

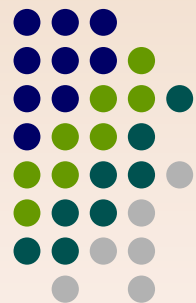
The Perils of Small-Minority Controllers

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ECGI and Bar Ilan Conference on
Differential Voting Shares

December 2018

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 α of the equity capital;
 - Faces a choice whether to take a value-reducing action that would decrease value by ΔV , but provide a private benefit B .
- The controller would take the value-decreasing action if:
$$\Delta V < B / \alpha.$$

Distortion Larger when Equity Stake Declines



- As α 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 α 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 $[\Delta V < \$333 \text{ million}]$ to $[\Delta V < \$400 \text{ M million}]$.
- When a 10%-controller moves to 5%, the range would increase from $[\Delta V < \$1 \text{ billion}]$ to $[\Delta V < \$2 \text{ billion}]$.

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)



	Incidence at Present	Potential Incidence
Controlling Minority Shareholders	83.6%	100%
Small-Minority Controllers	18.9%	91.8%
Very-Small-Minority Controllers	9.8%	81.2%
Tiny-Minority Controllers	1.6%	30.3 %

Policy Implications (1)



Improving disclosure:

- Requiring disclosure of the controller's equity stake.
 - Not *a/ways* 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.