

CONTROLLING CONTROLLING-MINORITY SHAREHOLDERS: CORPORATE GOVERNANCE AND LEVERAGED CORPORATE CONTROL

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The “one-share one-vote principle,” which states that a shareholder’s voting power is proportionate to his or her economic right, is one of the most fundamental rules in modern corporate law. However, in reality, controlling shareholders often obtain voting rights in excess of their economic rights through control-enhancing mechanisms, allowing them to leverage control over the firm. Empirical studies indicate that leveraged corporate control is prevalent among listed companies of various countries, yet, to date, many countries still disagree on a regulatory framework. The EU and OECD conducted studies concerning the regulatory policy over control-enhancing mechanisms several years ago. However, failing to reach a consensus, the reports only advised governments to enhance disclosure and transparency. In recent years, entrepreneurs hoping to maintain their control after public listing have sought to utilize dual-class share structures to leverage corporate control when going public. This led to recent reviews by the Hong Kong and Singapore stock exchanges—the Hong Kong Stock Exchange

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refused to grant listing with dual-class share structure, while the Singapore Stock Exchange approved the proposal to allow listing companies to have dual-class shares in order to maintain competitiveness. This recent development further exemplifies the complexities involved in regulating leveraged corporate control and the need to address relevant corporate governance concerns.

This Article reviews the inadequacy of past theoretical and empirical research on leveraged corporate control, and re-examines the issue of corporate governance from the contractarian view of corporate law. The Article differentiates between the IPO and post-IPO (or midstream) stages and argues that the contracting mechanism does not work well in the midstream stage. Controlling-minority shareholders usually set out various pro-insider provisions in IPO charters, which deters minority shareholders from repealing inefficient provisions or adopting other value-increasing provisions in the midstream. Furthermore, through an analysis Google and Facebook’s midstream issuance of non-voting Class C shares and the recent going-private transactions of U.S.-listed Chinese firms, this Article illustrates the opportunistic behaviors of leveraged corporate controllers through midstream charter amendments. Finally, this Article discusses potential governance strategies against pro-insider midstream distortions. Adhering to the “one-share one-vote” principle and prohibiting dual-class share structure would hinder the flexibility of corporate financing and affect economic development. This Article therefore argues against outright prohibition of control-enhancing mechanisms and advocates returning the governance decision to the hands of shareholders by empowering shareholders. In particular, the participation of institutional investors and shareholder activists is essential to counteract the superpower of controlling-minority shareholders and to govern their midstream opportunistic behaviors.

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“In the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. This structure will also make it easier for our management team to follow the long term, innovative approach emphasized earlier.”

— Larry Page and Sergey Brin, Founders of Google (2004)¹

I. INTRODUCTION

One-share one-vote is the key principle behind the allocation of corporate ownership and control.² In keeping with this principle, shareholders who contribute more equity to a firm exert more control through their voting power. With proportionate equity ownership and control, this governance structure should provide shareholders with the proper incentive to make appropriate decisions and properly monitor the firm through voting.³ In reality, a large number of public firms around the world do not adhere to the one-share one-vote rule. Instead, controllers usually leverage their control through various control-enhancing mechanisms, such as dual-class shares, pyramidal ownership, or cross-shareholding. These structures are coined as “controlling-minority structures” to reflect the fact that even though controlling shareholders own a minority of the shares, they are able to maintain control through the use of control-enhancing mechanisms.⁴ This Article also uses “leveraged control” to refer to this type of corporate control.⁵ Proponents

¹ Google Inc., Final Prospectus (Form 424B4), at 29 (Aug. 18, 2004), <https://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm>.

² See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 67–70 (1991).

³ *Id.*

⁴ Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in *CONCENTRATED CORPORATE OWNERSHIP* 295, 295 (Randall K. Morck ed., 2000).

⁵ Professor Ronald Gilson specifically uses the term “leveraged control” to refer to such type of corporate control. Ronald J. Gilson, *The*

of leveraged control argue that the deviation from one-share one-vote should be allowed because shareholders have the freedom to contract with respect to the allocation of corporate control. However, such deviation from the one-share one-vote rule may exacerbate the principal-agent problem in a controlled firm because a controlling-minority shareholder is not only entrenched, but also has the incentive to extract private benefits of control because the controlling-minority shareholder owns disproportionately less equity.⁶ On the other hand, a leveraged control firm still enjoys the benefits of efficient monitoring by the controlling shareholder. Therefore, it is unclear whether a leveraged control structure generates net benefits or net costs to shareholders.

Despite the theoretical controversies, firms with controlling-minority structures are widespread: 44% of European public companies have at least one type of control-enhancing mechanism, while 38.7% of East Asian public companies use a pyramidal ownership structure to enhance corporate control.⁷ Even in the U.S., where the percentage of leveraged control firms has traditionally been low, there is a growing number of newly-listed firms adopting dual-class shares:⁸ 28% of firms that underwent an initial public offering (“IPO”) between 2011 and 2013 in the U.S. have a dual-class share structure.⁹ Google, Facebook, Groupon, LinkedIn, Zynga, and Alibaba are well-known examples of leveraged control firms.¹⁰ Further research is needed to

Nordic Model in an International Perspective: The Role of Ownership, in THE NORDIC CORPORATE GOVERNANCE MODEL 94, 98, 102 (Per Lekvall ed., 2014).

⁶ Bebchuk et al., *supra* note 4, at 301–06.

⁷ ISS ET AL., REPORT ON THE PROPORTIONALITY PRINCIPLE IN THE EUROPEAN UNION 24 (2007); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 92–93 (2000).

⁸ Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1057 (2010).

⁹ Richard J. Sandler & Joseph A. Hall, *Corporate Governance Practices in IPOs*, CORP. GOVERNANCE ADVISOR, July/Aug. 2014, at 17, 18.

¹⁰ Paul Hodgson, *Alibaba IPO: Shareholders Can Buy Shares, Not Influence*, FORTUNE (Sept. 18, 2014), <http://fortune.com/2014/09/18/alibaba->

understand the dynamics that shape the proper use of control-enhancing mechanisms and the role of law and governance in mitigating the distortions in a leveraged control structure.¹¹

This Article first reviews the practice and regulatory framework of leveraged control in the United States, Europe, and East Asia. In general, most jurisdictions allow for a certain amount of deviation from the one-share one-vote rule. Yet, there does not seem to be a consensus on how to regulate different forms of deviation devices. This Article then reviews current theories and empirical studies on leveraged control to see if there are coherent grounds either for or against leveraged control. As mentioned, the theories do not seem to point in a clear direction. Even though the findings of the existing empirical studies are mixed, there are more studies that suggest leveraged control correlates with lower firm value. In particular, there is evidence showing that the value discount may not come from inefficient monitoring, but rather from the extraction of private benefits by controlling-minority shareholders. This result explains the concern over increased entrenchment agency costs in a leveraged control firm.

Next, this Article critically reviews the freedom of contract argument, which supports practices that deviate from the one-share one-vote principle. Through the lens of the contractarian theory of the firm, this Article suggests that differentiating the IPO stage from the post-IPO (or “midstream”) stage is essential in analyzing the agency problem faced by outside shareholders in a leveraged control firm. This Article argues that the contracting mechanism, which ensures the efficiency of any governance design, can be

ipo-shareholders/ [https://perma.cc/GR2R-N4XC]; Nell Minow, *The Hidden Danger of IPOs Like Groupon and LinkedIn—and What It Will Cost*, CBS MONEYWATCH (June 10, 2011), <http://www.cbsnews.com/news/the-hidden-danger-of-ipos-like-groupon-and-linkedin-and-what-it-will-cost/> [https://perma.cc/5VBK-P3WU].

¹¹ Sara Saggese et al., *Evolution of the Debate on Control Enhancing Mechanisms: A Systematic Review and Bibliometric Analysis*, 18 INT. J. MGM'T REVS. 417, 434–35 (2016).

achieved, at best, only in the IPO stage where potential investors can place discounts on any pro-insider governance measure and corporate insiders directly suffer the loss of a price discount. In the midstream stage, the contracting mechanism that is present at the IPO stage is no longer present. Therefore, pro-insider charter amendments are likely to be passed because outside shareholders lose their bargaining power by giving up a majority of the votes to controlling-minority shareholders. In the case where a leveraged control firm adopted a supermajority voting requirement for charter amendments during its IPO, like in the case of Google and Alibaba, such a supermajority provision further distorts the contracting mechanism in the midstream and weakens minority shareholders' ability to adopt value-enhancing amendments. With disproportionate voting power at hand, controlling-minority shareholders can easily block such amendment proposals. Recent recapitalizations of Google and Facebook, as well as going-private transactions among many U.S.-listed Chinese firms, provide vivid examples of the midstream opportunistic behaviors of controlling-minority shareholders.

In the final part, this Article discusses the ways in which policy should address the midstream pro-insider distortions in leveraged control firms. One size does not fit all. Considering how different corporations demonstrate different characteristics, this Article argues that an outright prohibition of certain types of control-enhancing mechanisms may not be optimal. Instead, we should leave these decisions in the hands of shareholders. To do so, empowering shareholders by increasing shareholder participation would be the best way to resolve the imbalance of power in a leveraged control firm. In particular, institutional investors, together with shareholder activists, could fix the collective action problem of outside shareholders and draw attention to governance failures in leveraged control firms.

Part II reviews the current practice and regulatory framework of leveraged control in major jurisdictions. Part III considers different theories and empirical studies of leveraged control and deviation devices. Drawing on the

contractarian theory of the firm, Part IV differentiates the IPO stage from the midstream stage and identifies midstream pro-insider distortions. Part V discusses regulatory strategies in governing such distortions. Part VI concludes the Article.

II. OVERVIEW

A. The Practice

The most commonly observed structures that create deviations between control rights and economic rights include multiple voting rights shares, priority shares, pyramidal structures, cross-shareholdings, and shareholders' agreements.¹² In a 2007 survey ("EU Proportionality Report") of 464 public companies in sixteen European Union member states, 44% of the surveyed companies had at least one control-enhancing mechanism.¹³ Pyramidal structure, multiple voting rights shares, and shareholders' agreements are the most common mechanisms used among European public companies to create leveraged control.¹⁴ In contrast,

¹² Multiple voting rights shares, or in its most commonly seen form "dual class shares," are voting structures where two share classes are issued and one class carries a greater number of votes per share or exclusive director election rights. Pyramid structures are defined as owning a majority of the stock of one corporation which in turn holds a majority of the stock of another corporation, a process that can be repeated a number of times. Through pyramid structures, controlling shareholders can control firms through a chain of companies while owning only a minority of the shares. Cross-shareholding means that a firm owns shares in another firm that belongs to the same business group. Finally, shareholder voting agreements are agreements among certain shareholders to vote in favor of the director candidates or other corporate affairs proposed by certain shareholders. See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. Fin. 471, 498–505 (1999); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. Fin. Econ. 365, 366 (2002); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. Fin. Econ. 81, 93 (2000).

¹³ ISS ET AL., *supra* note 7, at 24.

¹⁴ *Id.* at 25.

companies in Western Europe, like Sweden, Switzerland, Italy, and Finland mostly use dual-class shares to secure disproportionate corporate control.¹⁵ Other mechanisms, such as pyramids and cross-shareholding, are less common in Western Europe. On the other hand, corporate control in East Asian countries is typically enhanced by pyramidal structures and cross-shareholdings among firms.¹⁶ Dual-class shares are not common in East Asian countries because they are banned in some jurisdictions in conformance with the one-share one-vote principle.¹⁷ Pyramidal ownership is the most common form of leveraged control among public companies in Indonesia (66.9%), Singapore (55%), Taiwan (49%), and Korea (42.6%); on average, 38.7% of East Asian public companies use pyramids to maintain corporate control.¹⁸

In the United States, ownership of public companies is mostly dispersed. Only approximately 7% of S&P Composite 1500 companies are controlled firms.¹⁹ Pyramids and cross-shareholding are not common and most U.S. public

¹⁵ 66.07%, 51.17%, 41.35%, and 37.6% of public companies in Sweden, Switzerland, Italy, and Finland respectively issue dual-class shares. Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 385-87 (2002).

¹⁶ Claessens et al., *supra* note 7, at 82.

¹⁷ Hong Kong, China, South Korea, and Taiwan all follow the one-share one-vote principle and prohibit dual-class share structure. Japan did not have any listed companies with dual-class share structure until 2014. See HONG KONG EXCHANGES & CLEARING LTD., CONCEPT PAPER: WEIGHTED VOTING RIGHTS 25 (2014), <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082.pdf> [<https://perma.cc/84GT-B6EZ>]; Hwa-Jin Kim, *Concentrated Ownership and Corporate Control: Wallenberg Sphere and Samsung Group*, 14 J. KOREAN L. 39, 50 (2014); Koji Toshima, *Letter: Dual-Class Share Structure is Permitted in Japan*, FIN. TIMES (June 25, 2015), <https://www.ft.com/content/5f0f2d44-19cf-11e5-a130-2e7db721f996>.

¹⁸ Claessens et al., *supra* note 7, at 92–93.

¹⁹ In 2012, 114 companies in the S&P 1500 Composite were controlled firms. IRRIC INSTITUTE & ISS, CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012), <http://irricinstitute.org/wp-content/uploads/2015/09/FINAL-Controlled-Company-ISS-Report1.pdf> [<https://perma.cc/4MYQ-9Q87>].

companies do not belong to a business group.²⁰ The most popular mechanism that U.S. public companies tend to use to create leveraged control is dual-class shares. A study on U.S. public firms reveals that 70% of the controlled firms feature a dual-class voting structure or attach special rights to specific shareholders.²¹ A comprehensive study of U.S. public companies carried out by Gompers, Ishii, and Metrick shows that around 6% have dual- or multi-class shares, comprising approximately 8% of the market capitalization of all firms.²² Although the initial number was not large, it has increased in recent years along with the growing number of U.S. technology firms going public with dual-class share structures. The percentage of new IPO firms adopting dual-class shares in the U.S. rose from 8% in 2008 to 28% in 2013.²³

B. Regulatory Framework

Over the past century, both at the national and regional levels, there have been several fruitful policy debates over how and whether to regulate mechanisms that create deviations between ownership and control.²⁴ Due to the

²⁰ Eugene Kandel et al., *The Great Pyramids of America: A Revised History of U.S. Business Groups, Corporate Ownership and Regulation* 2–7 (Nat'l Bureau of Econ, Research, Working Paper No. 19691, 2013).

²¹ As of 2012, 79 out of 114 controlled firms in the S&P 1500 Composite featured multiclass capital structures with unequal voting rights. IRRIC INSTITUTE & ISS, *supra* note 19, at 3.

²² Gompers et al., *supra* note 8, at 1053.

²³ Sandler & Hall, *supra* note 9, at 18.

²⁴ See generally HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKEOVER BIDS (2002), http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf [https://perma.cc/39HQ-HP52]; COMMISSION OF THE EUROPEAN COMMUNITIES, IMPACT ASSESSMENT ON THE PROPORTIONALITY BETWEEN CAPITAL AND CONTROL IN LISTED COMPANIES (2007), http://ec.europa.eu/internal_market/company/docs/shareholders/impact_assessment_122007.pdf [https://perma.cc/BMF4-RPDE]; OECD STEERING GROUP ON CORPORATE GOVERNANCE, LACK OF PROPORTIONALITY BETWEEN OWNERSHIP AND CONTROL: OVERVIEW AND

complexity of the issues involved and the fact that each jurisdiction operates within very different corporate and regulatory environments, the regulatory responses to such mechanisms seem drastically different. The 2007 EU Proportionality Report showed that pyramidal structure, cross-shareholding, and shareholders' agreements are available in all of the surveyed countries whereas multiple voting rights shares are only available in 53% of them.²⁵ The regulatory framework varies drastically for other mechanisms that restrict or empower certain types of shares or specific shareholders.²⁶ In this section, the Article highlights three broader global regulatory trends with respect to deviation devices: no consolidated view at the regional level, divergent regulatory policies towards dual-class shares, and the promotion of long-term investments through time-phased voting.

1. No Consolidated View at the Regional Level

The European Commission initiated the most recent regional policy debate. According to its 2002 *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* (the “Winter Group Report”),²⁷ the issue of proportionality between equity ownership and control was brought up with the idea of exploring the possibility of harmonizing European company law. Hence, the Commission was considering implementing the one-share one-vote rule across Europe. Specifically, the Winter Group Report states that:

[P]roportionality between ultimate economic risk and control means that share capital which has an

ISSUES FOR DISCUSSION (2007), <https://www.oecd.org/daf/ca/40038351.pdf> [<https://perma.cc/9W4T-QLD8>].

²⁵ ISS ET AL., *supra* note 7, at 18–22.

²⁶ The availability of different mechanisms ranges from 81% to 31% of the surveyed countries: Non-Voting Preference Shares (81%), Voting Right Ceilings (69%), Priority Shares (56%), Golden Shares (44%), Ownership Ceilings (37%), Non-Voting Shares (31%). *Id.* at 16 fig.3.4.

²⁷ HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, *supra* note 24.

unlimited right to participate in the profits of the company or in the residue on liquidation, and *only* such share capital, should normally carry control rights, in proportion to the risk carried. The holders of these rights to the residual profits and assets of the company are best equipped to decide on the affairs of the company as the ultimate effects of their decisions will be borne by them.²⁸

Following this report, the European Commission entrusted ISS Europe, the European Corporate Governance Institute, and the law firm Shearman & Sterling to conduct a thorough study on the issue of proportionality of ownership and control.²⁹ Once the EU Proportionality Report was published in 2007, the proportionality issue began to be discussed not only at the EU level, but also within various European countries.³⁰ Finally, in September 2007, the European Corporate Governance Forum published a statement declaring that “[o]ur current information on and understanding of the application of proportionality in EU Member States and the effects of non-proportionality on the stated EU policy objectives . . . do not provide a basis for mandating proportionality rules across the EU.”³¹ Since then, the EU has been regulating control-enhancing mechanisms through enhancing disclosure and transparency.³²

Similarly, the Organisation for Economic Co-operation and Development (“OECD”) conducted an assessment of the issue of proportionality in 2007.³³ The OECD report concludes that regulation imposing a one-share one-vote principle may not be effective because there are many substitutes to voting restrictions that would create similar

²⁸ *Id.* at 3.

²⁹ ISS et al., *supra* note 7.

³⁰ COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 24, 8–9.

³¹ *Id.* at 49.

³² Wolf-Georg Ringe, *Deviations from Ownership-Control Proportionality—Economic Protectionism Revisited*, in COMPANY LAW AND ECONOMIC PROTECTIONISM: NEW CHALLENGES TO EUROPEAN INTEGRATION 212–13 (Ulf Bernitz and Wolf-Georg Ringe eds., 2010).

³³ OECD STEERING GROUP ON CORPORATE GOVERNANCE, *supra* note 24.

deviations as a result.³⁴ In addition, mandating one-share one-vote may deter companies controlled by entrepreneurs from seeking public listing and thus discourage the innovation and entrepreneurship that are essential for economic development.³⁵ In the end, the OECD recommended alternatives, such as strengthening the corporate governance framework, to reduce private benefits extraction and to target specific problems involving proportionality with appropriate regulatory impact assessments.³⁶ Ultimately, both the EU and OECD came to the same conclusion—rather than impose the one-share one-vote principle across jurisdictions, the decision should be left to local government authorities.

2. Divergent Regulatory Policies Towards Dual-Class Shares

In general, there is consensus on the principle of proportionality between equity ownership and control based on relatively straightforward economic sense and equal treatment among shareholders. At the same time, there seems to be consensus that companies should be allowed to deviate from this proportionality principle—at least as evidenced by the prevalence of pyramidal group structures in most countries.³⁷ Within this consensus, however, lie disagreements over which mechanisms should be allowed to create such deviations. As the ISS survey shows, the main difficulty pertains to the restriction or empowerment of certain types of shares, or specific shareholders, in the corporate charter.³⁸ In particular, the dual-class share structure has attracted the most attention in recent years because many prominent IPO firms adopted such a

³⁴ *Id.* at 5.

³⁵ *Id.*

³⁶ *See id.* at 4–6.

³⁷ *See ISS ET AL.*, *supra* note 7, at 14–15.

³⁸ *See id.* at 15–16.

structure, and it has provoked debate among stock exchanges as to whether to allow multiple voting rights shares.³⁹

There are three main regulatory policies governing dual-class share structures.⁴⁰ The first is the permissive approach, which is complemented by substantial disclosure requirements, such as those that are seen in the United States and Canada.⁴¹ The second approach is prohibition and mandating one-share one-vote through corporate law. This approach applies in countries such as Germany, Spain, and China.⁴² The third is to allow dual-class shares in private companies but prohibit public companies from deviating from the one-share one-vote principle. Most Commonwealth jurisdictions, such as the UK, Hong Kong, and Australia, have adopted the third approach.⁴³

Since 2014, regulators in China, Hong Kong, and Singapore have revisited their one-share one-vote policy and reconsidered accepting a dual-class share structure. China's largest e-retailer, Alibaba, launched the largest IPO of all time in September 2014 on the New York Stock Exchange ("NYSE"). Alibaba had previously sought to list on the Stock Exchange of Hong Kong ("HKEx") with a dual-class share structure,⁴⁴ but it was rebuffed on the grounds that the dual-class share structure violated the one-share one-vote rule.⁴⁵ However, competition among international stock exchanges has forced participants in the Hong Kong market to reconsider their strict one-share one-vote policy. In August 2014, HKEx issued a concept paper on weighted voting rights and solicited the opinions of market participants.⁴⁶ In June 2015, HKEx concluded, "generally, 'one share, one vote'

³⁹ See *infra* text accompanying notes 43–52.

⁴⁰ HONG KONG EXCHANGES & CLEARING LTD., *supra* note 17, at 10.

⁴¹ *Id.*

⁴² *Id.*

⁴³ See *id.*

⁴⁴ Yu-Hsin Lin & Thomas Mehaffy, *Open Sesame: The Myth of Alibaba's Extreme Corporate Governance and Control*, 10 BROOK. J. CORP. FIN. & COM. L. 437, 441–42 (2016).

⁴⁵ *Id.*

⁴⁶ HONG KONG EXCHANGES & CLEARING LTD., *supra* note 17.

should prevail but that WVR [weighted voting rights] structures should be allowed for certain companies in certain circumstances and with certain safeguards.”⁴⁷ However, the Securities and Futures Commission rejected HKEx’s proposal on the basis that safeguards and conditions might not be monitored on an ongoing basis.⁴⁸ In October 2015, HKEx finally decided to abandon its proposal to allow a dual-class share structure and to continue to strictly uphold the one-share one-vote rule for future listings.⁴⁹

In contrast to Hong Kong, Singapore has been more aggressive in competing for international equity offerings. On August 29, 2016, the Singapore Exchange’s Listings Advisory Committee approved the proposal to allow listing companies to have dual-class shares.⁵⁰ Singapore has debated this issue ever since Manchester United considered listing there in 2011 but eventually listed in the United States under a dual-class share structure.⁵¹ Traditionally, Singapore has followed the Commonwealth approach, where only private companies are allowed to have dual-class shares. To pave the way for the change, the Singapore Companies Act was amended and took effect in early 2016, allowing public companies to have different classes of shares that confer different voting rights, including dual-class

⁴⁷ HONG KONG EXCHANGES & CLEARING LTD., CONSULTATION CONCLUSIONS TO CONCEPT PAPER ON WEIGHTED VOTING RIGHTS 3 (2015).

⁴⁸ SFC Statement On The SEHK’s Draft Proposal On Weighted Voting Rights, SEC. & FUTURES COMM’N (June 25, 2015), <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR69>.

⁴⁹ Jennifer Hughes, *Hong Kong Puts Shareholder Rights Ahead of Desire for IPOs*, FIN. TIMES (Oct. 5, 2015), <http://www.ft.com/cms/s/0/7b8a1732-6b4a-11e5-aca9-d87542bf8673.html#axzz3nkFPKRNH>.

⁵⁰ Andrea Tan, Joyce Koh & Yoolim Lee, *Singapore’s Dual-Class Shares Change Looks Like Just a First Step*, BLOOMBERG (Aug. 29, 2016, 6:44 AM), <http://www.bloomberg.com/news/articles/2016-08-29/singapore-s-dual-class-shares-move-wins-nod-from-listings-group> [<https://perma.cc/D4GD-XAM7>].

⁵¹ *Id.*

shares.⁵² Following Hong Kong's rejection of the dual-class share structure, market observers expect Singapore to fill the gap and attract more international equity offerings.⁵³

As for China, the State Council and Shanghai Stock Exchange had considered opening the market to foreign-registered Chinese firms that have a dual-class share structure to encourage entrepreneurship and innovation and the return of foreign-listed Chinese firms.⁵⁴ As of May 2014, 102 Chinese companies listed their shares on U.S. stock exchanges; among them, almost one-third (30 out of 102) had dual-class share structures.⁵⁵ This third represents 70% of the market capitalization of all U.S.-listed Chinese firms.⁵⁶ However, this proposal has not been put into practice so far. That being said, the policy debate over the relaxation of the one-share one-vote principle in China is still ongoing. Whether due to the purpose of encouraging long-term focus in public companies or of providing more equity financing options to start-up companies, the trend towards more diverse corporate control design is inevitable.⁵⁷

⁵² Companies (Amendment) Act 2014, § 64A (No. 36 of 2014); Jacqueline Woo, *Dual-Class Shares Could Help Boost Local Market*, STRAITS TIMES (Nov. 16, 2015, 5:00 AM), <http://www.straitstimes.com/business/companies-markets/dual-class-shares-could-help-boost-local-market> [<https://perma.cc/PR3A-83J7>].

⁵³ *Id.*

⁵⁴ THE STATE COUNCIL OF PEOPLE'S REPUBLIC OF CHINA, OPINIONS OF THE GENERAL OFFICE OF THE STATE COUNCIL ON CONSTRUCTING MASS ENTREPRENEURSHIP AND INNOVATION (*guo wu yuan guan yu da li tui jin da zhong chuang ye wan zhong chuang xin ruo gan zheng ce cuo shi de yi jian*), GUOFA [2015] No. 32 (2015) http://www.gov.cn/zhengce/content/2015-06/16/content_9855.htm [<https://perma.cc/2TTT-DUJB>]; WU XINCHUN & XING MEI, ALLOWING DUAL-CLASS SHARE STRUCTURES TO ADAPT TO NEW CORPORATE GOVERNANCE PRACTICE (*cheng ren shuang ceng gu quan jie gou shi ying xin xing gong si zhi li shi jian*) (Shanghai Stock Exchange Research Report Series 2015 No. 50, 2015), <http://www.sse.com.cn/aboutus/research/research/c/3986627.pdf> [<https://perma.cc/UHB3-P5K9>].

⁵⁵ HONG KONG EXCHANGES & CLEARING LTD., *supra* note 47, at 41.

⁵⁶ *Id.*

⁵⁷ Zhu Ciyun and Shen Zhaohui, *Classified Shares and the Evolution of Chinese Corporate Law*, 9 SOC. SCI. CHINA 147, 158–62 (2013); Special

3. Promoting Long-Term Investments through Time-Phased Voting

Recently, within European countries there has also been a trend towards granting multiple voting rights to encourage long-term investment. France passed the Florange Act in March 2014, which amends Article L.225-123 of the French Commercial Code, making it a default rule that shareholders who hold shares for more than two years will be granted double voting rights unless two-thirds of shareholders agree to opt out.⁵⁸ The new law rewards loyalty shares with double voting rights to encourage long-term investments. Before the Act took effect, 57% of French SBF-120 companies had time-phased voting, suggesting that deviations from one-share one-vote were common in France even before the adoption of the Florange Act.⁵⁹ After making time-phased voting a default rule, the adoption rate among French SBF-120 companies rose by 12%.⁶⁰ By June 30, 2015, 41 French SBF-120 companies had proposed to opt-out of the Florange Act and 34 had passed.⁶¹ Opt-out proposals were strongly supported by shareholders; 75% of the firms passed the opt-out proposal with over 90% shareholder support.⁶² Italy

Reporting Grp. of Shanghai Sec. Journal for the Two Sessions, *Wu Xiaoling Comments on Baoneng-Vanke Hostile Takeover: Consider Introducing Dual-class Shares and Anti-takeover Measures* (wu xiao ling ping bao wan zhi zheng jiao xun: ke yan jiu AB gu zhi du fan shou gou tiao kuan) (Mar. 9, 2017), CNSTOCK.COM, <http://news.cnstock.com/event,2017lh-2017lhzb-201703-4046037.htm> [<https://perma.cc/2BWR-527U>].

⁵⁸ Loi 2014-384 du 29 mars 2014 visant à reconquérir l'économie réelle [Law 2014-384 of March 29, 2014 Aimed at Reconquering the Real Economy], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Apr. 1, 2014, p. 6227, Art. 7, https://www.legifrance.gouv.fr/affichTexte.do;jsessionid=482196C6894787033E7531E4ED86B196.tpdila14v_3?cidTexte=JORFTEXT000028811102&d ateTexte=&oldAction=rechJO&categorieLien=id&idJO=JORFCONT000028811093 [<https://perma.cc/34K5-3WXS>].

⁵⁹ KEVIN DE PRIL ET AL., ISS, EUROPEAN VOTING RESULTS REPORT: 2015 UPDATE 21 (2015).

⁶⁰ *Id.*

⁶¹ *Id.* at 22.

⁶² *Id.*

followed France and removed its prohibition on multiple voting rights in August 2015 to allow companies to opt-in if two-thirds of the shareholders approve.⁶³ However, a further revision to lower the threshold to a simple majority was later suspended due to fierce opposition from institutional investors since most Italian public companies have controlling shareholders.⁶⁴ In 2015, the European Union also considered an amendment proposal to the Shareholders' Rights Directive of 2007 to reward long-term shareholders with extra voting rights or dividends.⁶⁵ Even in the United States, scholars advocate that companies should use time-phased voting to address concerns over short-termism.⁶⁶

However, time-phased voting also raises the concern over protectionism in Europe if used by a state-owned enterprise.⁶⁷ The French government actively supports time-

⁶³ Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat 1* (European Corporate Governance Institute, Law Working Paper No. 288/2015, 2015), <http://ssrn.com/abstract=2574236>.

⁶⁴ Bram Hendriks, *Differential Ownership Rights: A Tool to Stimulate Long-Term Share Ownership with Negative Consequences*, INVESTMENT EUROPE (Sept. 30, 2015), <http://www.investmenteurope.net/opinion/differential-ownership-rights-a-tool-to-stimulate-long-term-share-ownership-with-negative-consequences/> [https://perma.cc/9NEU-UV82]; Faccio & Lang, *supra* note 15, at 378–79.

⁶⁵ *Report on the Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement*, at 10, 33, COM (2014) 0213 (May 12, 2015); Jeroen Delvoie & Carl Clottens, *Accountability and Short-Termism: Some Notes on Loyalty Shares*, 9 L. & FIN. MARKETS REV. 19, 23 (2015). On July 8, 2015, the European Parliament rejected the proposal to reward long-term shareholders. See Nctm Studio Legale, *Revision of the Shareholders Rights Directive: It's a Long Way Home*, LEXOLOGY (July 14, 2015), <http://www.lexology.com/library/detail.aspx?g=10cdafcd-9dea-43fc-9016-a96ae6952489> [https://perma.cc/6YEL-YN3M].

⁶⁶ Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 546–47 (2015). See generally David J. Berger et al., *Tenure Voting and the U.S. Public Company*, 72 BUS. LAW. 295 (2017).

⁶⁷ Ringe, *supra* note 32, at 218.

phased voting in companies where the government itself is a major shareholder.⁶⁸ For example, the French government temporarily increased its stakes in Renault, for which it is a major shareholder, during the voting season through share borrowing and put and call options.⁶⁹ Critics have commented that the French reforms were led by a socialist government in order to control state-owned enterprises with less capital and as a protectionist guard against foreign investors.⁷⁰

III. THEORETICAL DEBATE AND EMPIRICAL FINDINGS

As illustrated in the previous section, leveraged corporate control is common, but the means utilized by controlling shareholders are quite diverse and vary markedly among jurisdictions. No consensus on policy has been reached on a regional level and different jurisdictions usually have different preferences when it comes to the means for leveraged control. Different countries may value equality and democracy in the corporate setting differently due to diversity in their political, societal, cultural, and economic conditions. This section reviews existing theories with regard to proportionality in corporate control to explore whether there are coherent grounds for or against proportionality in corporate ownership and control. As demonstrated in this section, since there are competing views among scholars about the effects of leveraged control, a further review of the empirical studies is warranted.

A. Agency Theory Account

The agency theory views controlling-minority structures from an economic perspective and provides a framework to

⁶⁸ KEVIN DE PRIL ET AL., ISS, *supra* note 59, at 22.

⁶⁹ *Id.*

⁷⁰ *Short-Term or Short-Changed?*, ECONOMIST (May 2, 2015), <http://www.economist.com/news/business/21650149-enhanced-rights-loyal-investors-are-increasingly-touted-way-make-companies-think> [<https://perma.cc/22CC-68AJ>].

empirically examine the effects of leveraged control. In a controlled firm, the principal-agency problem arises between controlling shareholders and non-controlling shareholders, as opposed to that which exists between managers and shareholders in a dispersed ownership firm. There are two counteracting effects of concentrated ownership on the governance of firms: (1) the entrenchment effect, where concentrated ownership protects controlling shareholders from potential takeover threats and makes it easier for opportunistic controllers to expropriate minority shareholders; and (2) the incentive effect, where concentrated ownership provides controlling shareholders with incentives to monitor management, which makes monitoring more efficient.⁷¹ As long as the incentive effect is greater than the entrenchment effect, non-controlling shareholders should benefit from having controlling shareholders in a firm.⁷² In a firm with leveraged control, it is not clear from the agency theory whether the benefits of the incentive effect would outweigh the costs of the entrenchment effect or the other way around.

Easterbrook and Fischel promoted the one-share one-vote principle by arguing that shareholders are the only group of corporate stakeholders who have the appropriate incentives to make discretionary decisions because they are the ones who bear the risks of bad decisions.⁷³ Leveraged control would undermine the incentive mechanism arising from ownership-control proportionality and result in great risks of opportunistic expropriation. Furthermore, a controlling-minority structure would insulate controllers from potential takeovers and protect them from being replaced, even if there are inefficiencies.⁷⁴ As a result, leveraged control firms

⁷¹ Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293, 294 (1988); Morten Bennesen & Kasper Meisner Nielsen, *Incentive and Entrenchment Effects in European Ownership*, 34 J. BANKING & FIN. 2212, 2212 (2010).

⁷² Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785–86 (2003).

⁷³ EASTERBROOK & FISCHEL, *supra* note 2, at 67–70.

⁷⁴ *Id.* at 70–74; Ringe, *supra* note 32, at 217.

suffer from increased agency costs, which have an adverse effect on firm value.⁷⁵ The agency theory provides a normative theory on concentrated ownership. Whether a leveraged control structure generates net benefits or net costs to shareholders may vary depending on the characteristics of the companies or the regulatory environment of a given jurisdiction. Empirical studies are thus useful for a positive account of the net effect of leveraged corporate control.

B. Freedom of Contract Account

The freedom of contract account is a market-based claim that challenges the strict proportionality principle from the perspective of contractual freedom.⁷⁶ Proponents of the freedom of contract account consider a mandatory one-share one-vote rule as interference in shareholder's sovereignty and independence. Shareholders are free to decide a company's internal affairs because they are the ones who ultimately bear the risks. Companies should enjoy autonomy and regulators should not intervene unless the corporate decision causes harm to society as a whole. The freedom of contract claim basically advocates contractual freedom among shareholders for the governance of internal corporate affairs.⁷⁷ This is the claim that is mostly used by Nordic scholars and policy makers to explain the widespread adoption of multiple voting rights shares in the region.⁷⁸

C. Long-Term Value Account

The long-term value account argues that by shielding companies from the market for corporate control, control-enhancing mechanisms help incumbents fight short-termism

⁷⁵ Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1684–86 (2013).

⁷⁶ See OECD STEERING GROUP ON CORPORATE GOVERNANCE, *supra* note 24, at 6–7; Ringe, *supra* note 32, at 219.

⁷⁷ Ringe, *supra* note 32, at 219.

⁷⁸ Ulf Bernitz, *The Attack on the Nordic Multiple Voting Rights Model: The Legal Limits Under EU Law*, 15 EUR. BUS. L. REV. 1423, 1424 (2004).

and encourage them to pursue long-term investments, which in turn increase long-term shareholder value.⁷⁹ Recent legal scholarship further expands on this argument by focusing on entrepreneurial vision. In recent years, many high-tech firms have gone public with their entrepreneurs still maintaining control through the adoption of dual-class shares or other control-enhancing mechanisms. Scholars argue that entrepreneurs usually possess idiosyncratic visions for their companies that outside shareholders do not have.⁸⁰ With stable control, entrepreneurs will be able to realize their idiosyncratic visions by executing the business decisions of their choice even though outside investors may not recognize the potential value of the decision. If an investment succeeds, all the shareholders will share the profits pro rata. Thus, a dual-class share structure is likely to benefit the investors if the entrepreneurs turn out to be right.⁸¹ This is especially true with today's corporations. Unlike the corporations during the Industrial Age when most of their value was derived from physical assets and manufacturing activities, corporations in the information economy create value from human capital and intangible assets, such as know-how, patents, and research and development projects.⁸² From the perspective of asset pricing theory, information about the value of long-term investments is not observable or verifiable by outside investors and hence it is less accurately reflected in the asset price. In this situation, the market is more likely to suffer from short-termism because shareholders are apt to misjudge a valuable long-term investment as value-decreasing because of a short-term increase in capital

⁷⁹ See LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 63–73 (2012); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 656 (2010); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1739 (2006).

⁸⁰ Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 577–579 (2016).

⁸¹ See *id.*

⁸² See Carol A. Corrado & Charles R. Hulten, *How Do You Measure a “Technological Revolution”?*, 100 AM. ECON. REV. 99, 100–03 (2010).

expenditure.⁸³ In this case, it would be more efficient to allocate more power to the entrepreneurs by granting them leveraged control through adopting a dual-class share structure or other control-enhancing devices.

D. Empirical Findings

In the face of opposing theoretical claims and unsettled regulatory approaches, existing empirical evidence must be analyzed for further guidance. The key question is whether control-enhancing mechanisms affect shareholder value. Would leveraged control create greater agency costs of entrenchment and thus decrease outside shareholders' value (the entrenchment effect)? Or would leveraged control help controlling shareholders better monitor the firm and maximize its value (the incentive effect)? Under what circumstances would the benefits of value creation outweigh the costs of entrenchment?

For shareholder value, it should be noted that the value of control-enhancing mechanisms to outside shareholders is different from the value to controlling shareholders. For example, in a firm with a dual-class share structure, shares that carry more votes should be worth more than shares that carry only one vote. The extra value that the market awards to these multiple vote shares is called the "control premium." However, multiple vote shares are usually not tradable in the market. Most prior empirical studies use market price as a proxy for shareholder value, which in fact only measures the value of shares to outside shareholders.⁸⁴ Consequently, the value of leveraged control to a controlling shareholder is very difficult to measure empirically and typically can only be assessed in a change-of-control transaction. For the purposes of this research, we care more about the impact of the control-enhancing mechanism on the share value of

⁸³ Alex Edmans et al., *The Real Costs of Financial Efficiency When Some Information Is Soft*, 20 REV. FIN. 2151, 2153 (2016); Cremers & Sepe, *supra* note 80, at 81.

⁸⁴ Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 62–63 (2008).

outside shareholdings. Therefore, in this section we review empirical studies that address this issue.

Most earlier studies use the wedge between the economic rights and the control rights of shareholders to measure the level of deviation and examine the impact of such deviation on shareholder value without differentiating between the types of mechanisms that have caused the wedge. Using cross-country data, both La Porta et al. and Claessens et al. find that the cash-flow rights of controlling shareholders are positively correlated with shareholder value, which is consistent with the incentive effect of cash-flow ownership under agency theory.⁸⁵ With regard to the effect of the wedge on firm value, the results are somewhat mixed. Most studies find the wedge correlates with lower firm value, supporting the entrenchment effect hypothesis. Claessens et al.'s study of firms in eight East Asian economies found that the wedge correlates with lower firm value. However, they did not uncover whether any specific type of mechanism, i.e., pyramids, cross-shareholding, or dual-class shares, drives the value discount.⁸⁶ Lins found similar evidence on the negative impact of the wedge created by disproportionate mechanisms on firm value in 1433 sample firms from 18 emerging economies.⁸⁷ In contrast, based on a sample of large firms in 27 wealthy economies, La Porta et al. did not find a significant correlation between the wedge and firm value, but they support the notion that country-level investor protection increases firm value.⁸⁸

Other studies on European countries fail to support the incentive effect and find limited evidence on the entrenchment effect. Cronqvist and Nilsson analyzed a sample of 309 Swedish firms and found that the voting power

⁸⁵ Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1147–49 (2002); Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2758 (2002).

⁸⁶ Claessens et al., *supra* note 86, at 2756–58, 2768.

⁸⁷ Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUAN. ANALYSIS 159, 181 (2003).

⁸⁸ La Porta et al., *supra* note 85, at 1162–64, 1163 n.11.

of controlling shareholders is negatively correlated with firm value. They did not find a significant correlation between cash-flow rights and the wedge, but relate family ownership to negative firm value.⁸⁹ Maury and Pajuste studied Finnish firms and used the control-to-ownership ratio as a proxy for the entrenchment effect. They found a negative impact of vote concentration on firm value (which supports the entrenchment effect), but they did not find evidence for the incentive effect of cash-flow ownership.⁹⁰

Apart from large-scale cross-country analyses, studies on U.S. public firms mainly focus on one mechanism—dual-class shares.⁹¹ The seminal paper written by Gompers et al. tried to disentangle the incentive and entrenchment effects by examining U.S. public firms with dual-class share structures.⁹² They found that firm value increases alongside an increase in insider cash flow rights and decreases with the increase in insider voting rights. They also found firm value to be negatively correlated with the wedge between cash flow rights and voting rights, suggesting a negative impact of the dual-class share structure on shareholder value.⁹³ Since control-enhancing mechanisms are chosen by the firm, they are inherently endogenous. Hence, these studies are subject to the endogeneity problem and require a cautious interpretation of their results.⁹⁴ Gompers et al. attempted to address the endogeneity problem by using seven instrumental variables.⁹⁵ However, the quality of the instruments has been contested by scholars and additional

⁸⁹ Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUAN. ANALYSIS 695, 697 (2003).

⁹⁰ Benjamin Maury & Anete Pajuste, *Multiple Large Shareholders and Firm Value*, 29 J. BANKING & FIN. 1813, 1827 (2005).

⁹¹ Large firms in the United States are free-standing and widely held. Pyramidal ownership is virtually non-existent due to the introduction of the intercorporate dividend tax in 1935. Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, 164 (2005).

⁹² Gompers et al., *supra* note 8, at 1054.

⁹³ *Id.* at 1073–76.

⁹⁴ Adams & Ferreira, *supra* note 84, at 67–68.

⁹⁵ Gompers et al., *supra* note 8, at 1071–72.

research needs to be undertaken to address the endogeneity issue.⁹⁶ In summary, there is empirical evidence supporting the correlation between control-enhancing mechanisms and lower firm value, but a causal link between the two has yet to be established.⁹⁷ If our policy goal is to protect outside shareholders, it is then justified to implement policies that would align the proportionality between control and ownership. However, do we know which mechanism creates the most agency costs to outside shareholders?

Most studies focus on the degree of deviation from proportionality, whereas very few discuss whether the mechanisms used also matter. Bennedsen and Nielsen addressed this issue by studying a large sample of European firms. Consistent with prior research, they found large and significant value discounts on firms with leveraged control in Europe.⁹⁸ In particular, the value discount on firms with dual-class shares was more than twice as large as the discounts on firms with pyramidal structures, while cross-shareholding and other mechanisms did not have a significant impact on firm value.⁹⁹ When comparing firms with different control-enhancing mechanisms, they found that the larger value discount in dual-class share firms may be attributed to worse operating performance, smaller dividend payout, and lower growth in assets relative to pyramidal firms.¹⁰⁰ Since family firms are overrepresented among firms with a controlling-minority structure, it is not clear whether the lower value discount is driven by their over-representation among dual-class firms.¹⁰¹

Villalonga and Amit studied whether different forms of control-enhancing mechanisms matter in U.S. firms by examining the individual effects of dual-class shares, voting agreements, pyramids, and disproportional board

⁹⁶ Bennedsen & Nielsen, *supra* note 71, at 2213; Adams & Ferreira, *supra* note 84, at 64–65.

⁹⁷ Adams & Ferreira, *supra* note 84, at 64–65.

⁹⁸ Bennedsen & Nielsen, *supra* note 71, at 2216–17.

⁹⁹ *Id.* at 2217, 2220.

¹⁰⁰ *Id.* at 2221–23.

¹⁰¹ *Id.* at 2222.

representation. They found that dual-class shares and disproportional board representation have a negative impact, though not statistically significant, while pyramids and voting agreements have a positive impact on the market value of a firm.¹⁰² Based on the research presented thus far, the difference in the value discount between dual-class firms and pyramidal firms—which is both economically and statistically significant—implies that future policymakers and researchers need to pay more attention to the impact of different forms of control-enhancing mechanisms.¹⁰³ However, it should also be noted that, similar to other ownership studies, these studies encounter the problem that firms do not randomly choose their ownership structure and it is very hard to dissect the pure effects of adopting control-enhancing mechanisms.

With regard to the channels through which the wedge leads to lower shareholder values, empirical studies have shown that the operating performance of leveraged control firms is not significantly different than that of regular firms, yet the market values of leveraged control firms are significantly lower than those of regular firms. The result indicates that controlling shareholders efficiently monitor firm operations but extract disproportional surplus after the operations have been carried out.¹⁰⁴ Masulis et al. found evidence that supports the notion that managers in U.S. dual-class firms extract private benefits at the expense of outside shareholders. They found that as the gap between voting rights and cash flow rights widen, cash reserves are worth less to outside shareholders, CEOs receive higher compensation, managers make shareholder value-destroying acquisitions that benefit themselves more often, and capital expenditures contribute less to shareholder value.¹⁰⁵

¹⁰² Belén Villalonga & Raphael Amit, *How Are U.S. Family Firms Controlled?*, 22 REV. FIN. STUD. 3047, 3082–88 (2009).

¹⁰³ Bennedsen & Nielsen, *supra* note 71, at 2227.

¹⁰⁴ *Id.* at 2222.

¹⁰⁵ Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1697 (2009).

Despite the fact that there are certain variations in the empirical results, most of the research studies that we surveyed suggest that controlling-minority structure correlates with lower firm value. That means that there is a value discount on firms with leveraged corporate control. The evidence, though limited, tends to show that the value discount does not come from the inefficient monitoring of controllers, but rather, it comes from the extraction of private benefits of control by controllers. From an outside shareholder's perspective, the cost of extraction is higher than the benefits of efficient monitoring. Furthermore, the mechanism that is used to create leveraged corporate control matters; dual-class share structures seem to receive a higher discount than pyramidal structures, yet we do not know much about the factors contributing to the creation of such difference.

IV. A CONTRACTARIAN VIEW OF THE CURRENT REGIME

The most common challenge associated with a strict proportionality principle is the contractual freedom of shareholders.¹⁰⁶ The contractarian theory of the firm views the corporation as a nexus of contracts between stakeholders, including shareholders, managers, employees, creditors, and others.¹⁰⁷ The most important contractual right that shareholders have is to vote on corporate matters. Shareholders should be free to decide on the allocation of corporate control, including limiting or giving up their voting rights and control. In an efficient market, we shall see different allocations of corporate control in different firms, thus reflecting the preferences of shareholders and the characteristics of individual firms. The contractual

¹⁰⁶ To narrow the scope of discussion, this Article only focuses on the deviations stipulated in the corporate charters that are directly related to the contractual freedom claim, such as dual-class shares, priority shares, or non-voting shares.

¹⁰⁷ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (1976).

mechanism is achieved through pricing. If the shareholders perceive high entrenchment costs arising from the controlling-minority structure, shareholders would place a discount on the share price and the insiders would be penalized by such a discount directly in the IPO.¹⁰⁸ However, markets are not perfect. The existing literature has identified externalities in the IPO contracting process and has found empirical evidence that counteracts the notion that IPO governance design is optimal.¹⁰⁹ Furthermore, prior literature has also identified inefficiencies in corporate contracting in the post-IPO stage in a widely-held firm and called for limits to contractual freedom post-IPO.¹¹⁰ This Article draws on existing contractarian literature and applies it to the controlling-minority corporate structure with the aim of reconsidering the freedom of contract account and identifying externalities in the post-IPO contracting process. Importantly, this Article uncovers serious pro-insider distortions in the post-IPO stage through examples taken from leveraged control firms and calls for changes to protect the interests of outside shareholders.

A. Is the IPO Governance Design Optimal?

The agency relation between managers and shareholders in a dispersed-ownership firm, or that between controlling shareholders and minority shareholders in a concentrated-ownership firm, is at the heart of modern corporate governance theory.¹¹¹ The aim of corporate governance rules

¹⁰⁸ See Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1828–29 (1989).

¹⁰⁹ See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 759 (1995); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “the Economics of Boilerplate”)*, 83 VA. L. REV. 713, 717 (1997); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1385 (2001). For empirical studies, see *infra* note 121.

¹¹⁰ See Bebchuk, *supra* note 108, at 1827–29.

¹¹¹ Jensen & Meckling, *supra* note 107, at 308–10.

is to minimize agency costs and maximize shareholder value.¹¹² The contractarian view of corporate law characterizes a corporate charter as a contract between the firm, its controllers (managers or controlling shareholders), and outside shareholders. The contractual agreement is formed through pricing.¹¹³ The price of a stock reflects the quality of the corporate governance rules and the extent to which these rules reduce agency costs and maximize firm value.¹¹⁴

This theory predicts that when firms go public, they will adopt a set of optimal governance rules in their IPO charters in order to be competitive in obtaining external finance. Pre-IPO shareholders would bear the cost of any price discount if outside investors were to price the shares lower for bad corporate governance design.¹¹⁵ Therefore, provisions that would decrease shareholder value are not expected to be included in IPO charters.¹¹⁶ The contractarian theory provides a powerful normative claim for what IPO charters should look like. Similar to other theoretical claims, contractarian theory is based on the assumption of a perfect market in which there are no transaction costs or other market imperfections. Even if there were, they would only be the drafting costs for corporate charters, which should be modest.¹¹⁷ In reality, market imperfections are more complex and prevalent than the contractarian theory posits.¹¹⁸

Scholars have identified the network externalities of corporate contracting as one of the impediments to the optimal IPO charter predicted by the contractarian

¹¹² *Id.* at 309–10.

¹¹³ EASTERBROOK & FISCHER, *supra* note 2, at 15–22; Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1332 (2013).

¹¹⁴ EASTERBROOK & FISCHER, *supra* note 2, at 17–19.

¹¹⁵ *Id.* at 17–19.

¹¹⁶ *Id.* at 204–05; Klausner, *supra* note 113, at 1332–33.

¹¹⁷ Klausner, *supra* note 113, at 1330.

¹¹⁸ *Id.* at 1330; Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 779 (2006).

theorists.¹¹⁹ In practice, firms adopt boilerplate charter provisions to avoid the legal uncertainty of adopting innovative and customized provisions that are best suited to their firms.¹²⁰ Empirical studies also provide evidence that firms do not always adopt value-enhancing provisions in their IPO charters. Instead, IPO charters commonly include a staggered board, which is a takeover defense that is considered to be value-decreasing.¹²¹

From an agency theory perspective, one-share one-vote is an efficient allocation of corporate control because shareholders are the only group of corporate stakeholders who bear the risks of bad decisions and have the right incentives to make discretionary decisions.¹²² Mechanisms that create deviations from the one-share one-vote rule would result in greater entrenchment agency costs by insulating managers from the market for corporate control.¹²³ Controlling-minority shareholders not only have the incentive, but also the ability, to extract private benefits at the expense of outside shareholders.¹²⁴ From a contractarian theorist's point of view, mechanisms that offer shareholders leveraged control are not desirable in IPO charters.

However, as mentioned earlier, leveraged control mechanisms among European and East Asian firms are

¹¹⁹ Klausner, *supra* note 109, at 785–86.

¹²⁰ Kahan & Klausner, *supra* note 109, at 718–24.

¹²¹ Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 110 (2001); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857, 1858 (2002); William C. Johnson et al., *The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms*, 117 J. FIN. ECON. 307, 308 (2015).

¹²² See EASTERBROOK & FISCHER, *supra* note 2, at 67–70.

¹²³ *Id.* at 71; see Bebchuk, *supra* note 75, 1679–81; *c.f.* Rolf Skog, *The European Union's Proposed Takeover Directive, the "Breakthrough" Rule and the Swedish System of Dual Class Common Stock*, 45 SCANDINAVIAN STUD. L. 293, 302–04 (2003).

¹²⁴ See Bebchuk et al., *supra* note 4.

widespread.¹²⁵ Even in the United States, where historically only around 6% of firms have employed a multi-class share structure, leveraged control mechanisms have gained more traction in recent decades.¹²⁶ In their IPO charters, large tech firms that went public since Google's IPO in 2004 have commonly adopted dual-class shares or other leveraged control mechanisms that grant multiple voting rights or other priority rights to their founders.¹²⁷ Google, Facebook, Groupon, LinkedIn, Zynga, and Alibaba are some well-known examples.¹²⁸ A recent survey by Davis Polk on U.S. IPOs between September 1, 2011 and October 31, 2013 reports that 28% of the newly listed non-controlled firms employ dual or multi-class common stock.¹²⁹ As compared to 8% in 2008 and 18% in 2011, we see a steady growth in adopting leveraged control mechanisms in the U.S. IPO market.¹³⁰ Since these firms are the driving force of the economy and their market capitalizations are huge, we should not overlook the impact of their corporate governance practices on investor protection and capital market development.

In sum, the contractarian view of corporate law suggests that IPO charters are optimal, yet in practice these charters commonly include leveraged control or other entrenchment provisions. Scholars have tried to examine whether there are efficiency reasons for firms to adopt entrenchment provisions at the IPO stage, such as ensuring stronger bargaining

¹²⁵ See ISS ET AL., *supra* note 7; Faccio & Lang, *supra* note 15; Claessens et al., *supra* note 7.

¹²⁶ See Gompers et al., *supra* note 8, at 1052; IRRIC INSTITUTE & ISS, *supra* note 19.

¹²⁷ James Surowiecki, *Unequal Shares*, NEW YORKER (May 28, 2012), <http://www.newyorker.com/magazine/2012/05/28/unequal-shares> [<https://perma.cc/9YWU-2QW9>].

¹²⁸ See Hodgson, *supra* note 10.

¹²⁹ See Sandler & Hall, *supra* note 9, at 18 tbl.1. The definition of “controlled companies” is in accordance with the NYSE listing rule which provides that “[a] listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company”. See NYSE, LISTED COMPANY MANUAL § 303A.00.

¹³⁰ Sandler & Hall, *supra* note 9, at 18 tbl.1.

power in the event of a hostile bid. However, they not only find no supporting evidence, but they actually find evidence supporting the notion that IPO managers deploy antitakeover measures to pursue private benefits of control.¹³¹ Further evidence from the United States suggests that lawyers are the primary influence in firms adopting a staggered board, an entrenchment provision in IPO charters.¹³² Anecdotal reports from practitioners also imply that entrenched governance provisions do not affect IPO pricing.¹³³ What investors care more about in the IPO stage is the business' value itself, not so much corporate governance issues. From the empirical evidence that we have so far, it seems that practitioners do not factor in governance rules in IPO pricing as hypothesized by the contractarian theory. This casts further doubt on the contractarians' belief that IPO charters are optimal.

B. Pro-Insider Distortions in the Midstream Stage

Even if we consider the initial charter to be optimal and that governance rules are fully integrated into the IPO pricing where entrepreneurs fully internalize the costs of suboptimal governance mechanisms, the contracting mechanism posited by contractarians does not seem to work that well after the initial offering—a stage that is known as the “midstream” stage.¹³⁴ A corporation is a separate legal entity from its founders and has a distinct legal personality that lasts in perpetuity, wholly independent of its founders.¹³⁵ To succeed and stay profitable in a competitive market, companies need to have the ability to adapt to the ever-changing business environment.¹³⁶ Even corporate

¹³¹ See Daines & Klausner, *supra* note 121, at 98–104; Field & Karpoff, *supra* note 121, at 1857–58.

¹³² See Coates IV, *supra* note 109, at 1304.

¹³³ *Id.* at 1381–82; see Klausner, *supra* note 113, at 1334.

¹³⁴ See Bebchuk, *supra* note 108, at 1825–29; see Klausner, *supra* note 113, at 134–47.

¹³⁵ *Salomon v. Salomon* [1897] AC 22 (H.L.) 30 (U.K.).

¹³⁶ See Bebchuk, *supra* note 108.

ownership may change over time as the firm ages.¹³⁷ The optimal governance design in the initial offering stage may not, and cannot, be the optimal design forever.¹³⁸ Midstream changes by managers or controllers represent a governance issue that is widely recognized by scholars and institutional shareholders.¹³⁹ After the IPO, managers and controlling shareholders tend to adopt changes that entrench themselves at the expense of shareholders, notably in the poison pills and staggered boards witnessed in the United States.¹⁴⁰

In a leveraged control firm, pro-insider distortions in the midstream stage would be more severe as insiders are more entrenched and outside shareholders lack the necessary voting powers to counter any potentially value-decreasing proposals. Therefore, shareholders need an appropriate midstream charter amendment procedure to adjust the governance design to reach an optimal level that would benefit all shareholders.¹⁴¹ However, as this Article argues in the following section, the common adoption of supermajority provisions in charter amendments deters shareholders from making any value-increasing midstream changes and distorts the contracting mechanism between leveraged controllers and outside shareholders. Examples provided by Google's and Facebook's issuance of non-voting Class C

¹³⁷ Julian Franks et al., *The Life Cycle of Family Ownership: International Evidence*, 25 REV. FIN. STUD. 1675, 1675 (2012) (finding that family firms in a strong investor protection jurisdiction tend to evolve into widely-held firms, while family firms in a weak investor protection regime tend to preserve family control overtime).

¹³⁸ Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865 (2005); see Bebchuk, *supra* note 108, at 1830.

¹³⁹ See Bebchuk, *supra* note 108 at 1820; Klausner, *supra* note 113, at 1346; Goshen & Hamdani, *supra* note 81, at 608–10.

¹⁴⁰ John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 273–74 (2000); Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 895 (2002).

¹⁴¹ Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573–85 (1989) (elaborating the risks of midstream charter amendments).

shares and recent going-private transactions of U.S.-listed Chinese firms further illustrate how midstream decisions are distorted towards pro-insider decisions in a leveraged control firm.

1. Supermajority Provision Deters Value-Increasing Midstream Changes

The fact that IPO charters are not optimal should come as no surprise given that the market is imperfect. In addition to including control-enhancing mechanisms in IPO charters, founders often raise the threshold to amend charters as well.¹⁴² By adopting a supermajority vote requirement for charter amendments, controlling-minority shareholders effectively deter shareholders from amending IPO charters in the midstream stage and thereby maintain leveraged control. Within European countries, supermajority voting requirements are widely adopted in different matters.¹⁴³ Most EU member states allow companies to adopt a supermajority vote requirement for charter amendments.¹⁴⁴ In fact, supermajority provisions are often seen as a tool to protect minority shareholders because they prevent controllers from adopting amendments that favor controllers at the detriment of minority shareholders. However, in a firm with a controlling-minority structure, a supermajority provision for charter amendment may serve to further entrench the controllers at the expense of minority shareholders because leveraged controllers can easily block charter amendments with enhanced voting power.

In a dispersed ownership firm, a supermajority provision is generally seen as an entrenchment provision with the effect of an anti-takeover provision. In the United States,

¹⁴² Klausner, *Fact and Fiction in Corporate Law and Governance*, *supra* note 113, at 1348; see Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 146 (2003).

¹⁴³ ISS ET AL., *supra* note 7, at 21.

¹⁴⁴ According to the survey of 16 EU member states in 2007, only Ireland restricts the application of supermajority vote on amendments to the articles of association. *Id.*

state corporate law generally provides that a charter amendment has to be initiated by the board and approved by a majority vote of shareholders.¹⁴⁵ The law does not require a supermajority provision, as do some laws in European countries, yet the law does not restrict the adoption of supermajority provisions either.¹⁴⁶ A recent survey of U.S. IPO firms from 2009–2011 reports that 74% of non-controlled IPO companies required a supermajority shareholder vote to amend their charters.¹⁴⁷ In general, modern company law only sets the lower bound threshold for charter amendment, not the ceiling.¹⁴⁸ In extreme cases, the threshold for amending leveraged-control-related provisions can be as high as unanimous consent. For example, the Chinese Internet giant Alibaba publicly listed its shares on the NYSE in September 2014.¹⁴⁹ Instead of adopting dual-class shares, Alibaba granted a partnership formed by a group of its founders and executives an exclusive right to nominate the majority of the board of directors.¹⁵⁰ The nomination right is not attached to any shares but has the same function as priority shares where special nomination (or veto) rights are granted to certain shareholders.¹⁵¹ To ensure that these leveraged control rights will not be changed through midstream amendments, Alibaba also inserted a supermajority vote requirement for future charter

¹⁴⁵ See, e.g., MODEL BUSINESS CORP. ACT § 10.03 (2006); DEL. CODE. ANN. tit. 8, § 242(b)(1) (2016); CAL. CORP. CODE § 902 (2016); N.Y. BUS. CORP. LAW § 803 (2016).

¹⁴⁶ See, e.g., MODEL BUS. CORP. ACT § 7.27 (2006).

¹⁴⁷ RICHARD SANDLER & ELIZABETH WEINSTEIN, CORPORATE GOVERNANCE PRACTICES FOR INITIAL PUBLIC OFFERINGS IN THE UNITED STATES 5 (2012), <https://www.davispolk.com/files/files/Publication/81644133-c3f2-4eb4-a30c-78cb3fe421ac/Preview/PublicationAttachment/58d40b26-2090-4625-9651-858d3b0a8600/sandler.eweinstn.conference.board.article.feb12.pdf>.

¹⁴⁸ Exceptions are found in some European countries. In Greece, Spain, Italy, and Poland, the law restricts supermajority from attaining unanimity. ISS ET AL., *supra* note 7, at 21.

¹⁴⁹ See *supra* note 44 and accompanying text.

¹⁵⁰ Lin & Mehaffy, *supra* note 44, at 455–56.

¹⁵¹ *Id.*

amendments in its IPO charter. The charter provides that any change to the nomination rights requires the approval of 95% of all shareholders at the shareholders' meeting.¹⁵²

The near unanimous consent requirement for a charter amendment is unusual, but legal, as there is no restriction on the height of the voting requirement ceiling. However, requiring unanimity in a charter amendment creates a holdout problem. One or more shareholders may engage in holdout behavior where, in exchange for some extra private benefits, they may deny consent for amendments that are value-enhancing to all shareholders.¹⁵³ Therefore, Alibaba's near-unanimity requirement for charter amendment leads to greater entrenchment agency costs to minority shareholders.

Similarly, Google inserted several protective provisions to prevent its shareholders from repealing its leveraged control structure through midstream amendments. Google, as a representative case for controlling-minority structure in the United States, issued two classes of shares upon its IPO. Class A carries one vote per share, while class B carries ten votes per share. Class B shares are issued to founders, executives, and directors, whereas class A shares are issued to the public.¹⁵⁴ Two protective provisions operate to prevent making a midstream change to the founders' leveraged control. The first provision is similar to the supermajority vote requirement for charter amendments. In Article 12 of Google's IPO charter, any amendment to, or repeal of, the

¹⁵² Alibaba Grp. Holding Ltd., Ex. 3.2 Amended and Restated Memorandum and Articles of Association of Alibaba Group Holding Limited 6 (Form F-1) (June 5, 2014), <https://www.sec.gov/Archives/edgar/data/1577552/000119312514333674/d709111dex32.htm> [<https://perma.cc/2JL4-XCD9>] (“Special Resolution . . . being a resolution: (a) passed by a majority of not less than three-fourths (or, in respect of any resolution relating to a Special Partnership Matter, or in any way having the effect of affecting a Special Partnership Matter, including, without limitation, any amendment to the provisions of the Memorandum or Articles which relate to a Special Partnership Matter, by 95% . . .)”).

¹⁵³ Bebchuk, *supra* note 108, at 1830–31.

¹⁵⁴ Google Inc., Final Prospectus (Form 424B4), at 102–03 (Aug. 18, 2004), <https://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm> [<https://perma.cc/LL5Q-JQPF>].

dual-class share structure will require unanimous consent from the board of directors, as well as the affirmative vote of the holders of at least a majority of the voting power.¹⁵⁵ Although the threshold for the shareholder vote is a majority, instead of a supermajority, this provision requires unanimous consent from all directors. Since the directors are also holders of multiple voting rights shares, such a provision effectively precludes the possibility of passing any midstream amendments seeking to amend or repeal the dual-class share structure. The second obstacle to changing Google's controlling-minority structure midstream is that any change to the special powers, preferences, or rights of a class of stock in an adverse way would require that class to vote separately to approve the proposed amendment.¹⁵⁶ Again, if the shareholders wish to change the right of multiple voting rights shares, an approval from the founders of Google is required.

The fact that firms adopt a supermajority vote requirement for amending charters is especially problematic in leveraged control firms. A supermajority vote provision typically requires the approval of between two-thirds to three-quarters of the voting rights. That means that, at most, controllers only need to control one-third of the voting power to outvote an amendment proposal suggested by outside shareholders. With leveraged control mechanisms in place, controllers can easily control one-third of the total voting rights. Contrary to the traditional view of a supermajority vote as a shareholder protection mechanism, the supermajority provision actually operates to achieve the opposite effect of entrenching insiders. Therefore, the

¹⁵⁵ Google Inc., Ex. 3.01.2 Third Amended and Restated Certificate of Incorporation of Google Inc. 11 art. 12 (Form S-1/A) (Aug. 9, 2004), <https://www.sec.gov/Archives/edgar/data/1288776/000119312504135503/dex3012.htm> [<https://perma.cc/VW2G-6CQG>] (“(i) the unanimous consent of Board of Directors then in office, and the affirmative vote of the holders at least a majority of the voting power of the issued and outstanding shares of capital stock of the Corporation then entitled to vote, shall be required to amend or repeal Article IV, Section 2 or this clause (i) of Article XII;”).

¹⁵⁶ DEL. CODE. ANN. tit. 8, § 242(b)(2) (2016); Google Inc., *supra* note 154, at 105.

combination of control-enhancing mechanisms and a supermajority vote requirement for charter amendment deters minority shareholders from adopting midstream charter amendments that would amend or repeal an inefficient control-enhancing mechanism or one that would enhance overall shareholder value.

2. Potential Expropriation in Midstream Changes

In a leveraged control firm, outside shareholders are exposed to high risks of expropriation by controlling-minority shareholders. Google's issuance of non-voting Class C shares in 2014 is a vivid example. As mentioned, when Google went public in 2004, there were two classes of shares, Class B with ten votes per share and Class A with one vote per share.¹⁵⁷ Class B shares were held by Larry Page, Sergey Brin, and other executives. Over the years, Google has issued Class A shares to fund acquisitions and employee compensation. As a result, the control power of Class B shares was gradually diluted and, as asserted by Class A shareholders in a lawsuit challenging the issuance of the Class C stock, the founders became concerned that they would lose control in the foreseeable future. To avoid that, Page and Brin presented a proposal to the board to create a new, non-voting class of shares on January 11, 2011.¹⁵⁸

On April 11, 2012, Google's special board committee and the board approved a recapitalization plan to create a new class of shares, Class C shares, and to undergo a stock split where each Class A or Class B share would receive a dividend of non-voting Class C share.¹⁵⁹ The purpose of recapitalization was to extend the control of Google's founders, Page and Brin, who enjoyed over 56.1% of Google's

¹⁵⁷ See *supra* note 154 and accompanying text.

¹⁵⁸ Plaintiffs' Opening Pre-Trial Brief at 12, *In re Google Inc. Class C S'holder Litig.*, No. 7469-CS (Del. Ch. Jun. 10, 2013), 2013 WL 6735045.

¹⁵⁹ *Id.* at 31.

voting power with only 15% equity ownership.¹⁶⁰ The recapitalization plan raised several shareholder protection concerns. Two weeks after the board's approval, shareholders filed class action complaints alleging breach of directors' fiduciary duties.¹⁶¹ When the recapitalization proposal was finally presented to the shareholders, 85.3% of Class A shareholders voted against the recapitalization proposal at the shareholders' meeting. Nevertheless, the proposal still passed with the support of the founders' super-voting Class B shares.¹⁶² This was clearly a pro-insider distorted midstream amendment by controlling-minority shareholders. The case finally settled on the eve of the Delaware Chancery Court trial proceedings.¹⁶³

Similarly, Facebook, which also has a dual-class share structure, announced a three-for-one stock split in April 2016 whereby Facebook will issue two non-voting Class C shares for each outstanding Class A and Class B share held by shareholders.¹⁶⁴ The main purpose for the recapitalization is to enable Facebook's founder Mark Zuckerberg to sell 99% of his shares for philanthropy purposes yet still maintain control.¹⁶⁵ With Mr. Zuckerberg holding 60% of the voting power, recapitalization plan to issue Class C shares passed

¹⁶⁰ Settlement Hearing and Rulings of the Court, *In re Google Inc. Class C S'holder Litig.*, No. 7469-CS (Del. Ch. Oct. 28, 2013), 2013 WL 6735045.

¹⁶¹ Plaintiffs' Opening Pre-Trial Brief at 32–37, *In re Google Inc. Class C S'holder Litig.*, No. 7469-CS (Del. Ch. June 10, 2013), 2013 WL 6735045.

¹⁶² *See Google Inc.*, Current Report (Form 8-K), at 3–4 (June 21, 2012).

¹⁶³ Jamie Santo, *Google Settles Stock-Split Suit on Eve of Trial*, LAW360 (June 17, 2013), <https://www.law360.com/articles/450580/google-settles-stock-split-suit-on-eve-of-trial> [<https://perma.cc/L2H9-AYCJ>].

¹⁶⁴ Dan Levine, *Facebook Hit with Lawsuit over Plan to Issue New Stock*, REUTERS (Apr. 29, 2016), <http://www.reuters.com/article/us-facebook-stocks-lawsuit-idUSKCN0XQ2LM> [<https://perma.cc/A8E3-99KX>].

¹⁶⁵ Zacks Equity Research, *Facebook Shareholders Approve Creation of Class C Shares*, NASDAQ (June 21, 2016), <http://www.nasdaq.com/article/facebook-shareholders-approve-creation-of-class-c-shares-cm638528> [<https://perma.cc/VV2U-KYAE>].

at the shareholders' meeting on June 20, 2016.¹⁶⁶ Shareholders filed class action lawsuits shortly after the board announced the recapitalization plan, alleging that directors breached their fiduciary duties by diluting voting rights and entrenching control by existing controllers.¹⁶⁷ The recapitalization plan is a pro-insider charter amendment that will allow controlling-minority shareholders to sell billions of dollars of shares without relinquishing corporate control. Both Google's and Facebook's recent recapitalization plans vividly illustrate the expropriation risks faced by minority shareholders of pro-insider midstream charter amendments.

Another example of pro-insider midstream change is the recent privatization of many U.S.-listed Chinese firms. An entrenched controlling shareholder normally extracts private benefits of control through three major channels: related party transactions, change-of-control transactions, and the freeze-out of minority shareholders.¹⁶⁸ In a public corporation with a controlling shareholder, the market price of a share reflects the value of a non-controlling share.¹⁶⁹ The price of a non-controlling share is usually discounted by the capitalized value of the expected private benefits.¹⁷⁰ In a freeze-out transaction, controlling shareholders will be able to capture the value of future private benefits by buying out non-controlling shares at the then market price.¹⁷¹ This Article uses the recent privatization of U.S.-listed Chinese firms as an example to illustrate how controlling-minority shareholders can easily extract private benefits by freezing out minority shareholders in a leveraged control firm.

¹⁶⁶ See Facebook Inc., Current Report (Form 8-K) (June 20, 2016), <https://www.sec.gov/Archives/edgar/data/1326801/000132680116000077/form8-k2016annualmeeting.htm> [<https://perma.cc/9D87-KWGZ>].

¹⁶⁷ Tom Zanki, *Facebook Class C Share Plan Could Spur Followers*, LAW360 (May 19, 2016), <https://www.law360.com/articles/798263/facebook-class-c-share-plan-could-spur-followers> [<https://perma.cc/2MF8-93PS>].

¹⁶⁸ Gilson & Gordon, *supra* note 72, at 786.

¹⁶⁹ *Id.* at 787.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

In light of the higher valuation of tech stocks in the Chinese stock market, many U.S.-listed Chinese firms plan to de-list in the United States and re-list in China. Privatization of these firms typically involves buyout offers from founders, controlling shareholders, or private equity investors. Since 2015, 37 U.S.-listed Chinese firms have received buyout offers totaling \$38.9 billion, which is larger than the total U.S. IPO proceeds of \$30.3 billion in 2015.¹⁷² The scale is widespread and has a substantial impact on U.S. capital markets. In a management buyout, manager controllers usually have substantial control over the privatization process, from offer timing and offer price to funding sources. In a firm that adopts a dual-class share structure, controlling shareholders typically retain more than half of the voting power through multiple voting shares, which means they are able to dominate the resolutions of a shareholders' meeting.¹⁷³ Outside investors are consequently exposed to high expropriation risks because controlling shareholders can engineer the whole process, such as choosing a time when the share price is low to minimize the privatization costs.¹⁷⁴

Here, we take Qihoo 360 Technology Co. (“Qihoo”), which underwent the largest privatization among U.S.-listed Chinese firms, as an example. Qihoo announced receipt of a

¹⁷² Wei Gu, *Scrutiny Greets Overseas-Listed Chinese Companies Returning Home to Relist*, WALL ST. J. (May 6, 2016), <http://www.wsj.com/articles/china-scrutinizes-deals-for-foreign-listed-companies-to-relist-at-home-1462537821>; *IPO Proceeds Raised*, RENAISSANCE CAPITAL, <http://www.renaissancecapital.com/IPO-Center/Stats/Proceeds> [<https://perma.cc/J5WR-5SHH>] (last visited Feb. 14, 2017).

¹⁷³ The founders generally have control over the resolutions of shareholders' meetings unless the law or the corporate charter requires majority of the disinterested shareholders' approval.

¹⁷⁴ Controllers, who decide on whether and when to effect a freeze-out, are likely to have private information on the true value of the firm. Therefore, the pre-freezeout market price is likely to underestimate a firm's true value. See Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in CONCENTRATED CORPORATE OWNERSHIP 247, 249 (Randall K. Morck ed., 2000).

buyout offer from its founders and other private investors on June 17, 2015.¹⁷⁵ The offer price was \$77 per American Depositary Share, representing a 16.6% premium on the market price when the offer was made. The total buyout offer was \$9.3 billion.¹⁷⁶ On December 18, 2015, the board, acting upon the recommendation of an independent special committee, approved the proposed merger and recommended that shareholders vote in favor of the merger plan. Qihoo adopted a dual-class share structure where its founders held multiple voting rights shares with five votes per share and controlled more than 61% of the voting power.¹⁷⁷ To complete the statutory merger, approval by an affirmative vote of the shareholders, representing at least two-thirds of the voting power of the shares present and voting, was required by the Companies Law of the Cayman Islands.¹⁷⁸ With 61% of votes at hand,¹⁷⁹ the founders easily passed the resolution at a shareholders' meeting, with 69.3% of votes presenting and 99.8% of presenting shares approving the merger.¹⁸⁰

There are several reasons to be concerned about expropriation from Qihoo's going-private transaction. First, the buyout offer was made at a time when the market price

¹⁷⁵ Carlos Tejada, *Qihoo Gets \$9 Billion Buyout Offer From CEO*, WALL ST. J. (June 17, 2015) <https://www.wsj.com/articles/qihoo-receives-buyout-offer-from-ceo-1434542416>.

¹⁷⁶ Bonnie Cao & Jonathan Browning, *Qihoo's \$9.3 Billion Privatization Rekindles China Buyout Spree*, BLOOMBERG (Dec. 21, 2015), <http://www.bloomberg.com/news/articles/2015-12-21/qihoo-s-9-3-billion-privatization-rekindles-china-buyout-spree-iifwyh3c> [<https://perma.cc/ZC99-UR7L>].

¹⁷⁷ Press Release, Qihoo 360 Technology Co. Ltd., Qihoo 360 Enters into Definitive Agreement for Going Private Transaction (Dec. 18, 2015), <http://www.prnewswire.com/news-releases/qihoo-360-enters-into-definitive-agreement-for-going-private-transaction-300195135.html> [<https://perma.cc/DT4P-D4PU>].

¹⁷⁸ Companies Law § 233(6) (2013) (Cayman Is.).

¹⁷⁹ Press Release, Qihoo 360 Technology Co. Ltd., *supra* note 177.

¹⁸⁰ Press Release, Qihoo 360 Technology Co. Ltd., Qihoo 360 Announces Shareholder Approval of Merger Agreement (Mar. 30, 2016), <http://www.prnewswire.com/news-releases/qihoo-360-announces-shareholder-approval-of-merger-agreement-300243230.html> [<https://perma.cc/ZEC7-EA88>].

was at its lowest point since mid-2013. The average share price of Qihoo in May 2015, the month before the buyout offer, was \$52.05. With the exception of February and March 2015, this was its lowest price since July 2013.¹⁸¹ One way to compensate minority shareholders is to grant them appraisal rights. However, in practice, an appraisal remedy is far from satisfactory. Firstly, an appraisal right is not always available in situations involving privatization and usually the dissenters will not be able to perfect their rights unless they give the company written notice before the shareholder vote on the merger.¹⁸² For example, under Delaware law, appraisal rights are not available for shareholders of listed companies or companies which have more than 2000 record shareholders.¹⁸³ Secondly, even if the appraisal rights are available, courts, up until today, still face difficulties in finding a universal valuation method to ascertain the “fair value” of a firm simply because there is no single perfect way to decide “fair value”.¹⁸⁴ Courts in both Delaware and the Cayman Islands, where Qihoo is incorporated, are open to different methods or a combination of different methods for making the “fair value” determination.¹⁸⁵ For listed

¹⁸¹ QIHU Stock Quote, BLOOMBERG MARKETS, <https://www.bloomberg.com/quote/QIHU:US> [https://perma.cc/VG96-YTHB] (last visited Feb. 2, 2017).

¹⁸² Delaware law provides appraisal rights only in connection with statutory mergers and requires shareholders to make a written demand for appraisal before the vote on the merger. See DEL. CODE ANN. tit. 8, §§ 262(a), (b)(1), (d), and (e) (2016); MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS CASES AND MATERIALS 1147–48 (11th ed. 2014); STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 132–33 (3rd ed. 2012).

¹⁸³ DEL. CODE ANN. tit. 8, § 262(b)(1) (2016).

¹⁸⁴ BAINBRIDGE, *supra* note 182, at 99–108.

¹⁸⁵ The law in Cayman Island does not dictate any particular approach. See *Cayman Court Makes First Ruling on the Meaning of “Fair Value” Under the Statutory Merger Regime*, MOURANT OZANNES (Sept. 2015), <https://www.mourantozannes.com/media/1393540/cayman-court-makes-first-ruling-on-the-meaning-of-fair-value-under-the-statutory-merger-regime.pdf> [https://perma.cc/WD4J-RYAB]. “The Cayman Court cited Canadian and Delaware jurisprudence which establishes that fair value should be proved by any techniques or methods which are generally

companies, trading prices are likely to be a benchmark for fair value if there is a well-informed and liquid market with a large public float.¹⁸⁶ Therefore, even an appraisal right does not help much because insiders can choose a time when the price and earnings performance will give an unfairly low indication of the company's true value.¹⁸⁷

Second, the going-private transaction had no independent business purpose. The only reason to go private was that the insiders wanted to eliminate the minority public investors and re-list the company in China where the market valuation would be much higher.¹⁸⁸ In the United States, most state courts would closely scrutinize the deal if there were no legitimate business purpose because there is a higher chance of expropriation.¹⁸⁹ In addition, the founders

considered acceptable in the financial community and are otherwise admissible in court." *Id.*; see also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983).

¹⁸⁶ See *Cayman Court Makes First Ruling on the Meaning of "Fair Value" Under the Statutory Merger Regime*, *supra* note 185; BAINBRIDGE, *supra* note 182, at 105. "Public float" refers to the percentage of shares available to the public. See Michael L. Hartzmark & H. Nejat Seyhun, *Understanding the Efficiency of the Market for Preferred Stock*, 8 VA. L. & BUS. REV. 149, 155–56 (2014).

¹⁸⁷ There are three main valuation methods: net asset value, capitalized earnings, and market value. Net asset valuation is a balance sheet-based valuation method that requires an appraisal of the current fair market value of the corporation's assets on a going concern basis. Capitalized earnings valuation is an income statement-based valuation method that determines fair value by dividing the corporation's earnings per share by a capitalization rate (usually the reciprocal of a comparable company's price/earnings ratio). The capitalized earnings method is frequently used to value close corporations. The market value method relies on the market value of the firm's stock. Therefore, market prices are considered both in capitalized earnings valuation and the market value method. See BAINBRIDGE, *supra* note 182, at 99–105; ROBERT CHARLES CLARK, CORPORATE LAW § 12.2 (1986).

¹⁸⁸ Samuel Shen & Pete Sweeney, *Chinese Companies Relisting at Home Attract Swarm of Quick-Hit Investors*, REUTERS (June 29, 2016, 7:17 PM), <http://www.reuters.com/article/us-china-relisting-idUSKCN0ZF2VP> [<https://perma.cc/7UKW-HW2M>].

¹⁸⁹ Delaware courts abandoned the business purpose test in the *Weinberger* case, but New York and Massachusetts continue to use the

and the investor group expect to reap a huge reward when they re-list the shares in the Chinese stock market. Commentators expect that the market value of Qihoo in the Chinese market will be more than six times that of its buyout value, but current U.S. public investors will not be able to share in the gains.¹⁹⁰

Third, the Qihoo freeze-out transaction, like most other privatization deals of U.S.-listed Chinese firms, is backed by not only founders but also U.S. venture capital firms and other Chinese institutional investors.¹⁹¹ The investor group was invited and selected by the founders without the participation of U.S. public shareholders. These investors all expect to gain a huge profit from the going-private transaction. A recent news report reveals that some domestic financial institutions are promising retail investors in China a 500% return on products that are linked to Qihoo's re-listing in China.¹⁹² Such a promise suggests the potential profits associated with investing in Qihoo's privatization deal.

Finally, most of the legal scrutiny on the extraction of private benefits of control in a going-private deal lies with state corporate law, not federal securities law. Federal securities law mainly focuses on disclosure and anti-fraud, as in Rule 10b-5 and 13e-3, which have little effect on the structure of going-private deals.¹⁹³ Under Delaware law, the entire fairness standard would apply to a freeze-out transaction where the majority shareholder is standing on

business purpose test. *See, e.g.,* *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112, 1116–17 (Mass. 1986).

¹⁹⁰ Lulu Yilun Chen & Shai Oster, *A Slice of Qihoo's \$9.3 Billion Buyout for Sale on China Streets*, BLOOMBERG (June 27, 2016, 8:01 PM), <http://www.bloomberg.com/news/articles/2016-06-27/a-slice-of-qihoo-s-9-3-billion-buyout-for-sale-on-china-streets> [<https://perma.cc/28JX-Y3ZM>].

¹⁹¹ Qu Yunxu & Wang Qionghui, *Several Buyout Investors Backing Qihoo Voice Concern over Firm's Relisting Arrangement*, CAIXIN ONLINE (Aug. 4, 2016, 7:04 AM), <http://www.caixinglobal.com/2016-08-04/101011470.html> (last visited Feb. 25, 2017) [<https://perma.cc/KX4K-UZED>].

¹⁹² *Id.*

¹⁹³ *See* CLARK, *supra* note 187, at 524.

both sides of the transaction.¹⁹⁴ However, if the transaction is approved *ex ante* by a truly independent and empowered committee as well as by an informed majority of minority shareholders, the business judgment rule would apply and the burden of proof on the issue of fairness would shift from the controlling shareholder to the challenging shareholder-plaintiff.¹⁹⁵ Hence, approvals by an empowered independent committee and majority of minority shareholders serve as important *ex ante* safeguards for the interest of minority shareholders in a going-private transaction by controlling shareholders.

In the case of Qihoo, it is not subject to the laws of Delaware because Qihoo is incorporated in the Cayman Islands.¹⁹⁶ Since the laws of the Cayman Islands do not require a majority of minority shareholder vote, shareholders who are related to the buyer's group are allowed to vote in the shareholders' approval of the merger proposal.¹⁹⁷

¹⁹⁴ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

¹⁹⁵ Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1120–21 (Del. 1994); Kahn v. Lynch Commc'ns Sys., Inc., 669 A.2d 79, 82 (Del. 1995); Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014). On May 5, 2016, the New York Court of Appeals also follow suit in its landmark decision *In the Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*. See *In re Matter of Kenneth Cole Productions, Inc., S'holder Litig.*, 52 N.E.3d 214 (N.Y. 2016). Note, however, that in practice, companies may rather subject themselves to the higher entire fairness standard when someone challenges the fairness of the transaction than recommend a majority of minority shareholder vote prior to the transaction because the risk of failing a majority of minority vote is high. See Alert Memorandum, Cleary Gottlieb, Going Private Transactions—MFW's Bumpy Road to Business Judgment Review (Mar. 18, 2014), <https://www.clearygottlieb.com/~media/cgsh/files/publication-pdfs/going-private-transactions-mfws-bumpy-road-to-business-judgment-review.pdf> [<https://perma.cc/E6VW-8PG9>]; Suneela Jain, Ethan Klingsberg & Neil Whoriskey, *Examining Data Points in Minority Buy-Outs: A Practitioners' Report*, 36 DEL. J. CORP. L. 939, 953–55 (2011).

¹⁹⁶ Qihoo 360 Technology Co. Ltd., Prospectus (Form 424B4), at 4 (Mar. 29, 2011), <https://www.sec.gov/Archives/edgar/data/1508913/000104746911002864/a2203165z424b4.htm> [<https://perma.cc/LQA2-D977>].

¹⁹⁷ Rupert Bell & Joanne Collett, *Lessons Learnt from Take Private Transactions in Cayman Islands Merger Cases*, WALKERS (Mar. 18, 2016), http://www.walkersglobal.com/images/Publications/News/2016/03.18.2016_

Accordingly, Qihoo's chairman, who initiated the going-private proposal, voted in the shareholders' meeting to approve the merger plan.¹⁹⁸ Qihoo's chairman, together with Qihoo's president, controlled approximately 61% of the votes through dual-class shares and they all voted for the merger.¹⁹⁹

From the Qihoo case study, this Article demonstrates that there are serious conflicts of interest involved in going-private transactions of U.S.-listed Chinese firms. Among the 43 going-private transactions of U.S.-listed Chinese firms announced since 2015, only 7% of these firms are incorporated in Delaware.²⁰⁰ Among the 22 deals that were submitted for shareholder approval, 90% (20 out of 22) required no approval from a majority of minority shareholders.²⁰¹ Even worse, 35% (15 out of 43) of these firms have a dual-class share structure, which means that a substantial portion of the insiders have disproportionate control and can influence, or even dominate, the shareholder approval for going-private mergers.²⁰² The leveraged control of these firms exacerbates the expropriation concern because shareholder approval serves no scrutiny function to mitigate the conflict of interest problem in a going-private decision.

Lessons_Learnt_from_Take_Private_Transactions.pdf [https://perma.cc/K368-BJHG].

¹⁹⁸ “Global Village Associates Limited, an entity controlled by Mr. Hongyi Zhou, and Young Vision Group Limited, an entity controlled by Mr. Xiangdong Qi, have agreed to vote all of the Shares they beneficially own, which represent approximately 61% of the voting rights attached to the outstanding Shares as of the date of the merger agreement, in favor of the authorization and approval of the merger agreement and the merger.” Press Release, Qihoo 360 Technology Co. Ltd., *supra* note 177.

¹⁹⁹ *Id.*

²⁰⁰ Lin, 2016 U.S.-Listed Chinese Firms Going-Private Transactions Data Base (on file with author).

²⁰¹ *Id.*

²⁰² *Id.*

V. GOVERNING MIDSTREAM PRO-INSIDER DISTORTIONS

A. Prohibiting Leveraged Corporate Control?

The inability of minority shareholders to act in response to inefficient governance rules or other value-destroying business decisions in a leveraged control firm can partly be cured with proper legal intervention. For instance, mandatory rules that forbid the adoption of control-enhancing mechanisms could be a sensible solution to the currently distorted system.²⁰³ Mandatory rules in corporate law can restore the imbalance of power between controllers and minority shareholders. A mandatory structure of corporate law, which bars a wide variety of suspected corporate behavior, would be especially justified in jurisdictions where enforcement is weak and investor protection is low.²⁰⁴ In such jurisdictions, the level of private benefits extracted by controllers is high. Therefore, an outright ban on certain control-enhancing mechanisms could be an effective way to restrict expropriations from controllers.

For example, in South Korea, the economy is dominated by large *chaebols*, which are family-controlled conglomerates.²⁰⁵ Pyramids and cross-shareholding are frequently used to enhance the control of *chaebol* families.²⁰⁶ To improve the corporate governance of *chaebols*, the government of South Korea passed a rule that bans any new cross-shareholding investment among the affiliates of conglomerates. Under South Korea's Monopoly Regulation and Fair Trade Act, affiliates of large conglomerates with assets worth five trillion won (equal to around \$4.8 billion) or more are banned from making new investments in one

²⁰³ See Bebchuk, *supra* note 108, at 1851–52; Gordon, *supra* note 141.

²⁰⁴ Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1929 (1996).

²⁰⁵ Terry L. Campbell II & Phyllis Y. Keys, *Corporate Governance in South Korea: The Chaebol Experience*, 8 J. CORP. FIN. 373, 374 (2002).

²⁰⁶ Claessens et al., *supra* note 7, at 92.

another.²⁰⁷ In 2001 and 2005, Taiwan adopted a similar prohibition on cross-shareholding between parent companies and subsidiaries and also restricted the voting power of subsidiaries.²⁰⁸

Dual-class shares are banned in almost half of the European countries. The 2007 EU Proportionality Report showed that 47% of the 16 surveyed E.U. countries prohibit multiple voting right shares while all of them allow pyramidal ownership and cross-shareholding.²⁰⁹ Similar to European countries, dual-class shares are also banned in most East Asian jurisdictions.²¹⁰ Most controlling shareholders of East Asian public companies enhance their control through pyramidal ownership and cross-shareholding.²¹¹ To limit the anti-takeover effect of leveraged control provisions in the articles of association of European companies, the High Level Group of Company Law Experts proposed a “breakthrough rule” which disables such leveraged control mechanisms when a takeover bidder acquires 75% or more of the risk-bearing capital.²¹² Under the proposed rule, all control-enhancing mechanisms stipulated in articles of association would be dismantled, including voting caps, multiple voting rights, non-voting shares, voting rights attributed to non-risk-bearing capital, and special rights to appoint directors or amend articles of association.²¹³ As a result of the criticism levied on the effect of such a rule and pressure from interested groups, the rule was adopted in the European Takeover Directive as

²⁰⁷ Oh Kyu-wook, *New Cross-Shareholding Ban Takes Effect: Conglomerates Pressured to Improve Governance*, KOREA HERALD (July 25, 2014), <http://www.koreaherald.com/view.php?ud=20140725000716> [<https://perma.cc/8Y6J-L2XT>].

²⁰⁸ COMPANY ACT art. 167 (3) (4) & 179 II (2) (3) (2016) (Taiwan).

²⁰⁹ ISS ET AL., *supra* note 7, at 18–22.

²¹⁰ See Claessens et al., *supra* note 7, at 91–92.

²¹¹ *Id.*

²¹² See HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, *supra* note 24, at 32; Guido Ferrarini, *One Share–One Vote: A European Rule?*, 3 EUROPEAN COMPANY & FIN. L. REV. (ECFR) 147, 149–50 (2006).

²¹³ Ferrarini, *supra* note 212, at 149–50.

optional.²¹⁴ Ultimately, only three member states adopted the breakthrough rule.²¹⁵ A European Commission review in 2012 deemed the breakthrough rule unsuccessful; however, it did not seek to make the rule mandatory because, in the Commission's estimation, the current mixed regulatory approach seems to provide sufficient means to break through takeover defenses even without adopting the proposed breakthrough rule.²¹⁶

Mandatory rules have been adopted by regulators in different jurisdictions to restrict certain types of control-enhancing mechanisms. Yet, there does not seem to be a consistent rationale in the choice of prohibitive mechanisms. Most European and East Asian jurisdictions prohibit multiple voting rights shares through the one-share one-vote rule. However, these jurisdictions also allow pyramidal ownership and cross-shareholding, which create deviations between control rights and voting rights similar to multiple voting rights shares. It would be a challenge for regulators to prohibit pyramidal ownership because business groups, which are structured on pyramidal ownership, create synergies in business operation and therefore should generally be allowed. In addition, it may not be easy for regulators to define the scope of pyramids and to properly limit their use.²¹⁷

Every company has its own distinct characteristics, and shareholders are the best party to decide on internal corporate affairs. The rationale of "one size fits all" does not work in corporate governance regulation. Control-enhancing

²¹⁴ Council Directive 04/25, 2004 O.J. (L 142) 12 (EC) (on takeover bids). Several Nordic countries, including Sweden, Finland and Denmark, opposed the extension of "breakthrough" rule. For a detailed description on criticisms and oppositions from member states, see Skog, *supra* note 123, at 296–99.

²¹⁵ The three countries are Estonia, Latvia, and Lithuania. *See Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Application of Directive 2004/25/EC on Takeover Bids*, at 3–4, COM (2012) 346 final (June 28, 2012).

²¹⁶ *Id.* at 10.

²¹⁷ Ferrarini, *supra* note 212, at 150–51.

mechanisms could be beneficial under certain situations and/or for certain companies. Family-controlled firms, firms in the media industry, and, recently, firms in the high-tech industry are the types of firms that tend to choose a leveraged control structure.²¹⁸ Oftentimes, founding families and entrepreneurs are unwilling to relinquish control in exchange for external financing. However, if control-enhancing mechanisms are not allowed, many start-up companies or family businesses may lose the chance to grow, which could hamper national economic development. Thus, this Article argues against the outright prohibition of any specific type of control-enhancing device and advocates returning decision-making rights to shareholders to decide whether specific governance structures are good for the company.

B. Empowering Minority Shareholders

This Article argues that empowering shareholders would best mitigate the risks of midstream opportunistic change by controllers with leveraged control and would allow shareholders to adopt value-increasing midstream charter amendments. As this Article has previously illustrated, there is an extreme imbalance of power between leveraged controllers and outside shareholders. The extreme protective schemes created during the IPO stage are unlikely to be renegotiated by outside shareholders afterwards due to the nature of control-enhancing mechanisms and the commonly included supermajority vote requirement for charter amendments. Even without the supermajority provision, controllers are likely to control over half of voting powers through control-enhancing mechanisms. Thus, outside shareholders of leveraged control firms are generally unable to exercise their renegotiation right and thus are exposed to higher agency costs arising from insiders' moral hazard problem.²¹⁹ The best way to restore the balance of power in a

²¹⁸ Gompers et al., *supra* note 8, at 1084; Goshen & Hamdani, *supra* note 81, at 591.

²¹⁹ See Goshen & Hamdani, *supra* note 81, at 588–91.

leveraged control firm is to empower outside shareholders. Specifically, this Article proposes empowering outside shareholders by increasing shareholder participation through shareholder activism.

1. Increasing Shareholder Participation

Similar to control-enhancing mechanisms, anti-takeover measures are commonly viewed as protective schemes that entrench incumbents and reduce shareholder value.²²⁰ However, shareholder participation in the adoption of anti-takeover measures may bring positive value to shareholders. This is because their approval may represent shareholder commitment not to dismiss directors prematurely and thus allow directors to pursue projects that are beneficial to shareholders in the long run.²²¹ Recent empirical studies also confirm the validity of this hypothesis and find that anti-takeover measures that require shareholder approval, such as staggered boards and charter amendment restrictions, are associated with higher firm value than those adopted unilaterally by the board, such as poison pills and golden parachutes.²²²

People may doubt the effectiveness of shareholder voting in a controlled firm, particularly in a leveraged control firm, because the higher the percentage of votes controlled by insiders, the lesser the chance that outside shareholders will be able to challenge the exertion of such control. However, recent empirical studies report otherwise. They show that shareholder voting can be an effective means to exercise governance, not only in U.S. firms but also in non-U.S.

²²⁰ Gompers et al., *supra* note 8; Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUDS. 783, 784 (2009).

²²¹ Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 63–64 (1982).

²²² K.J. Martijn Cremers et al., *Commitment and Entrenchment in Corporate Governance*, 110 NW U.L. REV. 727, 730 (2016); Cremers & Sepe, *supra* note 80, at 67.

firms²²³ and firms with substantial insider control.²²⁴ Peter Iliev et al. investigated the effectiveness of shareholder voting by U.S. institutional investors on director election and merger approval in 8160 firms across 43 countries. The sample firms had an average insider control of 38.2%; yet, they found evidence showing that there were active shareholder voting actions and that such voting actions resulted in governance-related outcomes.²²⁵ In particular, greater dissent voting by outside shareholders is associated with higher subsequent director turnover and more withdrawals from merger and acquisition deals.²²⁶ Therefore, shareholder participation through voting may serve as an effective monitoring device, even in a controlled firm.

Furthermore, institutional ownership has grown dramatically in recent years. In the United States, the institutional holdings of public equities have grown from 6.1% in the 1950s to 28.4% in 1980 and reached 50.6% in 2009.²²⁷ Other countries are also experiencing steady growth in institutional ownership in public equities.²²⁸ According to a survey of public companies in 23 countries, the average total institutional ownership in non-U.S. jurisdictions was around 27% in 2007, with an average growth of 2.4% each year from 2003.²²⁹ It is expected that institutional investors, including pension funds, mutual funds, and insurance

²²³ Recent studies on U.K. corporate acquisition voting also support the positive impact of shareholder voting on firm value. See Marco Becht et al., *Does Mandatory Shareholder Voting Prevent Bad Acquisitions?*, 29 REV. FIN. STUD. 3035, 3035–36.

²²⁴ Reena Aggarwal et al., *Does Governance Travel Around the World? Evidence from Institutional Investors*, 100 J. FIN. ECON. 154, 154, 167 (2011); Peter Iliev et al., *Shareholder Voting and Corporate Governance Around the World*, 28 REV. FIN. STUD. 2167, 2168 (2015).

²²⁵ Iliev et al., *supra* note 224 at 2168, 2170–71, 2180.

²²⁶ *Id.* at 2188–96.

²²⁷ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 874–75 (2013).

²²⁸ OECD, *THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE* 20–21 (2011).

²²⁹ Aggarwal et al., *supra* note 224, at 159.

companies, will play an important role in constraining the opportunistic behavior of controlling shareholders.²³⁰

2. The Role of Institutional Shareholders and Shareholder Activism

The growth of institutional ownership does not, in and of itself, improve the corporate governance of controlled firms. Institutional investors are usually passive investors who tend to be silent on voting. The voting power of institutional investors only becomes influential when they are persuaded by activist shareholders or proxy advisory services firms.²³¹ That is, shareholder activists propose governance proposals while institutional investors evaluate proposals and decide their voting strategies.²³² Such cooperation has gained prominence and drastically changed the landscape of corporate governance in recent years.²³³ With the assistance of shareholder activists, institutional investors are playing an active role in policing corporations and asking for change through shareholder proposals to declassify boards and advocate for other governance-related changes.²³⁴ The common view is that staggered boards decrease shareholder value.²³⁵ The Shareholder Rights Project at Harvard Law

²³⁰ OECD, *THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE* 20–21 (2011); Gilson, *supra* note 5, at 108–12.

²³¹ Gilson and Gordon described the attitude as “rationally reticent”—a willingness to respond to governance proposals but not to propose them. Gilson & Gordon, *supra* note 227, at 895.

²³² *Id.* at 896–97.

²³³ See Bebchuk, *supra* note 138, 18–22.

²³⁴ ISS, *ISS 2016 Board Practices Study*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 1, 2016), <https://corpgov.law.harvard.edu/2016/06/01/iss-2016-board-practices-study/> [<https://perma.cc/MG8C-NJ2X>].

²³⁵ Bebchuk, Cohen & Ferrell, *supra* note 220, at 784–85 (finding six measures, including staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments, are correlated with negative firm value). Later, Bebchuk, Cohen, and Wang further focused on the effect of staggered boards and found that staggered boards were associated with statistically significant reduction in firm value. See Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder*

School has worked with institutional investors since 2012 to bring shareholder proposals for de-staggering boards to S&P 500 and Fortune 500 companies. From 2012 to 2015, 102 S&P 500 and Fortune 500 companies declassified their boards as a result of shareholder actions.²³⁶ The shareholder empowerment movement began to change the dynamics of corporate powers in the 1980s when many large companies adopted protective measures in response to an active takeover market.²³⁷ The percentage of S&P 500 companies that have classified boards drastically decreased from 45% in 2004 to 7% in 2014.²³⁸ U.S. hedge fund activists are not only active in policing firms with dispersed corporate ownership, but also go after controlled firms. With proper legal tools, such as the right to nominate and elect minority directors, activists are able to exert effective influence even in a dual-class firm with the presence of a controlling-minority shareholder.²³⁹ A survey of interventions by hedge fund activists in Europe reports a positive increase in the

Value? Evidence from a Natural Experiment, 110 J. FIN. ECON. 627, 627 (2013); Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 409 (2005); see also Cremers & Sepe, *supra* note 80, at 67 (finding staggered boards are positively correlated with firm value); Cremers et al., *supra* note 222 at 727 (finding shareholder approved anti-takeover measures, including staggered boards, are positively correlated with firm value).

²³⁶ *Declassifications*, SHAREHOLDER RIGHTS PROJECT, <http://www.srp.law.harvard.edu/declassifications.shtml> [https://perma.cc/8QZ3-39NQ] (last visited Feb. 17, 2017).

²³⁷ Harwell Wells, *Shareholder Power in America, 1800-2000: A Short History*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 13, 24 (2015).

²³⁸ SPENCER STUART, SPENCER STUART 2014 U.S. BOARD INDEX 7, <https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi2014web14nov2014.pdf%20target> [https://perma.cc/7CVV-25PA].

²³⁹ Other legal tools include majority of minority shareholder approval in a going-private transaction and shareholder litigation. See Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 90–103 (2016). Empirical research shows that minority shareholders receive lower merger consideration when controllers do not have to seek the approval of majority of minority shareholders or of an independent board committee. See Guhan Subramanian, *Post-Siliconix Freeze-Outs: Theory and Evidence*, 36 J. LEG. STUD. 1, 14–18 (2007).

shareholder value of target firms and further supports the notion that shareholder participation creates value for the firm.²⁴⁰

This Article thus argues that proxy advisory firms and shareholder activists should also include leveraged control devices in their agenda. In recent years, ISS and Glass Lewis, the two most prominent proxy advisory services firms, have made great progress²⁴¹ by focusing heavily on declassifying boards, majority voting rules for director election, and proxy access.²⁴² The risk of insiders making opportunistic decisions at the midstream stage in leveraged control firms has not been fully recognized by shareholder activists. Recently, ISS identified inefficient IPO governance arrangements as detrimental to shareholders. In November 2015, ISS announced a new voting policy on unilateral bylaw or charter amendments. ISS recommends either withholding or voting against directors of companies who, prior to or in connection with, their IPO, adopt bylaw or charter provisions that are detrimental to shareholders until the amendments are reversed or ratified by shareholders.²⁴³ ISS regards pre-IPO bylaw or charter provisions as unilateral actions because post-IPO investors do not have a chance to participate in the decision-making process when the provisions are adopted during the IPO stage. Most of the time, pre-IPO shareholders also implement a supermajority vote provision to make it harder to change charters afterwards and in order to ensure

²⁴⁰ Marco Becht et al., *Hedge Fund Activism in Europe* 20–22 (ECGI-Finance Working Paper No. 283/2010, 2010).

²⁴¹ S&P 500 companies that adopt majority voting grow from nearly 60% in 2009 to nearly 90% in 2015. See ISS, *supra* note 234.

²⁴² See ISS, EXECUTIVE SUMMARY: PROXY VOTING GUIDELINE UPDATES AND PROCESS (2015), <https://www.issgovernance.com/file/policy/executive-summary-of-key-2016-updates-and-policy.pdf> [https://perma.cc/4ZB5-374W]; GLASS LEWIS, PROXY PAPER GUIDELINES 2016 PROXY SEASON: UNITED STATES (2016), http://www.glasslewis.com/wp-content/uploads/2016/01/2016_Guidelines_United_States.pdf [https://perma.cc/WP73-B476].

²⁴³ ISS *Releases 2016 Benchmark Policy Updates*, ISS, <https://www.issgovernance.com/iss-releases-2016-benchmark-policy-updates-2/> [https://perma.cc/9PCR-VY96] (last visited Feb. 14, 2017).

that the entrenchment provisions they surreptitiously implemented at the IPO stage remain in place after the company goes public.²⁴⁴ To prevent midstream opportunistic behaviors from occurring, ISS proposes that IPO governance measures that are detrimental to shareholders should be ratified by post-IPO shareholders in order to make insiders accountable to shareholders.²⁴⁵ Even though ISS's actions mainly focus on the pre-IPO adoption of classified boards and supermajority vote requirements for charter amendments, this Article argues that a dual-class share structure and other leveraged control arrangements should also be subject to post-IPO ratification by shareholders.

VI. CONCLUSIONS

Corporate control structure differs according to firms. What works in one firm may not work in another. The tradeoff between monitoring benefits and entrenchment agency costs is always difficult to weigh in a controlled firm; the key is to constrain the extraction of private benefits of control by controlling shareholders. Regulators can create a sound legal system that reduces the level of private benefits extractions by leveraged controllers, but they are not in a suitable position to make choices for shareholders. This Article therefore argues against the outright prohibition of any specific types of control-enhancing mechanisms. Instead, the shareholders of each firm should choose an optimal governance regime. Inefficiencies in governance would be best addressed by each firm's shareholders through voting. Therefore, this Article advocates increasing shareholder participation in leveraged control firms and suggests proxy advisory firms and shareholder activists include leveraged control devices in their agenda so as to govern the midstream opportunistic behaviors of leveraged controllers.

²⁴⁴ "A significant percentage of recent IPOs in the U.S. have included provisions that limit board accountability to post-IPO investors and make it difficult for shareholders to amend the company's governing documents or take other corporate actions." *Id.*

²⁴⁵ *Id.*