The Perils of Small-Minority Controllers

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Joint work with Lucian Bebchuk (HLS)
The Snap IPO

- Company went public in March 2017.
- Each co-founder initially owned about 18% of the equity capital.
- However, although it was not transparent in the IPO documents, our analysis indicates that they will be able to reduce their stakes to less than 1.4% each and still retain control.
Facebook Reclassification

- In April 2016, Facebook passed a reclassification plan, approved by Zuckerberg’s majority voting power.
- It would have enabled him to reduce his stake of equity capital to about 4% and possibly less, without losing his majority control.
- The plan was challenged at court, and in September 2017 Facebook decided not to proceed with it.
This Paper:

- Places a spotlight on a subset of dual-class structures in which the controller has a small (or even tiny) minority of equity capital
  - These structures are especially pernicious and deserve special attention.
- We analyze the efficiency costs, drivers, incidence, and policy implications of small-minority controllers.
- Paper complements our earlier article: The Untenable Case for Perpetual Dual-Class Stock (Virginia Law Review 2017).
Small-Minority Controllers: The Governance Problem

- Suppose that a controller:
  - Owns a fraction $\alpha$ of the equity capital;
  - Faces a choice whether to take a value-reducing action that would decrease value by $\Delta V$, but provide a private benefit $B$.
- The controller would take the value-decreasing action if:
  \[ \Delta V < \frac{B}{\alpha}. \]
Distortion Larger when Equity Stake Declines

- As $\alpha$ declines, the costs arising from situations in which $\Delta V < B / \alpha$ are expected to increase because:
  - the likelihood that the value-reducing action will take place increases; and
  - the expected reduction in value in such a case increases.
- This prediction is consistent with substantial evidence that dual-class controllers with lower equity stakes are associated with lower value / greater agency problems (see, e.g., Gompers et al.; (2010) and Masulis et al. (2009)).
The Severe Costs of Small Equity Stakes

- Moreover, we show (building on Bebchuk, Kraakman & Triantis (1999)) that expected agency costs rise at an increasingly steep rate as $\alpha$ declines.

Example: initial $V = $4 billion, $B = $100 million:
- When a 30%-controller moves to 25%, the range of situations in which the controller would prefer to avoid a value-increasing action would increase from $[\Delta V < $333 million]$ to $[\Delta V < $400 M million]$.
- When a 10%-controller moves to 5%, the range would increase from $[\Delta V < $1 billion]$ to $[\Delta V < $2 billion]$. 
Breadth of Distortions

The structural distortions we analyze afflict a wide array of settings and corporate decisions:

- Related party transactions;
- Allocation of opportunities and talents;
- Choice of CEO;
- Choice of business strategy;
- Scale and acquisitions decisions; and
- Response to acquisition offers.
The Mechanisms of Extreme Separation (1)

We identify and analyze the mechanisms that enable controllers with a small-minority stake, and provide empirical evidence on their prevalence:

(i) Hardwiring for votes or directors;

(ii) Large ratio of high votes/ low votes;

(iii) Nonvoting stock;

(iv) Voluntary conversion to low-vote shares when the controller sells shares;
The Mechanisms of Extreme Separation (2)

(v) Automatic conversion;

(vi) Dividend in low-vote shares;

(vii) Post-IPO voting agreements;

(viii) Using the controller’s power to make midstream governance changes that add or strengthen one or more of the above mechanisms.
The Mechanisms of Extreme Separation (3)

The example of Snap:

- Snap sold public investors nonvoting stock.
- However, the potential for massive reduction in controllers’ equity stakes comes from the ~1.2 billion nonvoting shares that are authorized but unissued.
- Upon issuing pro rata dividends of these authorized nonvoting shares, the co-founders may sell without any diminution of their voting power.
- Each co-founder could sell 92% of their equity stake — lowering it to less than 1.4% of the equity capital — without relinquishing control.
The Unfulfilled Promise of Existing Sunsets

- Current use of the ownership-based sunset provisions provides a weak and often nonexistent constraint on the mechanisms of extreme separation.
- In Snap, co-founders can go down to around 1.3% despite an ownership sunset.
The Prevalence of Extreme Separation (1)

We introduce a typology of controllers with a lock on control:

- **Controlling Minority Shareholder** – a controller that owns 50%, or less, of the company’s equity capital.
- **Small-Minority Controller** – a controller with a 15% equity stake, or less.
- **Very-Small-Minority Controller** – a controller with a 10% equity stake, or less.
- **Tiny-Minority Controller** – a controller with a 5% equity stake, or less.
The Prevalence of Extreme Separation (2)

We reviewed the governance documents of all majority-controlled dual-class companies among the Russell 3000 as of 2017 to determine:

(i) The fraction of equity capital currently held by each controller;
(ii) The lowest equity stake sufficient for control
## The Prevalence of Extreme Separation (3)

<table>
<thead>
<tr>
<th>Category</th>
<th>Incidence at Present</th>
<th>Potential Incidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controlling Minority Shareholders</td>
<td>83.6%</td>
<td>100%</td>
</tr>
<tr>
<td>Small-Minority Controllers</td>
<td>18.9%</td>
<td>91.8%</td>
</tr>
<tr>
<td>Very-Small-Minority Controllers</td>
<td>9.8%</td>
<td>81.2%</td>
</tr>
<tr>
<td>Tiny-Minority Controllers</td>
<td>1.6%</td>
<td>30.3%</td>
</tr>
</tbody>
</table>
Policy Implications (1)

Improving disclosure:
- Requiring disclosure of the controller’s equity stake.
  - Not *always* provided by current disclosures.
- Requiring disclosure of the minimal equity stake that the controller could retain without relinquishing control.
  - Currently not transparent to investors.
- The SEC Investor Advisory Committee recently issued a discussion draft that endorses our proposal for enhancing disclosure => we hope the SEC adopts it as well.
Policy Implications (2)

Limiting the potential reduction in equity stake while retaining control:

- Ownership-based sunsets;
- Caps on the ratio of high/low votes;
- Limiting the issuance of non-voting shares.
Policy Implications (3)

Enhancing shareholder protections in companies with a small-minority controller.

Such enhanced protections in companies with a small-minority controller could include:

- Applying heightened judicial scrutiny when the equity stake is smaller;
- Limiting the controller's power regarding some issues (e.g., changes in rules of the game);
- Eliminating the controlled-company exemption from independence requirements; and
- Introducing enhanced-independence requirements for directors (Bebchuk-Hamdani 2017).
Policy Implications (4)

Screening midstream changes:

- Requiring majority approval of unaffiliated investors for governance changes that would enable the controller to reduce ownership stake without relinquishing control.
Conclusions

Small-minority controllers:
- Pose large governance risks;
- Are introduced by mechanisms that we identified;
- Their incidence is already significant and could increase substantially if controllers fully use arrangements in place;
- Their presence and potential emergence are not sufficiently transparent;
- Policymakers and investors should consider measures to
  - Limit/regulate the emergence of small-minority controllers; and
  - Introduce additional protections for public investors when small-minority controllers are present.