scrutinize their actions. This regulatory oversight must be addressed. Specifically, given the growing role of these organizations in setting governance standards for U.S. corporations, they should be viewed as SSOs for antitrust purposes.[761]

As explained, SSOs have traditionally raised significant anticompetitive risks because they involve agreements among competitors and provide opportunities for collusion.[762] The primary concern is that these organizations would use the standard-setting process as a cover to fix prices or to exclude or disadvantage other market participants.[763] Acknowledging that the effects of product standards "may result in economic prosperity or economic failure" for market competitors,[764] courts have traditionally required regulators to be proactive about the standard-setting process,[765] particularly if members of the SSO represent a large majority of the ultimate buyers of the "standardized products."[766]

To ensure a competitive selection process, antitrust law requires that the standard-setting process will involve certain policies and procedures. Notably, it must include adequate industry representation and take into account divergent economic interests.[767] In addition, both the supply and demand sides of the potential market for the standardized product should be represented, as both will be affected by the standard.[768] In the more extreme cases in which the standard has broad

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[761] Although these consortiums engage in activities other than setting standards, it is now well-established that trade associations, even ones with broader agendas than standard-setting, can undertake standard-setting as one part of their activities. *See* OECD Roundtable, *supra* note 492, at 23.
[762] American Soc'y of Mechanical Eng'rs, 456 U.S. at 570; OECD Report, *supra* note 492.
[763] *See supra* notes 715-717 and accompanying text.
[764] Lemley, *supra* note 662, at 1940 (2002).
[765] *See* OECD Roundtable, *supra* note 492, at 10.
[766] *See* Robert A. Skitol, *Concerted Buying Power: Its Potential for Addressing the Patent Holdup*, 72 ANTITRUST L. J. 727, 739-740 (2005).
[767] *See* OECD Roundtable, *supra* note 492, at 11.
[768] Teece & Sherry, *supra* note 491, at 1927-1928. The underlying assumption is that if there is industry-wide participation in the selection process, a presumption that the marketplace selected an appropriate standard should apply (see BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMM'N, STANDARDS AND CERTIFICATION FINAL STAFF REPORT (1983)). In the words of the Federal Trade Commission, standards should be selected "in a nonpartisan manner … and in the presence of 'meaningful safeguards' that 'prevent the standard-setting process from being biased by members with economic interests in stifling product competition."

market effects, an extra-market agent to "control the specification and administration of standards so that the standards themselves do not cause or perpetuate market failure" may be required.[769] And, in circumstances where anticompetitive harm occurs due to the organization's failure to implement procedures aimed at preventing abuse of the standard-setting processes, strict antitrust liability should apply.[770]

As this chapter shows, the standard-setting process undertaken by investor consortiums lacks such safeguards. Investor consortiums have unilaterally set market-wide governance standards without including all interested parties, such as the companies' representatives, and without conducting third-party consultation. This lack of procedural safeguards was particularly pertinent to the coalition against dual-class. Not only did the process fail to implement a market-agent check, but the potential "agents" that were solicited by these investor consortiums to regulate dual-class structures—notably, the SEC and the stock exchanges—declined to support the equal voting rights standard. The refusal of these bodies to adopt a strict single-class standard indicates that they believed a market-wide prohibition on dual-class structures is not justifiable.[771] The fact that institutional investors continued to promote this governance standard, particularly by pursuing "governance by indexation," calls into question the investors' motives and the legitimacy of this one-sided market standard. Considering the above, the actions of investor consortiums and their members must face antitrust liability, and the fruits of their efforts to dictate governance standards should be nulled.

[769] *See* Gates, *supra* note 710, at 585.
[770] American Soc'y of Mechanical Eng'rs, 456 U.S. at 570; Trueposition, Inc. v. L.M. Ericsson Telephone Co., 899 F. Supp. 2d 356 (E.D. Pa. 2012).
[771] *See supra* note 551.

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