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WILL LOYALTY SHARES DO MUCH FOR CORPORATE SHORT-TERMISM?

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Will Loyalty Shares Do Much for Corporate Short-Termism?

Mark J. Roe and Federico Cenzi Venezze*

Stock-market short-termism is, a widespread view has it, hurting the economy. Because stock markets will not support corporate long-term planning, the thinking goes, companies fail to invest enough, do not do enough research and development, and buy back too much of their stock. As a remedy to the perceived short-termism problem, an increasing number of European companies are adopting "loyalty shares," whereby stockholders who own their stock for longer periods have more voting power than those who do not. There is a strong intuitive appeal to the idea that more votes for long-term shareholders would promote more long-term corporations. While loyalty shares are scarce in the United States, proposals to facilitate their use are emerging. We show here why loyalty shares promoters' thinking is overly optimistic—often the central goal for users of loyalty shares will be to retain control, which need not have any beneficial impact on corporate time horizons. Other reasons may well justify loyalty-share programs. We introduce to the loyalty-share analysis the ex ante value to the entrepreneur of retaining control—i.e., loyalty shares can help motivate founders and thereby induce new entry, new start-ups, and new, original entrepreneurial activity. But the prevailing raison d'etre of diminishing short-termism seems likely to be weak or absent.

Will Loyalty Shares Do Much for Corporate Short-Termism?

Mark J. Roe and Federico Cenzi Venezze [*]

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INTRODUCTION

Loyalty shares—which reward long-term shareholders with extra voting power—are increasingly touted to combat stock-market-driven short-termism, which is widely viewed as a deep corporate and economic cost. The corporate short-term problem is that the stock market's rapid trading and excessive activism, in the view of the critics in the United States, induce America's public companies to reduce their investment in capital and their

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workforce's skills and morale, cut back research and development from what it should be, and return so much cash to shareholders that the firms cannot operate well. The shortened time horizon for American business, in this view, reduces the health of the American economy. The present and the next financial quarter are valued highly; the future, not so much.

Policy leaders criticize corporations for too much short-term thinking. Political leaders and the business media criticize corporate America for overly focusing on the next quarter's financial reports—leading to the epithet of "quarterly capitalism." The Securities and Exchange Commission worries about how its policies and regulations could foster short-termism and quarterly capitalism, leading to a recent July 2019 roundtable focused on how the SEC could bolster long-term actions and reduce short-term influences.[1]

The SEC has been considering major proposals to permit new stock exchanges that would foster wide use of loyalty shares, particularly in Silicon Valley and for newer, innovative firms.[2] The primary proposal—to the Securities and Exchange Commission to approve a long-term stock exchange, the LTSE, which would specialize in loyalty shares—is controversial, drawing sharp institutional investor opposition, because differential voting rights have generally been disfavored in the United States, with one-share, one-vote being the usual (but not unanimous) norm.[3]

The proffered rationale for the loyalty-share stock exchange comes from the expectation that more votes for shareholders that own their shares for longer periods will lead companies to be more long-term oriented. Proponents see the American public firm as too short-term oriented, primarily due to stockholders' short attention span. Stockholders trade their stock rapidly, inducing American firms to shun long-term investments. Stock traders and activists push firms for short-term action and sell their stock quickly thereafter, the thinking runs. Too many firms overly focus on their immediate performance, too many seek immediate cash, and too many fail to invest for the long run. They thereby allow their firms' productive capacities to decline.

In the proponents' vision, executives would appeal to loyal, longer-term stock- holders for votes against activists and traders and, by investing for the long run, would obtain the loyalty-share votes. The longer-run stockholders, with extra votes, would elect like-minded boards and support longer-term

[1] Jay Clayton, Chairman, U.S. Sec. and Exch. Comm'n, Statement on Short-Term/Long-Term Management of Public Companies (July 18, 2019), www.sec.gov/news/public-statement/statement- clayton-071819.

[2] In the Matter of the Application of Long-Term Stock Exchange, Inc. for Registration as a National Securities Exchange, Exchange Act Release No. 34–85828, 84 Fed. Reg. 21841, 21851 (May 10, 2019). The SEC order noted the opposition to loyalty shares coming from the Council of Institutional Investors. The application process in the end omitted any request for authority to list loyalty shares. That effort will presumably come later.

[3] Letter from Jeffrey P. Mahoney, Gen. Counsel, Council of Inst. Inv'rs, to the U.S. Sec. & Exch. Comm'n (Jan. 22, 2019) ("we do not support the LTSE Application"). LTSE is the acronym for the so-called Long-Term Stock Exchange.

corporate business policies. The affected companies would profit more and the American economy would prosper.

Although this intuition is appealing, we consider here reasons for skepticism. We analyze (1) what loyalty shares are and how their governing structure would arise in the United States—who would make loyalty shares "happen" and what their interests are—which do not inevitably lead to less short-termism, (2) which shareholders would obtain the loyalty-share boost in the United States and whether they could reliably be counted on to reduce short-termism, (3) how loyalty shares would affect the most prominently discussed ways that stock markets are thought to propel corporate short-termism, and (4) the loyalty-share experience thus far around the world and what that experience tells about its likely impact in the United States.

Each of these four analytic streams points to no more than a limited time horizon benefit. And surprisingly, given the glowing rhetoric, sometimes they could even be detrimental for the long term. Distant, smaller shareholders, even if they hold their stock for longer, will still be free riders in corporate governance and, hence, passive. Trading may decline, but the stock will still have a current price that adjusts to new information—and to the extent directors and managers pay attention to changing stock prices, they will continue to see a stock price to pay attention to.

This analytic does not ineluctably mean that loyalty shares should be disfavored—facilitating longer corporate horizons and more investment is not the only margin for evaluating them. The voting bonus could support entrepreneurship and start-ups[4]—particularly because entrepreneurs are thought to highly value continued control—in a "biodegradable" format that allows the entrepreneur to retain control in a way that is less rigid than dual class stock.

But loyalty shares' ongoing primary public-regarding propellant of fostering the long term should be treated skeptically, or rejected outright.

* * *

First off, loyalty shares will redistribute the voting power inside a public corporation through its impact on two main ownership structures. The first one is the public company with widely held shares; these are typically mature companies. The second one is the public company with a controlling shareholder/founder running the company, which is usually seen in the United States when the company initially goes public and for several years thereafter (and is more common in Europe).

Insiders and controlling shareholders will disproportionately affect the design structure for loyalty shares and will favor mechanisms that, in turn, favor their own interests. They and their legal advisors will have a pivotal role in designing and adopting the loyalty-share structures and their

[4] *See infra* Part V.C.

governing rules. CEOs and controllers will retain the power to stop their corporation from adopting loyalty shares if the insiders do not see the structure as fitting their interests. Insiders will be less enthusiastic about loyalty-share voting boosts in firms with a large stable base of outsiders (who would get the boost) than in firms whose outside shareholders would not get the voting boost. These insiders will typically have the incentive to favor a loyalty-voting boost only if they are the primary beneficiary of the boost. Second, the experience in nations that have used loyalty shares is consistent with this analysis. Dominant, controlling shareholders have been the primary users of loyalty shares. Although the loyalty-voting boost is formally available to all shareholders, the real-world implementation mechanisms impede outsiders, such as most institutional investors—even long-term institutional investors—from acquiring the loyalty-voting boost and the real-world structures facilitate insider-controllers getting the voting boost. We show how this experience is likely to be replicated if the United States widely uses loyalty shares.

Third, the types of shareholders that would gain and lose voting power in the United States do not inexorably induce better long-term outcomes. Insider-managers would get more votes, as would the increasingly important index funds, which hold stock for the long term weighted by a standard stock market index, like the Standard & Poor's 500. The three major index fund managers (BlackRock, Vanguard, and State Street) already own nearly one-quarter of the stock in a wide array of large public companies in the United States. In any evenhanded setup, the index funds would be big winners of extra votes. Traders, shareholder activists, and newly formed blockholders with long-term intentions would all *lose* voting power. We show how the likely voting shift, if evenhandedly implemented, would not assuredly promote the long term; the dominant variable is the extent to which shifting voting power from activists to indexers promotes or degrades the long run. The impact of this shift on corporate time horizons is, we show, uncertain.

Even worse, though, we should not expect that lawmakers will evenhandedly set up the rules for loyalty shares, nor should we expect that the adopting companies' loyalty-share structures will be evenhanded. On-the-ground rules and company-by-company implementation will favor those with an interest in getting more votes for themselves and fewer votes for outsiders; they would usually not have the long term foremost in mind as their primary motivation (although long-termism may be foremost in their headline rhetoric).

Fourth, the most prominent means touted for why the stock market promotes short-term behavior is that excessively rapid trading pulls executives' time horizons to match the traders' short horizons. Often the channel for alignment is thought to be executive compensation. Executive pay is tightly tied to share price, and, if share price is decided by rapid trading, the thinking runs, executives will focus on short-term results that keep stock

prices up and, hence, their bonuses and other compensation up. Loyalty shares will, the thinking runs, slow down this trading.

But loyalty shares will *not* stop stock prices from rising and falling. If quarterly results overly influence stock price now, they will overly influence stock price of companies with loyalty shares. The stock will still trade and have a price. Trading volume may decrease, yes, but loyalty shares alone will not stop share price from affecting stock-based executive compensation. If stock price overly affects executive compensation now, it will overly affect it even when companies use loyalty shares. Indeed, loyalty shares could worsen the perceived problem, because loyalty-share proponents expect that the voting bonus will motivate *longer-term* shareholders to trade even less. Hence, if the loyalty-share theory is correct, *longer-term* shareholders *will contribute less* to the stock's current price. In contrast, the purportedly erratic remaining short-termers will continue to trade and contribute *more* to the stock's price and thereby enhance their influence on management.

Hence, there is little reason to expect much long-term benefit from facilitating loyalty shares in the United States. It will likely primarily cement insider control and only secondarily and derivatively, if at all, improve the long term.

There are other reasons to facilitate loyalty shares that we briefly explore—the prospect that founders value control and, if there are more means such as loyalty shares for them to retain control, more new firms are likely to be founded. This rationale appears not to be prominent in the current public analysis, but we see it as the most important justification. Moreover, there are good reasons to defer to investors' and founders' decisions and deals at the time of the initial public offering. But one should not strongly hope that wide use of loyalty shares will lengthen the time horizon of the U.S. public firm.[5]

* * *

The roadmap for this article is as follows: In Part I, we describe loyalty shares in theory and in practice. Then we look at who wants them: policy analysts who ascribe long-term benefits to loyalty shares and private controllers who see loyalty shares as a mean to cement their control for the long term.

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[5] We build on several insightful papers on loyalty shares, including Marco Becht, Yuliya Kamisarenka & Anete Pajuste, *Loyalty Shares with Tenure Voting—Does the Default Rule Matter? Evidence from the Loi Florange Experiment*, 63 J.L. & ECON. 473 (2020); David J. Berger, Steven Davidoff Solomon & Aaron J. Benjamin, *Tenure Voting and the U.S. Public Company*, 72 BUS. LAW. 295 (2017); Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541 (2016); Paul H. Edelman, Wei Jiang & Randall S. Thomas, *Will Tenure Voting Give Corporate Managers Lifetime Tenure?*, 97 TEX. L. REV. 991 (2019); and Chiara Mosca, *Should Shareholders Be Rewarded for Loyalty? European Experiments on the Wedge Between Tenured Voting and Takeover Law*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 245 (2019). We refer to these papers in this article's text. Dual-class stock has features analogous to those of loyalty shares; we do not set out the extensive dual-class work here, but refer to specific works where relevant. We also draw on the European experience with loyalty shares, which is much more extensive than the American; we refer to the specific works where relevant.

In Part II, we analyze the loyalty shares' incentive structure to show that more votes for long-term owners does not translate into more long-term corporate behavior. Insiders would have more power, but their long-term orientation cannot be assured. Small, stable shareholders may get more votes than they have now. Indexed and quasi-indexed funds would have more voting power in the United States in any evenhanded implementation. Losers would be active shareholders and activist funds, which would be saddled with low-vote shares for several years. In Part III, we show that the purported impact on corporate time horizons is uncertain and weak, and could readily shorten horizons. Small, stable shareholders would get more votes than they have now, but their incentives to be uninvolved in corporate governance would persist. The longstanding, well-understood free-rider problem of having many shareholders who are passive would persist unameliorated, even if the smaller shareholders had more votes. The new power centers in American corporate governance—the indexers—are generally passive. There is little reason to think that more votes would make them more active. The case for improving time horizons then rests with loyalty shares' potential to weaken presumably short-term active shareholders and activist funds and the shares' potential to strengthen the presumably long-term-focused insiders and controlling shareholders.

In Part IV, we look at how loyalty shares have played out around the world. They have locked in controllers—including the state—and locked out foreign investors, serving a national goal of keeping domestic control of large firms. They have not led outside owners—even the long-term ones—to get more votes. Loyalty shares lock in insider, founder, domestic, and governmental control, with long-termism the rhetorical justification.

In Part V, we set out the current governing structure for loyalty shares in the United States and the current proposals for change.

In Part VI, we analyze the choice mechanisms (1) for how loyalty shares would be authorized in the law and (2) for how they would be adopted firm-by-firm. The choice mechanisms for adoption will favor loyalty shares when they protect insiders, not when they facilitate long-term thinking. In Part VI we also bring forward—we believe for the first time—a vital rationale for loyalty shares that does not involve promoting the long term. Loyalty shares could help to bring forward more new start-ups that help to propel competition, change, and the economy. These are benefits, although they are not time-horizon benefits.

We then conclude. Loyalty shares would enhance the voting power of some shareholders—most notably insider-controllers and, in any broad implementation, index funds—and diminish the voting power of others, most notably new blockholder-activists. That configuration does not offer comfort that they would promote the long term.

The core justification for loyalty shares—in halting or substantially reducing stock-market-driven corporate short-termism in firms that use loyalty shares— is thus at least exaggerated and quite possibly false.

I. What Are Loyalty Shares and Who Wants Them?

A. What They Are

Shareholders who have held their stock for a specified period get enhanced voting power—in the most usual loyalty-share formulation, two votes per share if held for two years or more, instead of one vote.[6] A long-term benefit seems intuitive: shareholders with a longer time horizon will have more voting power, trade less often, and want their corporation to have a longer time horizon as well, thereby reducing corporate short-termism.

Departure from one-share, one-vote has long been considered dangerous for minority investors and the corporation. The U.S. governing rules treat loyalty shares and dual-class stock (by which one class of shares has a fixed, higher voting power) similarly and cautiously, effectively barring both structures unless adopted when a firm first sold shares to the public.[7] If the differential voting structure is in place at the time of the firm's initial public offering, buyers can "price" the terms of the votes into what they pay for the stock. Midstream changes, in contrast, are harder to price effectively.

Loyalty shares resemble dual-class stock. The latter gives more votes to owners (usually controllers) of specified stock, but that stock can trade and, when it trades, the buyers acquire the extra votes from the sellers. The controller can typically sell control by selling the voting rich shares, with the extra votes available to the buyer. With loyalty shares, in contrast, the buying shareholder loses the extra votes. And any loyal shareholder can obtain the voting bonus if it holds the stock for long enough. High-voting loyalty shares become low-vote shares when the long-term owner sells the shares; the buyer of high-vote dual-class shares buys the high votes along with the stock.

Loyalty-share voting has until recently mainly been a matter for theoretical discussion in the United States. But business lawyers are now discussing and promoting the idea.[8] Promoters have organized a new loyalty-share-focused stock exchange in Silicon Valley, obtained regulatory approval for its basic operation, and announced their intention to seek regulatory approval to use loyalty shares that would enhance the voting power of longer-

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[6] Loyalty shares are also called "tenure-share voting stock" or "time-phased voting stock.

[7] N.Y. Stock Exch., Listed Company Manual § 313.00(A) (2020) ("Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans…"); *see also* Nasdaq Stock Market, Nasdaq Listing Rules § 5640 (2019) (similar restrictions).

[8] *See, e.g.*, Berger, Solomon & Benjamin, *supra* note 5, at 323.

term investors by as much as a factor of ten.[9] The organizers of the exchange emphasize its long-term ambitions—indeed, its name, LTSE, is the acronym for "long-term stock exchange"—and they seek to specialize in loyalty shares. Institutional investors have opposed this initiative.[10] In this article, we analyze whether loyalty shares' purported big benefit—longer-term corporate behavior—is plausible. We conclude that much skepticism is warranted.

B. Who Wants Loyalty Shares?

1. Academics and lawmakers: viewing loyalty shares as designed to facilitate the long-term. A major criticism of the U.S. public firm is that rapid stock trading makes it too short-term oriented. If stockholders own shares for only a short time, the thinking runs, management cannot run the company for the long term.[11] Stock turns over so fast that shareholders do not sometimes even know basics about the underlying business of the corporation whose stocks the trader just bought and sold. Executives and boards, it is said, cater to traders and activists who want a quick profit, strong quarterly financial results, and a strong stock price right now, which affects much of their compensation. If the stockholding base is made of traders who overly focus on quarterly results, the thinking runs, then the executives and board of that company will do the same.

The case for loyalty shares—which is supported by several academics[12] and several political players[13]—rests on the expectation that firms using them

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[9] Alexander Osipovich & Dennis K. Berman, *Silicon Valley vs. Wall Street: Can the New Long- Term Stock Exchange Disrupt Capitalism?*, WALL ST. J. (Oct. 16, 2017), https://www.wsj.com/articles/ silicon-valley-vs-wall-street-can-the-new-long-term-stock-exchange-disrupt-capitalism-1508151600; Matt Levine, *The Long-Term Stock Exchange Is Worth a Shot*, BLOOMBERG (Oct. 16, 2017), https://www. bloomberg.com/opinion/articles/2017-10-16/the-long-term-stock-exchange-is-worth-a-shot; Andrew Ross Sorkin, *The Profits of Going Public Without the "Brain Damage,"* N.Y. TIMES, Sept. 18, 2017, at B1; Scott Kupor, *Rethinking What's Fair in Corporate Governance*, BARRON'S (Aug. 9, 2019), https:// www.barrons.com/articles/tenure-based-voting-offers-a-fresh-take-on-corporate-governance-515653 89914; Matt Levine, *Uber Misses the Enchanted Forest*, BLOOMBERG (May 13, 2019), https://www. bloomberg.com/opinion/articles/2019-05-13-uber-misses-the-enchanted-forest.

[10] *See* Mahoney, *supra* note 3.

[11] Tamara Belifanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789, 834 (2013) ("[T]ime-weighted voting allows companies to distinguish among shareholders based on the shareholders' level of commitment in owning the firm's stock. [I]t rewards stewardship capital on one hand, and potentially discourages the short-term gamblers."); Berger, Solomon & Benjamin, *supra* note 5, at 323 (concluding that "tenure-voting plans could help shareholders, companies, the marketplace, and society return to a disciplined, long-term approach to investment and growth"); Dallas & Barry, *supra* note 5, at 542, 551; Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 901 (2012) (time-phased voting "provides greater incentives to longer-term shareholders to invest in making those decisions and greater incentive to remaining shareholders to enjoy the increased voting rights").

[12] Belifanti, *supra* note 11, at 834; Berger, Solomon & Benjamin, *supra* note 5, at 323; Dallas & Barry, *supra* note 6, at 542, 551.

[13] *See infra* note 155.

would attract and retain more long-term investors and diminish the influence of short-term traders.

2. Real World Controllers: Loyalty Shares to Lock in Control. In the United States thus far, Silicon Valley entrepreneurs and their lawyers have promoted loyalty shares[14] by seeking regulatory approval for a stock exchange to trade these shares and by touting their benefit in promoting the long term. Some executives are said to have similar views: "The way to reimagine capitalism, [American business leaders] suggest, is to get investors off their backs. They propose . . . ways in which this might be done—from changes in law . . . to only allowing investors to vote their shares if they have held them for a sufficiently long period of time" so that "investors would have less power."[15] In Europe, several nations' governments seek to slow down corporate change and industrial displacement by promoting loyalty shares,[16] as have controlling shareholders. The European Commission is studying the issue. We shall see parallels between the U.S. and European developments.

II. WINNERS AND LOSERS FROM LOYALTY SHARES

A. The Big Winner: Controlling Shareholders

Concentrated ownership is less common among mature U.S. public companies than it is in continental Europe.[17] Concentrated ownership is, however, frequent in the United States for the years after a founder takes the company public in an IPO. And it persists for a few public companies—e.g., Oracle, Tesla, and Amazon—and on occasion for generations thereafter, such as for Walmart.[18]

[14] *See* Berger, Solomon & Benjamin, *supra* note 5 at 296; Dave Michaels & Alexander Osipovich, *Silicon Valley's Stock-Exchange Plan Snagged by Opposition at SEC*, WALL ST. J. (Nov. 27, 2018), https://www.wsj.com/articles/silicon-valleys-stock-exchange-hits-a-roadblock-1543320003.

[15] Rebecca Henderson, REIMAGINING CAPITALISM IN A WORLD ON FIRE 123 (2020).

[16] *See* EY STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE: FINAL REPORT (2020), https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en?mc_cid=664fe83cf0&mc_eid=657d91711d (report to the EU recommending loyalty shares, inter alia, to counter short-termism); Mark Roe, Holger Spamann, Jesse Fried & Charles Wang, *The Sustainable Corporate Governance Initiative in Europe,* 38 YALE J. ON REG. ONLINE BULL. 133 (2021); TOM VOS, ECGI ROUNDTABLE: LOYALTY SHARES 2 (June 18, 2018), https://ecgi.global/sites/default/files/events/ecgi_roundtable_report_on_loyalty_shares_ by_tom_vos.pdf.

[17] *See* Adriana De La Cruz, Alejandra Medina & Yung Tang, OWNERS OF THE WORLD'S LISTED COMPANIES 18 (2019), www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm; Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 472 (1999).

[18] According to Institutional Shareholder Services Inc. data, only 3.6 percent of S&P 500 and 8.4 percent of Russell 3000 have a controlling shareholder. However, CEOs have significant stakes in several U.S. public companies, especially smaller ones, with more than 20 percent of the smaller 1500 companies of the Russell 3000 having a CEO holding at least 5 percent of the stock. Kosmas Papadopoulos, *ISS Discusses CEO Ownership, Corporate Governance, and Company Performance,* CLS BLUE SKY BLOG (May 13, 2019),

Controlling shareholders and other insiders with significant stakes will gain voting power from loyalty shares. But the impact on their corporation's time horizon is uncertain. It could motivate them to favor the long term, to foster the short term, or to entrench their control with no systematic long- or short-term impact.

If controlling shareholders are naturally and usually long-term visionaries, then enhancing their voting power will strengthen their authority to foster long-term investments. But if their enhanced votes allow them to retain control with a lower dollar investment in their firm, the impact on the corporation's short- versus long-term behavior becomes uncertain. One cannot know in advance what the controllers' time horizons are. In this section we explain the uncertainty.

1. Mixed incentives from diversification while retaining power. The optimistic view posits that founder-controllers will seek the long term, if outside shareholders do not stop the controllers from doing so. Some controllers fear that outside investors would oust the dominant shareholder of control, if the insider-controller slips in any one quarter. So, a controller owning half of a company's 200 shares would fear raising new capital for the long term by having the company issue, say, 100 new shares. After the sale, the previously dominant shareholder would have only one-third of the vote (because it would own 100 of the firm's now 300 shares) and, hence, could lose control and be outvoted by finicky, nervous outsiders. But if the controller instead turned his or her stock into loyalty shares with two votes for each share that has been owned for more than two years, and if the original controller's ownership was stable, then the controller would have 200 votes, despite owning only 100 shares, while the outside shareholders owning 200 shares would, after the new stock issuance, have 200 votes. The owner could raise new capital from outside investors and still keep half of the votes and control.[19] That new capital could not readily impede the insider-controller from operating as the insider-controller saw fit, because the controller would have half of the votes (but only one-third of the shares).[20] If the insider-controller is long-term focused, the corporation would be long-term focused as well.

https://clsbluesky.law.columbia.edu/2019/05/13/iss-discusses-ceo-ownership-corporate-governance-and-company-performance/.

[19] Suman Banerjee & Ronald W. Masulis, *Ownership, Investment and Governance: The Costs and Benefits of Dual Class Shares* 46 (ECGI Fin. Working Paper No. 352/2013, Jan. 18, 2018), https://ssrn.com/abstract=2182849; Dallas & Barry, *supra* note 5, at 642 (for U.S. firms adopting time- phased voting ("TPV"), "approximately one-third of TPV firms substantially increased their outstanding equity within five years of adopting TPV"). Such considerations are analyzed as the controller's idiosyncratic vision in Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

[20] Fifty percent of a public company's votes is enough for control, but if the formality of uncontestable control is needed for the example, the controller could buy one more share, to have just over 50 percent of the votes.

Founders and CEOs with significant but noncontrolling stakes would also take advantage of loyalty shares (especially if, as has been proposed, more than two votes per share—the EU norm—are granted to loyal U.S. company shareholders). If the 5 percent CEO could get ten votes per share through loyalty shares, he or she could outvote transient investors that lacked the loyalty-voting boost and thereby preserve his or her long-term strategy.

The skeptical view is that loyalty shares could just as well empower the controller/CEO to settle in for the last few years of his or her tenure, cementing control with extra loyalty-share votes. Horizons would be left unchanged—or even *shortened* to the controller's expected tenure. Worse, since controlling shareholders are often under-diversified, with much of their wealth in their single firm, the loyalty-share voting bonus could free controllers to sell some stock to diversify while the extra votes would assure them of continued control. With less of their wealth inside the corporation, the controllers' commitment to their firms would ordinarily decrease.[21] The controller could well then refocus on obtaining quick value (through salary and other payments) rather than promoting long-term value.

Which of these two effects would dominate is hard to assess in the abstract and this conflict is missing in existing optimistic analyses of loyalty shares' impact on corporate time horizons.

2. Lower value on sale. Because the high-voting shares become low-voting shares upon those shares' sale, the controller cannot readily monetize the value of loyalty-share voting power. This locks the controller into the firm and means that the controller cannot readily sell the firm to an outsider who has a long-term vision for that firm.[22] That is, the inside-blockholder with half of the votes (but only one-third of the stock[23]) may wish to sell; a new investor with a long-term plan may be ready to buy. But under the loyalty-share rules, the new buyer would obtain only one-third of the votes, not half; the transaction would destroy half of the controller's votes. The weakening of the potential buyer's voting power (compared to the controller's) could

[21] *Cf.* Onur Arugaslan, Douglas O. Cook & Robert Kieschnick, *On the Decision to Go Public with Dual Class Stock*, 16 J. CORP. FIN. 170, 180–81 (2010) (data on initial public offerings show that "dual class IPO firms do not invest more than single class IPO firms in general or in R&D over either a one- or three-year horizon after their IPOs" and "deviations from a one share–one vote regime are done to permit insiders to diversify their portfolios while retaining control").

[22] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1669–70 (2006).

[23] The calculation: a one-share, one-vote structure with the controller owning one-third of the stock gets the controller 100 votes out of the 300 cast. In a loyalty share structure with the controller being the only shareholder with two votes for loyalty, the controller gets 200 votes of the 400. The controller gets one-half of the total votes, with one-third of the economic investment.

deter the sale to the longer-run player from the locked-in but short-horizon senior controller.[24]

Thus, loyalty shares could induce *more* firms to fail to adapt to the best longer-term strategy when incumbents lack the adaptive skills but cannot sell to those who have those skills. Long-term *degradation* could, hence, be a consequence of wide-spread adoption of loyalty shares. Loyalty shares can thus create a mismatch between the controller's skills and the firm's best long-term strategic adaptation. This problem appears to be unrecognized in the existing literature: *a priori*, loyalty shares do not enhance and protect a controller's long-term motivations but can harm the long term.

3. Take the private benefits now. Worse yet, under plausible and common circumstances, loyalty shares can *induce* greater short-termism.

Assume that a new technology would boost the firm's long-term value. The founder lacks the skill to implement that technology but prefers to keep running the company. The CEO prefers to be paid the excess salary ("excess" because the controlling CEO is not up to the job of bringing the company up to speed with the new technology) from continuance and the pleasure of running the company for the next five years (the short term in this example), even if that is costly to the firm's longer-term value. Without a loyalty-share voting boost, the CEO cannot control the board sufficiently to get that result. But with the loyalty-share voting boost to the CEO's shares, he or she has the voting power to implement the CEO's preference for continuance without the new technology for the next five years—i.e., the CEO's short-term plan.

Now, with numbers: Posit that the CEO controls a firm with one-third (plus one) of the shares. The other two-thirds of the stock get a single vote per share; the CEO-controller gets double votes. The controller therefore has just over 50 percent of the shareholder votes to elect the board.[25] He or she controls the firm. Assume now that, with control, he or she can and does take $60 in special benefits for himself or herself (via excessive salary, but also in the value to the controller from the prestige, satisfaction, power, and respect that comes with the position). This $60 comes at the expense of outside stockholders such that the firm, initially worth $300 operationally, is worth $240 operationally. From that $240, the controller gets $80 (from 1/3 x $240), with a total "take" of $60 + $80, or $140.

Posit that a better, longer-term strategy is available to the company; it requires though that the controlling CEO cede control because the long-term strategy requires technological changes that the incumbent CEO is ill-

[24] Loyalty shares would deter the sale for one of two reasons. Either the potential buyer would have to pay a "control premium" to the seller (because the seller is giving up control), but the buyer would not receive control in return, or the current controller would be reluctant to sell control without being paid a control premium (because the buyer would not obtain control).

[25] *See supra* note 23.

equipped to implement. That strategy will make the company worth $390, but with one-third of the stock, the CEO would obtain only $130 in value, $10 *less* than the CEO-controller gets from the short-term strategy. Hence, the incentives from the loyalty-share structure are for the controlling CEO to adopt the short-term strategy. The incumbent stays on as CEO for another five years and blocks the firm from implementing the new technology that the CEO cannot understand and that would require the CEO to step aside if implemented.

Without loyalty shares, however, the CEO *would* have had strong reason to go long term because if the CEO did not, then the other shareholders would have the votes to replace him or her. Loyalty shares in plausible and common circumstances diminish long-term investing.

To better see the details why: Posit that the new technology will make the firm worth $390 overall, $90 more than the short-term strategy. Without loyalty shares, the controller would have had only one-third of the votes, not enough to entrench his or her control and not enough to get the extra private $60 benefit.[26] The controller would get only $100 from the short-term strategy (from 1/3 x $300) but could boost his or her direct take to $130 (from 1/3 x $390) from adopting the new long-term technology. The outside stockholders, with two-thirds of the votes in the one-share, one-vote firm would incentivize the company's board to adopt the new technology, replacing the CEO-stockholder if necessary.[27]

Table 1. Loyalty shares induce a controlling CEO to go *short*-term

	Company value	CEO's voting power	CEO's cash rights	CEO's value from the firm
Control with loyalty shares, yielding incentives to go short-term				
A. Long-term strategy	$390	1/2	1/3	$130, from (1/3x$390)
B. **Short-term strategy**	$300	1/2	1/3	**$140**, from $60 (in benefits extracted from the $300 firm) + (1/3x$240)
No loyalty shares: one-share, one-vote without control; incentives are to go long-term				
C. **Long-term strategy**	$390	1/3	1/3	**$130**, from (1/3x$390)
D. Short-term strategy	$300	1/3	1/3	$100, from (1/3x$300)
No loyalty shares: control via 50% ownership with one-share, one-vote; incentives are still to go long-term				
E. **Long-term strategy**	$390	1/2	1/2	**$195**, from (1/2x$390)
F. Short-term strategy	$300	1/2	1/2	$180, from $60 (in benefits extracted from the $300 firm) + (1/2x$240)

[26] Sometimes one-third of the votes is enough to entrench, sometimes it is not; in this hypothetical we have one-third as insufficient for control and one-half as sufficient.

[27] Again, a more realistic example would be phrased in terms of probabilities: the firm without a loyalty-share controller would be more likely to go long term than a firm with a one-third shareholder/CEO with loyalty-share control worth $140 to the controller.

The controller uses its extra loyalty share votes to shift value to itself. It cannot do so under one-share, one-vote rules without buying more stock; but after buying more stock, the controller has less incentive to degrade company value. This capacity to take value from outside shareholders is in row B. The overall value of the company is less with loyalty shares ($300 instead of $390) because the controller enjoys the slack at the expense of the company's long-run value, but the controller with the voting boost gets a bigger fraction of that value, from the controller's ability to divert $60 in value to itself, as in row B. For the controller, this short-term strategy is more valuable than the long-term strategy with loyalty shares in row A and more valuable to the controller than the one-share, one-vote strategies in the next rows. If loyalty shares were unavailable and the firm had a one-share, one-vote structure, the controller's best strategy would be C, the long-term strategy. Hence, loyalty shares allow the controller with the voting boost to get *more* value with the *short-term* strategy. This plausible result contradicts the consensus view that time-phased voting with loyalty shares promotes long-term investing. It is not a necessary result, but it is a logically plausible result for some, perhaps many, loyalty-share companies.

Table 1 summarizes the scenario: loyalty shares, in realistic circumstances, lock in the *short* term and deter the long run, the *contrary* of what loyalty shares' supporters aim to accomplish. Rows A and B summarize the incentives with loyalty shares: the controller-CEO goes short term because the controller thereby obtains $140 overall from the company in delaying the best long-term strategy (that short-term $140 is more than the $130 that he or she would get from going long term—a strategy that would lead the CEO to, in effect, resign). If the firm had a one-share, one-vote structure, the controller would go with the strategy shown in row C, the *long*-term strategy. The controller might prefer the short-term strategy with extracted benefits but lacks the voting power to obtain those benefits.

If the CEO *lacks* loyalty-share control, he or she (1) cannot extract the same level of short-term private benefits and (2) can less effectively sidetrack the outside shareholders, because they have two-thirds of the votes.

While controllers could prefer a long-term, profitable strategy that other stockholders reject, loyalty shares could in principle also—as Table 1 shows—*undermine* the long term, contrary to the conventional wisdom.

B. The Potential Big Vote Winner from Loyalty Shares: Index Funds

Shareholding in the United States is dispersed, with most public firms lacking a controlling shareholder. The big new American corporate governance player (at least as to its potential power) is the index fund. These are investment funds that own a balanced portfolio of the entire stock market for the long term. At the end of 2018, indexed, passive investment funds—the biggest of which were BlackRock, Vanguard, and State Street—owned about 20 percent of the stock market—a portion that has been rising and is expected to continue rising further.[28] These big three indexers are

[28] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 721 (2019); John C. Coates, *The Future of Corporate Governance, Part I: The Problem of Twelve* 13 (Harv. Pub. L. Working Paper No. 19–07, Mar. 14, 2019), https://ssrn.com/abstract=3247337; *see also* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and*

collectively the largest owner in nearly all of the 500 largest public companies.[29]

These indexed investors buy and sell stock infrequently—only when they need to balance their holdings to the index or because of inflows and outflows of investors into the funds. Hence, they would automatically qualify for the loyalty-share voting boost in an evenhanded set-up for loyalty-vote bonuses. But since they are generally passive in corporate governance and primarily focused on keeping their fees and expenses ultra-low,[30] it is unclear what impact their enhanced votes will have on the corporate time horizon.[31] They might have no impact. Below in Part IV we examine this issue further.

C. The First Big Loser: Longer-Term Outside Blockholders

Much academic analysis puts information asymmetries as the biggest real reason for short-termism: small shareholders will not invest in understanding their company's complex long-term technological characteristics.[32] Active long-term blockholders ameliorate the problem, because they can spread the cost of acquiring and evaluating information about the company over a large investment. Would loyalty shares induce more such blockholding *by dedicated owners*?

Loyalty shares would *reduce* the number of dedicated outside blockholders, thereby degrading information flow on complex, proprietary,

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New Financial Risk, 19 BUS. & POL. 298, 302, 313 (2017). The $4 trillion passively managed stock in mutual funds exceeds the size of the hedge fund industry. *Id*. at 303.

[29] *Id*. at 313.

[30] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP.. L. 493, 494 (2018); *see generally* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019); Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV.. 803 (2018).

[31] The text assumes that index funds, because they own their shares semi-permanently, will obtain the extra votes. However, the designers of the loyalty system could impede that result. If, say, the shares need to be registered with the issuer, but the index funds do not wish to register the shares because they prefer to use the shares for financial operations—such as lending the shares for a fee to investors that need the shares temporarily for other purposes (which is a common and profitable practice for funds), then they would not be big vote winners. *See* Jesse Blocher & Robert E. Whaley, *Two-Sided Markets in Asset Management: Exchange-Traded Funds and Securities Lending* 1 (Vanderbilt Owen Graduate Sch. of Mgmt. Res. Paper No. 2474904, Sept. 28, 2016), https://ssrn.com/abstract= 2474904; Dawn Lim, *How Investing Giants Gave Away Voting Power Ahead of a Shareholder Fight*, WALL ST. J. (June 10, 2020), https://www.wsj.com/articles/how-investing-giants-gave-away-voting-power-ahead-of-a-shareholder-fight-11591793863 (reporting that, a few weeks before a proxy fight at Game-Stop, the three largest asset managers of the target company held 40 percent of the stock, but "when it was time to commit to voting, they controlled roughly 5 percent of ballots [as they] chose to loan out substantial GameStop shares for the rich stream of fees their investors stood to gain"). The European experience, discussed in Part IV, shows organizers *impeding* institutional investors from obtaining loyalty share bonus votes.

[32] *See* Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2485 (2009); Mark J. Roe, STRONG MANAGERS, WEAK OWNERS 240–47 (1994); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firm: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989).

and subtle aspects of the company's future business, and thereby damaging public company long-termism. The next paragraphs explain how.

Loyalty shares would make an outside investor who was considering buying a large percentage of the company's stock hesitate from buying. That investor would not get loyalty-share extra votes when it invests, making its own vote underweighted and diluted for two or more years. That would mean, first, that the investor would be less influential than its financial investment would warrant and, second, that it would have to sit for two or more years with prior investors who would have more weight in electing the board and running the company. The new investor would not acquire voting parity with the existing loyalty voters until the loyalty-share waiting period passed—two years in the typical formulation and as much as ten years under the American Long-Term Stock Exchange original proposal for loyalty shares.[33] Loyalty shares thus structured would thereby discourage outsider blockholder investments.[34]

Bottom-line: the loyalty-share structure would discourage the type of longer-term blockholders most likely to mitigate or reverse any stock-market driven short-termism due to poor transmission of complex information from inside the firm to its shareholders. Loyalty shares will lock in old, existing blockholding, and will deter new adaptive blocks.

D. The Second Big Loser: Shareholder Activists

Activist investing is controversial, with proponents bringing forward evidence that it enhances[35]—and detractors bringing forward evidence that it diminishes[36]— long-term performance. Loyalty shares will lower activists' direct voting power and thereby reduce activism. If one dislikes activists' time horizons, then diminishing their voting power is good. If the activists are valuable for corporate change, then loyalty shares will harm the corporation and its long-term prospects.

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[33] *See* Investors Exchange LLC, Proposed LTSE Listings Rule 14A.413(b) (Form 19b-4(e)) (Mar. 19, 2018).

[34] Dennis K. Berman, *Seeking a Cure for Raging Corporate Activism*, WALL ST. J. (Mar. 17, 2015), https://www.wsj.com/articles/seeking-a-cure-for-raging-corporate-activism-1426620893 (time-phased voting "may scare off investors, such as Warren Buffett, who want to buy a large position but won't accept worse voting rights").

[35] *E.g.*, Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Funds Activism*, 115 COLUM. L. REV. 1085, 1090 (2015); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (hedge fund activism is valuable to shareholders).

[36] *E.g.*, Martijn Cremers, Ankur Pareek & Zacharias Sautner, *Short-Term Investors, Long-Term In- vestments, and Firm Value: Evidence from Russell 2000 Index Inclusions*, 66 MGMT. SCI. 447 (2020); Martin Lipton, *Empiricism and Experience; Activism and Short-Termism; the Real World of Business*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 28, 2013), http://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/.

First, the activists' direct voting power will be weakened (as compared to a one-share, one-vote regime), because existing insiders and longer-term holders will have more voting power from their loyalty-share voting boost. Second, the new activist blockholders will need to wait, typically two years, before they can match the incumbent controllers in voting strength.

Activists' power to influence also comes from building alliances with existing shareholders. For example, in a company with no blockholders but with many index funds with double votes and a management that has drifted away from the corporate long term, the potential activist's calculations would be more complex. The activist would need votes from indexed investment funds and other long-term holders[37] who are generally, but not always, passive in corporate governance and often support management.[38] In an even-handed set-up, loyalty shares will increase the indexers' direct voting power and decrease the activists' power, weakening the latter's relative voting weight. Loyalty shares would thereby increase the activists' need for index and passive investors' support. To the extent that the activists depended on their own votes, they would become less active than before, because their own vote would be diluted (for two years) relative to those with the voting bonus.[39]

If loyalty-share promoters primarily seek to weaken activists, they are likely to succeed in doing so. If activists are usually short-term-oriented, a disputed proposition,[40] then loyalty shares would indeed reduce short-termism by reducing the activists' influence and their incentives to act. If weakening activists is not loyalty shares' primary purpose, then other loyalty-share designs would now be part of the discussion. For example, the voting bonus could come if the buyer assures that it will not sell the stock during the loyalty period. Such assurance could come via lock-ups, which are common corporate mechanisms, or via governing rules that levy a stinging fine (say, 10 percent of the value of the stock), if the assurer did not retain the stock for the loyalty vesting period. The fact that such ideas are not on the table, when the anti-activist impact of loyalty shares is apparent, could suggest an anti-activist purpose.

Thus, whether this loyalty-share shift in power would overall increase, decrease, or leave activist efforts unchanged is in the abstract indeterminate.

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[37] *See* 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, 867 (2013). *See also* Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 REV. FIN. STUD. 2720 (2019); Berman, *supra* note 34 (as Edward Rock states, "The short-term votes have to convince the long-term votes to agree.").

[38] *See* Jill E. Fisch, *The Uncertain Stewardship Potential of Index Funds*, *in* GLOBAL SHAREHOLDER STEWARDSHIP (Dionysia Katelouzou & Dan W. Puchniak eds., forthcoming)

[39] Below we discuss indexer-activist alliances. *See* Part VI.

[40] *Compare* Cremers, Pareek & Sautner, *supra* note 36, *with* Brav, Jiang, Partnoy & Thomas, *supra* note 35, *and* Bebchuk, Brav & Jiang, *supra* note 35.

III. LOYALTY SHARES' LIMITED CAPACITY TO LENGTHEN THE CORPORATE INVESTMENT HORIZON

As just discussed, the incentives of outside activists and blockholders to acquire blocks would diminish in a company using loyalty shares. But there is yet more uncertainty as to loyalty shares' impact on the corporate time horizon. Loyalty shares may get more votes for longer-term shareholdings, but if these longer-term shareholders are passive and inactive—and persist as passive and inactive when they have more votes—the result would not encourage corporate longer-term behavior. For example, to the extent that the problem to combat is how short-term stock price affects executive compensation, which in turn affects executives' time horizons, the intuition that loyalty shares will encourage a longer horizon is questionable and likely incorrect. To the extent that it is wide, rapid trading that in and of itself encourages short-termism, the passive, inactive (in corporate governance) shareholder is unlikely to give up trading in return for extra votes that it does not value. That purported propellant of short-term behavior would persist. We explicate further in the sections that follow.

A. Time Displacement: More Uncertainty

What counts for motivating a shareholder to think long term is not how long it has *already* held the stock, but how long it plans to hold the stock *after* the vote that determines the company's board, its management, and its direction.[41] It is the *forward* time period that determines the stockholder's time horizon, yet it is the *backward*-looking holding period that determines whether the voting power gets pumped up. Loyalty-share voting boosts may not, as a matter of logic, go to longer-term shareholders.

The loyalty-share program could thus backfire. If the two-year shareholder gets extra votes but plans to sell tomorrow, after the corporate vote today, then *the loyalty bonus gives more votes to a short-term shareholder*. And if a shareholder is settling in with plans to hold onto its own new stock for at least two years, then it still gets only one vote today; the new investor intends to be a long-term shareholder, but its vote is diluted for two years, until it gets its voting bonus. Although many of those who have owned for two years are likely to own for another two years, not all will; and, in contrast, those who bought yesterday include those who expect to hold for two years. Loyalty-share programs therefore do not accurately categorize long-term and short-term investor horizons *at the time when the investors vote*. They set up an imprecise tendency, not a hard certainty.

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[41] *See* Colin P. Mayer, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT 208 (2013).

B. Their Impact on Rapid Trading and Executive Compensation

Some corporate critics worry that volatile stock prices induce volatile corporate decision-making. Excessively rapid trading pulls executives' time horizons toward the traders' short horizons, often via executives' compensation. If compensation is tied to immediate stock price, then executives will seek short-term business results, it is said, to keep prices high and thereby keep their compensation high.

But the stock will still trade and its price will fluctuate. The traders who forsake the loyalty-voting bonus will still make for a fluctuating price for the stock, as will loyal shareholders who buy more or who give up their loyalty-voting bonus when they sell. Executive compensation tied to stock price will still give executives the motivation to pay attention to their stock's price.

True, loyalty shares may induce the *volume* of trading to decrease (if some shareholders want to keep or get their extra votes and hence trade less often), but with or without loyalty shares, the corporation's stock price will rise, fall, and affect stock-based executive compensation. Moreover, *longer-term* shareholders do sometimes trade their stock. Loyalty shares, if they have their promoters' intended effect, will incentivize those long-term shareholders to trade even less frequently; hence, *they will contribute less* to the stock's current price. In contrast, the purportedly erratic short-termers will trade and contribute relatively more to the stock's price and influence management.

C. The Persistence of Shareholder Free-Riding as Reducing Loyalty Shares' Impact

Loyalty-share proponents expect that the loyalty-share voting bonus will induce more shareholders to hold for the longer term and that these longer-term shareholders' corporate governance engagement will be beneficial.[42] There are good reasons to doubt that either of these two channels will be powerful.

1. More long-term shareholding? Ordinary shareholders have little reason to hold stock longer to get more votes. With or without the voting boost, their stake is small and their corporate governance power weak. Many institutional shareholders consider corporate voting a burden, not a benefit. Hence, loyalty shares incentivize longer-term holding less than its proponents posit.

[42] *E.g.*, François Belot, Edith Ginglinger & Laura T. Starks, *Encouraging Long-Term Shareholders: The Effects of Loyalty Shares with Double Voting Rights* 9 (U. Paris-Dauphine Res. Paper No. 3475429, Oct. 29, 2019), www.ssrn.com/abstract=3475429.

2. More long-term corporate orientation? The overall concept is that executives' horizons will match shareholders' horizons. If more shareholders, with more votes, hold for the longer term, the thinking runs, then executives' time horizons will also lengthen.

There is something to be said for that intuition *if* these long-term shareholders are powerfully involved in their firms' corporate governance. But most shareholders have too small a holding to be actively involved with the firms in which they invest. This free-rider problem is central to the public corporation's incentive structure, sharply weakens the incentives of typical shareholders to have ongoing input into corporate governance, *and loyalty shares will not alter these basic free-riding incentives*.

As a consequence, the basic logic of the loyalty-share program—longer-term owners will be better longer-term stewards—is faulty. Those with a small percentage of stock will typically be passive, regardless of how many votes they have, and extra votes will not induce smaller holdings to be held longer. Why not? Because the extra votes are valuable to those involved in corporate governance; but most shareholders free ride and are not involved in corporate governance. Hence, they will not find the voting bonus an attraction that will make them trade less.

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Thus, loyalty shares could increase long-termism or decrease it. Or make no difference at all.

We have limited experience with loyalty shares in the United States. Thus, we look next at how loyalty shares have played out in Europe. The European experience is not dispositive for what would happen in the United States, but it provides material evidence to examine whether results there parallel the foregoing incentive-based analysis for the United States.

IV. WHO WINS AND WHO LOSES IN EUROPE?

Controlling families and the government are the immediate beneficiaries of loyalty-share plans in Europe. These two beneficiaries sought loyalty shares to solidify their control of enterprises, and foreign investors found their shareholding diluted. Strong evidence for greater long-term orientation is absent, with some evidence even to the contrary.

A. The French Florange Law

More than half of the 104 most frequently traded French companies adopted loyalty shares by 2014.[43] Of the half that adopted them, nearly half of those had a controlling shareholder.[44] Family-controlled companies were the heaviest users of loyalty shares, with twenty-eight out of thirty-five family-controlled firms (80 percent) using them.[45]

Loyalty shares were somewhat less common in widely-held companies, with eleven out of nineteen companies with dispersed ownership (57 percent, as compared to 80 percent) adopting them.[46] However, in seven of the eleven adopting companies that are classified as dispersed, employees held significant stakes. The loyalty-voting boost enhanced the insider-employees' votes beyond their investment, making them the first shareholder by number of votes. Hence, for seven of the eleven, the loyalty shares boosted the votes of insiders—here, employee-insiders—and not those of financial investors.

Other research found that among the French dispersed-ownership firms using loyalty shares only 9.5 percent of the overall shares received the additional vote, while those companies with controlling shareholders had the loyalty-share vote boosting about four times as many shareholder votes, or 36 percent.[47] Overall, loyalty shares are used less widely and less intensely in firms with dispersed ownership than they are used in firms with a controlling shareholder.

The 2014 Florange law made loyalty shares the default voting structure for French public companies. If a company's shareholders did nothing, the company was thereafter ruled by loyalty-share voting. Shareholders could change this default rule by a two-thirds vote. When the law was being considered, outside investors generally opposed making loyalty shares the default provision, for fear that it would enhance the voting power of the French government, of unions with share ownership, and of other controlling

[43] Becht, Kamisarenka & Pajuste, *supra* note 5, at 477 (59 of 104).

[44] *Id*. at 490 tbl. 8 (28).

[45] *Id*. Other researchers, with differing samples, find a similar disjunction: controlled firms use loyalty shares more frequently than diffusely owned firms. *See* Belot, Ginglinger & Starks, *supra* note 42, at 14 (using a sample of 455 pre-Florange French firms, the authors found that "[t]he majority of the firms granting double voting rights (62 percent) are family firms, i.e.[,] closely held firms. In contrast, 37 percent of the firms with the one share–one vote structure are family firms").

[46] *Id*. And for French IPOs between 2010 and 2018, 70 percent of the family-owned firms used loyalty shares while fewer, 42 percent, of the venture-capital-controlled firms used loyalty shares. *Id*. at 479–80. The other ownership categories are companies controlled by other corporations (9 out of 23, or 39 percent used loyalty shares), financial firms (8 out of 15, or 53 percent), and firms con- trolled by the French state (3 out of 12, or 25 percent). *Id*.

[47] Christoph van der Elst, *Do Loyalty Shares Affect the Engagement of Shareholders? A Study of the French CAC-40 Companies*, 2 INT. J. FIN. SERVS. 33, 37 tbl. 1 (2017). France readily allows loyalty shares, but the voting bonus can only double the vote.

shareholders—all at the outside investors' expense.[48] But outside investors lost and the law was enacted. It is plausible to hypothesize that the law's proponents were not primarily concerned with short-termism, other than to delegitimize the prevailing ownership arrangements, but were rather most interested in promoting state and union authority inside large French companies.

Index funds, which would regularly hold shares for the requisite two-year loyalty period and thereby get the bonus votes, found the requisite registration and compliance mechanisms cumbersome and sometimes impossible.[49] A major international investor complained that "[i]n most cases*, only domestic shareholders* can effectively be granted [the loyalty-share bonus]"[50] because the law requires that the shares be registered with the company in the investor's name in order to get the double votes.[51] But foreign investors typically own their stock through intermediaries and cannot structurally register their stock directly with the company.[52] This impediment to outside investors was not an oversight; it was intended.[53] Quite plausibly, part of the law's goal was to reduce the power in French firms of foreign investors, with anti-short-termist rhetoric simply part of the justification.

1. The Florange law of 2014: loyalty shares as the default voting structure. "Florange" is the name of the town in France with key operations of ArcelorMittal—the world's largest steel producer. In 2012, ArcelorMittal

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48 Steve Johnson, '*Protectionist" French Law Alarms Investors*, FIN. TIMES (Feb. 22, 2015), https://www.ft.com/content/5f390b20-b839-11e4-b6a5-00144feab7de.

49 *Id*. (reporting that "LGIM, which holds just under 1 per cent of the French market through its index funds, was unable to register for double voting rights").

50 BLACKROCK, KEY CONSIDERATIONS IN THE DEBATE ON DIFFERENTIATED VOTING RIGHTS 2 (2015), www.blackrock.com/corporate/en-in/literature/whitepaper/blackrock-the-debate-on-differentiated-voting-rights.pdf (emphasis added); *see also* GEORGESON'S 2015 PROXY SEASON REVIEW UK, FRANCE, NETHERLANDS, SWITZERLAND 41 (2015), http://www.georgeson.com/uk/Documents/Georgeson%202015%20Proxy%20Season%20Review.pdf ("double voting rights . . . disadvantage many international and institutional investors, as they usually do not hold shares in registered form in the French market, and therefore will not receive double voting rights even if they have held the shares for two years").

51 In France, securities are held: (i) in "bearer" form by a financial intermediary, or (ii) in registered form recorded directly on the issuer's books or in the issuing company's accounts with an intermediary. Only shareholders holding their shares in registered form receive the additional loyalty share votes. *See* CODE DE COMMERCE [C. COM.] [FRENCH COMMERCIAL CODE] arts. L.228-1 & L.225-123.

52 Olivier de Guerre, *Les droits de vote double, un rejet des investisseurs étrangers ?* [*Double Voting Rights: Rejection of Foreign Investors?*], PHITRUST ENGAGEMENT ACTIONNARIAL (Oct. 31, 2014), http://engagementactionnarial.blogspot.com/2014/10 ("il sera très difficile . . . d'[]amener [les actionnaires minoritaires étrangers] à s'inscrire au nominatif" ["it will be very difficult to bring [foreign minority shareholder] to register"]). Olivier de Guerre is the Chairman of PhiTrust, a French asset management company; s*ee Analysis: Differentiated Voting Rights in Europe*, INST. S'HOLDER SERVS. (Jan. 23, 2015), www.issgovernance.com/analysis-differentiated-voting-rights-in-europe; BLACKROCK, *supra* note 50, at 2.

53 de Guerre, *supra* note 52 ("le gouvernement et les entreprises qui ont poussé à cette mesure avaient connaissance de ces points techniques, beaucoup d'investisseurs ou des chefs d'entreprises le leur ayant rappelé" ["the government and companies that pushed for the measure were aware of these technical points as many investors and heads of companies reminded them]").

closed two steel blast furnaces and dismissed workers, attracting viral French media attention[54] and a negative government reaction. The blast furnaces' closing became a presidential campaign issue in 2012 and the winning candidate, François Hollande, promised to act against such factories' closings. The Florange law, enacted after his election, was the result.

The law's default rule required all firms to use loyalty shares; firms that disliked the rule would have to opt out. Was the Florange law and its loyalty-share rule primarily motivated to induce longer-term thinking in the French firm or to protect incumbents, including controllers and favored labor sectors? To assess the likelihood that incumbent-protection was primary, consider the rest of the Florange statute, which had substantial anti-takeover, protect-the-incumbent qualities. That should open us to the hypothesis that its loyalty-share support was also motivated by anti-takeover, protect-the-incumbent considerations.

2. The rest of the Florange law. The Florange law was first and foremost an anti-takeover law. First, it ended the board neutrality principle that had governed French takeovers. Before the Florange law, French boards could not oppose takeovers, but after it, they could.[55] Second, it required that the offeror consult with the relevant unions before making any takeover offer,[56] and specified when a qualified expert had to evaluate the bidder's industrial, financial, and employment plans and their consequences prior to the offer.[57]

Third, the law required 1000-employee firms seeking to close a fifty-employee factory to market that factory as a going concern under the strict supervision of the firm's works council.[58] The works council was primarily

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[54] And foreign media attention as well: Kim Willsher, *French Minister Urges Steel-maker Arcelor- Mittal to Leave Country,* GUARDIAN (Nov. 26, 2012), https://www.theguardian.com/business/2012/nov/26/arcelormittal-france-steel-factory-closures; David Jolly & Nicola Clark, *Labor Dispute Pits France Against ArcelorMittal*, N.Y. TIMES (Nov. 27, 2012), https://www.nytimes.com/2012/11/28/business/global/labor-dispute-pits-france-against-arcelormittal.html.

[55] Loi 2014-384 du 29 mars 2014 visant à réconquérir l'ééconomie réelle [Law 2014-384 of March 29, 2014, to recapture the real economy] [hereinafter Florange Law] art. 10, amending CODE DE COMMERCE [C. COM.] [FRENCH COMMERCIAL CODE] art. L.233-32, JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Apr. 1, 2014, p. 6227 ("le directoire . . . peut prendre toute décision dont la mise en œuvre est susceptible de faire échouer l'offre . . . dans la limite de l'intérêt social de la société" [the board "may take any decision, the implementation of which could frustrate the bid, subject to . . . the limit[s] of the corporate purpose of the company"]).

[56] "Florange Law" art 8, amending CODE DU TRAVAIL [C. TRAV.] [FRENCH LABOR CODE] art. L.2323– 23 (2014).

[57] *Id.*; *Changes to French Takeover Rules*, ALLEN & OVERY, LLP (Apr. 1, 2014), www.allenovery.com/publications/en-gb/Pages/Changes-to-French-takeover-rules.aspx; *Securities Law in France: 9 Recent Legal Developments*, LATHAM & WATKINS, LLP (Jan. 28, 2015), https://m.lw.com/thoughtLeadership/LW-securities-law-developments-France.

[58] Profit-oriented managers would willingly sell the factory as a going concern if the price exceeded the value from shutting the factory down. To have an impact, the law would have had to induce firms to sell or continue operating *poorly* performing plants even if shut down was more valuable. This provision was declared

composed of representatives of the employees and the unions.[59] Under the Florange law, the works council would have three months to seek buyers. France's commercial courts could scrutinize the overall sale process and, if a court concluded that the selling firm's effort to find a buyer was insufficient, then the court could fine the company up to twenty times the minimum wage level for each employee laid off.[60]

Fourth, the loyalty-share-advocating Gallois Report to the French Prime Minister sought to mandate that there be four employees on the board of every French enterprise having 5,000 or more employees[61]—further suggesting labor protection as a prime motivation. Finally, and fifth, early versions of the Florange bill restricted double votes to French-based, or EU-based shareholders.[62] Foreign investors in one version, and non-EU investors in another, could never get loyalty votes under the original core default rule.

When the Florange law was passed, the French government opposed General Electric's proposed acquisition of the electricity generation assets of Alstrom, the huge French electrical company.[63] The government extended its veto power over foreign investments in energy, water supply, transportation, communication, and public health.[64] Protectionism was in the air and on the ground.

BlackRock, the huge investment firm, which manages some of the largest index funds, has sharply criticized short-termism in the United

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unconstitutional in early 2014. *See* Conseil Constitutionnel [CC] [Constitutional Court] decision No. 2014-692 DC art. 1, Mar. 27, 2014, JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Apr. 1, 2014, p. 6232.

59 *See* CODE DU TRAVAIL [C. TRAV.] [FRENCH LABOR CODE] arts. L.2324-1, -2 (2014) (Fr.).

60 *See* Proposition de Loi, Texte Adopté n. 309, 17 février 2014 [Law Proposal, text adopted No. 309, Feb. 17, 2014] art. 1, Assemblée Nationale [French Parliament] (2014), www.assemblee-nationale.fr/14/pdf/ta/ta0309.pdf.

61 LOUIS GALLOIS, RAPPORT AU PREMIER MINISTRE, PACTE POUR LA COMPÉTITIVITÉ DE L'INDUSTRIE FRANÇAISE [REPORT TO THE PRIME MINISTER, AGREEMENT FOR THE COMPETITIVENESS OF THE FRENCH ENTERPRISES] 21 (2012), www.ladocumentationfrancaise.fr/rapports-publics/124000591/index.shtml [the so-called Rapport Gallois]; Johnson, *supra* note 48.

62 *See* Proposition de Loi visant à redonner à l'économie réelle et à l'emploi industriel No. 1037 du 15 mai 2013 [Law Proposal to Restore Real Economy and Industrial Employment No. 1037, of May 15, 2013], Assemblée Nationale [French Parliament] art. 5-II (2013), http://www.assemblee-nationale.fr/14/propositions/pion1037.asp. The European Union bars members from discriminating against shareholders of other member states, but not against, say, American, Japanese, or Qatari shareholders. *See* Consolidated Version of the Treaty on the Functioning of the European Union, 2012 O.J. C 326/01, arts. 18, 56.

63 Eventually, General Electric acceded to enough French Government requests and the government approved the acquisition. *See* Michael Stothard, *France to Oppose GE's $13.5bn Alstom Deal*, FIN. TIMES (May 6, 2014), https://www.ft.com/content/c7529ff2-d4ad-11e3-8f77-00144feabdc0; Ted Mann & Inti Landauro, *GE Revises Alstom Bid to Woo Paris. New Proposal Offers Assurances of French Control but Less Cash*, WALL ST. J. (June 19, 2014), https://www.wsj.com/articles/general-electric-updates-its-alstom-offer-1403188225.

64 *See* Décret n° 2014-479 du 14 mai 2014 Relatif aux Investissements Etrangers Soumis à Autorisation Préalable [Decree 2014-479 of May 14, 2014, On Foreign Investments Subject to Prior Authorization], Journal Officiel de la République Française [J.O.] [Official Gazette of France], May 15, 2014, p. 8062; LATHAM & WATKINS, LLP, NEW FRENCH REGULATIONS TIGHTEN CONTROL ON FOREIGN INVESTMENTS (2014), https://www.lw.com/thoughtLeadership/New-French-Regs-Tighten-Control-on- Foreign-Investments.

States.[65] Yet it opposed the Florange law's loyalty-share efforts.[66] It concluded that the entrenchment channel would be too strong, allowing controllers to extract value more easily for themselves at the expense of outside shareholders.[67]

Thus, the motivations behind the law were to protect firms against takeovers, to protect French firms from foreign finance, and to protect the voting power inside the firm of politically favored incumbents, such as controlling shareholders, the state, and favored labor sectors. These were all means of protecting people with jobs from employment disruption.

3. Who benefited on-the-ground? In the big state-based firms, the French state's voting power was immediately and greatly boosted.[68]

The French state owned big blocks in seventy or more large firms,[69] and increasing the state's voting power was a major goal.[70] The boost facilitated the state's capacity to raise cash without raising taxes.[71] (Here's how: If the government owned 20 percent of Air France, then the Florange law doubled the state's votes, allowing it to sell half of its stock without losing any of its original voting power.)

The law allowed stockholders to stop the boost before it took effect, however. For a few major firms, such as Renault and Air France, the government feared that other investors would vote against loyalty shares, so it bought more stock to block outside investors from stripping out the double vote.[72] With its double vote protected, the state could then later sell some of its stock.

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[65] Larry Fink, Chairman & CEO, BlackRock, Letter Encouraging a Focus on Long-term Growth Strategies (Mar. 2014), www.blackrock.com/corporate/en-co/literature/publication/letter-to-corporates-fink-032114.pdf; Andrew Ross Sorkin, *BlackRock's Chief, Lawrence Fink, Urges Other C.E.O.s to Stop Being So Nice to Investors*, N.Y. TIMES (Apr. 13, 2015), https://www.nytimes.com/2015/04/14/business/dealbook/blackrocks-chief-laurence-fink-urges-other-ceos-to-stop-being-so-nice-to-investors.html.

[66] BLACKROCK, *supra* note 50.

[67] *Id*.

[68] Of the 104 widely traded firms, fifty-nine had loyalty shares and forty-five did not. Of these forty-five with loyalty shares, thirty-one opted out of the Florange Law default rule of double voting for loyalty shares. Of the remaining fourteen that the Florange law pushed into loyalty voting, six had the French state or other public entities as their main shareholder. Becht, Kamisarenka & Pajuste, *supra* note 5, at 480 tbl. 1.

[69] *L'Etat Ce´dera 5 a`10 Milliards d'Euros d'Actifs d'Ici a`2016* [The State Will Sell 5 to 10 Billion Euros in Assets by 2016], LE MONDE.FR (Oct. 15, 2014).

[70] Michael Stothard, *Florange Law Gives Paris the Upper Hand*, FIN. TIMES, Apr. 16, 2015, at 17.

[71] *Id*.

[72] Jean-Luc Gaffard & Maurizio Iacopetta, *On the Search to "Recapture the Industrial Spirit of Capitalism"—From Patient Shareholders to Shared Governance*, OBSERVATOIRE FRANÇAISE DES CONJONCTURES ÉCONOMIQUES ¶1 (June 2, 2015), www.ofce.sciences-po.fr/blog/search-recapture-industrial-spirit-capitalism-patient-shareholders-shared-governance; Anne-Sylvaine Chassany, *State Lifts Air France Stake to Win Vote*, FIN. TIMES (May 8, 2015), https://www.ft.com/content/f47f47ec-f56c-11e4-8c83-00144feab7de; *Short-term or Short-changed*, THE ECONOMIST, May 2, 2015, at 56.

The Florange law thus allowed the state "to increase its voting power . . . while permitting [it] both to sell stock and to maintain its influence."[73] The government justified its action as promoting the long term,[74] although management of both Renault and Air France opposed the government's actions.[75] Ironically enough, a few months after the law passed, the French government demanded cash from those companies—a request that a French government watchdog concluded worked to the "long-term detriment of the [underlying] businesses."[76]

In late 2014, Air France management sought to expand its low-cost unit. It planned to invest $1.3 billion over five years to buy fifty new aircraft and hire 250 new pilots[77] to face increasing competition by low-cost carriers. The airline's existing pilots opposed and went on strike. "However, [Air France] management finally cracked after coming under pressure from . . . the French government, its largest shareholder."[78] The loyalty-share voting bonus did not here bring short-termism under control. It was used to protect a favored labor sector, arguably to protect for a short while arrangements that have limited long-term staying power. It is plausible that the law aimed not so much to lengthen time horizons (other than in its rhetoric) but to empower the French state and to protect favored labor sectors. For these aspects, the law may well have been successful in the eyes of its supporters, even if it did not lengthen management's or stockholders' time horizons.

4. Impact. Loyalty shares bolster the large French stockholder's control, *not* the voting power of outside long-term investors.[79] During the 2015 to 2017 proxy seasons, nearly 100 controller-backed shareholder resolutions would have failed without the French controller's loyalty-share voting boost.[80]

The analytic data available from Marco Becht, Yuliya Kamisarenka, and Anete Pajuste shows that pre-Florange, higher quality firms adopted loyalty shares, but the researchers could not eliminate the possibility that the

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[73] Audrey Tonnelier, *Droits de Vote Double: Un Bon Calcul pour l'Etat* [Double Voting: A Good Bet for the State], LE MONDE ECONOMIE (Apr. 17, 2015).

[74] *Id.*

[75] *See* Chassany, *supra* note 72; Tonnelier, *supra* note 73 (the government expanded its block from "15 to 20% of Renault in order to impose its position [on loyalty shares], annoying the CEO, Carlos Ghosn").

[76] *See* Michael Stothard, *France: The Politics of State Ownership*, FIN. TIMES (Nov. 13, 2016), https://www.ft.com/content/9be75d5c-a72e-11e6-8898-79a99e2a4de6.

[77] Benjamin Zhang, *Why Air France's Pilots Are Striking and Costing the Airline $25 Million a Day*, BUS. INSIDER (Sept. 27, 2014), https://www.businessinsider.in/Heres-Why-Air-Frances-Pilots-Are-Striking-And-Costing-The-Airline-25-Million-A-Day/articleshow/43575081.cms.

[78] Geoffrey Smith, *Air France Buckles Under Pressure from Pilots, Government*, FORTUNE (Sept. 25, 2014), https://fortune.com/2014/09/25/air-france-buckles-under-pressure-from-pilots-government/.

[79] *See* Van der Elst, *supra* note 47, at 37; PROXINVEST, LES ASSEMBLÉES GÉNÉRALES DES SOCIÉTÉS COTÉES FRANÇAISES—SAISON 2017 29–31 (2017).

[80] *Id.*

better firms self-selected into loyalty shares (rather than that it was the loyalty shares that boosted quality).[81] After the Florange law made loyalty shares the default, however, one-share, one-vote firms that rejected the law's default transition to loyalty shares were *higher* quality businesses than those that proceeded with the law's switch to loyalty shares.[82] The majority of the latter were state-controlled firms.

Long-term foreign institutional investors in firms that acquiesced in the law's double voting (mostly for insiders) exited and the firms underperformed those that rejected loyalty shares in terms of stock performance.[83] In IPOs, firms using loyalty shares raised less money and were more likely to be family controlled than one-share, one-vote firms.[84]

Critics who seek to combat American short-termism hope that loyalty shares with reduced trading of shares will induce more long-term thinking and that this long-termism will lead to more future-focused research and development. But these sought-for consequences have not yet been found in the French firms adopting loyalty shares. Annual share turnover did not differ much for the adopting companies before and after the Florange reform—and the stockholders' average holding period shortened in state-controlled loyalty-share firms.[85] Similarly, French firms with loyalty shares did not differ in their R&D spending from one-share, one-vote firms.[86]

Thus, the overall impact: French loyalty shares facilitated insider and government control. Long-term benefits have yet to be seen.

B. Dutch Companies Adopting Loyalty Shares

Loyalty shares were first adopted in the Netherlands in 2013, when Fiat Industrial, an Italian truck-maker company, merged with its subsidiary CNH Global, creating the Dutch company CNH Industrial. Under the CNH arrangement, each shareholder registered in a special ledger was entitled to receive a non-tradeable "special voting share", without any economic rights, for each common share held for at least 3 years.[87] Additionally, shareholders

[81] The authors used Tobin's Q to measure quality. Tobin's Q is a standard but rough and disputed measure of firm quality, calculated from the ratio of stock value to underlying asset value. Firms whose stock is priced much higher than their underlying assets are thought to be better managed than firms whose ratio is lower.

[82] Becht, Kamisarenka & Pajuste, *supra* note 5, at 491.

[83] Thomas Bourveau, Francois Brochet & Alexandre Garel, The Capital Market Consequences of Tenure-Based Voting Rights: Evidence from the Florange Act (March. 30, 2021) (unpublished manuscript available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3324237). For a larger sample, including smaller firms, loyalty share opt-out decreased value, in contrast. Belot, Ginglinger & Starks, *supra* note 42, at 10.

[84] Becht, Kamisarenka & Pajuste, *supra* note 5, at 480.

[85] *Id*. at 489.

[86] Belot, Ginglinger & Starks, *supra* note 42, at 13. Leverage, another potential short-term problem, was not more pronounced in loyalty-share firms as well. *Id*.

[87] Also, under the CNH arrangement, the special voting shares cannot be traded and, as soon as loyal shareholders sell their common shares, the corresponding special voting shares are automatically transferred back

of merging entities were entitled to receive the special voting shares immediately after the merger without waiting the 3-year "loyalty period." No specific rules govern loyalty shares in the Netherlands.

Within a few months, CNH's sister company, the Italian automaker FIAT also moved to the Netherlands adopting a similar arrangement—precipitating, as we shall see in Section C, defensive action in the Italian Parliament.

However, the Italian reforms did not stop Italian companies from fleeing to the Netherlands. In 2016, EXOR the controlling company of CNH and FIAT reincorporated in the Netherlands to adopt an aggressive loyalty shares' structure, increasing the loyalty votes such that after ten years each share could have a total of 10 votes.

Then, in 2019, Mediaset, a company controlled by the former Italian Prime Minister Silvio Berlusconi, sought to move to the Netherlands, seeking to use loyalty shares that would triple the existing shareholders votes (as compared to newcomers) and boost their voting power to ten votes per share after five years.[88] According to Mediaset the "sole purpose of Special Voting Shares [was] to foster the development and continued involvement of a core base of long-term shareholders in a manner that reinforces the Company's stability."[89]

However, when the transaction was proposed, Mediaset and Mr. Berlusconi's holding company, Fininvest, were involved in disputes with Mediaset's second largest shareholder, Vivendi, which sought to stop the loyalty shares transaction.[90] The Amsterdam Enterprise Chamber initially rejected Vivendi's request of summary judgment. However, in September 2020, the Amsterdam Court of Appeal blocked the transaction, finding that that the loyalty scheme was designed to ensure absolute control of the post-transaction Dutch company by Fininvest, Berlusconi's company.[91]

Overall, between 2013 and 2020, five Italian companies reincorporated to the Netherlands to adopt loyalty shares structures (CNH, FIAT, Ferrari, EXOR and Campari). Interestingly, all these companies were family controlled, several belonging to the same business group.

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to the company at no consideration. See CNH INDUSTRIAL N.V. SPECIAL VOTING SHARES – TERMS AND CONDITIONS, https://www.cnhindustrial.com/en-us/investor_relations/stock_information/stock_information_documents/Special_Voting_Shares_Terms_and_Conditions_incl_annexes.pdf.

[88] See MFE—MEDIAFOREUROPE N.V. TERMS AND CONDITIONS FOR SPECIAL VOTING SHARES, https://www.mediaset.it/gruppomediaset/bin/67.$plit/Amended%20SVS%20T&Cs%20with%20attachments%20ENG.pdf.

[89] Id.

[90] One of the authors (Mr Cenzi Venezze) was counsel to Vivendi in the Vivendi-Mediaset litigation.

[91] Hof's-Amsterdam 1 september 2020, JOR 2020, 279 m.nt. van Leijten, (Vivendi S.E./Mediaset Investment N.V) (Neth.).

C. The Italian Experience

Loyalty shares became permissible in Italy in December 2014.[92] By May 2021, 68 of the approximately 230 companies[93] listed on Italy's main stock exchange had adopted loyalty-share bylaws. But the distribution of adopting firms suggests no major boost to the long term. Why? The best candidates for loyalty shares to combat short-termism are widely held companies because they are most susceptible to short-termism, in the conventional critics' story of excessive short-term trading and activism. But widely held companies were *not* the ones that jumped in Italy to use loyalty shares. Controlled companies were.

1. Background to the Double Voting Law. Cross-border competitive pressure on Italy to retain companies incorporated in Italy drove its loyalty-share reform of 2014.[94] As mentioned in Section B above, in 2013-2014 two major Italian listed companies reincorporated to the Netherlands and adopted a Dutch loyalty-share program,[95] which Italy did not then permit. The Italian parliament felt the competitive pressure and amended its corporate law to allow loyalty shares just a few months later.[96]

The spirit of the reform was competitiveness, with other provisions of the reform opening borrowing channels and granting tax credits for new investments. But critics also saw the law as allowing the Italian state to sell stock it owned in state-controlled companies without losing control and as helping insiders in private companies to lock in their control.[97] The law triggered strong media and lobbying backlash against what the media and critics said was an excessively insider-focused law.[98]

2. Concentrated owners, not widely-held companies, use loyalty shares. Ownership of Italian listed companies is typically concentrated. At

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[92] Consob, Delibera No. 19084 del 19 dicembre 2014 [Consob Resolution No. 19084, Dec. 19, 2014].

[93] *Societa` che hanno adottato il voto maggiorato* [*Listed Companies with Increased Voting Shares or Multiple-voting Shares*], CONSOB, www.consob.it/web/area-pubblica/quotate/main/emittenti/societa_quotate/voto_maggiorato_plurimo_lnk.htm?nav=true (last visited May. 25, 2021).

[94] *See* Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat* 114; ZEITSCHRIFT FÜR VERGLEICHENDE REICHSWISSENSCHAFT 192 (2015).

[95] Jeroen Delvoie & Carl Clottens, *Accountability and Short-termism: Some Notes on Loyalty Shares*,9 L. & FIN. MKT. REV. 19, 19 (2015). Belgium has authorized, and Spain is considering, loyalty shares.

[96] Decreto Legge No. 91, 24 giugno 2014 convertito con modificazioni dalla Legge No. 116, 11 agosto 2014 [Law Decree No. 91, June 24, 2014, converted with amendments into Law No. 116, Aug. 11, 2014].

[97] *See* Ventoruzzo, *supra* note 94 (loyalty shares "allow the Italian Treasury to sell [a] large amount of shares, cashing in the value of these corporations, without losing control"); Luigi Zingales, *Quel Voto Plurimo Cosı` Opaco* [*Multiple Vote Is Opaque*], IL SOLE 24 ORE (Aug. 1, 2015) (the state introduced loyalty shares which would allow it to "sell more shares without the risk of losing control").

[98] Alberto Alesina et al., *Il Voto Doppio e il Quorum Qualificato* [Double Voting and the Qualified Quorum], IL SOLE 24 ORE (Jan. 15, 2015).

year-end 2019, more than half were controlled by a single, majority shareholder, about another one-quarter had a controlling shareholder with a minority stake, and another 10 percent were controlled by group via a shareholders' agreement.[99] Only the largest firms tended to be widely-held or weakly-controlled.[100]

By December 2019, about one-quarter of the listed companies had loyalty share structures.[101] Nearly all of those had either a controlling shareholder or a coalition of investors bound by a shareholders' agreement. Most companies adopted loyalty shares when they were controlled by a single shareholder with 40 percent or more of the shares or when dominated similarly by an investor or a coalition of investors. Firms using loyalty shares were "family-controlled, small-sized industrial companies,"[102] *not* widely-held firms with no controller. But, again, it's widely-held firms are thought to be most susceptible to short-termism—meaning that the firms most susceptible to short-termism in conventional thinking were not using loyalty shares. It's controlling shareholders who obtain loyalty shares and who then can sell some shares while increasing their voting power. They tend not to use loyalty shares in transaction to raise money for further investment.[103]

Loyalty shares thus cemented insider control in Italy—*not* longer-term thinking in diffusely-held public companies.[104]

It is not easy in Italy, just as it has not been easy in France, for institutional investors to register their shares to obtain the voting bonus.[105] The Italian management company association concluded that the mechanics for registration *de facto* made loyalty shares unavailable in Italy to

[99] *Report on Corporate Governance of Italian Listed Companies 2020*, CONSOB 13 tbl. 1.2 (2021), https://www.consob.it/documents/46180/46181/rcg2020.pdf/023c1d9b-ac8b-49a8-b650-3a4ca2aca53a.

[100] *Id.*

[101] *Id.*

[102] *Report on Corporate Governance of Italian Listed Companies 2017*, CONSOB 8 (2018), www.consob.it/documents/46180/46181/rcg2017.pdf/7846a42b-1688-4f45-8437-40aceaa2b0e3. In the first Italian companies that adopted loyalty shares *after* their IPO, controlling shareholders grabbed the lion's share of loyalty votes.

[103] Emanuele Bajo, Massimiliano Barbi, Marco Bigelli & Ettore Croci, *Bolstering Family Control: Evidence from Loyalty Shares* 65 J. CORP. FIN. (2020) (forthcoming). *But see* Chiara Mio, Elise Soerger Zaro & Marco Fasan, *Are Loyalty Shares an Effective Antidote Against Short-termism? Empirical Evidence from Italy*, 29 BUS. STRATEGY & ENV. 1785, 1785 (2020) (finding evidence that Italian companies with loyalty-shares structures reduce earnings management, which the authors see as a proxy for corporate short-termism).

[104] Chiara Mosca examines the Italian loyalty-share system in depth and reaches a similar conclusion. Mosca, *supra* note 5.

[105] Shareholders wishing to receive loyalty shares in Italian companies need to register their shares in a special company-held ledger. Those shares cannot be traded or loaned out without notifying the issuer and losing the loyalty-voting bonus. *See* Article 127-quinquies, Decreto Legislativo n. 58, 24 febbraio 1998 [Legislative Decree No. 58, Feb. 24, 1998] (as amended by the Competitiveness Decree); Article 143-quater, Consob Resolution no. 11971 of May 14, 1999 (as amended); Article 43, Banca d'Italia/Consob Ruling, Feb. 22, 2008 (as amended).

institutional investors,[106] further suggesting that the motivation for facilitating loyalty shares was to bolster insiders, by using the excuse of combatting short-termism.

Institutional investors who excoriate short-termism in the United States opposed loyalty shares in Italy.[107] For example, when large shareholders of the huge, widely held Italian insurer, Assicurazioni Generali S.p.A., proposed loyalty shares for the company, BlackRock, a major American-based, worldwide investor, opposed using them.[108]

D. Loyalty Shares in Belgium

In 2019, Belgium adopted a new Companies Code and loyalty shares were one of its most debated innovations.[109]

The main goal of the reform was to increase the competitiveness of the Belgian economy by simplifying and incentivizing creation of new companies.[110] In this context, loyalty shares were introduced with the purpose of combating short-termism, promoting a long-term vision of the firm, and encouraging the listing of controlled companies, by making possible for their main shareholders to keep control after the IPO through the loyalty voting boost.[111]

However, some commenters claimed that loyalty shares also had the purpose of protecting Belgian listed companies against foreign takeovers and of allowing the State to sell shares in state-owned companies without losing

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[106] *Voto Maggiorato e Voto Plurimo: Un Vulnus al Principio One-Share One-Vote* [*Increased Voting and Multiple Voting: A Wound to the One-Share One-Vote Principle*], ASSOGESTIONI (Dec. 23, 2014), www.assogestioni.it/articolo/voto-maggiorato-e-voto-plurimo-un-vulnus-al-principio-di-one-share- one-vote.

[107] *See Proxy Voting Guidelines for European, Middle Eastern and African Securities*, BLACKROCK 9 (Jan. 2020), www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment- guidelines-emea.pdf; *2020 Guidelines Italy*, GLASS LEWIS 13, www.glasslewis.com/wp-content/uploads/ 2016/12/Guidelines_Italy.pdf (last visited Jan. 1, 2021) ("we will recommend shareholders vote against . . . such loyalty initiatives").

[108] *See Generali, per BlackRock il Voto Multiplo e`«Problematico»* [Generali: For BlackRock,Multi- ple Voting Is "Problematic"], IL SOLE24 ORE (May 26 2015).

[109] Hof's-Amsterdam, 1 september 2020, J.C.Rang (Vivendi S.E./Mediaset Investment N.V.) (Neth.), https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:GHAMS:2020:2379.

[110] To this end, the new Code, among others, reduced the number of corporate forms from 17 to 4, abolished the nominal capital in limited liability companies and introduced a limitation on directors' liability. See Christoph Van der Elst, *The New Belgian Companies Code: A Primer* (unpublished manuscript available at https://ssrn.com/abstract=3586278) (Mar. 1, 2020), http://dx.doi.org/10.2139/ssrn.3586278; Christiphe De Caevel, *Comment le nouveau Code des sociétés va bousculer l'économie belge* [How the new Company Code will shake up the Belgian economy], TRENDS-TENDANCES (Mar. 14, 2019).

[111] CHAMBRE DES REPRESENTANTS DE BELGIQUE, PROJET DE LOI INTRODUISANT LE CODE DES SOCIETES ET DES ASSOCIATIONS ET PORTANT DES DISPOSITIONS DIVERSES [CHAMBER OF REPRESENTATIVES OF BELGIUM, BILL INTRODUCING THE CODE OF COMPANIES AND ASSOCIATIONS AND CONTAINING VARIOUS PROVISIONS] 208 (June 4, 2018) https://www.senate.be/www/?MIval=/dossier&LEG=54&NR=3119&LANG=fr. [hereinafter, "First Draft of the Belgian Code"]

control.[112] Proxy advisors and institutional investors criticized the reform, claiming that it "adversely affect[s] minority, retail and institutional shareholder rights, who are less likely to register their shares."[113]

There is no data yet available on the adopting companies. However, some of the reform's features are consistent with the insiders' empowerment effect we saw for France and Italy.

First, loyalty voting rights are awarded to shareholders holding the shares in registered form for at least 24 months.[114] However, in Belgium, the waiting period starts when the shares are registered in the name of the relevant shareholder even if the company did not then have loyalty-share by-laws.[115] Hence, shareholders who held the stock in registered form for 24 months before the adoption of loyalty shares structures, would immediately receive the voting boost.

Second, loyalty shares votes are not considered for the purposes of the mandatory tender offer rule.[116] Therefore, shareholders exercising a weak and challengeable control over Belgian listed companies (e.g., a founder or family with a 20-25% stake), who may fear to be outvoted in case of proxy fights, can use loyalty shares to cement their control without having to launch the mandatory tender offer on all outstanding shares, which is normally triggered in Belgian companies when a shareholder passes the 30% voting threshold.

Third, while in Belgian listed companies, amending the by-laws normally requires a 75% majority, loyalty shares can be adopted in the by-laws with a smaller, two-thirds majority.[117]

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[112] Tom Vos, Are Loyalty Voting Rights Effective? Some Reflections on the Belgian Proposals, 13 July 2018, https://corporatefinancelab.org/2018/07/13/are-loyalty-votingrights-efficient/; Ariane Van Caloen, *Une loi qui pourrait donner trop de pouvoir à Albert Frère* [A law that could provide too much power to Albert Frère], LA LIBRE (May 26, 2018).

[113] *See* Deminor S.A.'s letter to the Belgian Chamber of Representatives and Minister of Justice of October 15, 2018 https://sgs.deminor.com/app/uploads/2018/10/Deminors-open-letter-Loyalty-shares-15-10-2018-signed-version.pdf; see also ICGN – International Corporate Governance Network's letter to the Belgian Chamber of Representatives and Minister of Justice of October 17, 2018, https://www.icgn.org/sites/default/files/22.%20Loyalty%20Shares%20for%20Belgian%20listed%20companies_0.pdf (arguing that the proposed loyalty-shares legislation could have affected "negatively institutional investor perception of the entire Belgian market"). Deminor is a Belgian consultancy firm specialized in corporate governance. ICGN is an international organization lead by pension funds, asset management firms, public listed companies and professional advisory firms.

[114] *See* CODE DES SOCIÉTÉS ET DES ASSOCIATIONS [Belgian Code of Companies and Associations] art. 7:53.

[115] *Id.*

[116] LOI DU 1° AVRIL 2007 RELATIVE AUX OFFRES PUBLIQUES D'ACQUISITION [LAW OF APRIL 1ST, 2007 ON MANDATORY TENDER OFFERS], M.B., APRIL 1, 2007, art. 5, par.5.

[117] *See* CODE DES SOCIÉTÉS ET DES ASSOCIATIONS [BELGIAN CODE OF COMPANIES AND ASSOCIATIONS], art. 7:53.

E. Loyalty Shares in Spain

The Spanish Parliament implemented the EU Shareholder Rights Directive II and authorized loyalty shares in March 2021.[118] The legislature justified loyalty shares as in furtherance of the EU directive,[119] explaining in the accompanying report that loyalty shares can "encourage shareholders to maintain their investment in the company in the long term and reduce short-term pressures on companies' management."[120]

Not everyone, however, shared this positive view of loyalty shares. Institutional investors and proxy advisors criticized the loyalty share proposal in 2019, fearing that in Spain, which had "a large number of companies with a concentrated shareholder structure[, . . .] control could be further cemented at the expense of minority shareholders." [121] The Bank of Spain opposed the loyalty share proposal.[122]

Spanish loyalty shares' structure resembles the Italian one. Shareholders interested in receiving "loyalty votes" need to register in a special ledger and wait for at least 24 months before receiving one additional vote for each share registered.[123]

However, institutional investors' backlash proved more effective in Spain than elsewhere. The reform added an automatic sunset of loyalty shares structures effective after five years from their introduction.[124] After five years, the loyalty-share bylaws automatically switch to one-share, one-vote,

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[118] DIRECTIVE (EU) 2017/828, OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 17 MAY 2017 AMENDING DIRECTIVE 2007/36/EC, 2017, O.J. (L 132) [hereinafter Shareholder Rights Directive II].

[119] See Section F below.

[120] LAW 5/2021, OF APRIL 12, Preamble (B.O.E. 2021, 5773).

[121] *See* Glass Lewis, Response to the Spanish consultation on the proposed changes to Spanish Companies Law which transposes Shareholder Rights Directive II of June 13, 2019, www.glasslewis.com/wp-content/uploads/2019/06/Glass_Lewis_Consultation_Spanish_Loyalty_Shares.pdf; ICGN—International Corporate Governance Network's letter to the Spanish Minister of Economy and Enterprises and the Spanish Government of October 17, 2018, www.icgn.org/sites/default/files/Loyalty%20Shares%20for%20Spanish%20Listed%20Companies%2C%20Spain%2C%20June%202019.pdf.

[122] In the public consultation launched before the approval of the reform, loyalty shares proved to be highly controversial. While the Spanish Securities Market Commission (CNMV) supported the new provisions, the Bank of Spain opposed them, mentioning the reservations already expressed by European Banking Authority that in the case of banks "increased voting rights for loyalty shares […] may create issues in the context of recapitalisation and governance." *See* Europa Press, La CNMV defiende las acciones de lealtad, pero el Banco de España advierte de sus inconvenientes [The CNMV defends loyalty shares but the Bank of Spain warns of its disadvantages], EUROPA PRESS, Jul. 19, 2020, www.europapress.es/economia/finanzas-00340/noticia-cnmv-defiende-acciones-lealtad-banco-espana-advierte-inconvenientes-20200719121138.html; EBA REPORT ON THE MONITORING OF CET1 INSTRUMENTS ISSUED BY EU INSTITUTIONS—SECOND UPDATE, 27, https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2551996/51a39b9d-a68d-476a-b2c6-e2c21527a05f/EBA%20Report%20on%20the%20monitoring%20of%20CET1%20instruments%20issued%20by%20EU%20Institutions.pdf?retry=1

[123] LEY DE SOCIEDADES DE CAPITAL [SPANISH CAPITAL COMPANIES LAW], art. 527-ter.

[124] Id art. 527-sexies.

unless a new shareholder resolution approves a continuation of loyalty shares for an additional five years.[125]

Further, while loyalty shares adoptions require a 60% majority (with a 50% quorum, otherwise a 75% majority), their removal could be passed with a simple voting majority and after ten years from their introduction loyalty shares will not grant double voting when shareholders vote on resolutions aimed at removing them.[126]

F. EU Proposals on Loyalty Shares

European institutions have long debated but not yet approved provisions on loyalty-share programs. In 2011 the "Reflection Group on the Future of EU Company Law" proposed to make available loyalty shares in all Member states "to favour long term share ownership and shareholder commitment". [127]

Negative undertow came from a view that loyalty shares would tend to entrench control.[128] The EU Commission's first draft of the Shareholder

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[125] In the US, institutional investors and academics have promoted sunset provisions in companies with dual class voting stock to reduce insiders' entrenchment. The Council of Institutional Investors even requested the NYSE and Nasdaq to amend their listing standards and refuse listing companies with dual class voting stock without sunset provisions, which convert the multiple voting shares into single voting shares within seven years from the IPO. *See* among others, Letter from Ash Williams, Chair, Ken Bertsch, Executive Director, Jeff Mahoney, General Counsel, Council of Inst. Inv'rs, to the Intercontinental Exchange Inc. (Oct. 24, 2018), www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf; Letter from Ash Williams, Chair, Ken Bertsch, Executive Director, Jeff Mahoney, General Counsel, Council of Inst. Inv'rs, to NASDAQ Stock Market (Oct. 24, 2018), www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf. Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017); Jackson, Jr., SEC Comm'r, Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018), www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporateroyalty#_ftn19.

[126] LEY DE SOCIEDADES DE CAPITAL [SPANISH CAPITAL COMPANIES LAW], Art. 527-quater.

[127] See Report of the Reflection Group on the Future of EU Company Law 46–47 (Apr. 5, 2011), https://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf (seeking EU-wide authorization of differential voting rights); EUROPEAN COMMON, ACTION PLAN: EUROPEAN COMPANY LAW AND CORPORATE GOVERNANCE—A MODERN LEGAL FRAMEWORK FOR MORE ENGAGED SHAREHOLDERS AND SUSTAINABLE COMPANIES (Dec. 12, 2012), http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0740 &from=EN. *See also* Delvoie & Clottens, *supra* note 95, at 23; José Engrácia Antunes et al., *Response to the European Commission's Action Plan on Company Law and Corporate Governance by the former Reflection Group on the Future of EU Company Law,* 10 EUR. COMP. FIN. L. REV. 304, 316 (2013).

[128] SUMMARY RESPONSES TO COMMISSION GREEN PAPER ON LONG-TERM FINANCING OF THE EUROPEAN ECONOMY 17 (Jan. 2014).

Rights Directive II and, after some debate,[129] the directive's final version each lack a statement on loyalty shares.[130]

More recently, in July 2020 a study of Ernst and Young for the European Commission on corporate short termism and "sustainable corporate governance" proposed requiring all members states to make available loyalty shares. [131] Following the EY Report, in October 2020, the European Commission, included in its "Work Programme 2021," "legislation on sustainable corporate governance … to foster long-term sustainable and responsible corporate behavior."[132] And in December 2020, the European Parliament called the European Commission to consider loyalty shares to "promote sustainable returns and the long-term performances of companies."[133]

The link between long term planning and corporate sustainability may seem evident to many. However, as one of the authors discussed in a reply to the consultation launched by the European Commission following the publication of the EY Report, while the debate on corporate short-termism is based on time-horizon issues, sustainability concerns externalities created by corporations, such as pollution and disruption of local communities. The two problems are not tightly linked and may even conflict one with another. Mining companies may have long term strategies to extract materials in unexplored and/or still unreachable areas, and may want to invest in long-term exploration and incur large R&D expenses, seeking to generate long-term profits. But that long-term shareholder value enhancing strategy can

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[129] Cf. DRAFT REPORT OF THE COMMITTEE OF LEGAL AFFAIRS OF THE EUROPEAN PARLIAMENT OF 19 DECEMBER 2014 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, COM (2014) 0213 – C8-0147/2014 – 2014/0121(COD), (Rapporteur SG Cofferati).

[130] Directive (EU) 2017/828, of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC, 2017, O.J. (L 132)

[131] According to the EY Report, loyalty would promote "a more stable and long-term shareholder base [and] corporate boards would be less pressured to focus on strategies to improve short-term market valuation and have more room to focus on more sustainable choices for resource allocation that might pay-off in the long-run and contribute to keeping the company productive, innovative, profitable and attractive in the long term, with possible positive consequences in terms of (long-term) shareholder value and employee satisfaction". *See* ERNST & YOUNG, STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE: FINAL REPORT, 88-89 (2020), https://op.europa.eu/it/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-de. [hereinafter the "EY Report"]. For a critical view of the EY Report, see Roe, Spamann, Fried and Wang, *supra* note 16.

[132] EUROPEAN COMMISSION, COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, COMMISSION WORK PROGRAMME 2021, 5, COM (2020) 690 final.

[133] EUROPEAN PARLIAMENT RESOLUTION OF 17 DECEMBER 2020 ON SUSTAINABLE CORPORATE GOVERNANCE (2020/2137(INI)) PAR. 23-24

readily have a negative impact on the environment and communities where they plan to operate.[134]

Long-term, dedicated investors, who heavily invested in one or few companies could be expected to be less supportive of sustainable strategies negatively affecting their long-term profits than diversified investors, who are less committed to the relevant company's results and more exposed to the externalities they create. In this context, loyalty shares, by providing more votes to the insiders and dedicated investors than to diversified institutional investors, may exacerbate the sustainability problem.[135]

Recent data supports this hypothesis. Contrary to the EU institutions' expectation, loyalty shares seem to have a negative impact on corporate sustainability. Bourveau, Brochet, and Garel, found that French companies adopting loyalty shares under the Florange Law, "experience a decrease in long-term foreign institutional ownership offset by an increase in insider/family ownership" and as a result "their environmental and social performance deteriorates."[136]

G. Overall: Entrenchment and Nationalism, Locking Controllers in and Foreign Investors Out

The experience in European countries and, in particular, the evidence in the Italian and French markets, where loyalty shares are broadly used, demonstrates that these structures are being used to support incumbent controllers and reduce foreign investors' voting power.[137] The two concepts can be collapsed into a single, incumbent-protection metric. The rhetoric of supporting local, national champions against foreign competitors and investors bolsters the political rhetoric for loyalty shares and other foreign exclusion.[138] That insulating incumbents leads primarily to greater long-term

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134 Roe, Spamann, Fried and Wang, *supra* note 16 (submission to the EU on the initiative); *see* MARK J. ROE, MISSING THE TARGET (forthcoming, 2022); Mark J. Roe, *Stock Market Short-Termism's Impact*, 167 U. PA. L. REV. 71 (2018).

135 *See* José Azar, Miguel Duro, Igor Kadach and Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World,* J. FIN. ECON. (forthcoming) 31 (finding evidence that "firms under the influence of the Big Three are more likely to reduce corporate carbon emissions"); Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance* (August 19, 2019). 93 SOUTH. CAL. L. REV. 1243 (2020) (discussing the reasons behind index funds' social activism); Luca Enriques & Alessandro Romano, *Rewiring Corporate Law for an Interconnected World*, 64 ARIZ. L. REV. (forthcoming) (institutional investors act as "portfolio value maximizers" rather than as "firm value maximizers," leading them to reduce the risk catastrophic externalities like climate change); Jeffrey N. Gordon, Systematic Stewardship (Colum. L. & Econ. Working Paper No. 640, 2021), www.ssrn.com/abstract=3782814.

136 *See* Bourveau Brochet & Garel, supra note 83 at 1.

137 *See also* Alessio Pacces, *Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance*, 9 ERASMUS L. REV. 199, 213 (2016).

138 On nationalism and corporate law, *see generally* Mariana Pargendler, *The Grip of Nationalism on Corporate Law*, 95 IND. L.J. 533 (2020).

corporate operations is not evident. Reducing short-termism seems to be neither the primary motivation nor clearly an effect.

Recent proposals to extend the use of loyalty shares across Europe to improve corporate sustainability are not supported by data showing a negative correlation between loyalty shares and companies' environmental and societal footprint.[139]

V. THE STATE OF LOYALTY SHARES IN THE UNITED STATES

Loyalty shares are permitted under Delaware law, are barred in midstream recapitalizations under the stock exchange rules (as are dual-class recapitalizations), and were sought to be facilitated under recent applications to the SEC.

A. The Existing Rules

1. *The Delaware law.* The Delaware courts have validated corporate charters providing for loyalty-shares structures. In *Williams v. Geier*,[140] the Delaware Supreme Court upheld a listed company's 1986 loyalty-shares recapitalization, seeing it as "promot[ing] long-term planning and values by enhance[ing the] voting rights of long-term shareholders."

More recently, the Delaware Chancery Court *de facto* impeded that result,[141] when concluding that a board authorizing low-voting and non-voting shares— presumably including loyalty shares—that support insider control would obtain business judgement deference only if independent directors and a majority of the outside shareholders approved. Public companies, even those with a controlling or influential shareholder, often have a significant portion of the minority owned by the large institutions (BlackRock, Vanguard, and State Street) that oppose departures from one-share, one-vote.[142] Their presence makes approval from a majority of the outside shareholders difficult to obtain. Hence, midstream restructurings to loyalty-share use are difficult.

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[139] *See* Bourveau Brochet & Garel, *supra* note 83, at 1.

[140] 671 A.2d 1368, 1377–78 (Del. 1996).

[141] *See* IRA Trust FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB,2017 Del. Ch. LEXIS 869 (Del. Ch. Dec. 11, 2017).

[142] *See* BLACKROCK INVESTMENT STEWARDSHIP CORPORATE GOVERNANCE AND PROXY VOTING GUIDELINES FOR U.S. SECURITIES 15 (2020), www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; VANGUARD FUNDS SUMMARY OF THE PROXY VOTING POLICY FOR U.S. PORTFOLIO COMPANIES 17 (2020), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf; STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES: NORTH AMERICA 7 (2020), www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guidelines-us-canada.pdf.

2. *The existing stock exchange listing rules.* Until 1988, U.S. listed companies were entitled to adopt loyalty-shares plans or dual-class structures "midstream," well after their initial public offerings. In 1988, however, the SEC adopted Rule 19c-4, which required stock exchanges to adopt listing standards prohibiting the issuance of securities or other corporate actions "with the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock."[143]

Rule 19c-4 was challenged and, in 1990, the U.S. Court of Appeals for the D.C. Circuit found that the SEC had exceeded its regulatory powers.[144] Although the courts struck down Rule 19c-4, the major stock exchanges implemented its substance, following an informal SEC campaign in its favor.[145] The New York Stock Exchange rules on voting rights illustrate:

> Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans [i.e., loyalty shares].[146]

Bottom-line: loyalty-share plans can be adopted in the United States now before the initial public offering and can persist thereafter, but cannot be adopted midstream, when the shares are already traded on regulated markets.

B. The Existing Use

Loyalty shares are now uncommon in the United States, with stock exchange proposals seeking to make them more widely available.

In the most comprehensive retrospective on loyalty shares in the United States, only a dozen American companies were found to have loyalty shares. Ten of them (all family controlled) adopted loyalty shares shortly before 1987, through a shareholders' vote, when stock exchange listing rules still allowed such mid-stream recapitalizations, while the remaining two went public in the early 1990s with this structure already in place.[147] Of the twelve

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143 *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 566 (1991).

144 *See* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

145 *See* Bainbridge, *supra* note 143, at 627.

146 N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 313.00(A) (2020); *see also* NASDAQ STOCK MARKET, NASDAQ LISTING RULES § 5640 (2019) (similar restrictions).

147 Dallas & Barry, *supra* note 5, at 593–97.

companies that adopted them in the 1980s and early 1990s, six rescinded them afterward.[148]

Thus, with usage so limited in the United States, it is hard to assess whether they thus far promote long-run behavior, insider control, or both. But what little evidence is available seems to be largely consistent with the European protectionist results: Lynne Dallas and Jordan Barry comprehensively examine the loyalty-share results in the United States, showing that, where used, they primarily protect controllers. They "found no evidence that [loyalty-share voting] was associated with increased ownership by dedicated shareholders or decreased ownership by transient shareholders."[149]

The few firms that adopted loyalty shares generally outperformed the market. However, their relative performance was better *before* they adopted loyalty shares.[150] This result does not support loyalty shares as promoting better corporate results. And companies that terminated loyalty shares were just as likely to see performance improve as to see it decline, providing mixed evidence.[151] But with the sample of loyalty-share firms in the United States so small, little that is definitive can be concluded.

C. The Reforms Proposed

1. The proposed format for "tenure-voting plans." Loyalty shares have been promoted via the Long-Term Stock Exchange proposals to the SEC and in well-placed writing on the benefits of "tenure-voting plans"—loyalty shares—to address the perceived short-termism affecting U.S. companies.[152] The proposals seek to facilitate midstream recapitalizations.[153] A major, liberal and respected think tank—the Roosevelt Institute—endorsed authorizing loyalty shares and suggested that Congress "pass legislation modeled on the . . . Florange Act."[154]

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[148] *Id*. at 599, 620.

[149] *Id*. at 542, 551, 627–28. Similar results for dual-class stock are described in Arugaslan, Cook & Kieschnick, *supra* note 21, at 180–81.

[150] Dallas & Barry*, supra* note 5, at 542, 552.

[151] *Id*. at 552.

[152] Berger, Davidoff & Solomon, *supra* note 5, at 323 (concluding that "[i]f adopted, tenure-voting plans could help shareholders, companies, the marketplace, and society return to a disciplined, long-term approach to investment and growth").

[153] *Id*.; *see also* Belifanti, *supra* note 11, at 834 ("with more attention being focused on the negative impacts caused by shareholder short-termism and some shareholder activists, the NYSE's ban on time-weighted voting may be ripe for reconsideration").

[154] Mike Konczal, J.W. Mason & Amanda Page-Hoongrajok, *Ending Short-Termism: An Investment Agenda for Growth*, ROOSEVELT INST. (Nov. 6, 2015), http://rooseveltinstitute.org/wp-content/ uploads/2015/11/Ending-Short-Termism.pdf.

2. Alternative formats: While the voting boost is the lure for long-term loyalty ownership in the public proposals, academics have designed other lures that could be more effective. Patrick Bolton and Frederic Samama proposed that longer-term shareholders be compensated with a boost to the cash dividend or with warrants to purchase the firm's stock at a favorable price.[155] Yet, this proposal has had, as far as we can tell, no traction in real-world proposals in the United States: the real-world initiatives seek to use extra votes, not extra cash. In Europe, there are some companies with loyalty-share dividends, but these are few in comparison to the voting-boost loyalty shares.[156]

While it is possible that the finance economists designed a mechanism that would not work, the alternative hypothesis, which we see as more likely, is that the real-world promoters of loyalty shares are for the most part interested in preserving control, with long-termism a justification, and maybe for some just a pretext. Extra votes for loyalty shares help to preserve control, extra cash does not.

VI. THE CHOICE MECHANISM

A. Local Choice and Private Ordering: One Size Doesn't Fit All

Above, we concluded that it is unclear whether loyalty shares would foster long-term behavior if adopted. Another feature of American corporate lawmaking furthers this uncertainty and strengthens the likelihood that it would not. The usual thinking in American corporate lawmaking is that different companies with differing businesses should be allowed to "tailor" their structures.[157] Each company (meaning each company's management,

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[155] Patrick Bolton & Frederic Samama, *Loyalty-Shares: Rewarding Long-term Investors*, 25 J. APP. CORP. FIN. 86, 86–97 (2013). Former Vice President Al Gore and Joseph Stiglitz endorsed their proposal. Al Gore & David Blood, *A Manifesto for Sustainable Capitalism*, WALL ST. J. (Dec. 14, 2011), https://www.wsj.com/articles/SB10001424052970203430404577092682864215896; Joseph Stiglitz, REWRITING THE RULES OF AMERICAN ECONOMY 8, 69 (2015), http://rooseveltinstitute.org/wp-content/uploads/2015/10/Rewriting-the-Rules-Report-Final-Single-Pages.pdf. In general, the dividend boost would favor index funds and further propel their growth (if the mechanics of indexers getting loyalty boosts were resolved). Whether index-fund growth is good for long-term corporate governance is open to question, as the indexers have been criticized as being overly passive. In general, longer- term holdings do not necessarily mean more engagement, as the most prominent of the academic proponents of dividend boosts for long-term holding recognize. Bolton & Samama, *supra*, at 96.

[156] As an example, among companies in the CAC40, the main French stock index, in December 2020 only three companies (7.5 percent) awarded monetary benefits (*dividende majoré*) to loyal shareholders (usually a 10 percent dividend increase if the shares are held for more than twenty-four months in registered form), while twenty-seven companies (67.5 percent) granted additional votes through traditional loyalty shares.

[157] *See, e.g.*, Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 771 (2017) ("[L]aw's proper role is to allow firms to select from a wide range of governance structures, rather than to mandate some structures and ban others.").

board, and shareholders) could choose what voting structure to use.[158] One size does not fit all.

This "private ordering" preference would, we believe, lead to loyalty-share adoptions being more control-oriented than long-term focused. In this part we explain why.

Consider firm-by-firm choice for loyalty shares. A board could propose that the firm reconfigure to use loyalty shares by amending the corporate charter. Then the shareholders could approve or reject the change. In an ideal business world, firms would sort themselves into those that would benefit strongly from loyalty shares (and adopt them) and those firms that would be damaged or not helped (and not adopt them). But analysts and regulators should not expect this result, because the board can effectively block the change. If the board—or its controller—benefits from loyalty shares, one should expect the proposal to be forwarded to shareholders for approval; if the board and the controller do not benefit, then the proposal will go nowhere. Controllers who value control highly (irrespective of whether that control would bolster the company's long-term prospects) would seek loyalty shares. But controllers who would not benefit from a loyalty-share structure—because, say, they plan to divest their shares rapidly or fear that outside investors like index funds will obtain the bulk of the loyalty-vote bonus—would not.

This sorting difficulty is an under-recognized problem in corporate governance. The rhetorical power of investor choice is so strong in the United States that it often dominates careful analysis of the choice mechanism. Michal Barzuza showed recently that private ordering often will not assuredly lead firms to adopt the right corporate governance rule for themselves.[159] In particular, "[f]irms that benefited most from independent directors … did *not* add them voluntarily."[160] If the incumbents would lose authority, they disfavored the rule even if the firm would be improved.

We expect that loyalty-share adoptions in the United States would sort themselves on similar incumbent-favoring lines, without necessarily benefiting long-term firm value.

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[158] For differential voting, the usual thinking is that this freedom of choice should be confined to when the private firm first sells its stock to the public.

[159] Michal Barzuza, *Inefficient Tailoring: Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. 131, 136–37 (2018). For loyalty-share adoptions at the time the firm goes public, the controlling founders internalize the costs and benefits; the problem primarily pertains to post-IPO adoptions.

[160] *Id.* at 136 (emphasis added); *cf.* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1824 (1989) ("Although an amendment requires approval by a shareholder vote . . . the amendment must first be pro- posed by the board.").

B. Index Funds, Again

Loyalty shares' impact in the United States depends considerably on their impact on index funds, which now own about one-fifth of the stock market. Index funds are core American long-term holders; they typically buy a balanced portfolio of the entire stock market.

The long-termist task is to match the long-term horizon of these index investors with their portfolio companies' decision-making. But the matchup, despite its intuitive appeal, is not strong. Indexed investors own stock across the economy, disincentivizing them from carefully examining each investment for the long run. They are passive investors who compete on the basis of the low fees they charge investors rather than on their portfolio's performance. They spend little on stewardship.[161]

Hence, doubling indexers' votes would bolster long-term investors who have only *weak incentives* to use those votes well.[162] Index funds tend to support corporate managers so as to attract and retain business deriving from pension-related services.[163]

As Ronald Gilson and Jeffrey Gordon explain, though institutional investors have the votes, activist investors have the skills "to identify strategic and governance shortfall with governance-related underperformance."[164] Because the activists typically lack control of the targeted firm, they need support from institutional investors,[165] such as the index funds.[166] As we saw in Part II.D, loyalty shares will reduce the activists' relative voting power (because the activists will be owning "fresh" shares that would not be entitled to the loyalty-share two-year voting boost) and would increase the indexers' voting power. Which effect is larger from loyalty voting changes—

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[161] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 94–95 (2017); Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101.

[162] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 28, at 317. However, indexers are often affiliated with active funds that are more involved in actively voting.

[163] Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 569 (2007); Rasha Ashraf, Narayanan Jayaraman & Harley E. Ryan, Jr., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. QUANTITATIVE ANALYSIS 567, 587 (2012).

[164] *See* Gilson & Gordon, *supra* note 37, at 896.

[165] David Benoit & Kirsten Grind, *Activist Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015), https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101. Recent data shows passively managed funds to be less likely than active funds to sup- port activism. Alon Brav, Wei Jiang, Tao Li & James Pinnington, Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests 4, 25–29 (Colum. Bus. Sch. Res. Paper 18-16, Nov. 23, 2020), www.ssrn.com/abstract=3101473.

[166] Jessica Toonkel & Soyoung Kim, *Activist Investors Find Allies in Mutual, Pension Funds*, REUTERS (Apr. 9, 2013), www.reuters.com/article/us-funds-activist-investors-find-allies-in-mutual-pension-funds-idUSBRE9380DU20130409#; Krouse et al., *supra* note 161; Asjylyn Loder & Inyoung Hwang, *The Passivists: "Passive" Investing Can Be Very Active*, WALL ST. J., Oct. 19, 2016, at C1.

magnifying long-term indexers or decreasing activists' incentives—is difficult to assess.

Here, the design problem—and the capacity of controllers to control the design—becomes relevant once more. Paul Edelman, Wei Jiang, and Randall Thomas show that American inside-managers could not lock in control with conventional loyalty shares without buying a quarter of the company[167]— more than management typically owns. But management would have noticeably more voting power with the conventional boost and it could even assure itself of control if it obtained more than the conventional voting boost (i.e., management could seek more than the conventional doubling of the vote). It could seek and obtain ten votes per share. That result could get management control with a modest investment.

Management (and controllers) could do even better in garnering a larger percentage of the votes if they sought a voting structure that impeded outsiders, such as the indexers, from getting the extra votes, a result that is common in Europe. The reigning U.S. proposal—to establish the so-called Long-Term Stock Exchange for Silicon Valley—as originally drafted would have done so.

The LTSE planned that shares that would get the voting boost had to be registered with the company.[168] But institutional investors prefer not to register their shares. They need to balance their portfolios intermittently, which would become cumbersome if the shares are registered; hence, the mechanics discourage institutional investors' ability to get the loyalty-share boost. (The indexers and other institutional investors do not value their votes highly but do value low cost when they rebalance their portfolios.) They also make a business of lending their shares to investors who seek to sell "short" (and thereby bet on the firm's stock price declining).[169] Hence, their loyalty-share plan would make it easy for insider-controllers to get the voting boost, make it hard for outside institutional investors to get it, and deny the voting boost to activists.

This registration structure and the indexers' aversion to it would weaken outside investor voting power and bolster insider-controller-management voting power.[170] The activist-index fund alliance works now in American corporate governance (although there are disagreements on this point, as some opponents believe that this alliance is too focused on shareholder value, neglecting the interests of other stakeholders). However, this alliance will weaken or disappear if insiders design and implement a

[167] *See* Edelman, Jiang & Thomas, *supra* note 5, at 1022. Dual-class structures, with the insider- retained class carrying bulked up votes, would better help the insiders, the authors show.

[168] Investors Exchange LLC, *supra* note 33. These plans are being updated.

[169] *See supra* note 31.

[170] *See supra* Part IV. An important recent work on loyalty shares outlines how the holding-period tracing could be done with new blockchain technology, without depending on traditional registration. Berger, Solomon & Benjamin, *supra* note 5.

loyalty-share system that disrupts that alliance by weakening the activists' and the institutions' voting power relative to the insiders.[171]

C. And Therefore?: Loyalty Shares to Propel Entrepreneurial Startups

Although we are skeptical that loyalty shares benefit the long term in any direct and major way, and although promoting the long term has been loyalty shares' major rationale, that does not mean they must be barred. Our analysis is partial and skeptical—focused on the widely-held, intuitively attractive, but erroneous view that loyalty shares would assuredly and powerfully ameliorate short-termism.

But loyalty shares have other benefits. Entrepreneurs who start firms often value keeping control even after their firm succeeds, goes public, and raises outside capital.[172] There is considerable evidence that entrepreneurs value the benefit of being the boss—and of not being someone else's employee.[173]

Autonomy is a value and goal in and of itself.[174] Though much corporate analysis focuses on control's monetary value, there is more that is not regularly attended to. Pride of ownership, power, prestige, and self-satisfaction from controlling the enterprise are major motivations for business leaders.[175] According to the great Alfred Marshall: the entrepreneur "often [puts up with] considerable disadvantages [because] the freedom and dignity

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[171] There's reason to facilitate loyalty shares that are put in place when the firm first went public, but not thereafter. Consumer sovereignty (not anti-short-termism) is the usual justification—the buyers know what they are buying and price their low-voting potential accordingly. We sympathize with that justification. In the next Section C, we introduce a more compelling justification for a "going-public" exception—also not based on anti-short-termism.

[172] *See* Ronald J. Gilson & Bernard S. Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 258–59 (1998) (indicating how an owner-founder loses control to venture capital but reacquires control if he or she is sufficiently successful that the firm can go public, whereupon the VC firm sells its shares, leaving the owner-founder in effective control). (And, *see supra* note 171, there is less reason to be concerned about loyalty-share adoptions when the founders take the firm public than with later adoptions.) *But cf.* Brian Broughman & Jesse M. Fried, *Do Founders Control Start-Up Firms that Go Public?*, 10 HARV. BUS. L. REV. 49 (2020) (founders are often no longer the CEO of start-ups that go public).

[173] Barton H. Hamilton, *Does Entrepreneurship Pay?*, 108 J. POL ECON. 604, 606 (2000).

[174] Matthias Benz, *Entrepreneurship as a Non-Profit-Seeking Activity*, 5 INT'L ENTREPRENEURSHIP & MGMT. J. 23, 24 (2009) (autonomy and control motivate entrepreneurs more than wealth). *Cf.* Matthias Benz & Bruno S. Frey, *Being Independent Is a Great Thing: Subjective Evaluations of Self-Employment and Hierarchy*, 75 ECONOMICA 362, 377, 379 (2007) (the self-employed report higher utility than those in middle of hierarchies).

[175] *See* Sanford J. Grossman & Oliver D. Hart, *One Share–One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175, 177 (1988); Thomas Hellman, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57, 58 (1998); *see also* Gilson, *supra* note 22, at 1663–64, 1673; Jon L. Pierce, Tatiana Kostova & Kurt T. Dirks, *Toward a Theory of Psychological Ownership in Organizations*, 26 ACAD. MGMT. REV. 298, 303 (2001).

of his position are very attractive[.]"[176] Stated more vigorously by Joseph Schumpeter, for the entrepreneur:

> There is a dream and the will to found a private kingdom… . The sensation of power and independence [is vital]….Then there is the will to conquer: the impulse to fight, to prove oneself superior to others, to succeed for the sake, *not of the fruits of success, but of success itself… .*[177]

Modern managerial analysis confirms Alfred Marshall's and Joseph Schumpeter's conjectures. Noam Wasserman, calling the problem the "founder's dilemma" in 2012, shows that founders' decisions are pervasively influenced by whether to be "rich" (actually, to be "richer") or to preserve the founder's control. He shows that for his set of investigated firms—10,000 initial founders of firms over a decade—when faced with value versus control choices, founders regularly choose control over maximizing value.[178]

Thus, loyalty shares' overarching justification could come from the plausible conjecture that they would encourage entry and competition. Entrepreneurs, or at least many of them, value control and autonomy. If entrepreneurs know upfront that they can lock in their control with loyalty shares, that should entice more of them to start businesses. Start-ups and more competition are valuable to the economy, even if there is no long-term benefit for loyalty shares in ongoing enterprises. This channel could alone justify loyalty shares for start-ups and for entrepreneurs when they take their firm public. For this channel, a long-term sunset is embedded in the loyalty share, because loyalty shares' autonomy-promoting quality would fade as the enterprise and the entrepreneur aged, terminating when the founder finally sells his or her stock.[179]

And that start-up channel also yields a speculative path toward long-termism. Posit (again) that start-up entrepreneurs highly value the continued control that loyalty shares facilitate. If that prospect of retained control facilitates more start-ups, and *if* more start-ups contribute to long-term progress, then loyalty shares could indeed foster the long term.

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[176] Benz, *supra* note 174, at 23.

[177] Joseph Schumpeter, THE THEORY OF ECONOMIC DEVELOPMENT 93 (1912) (emphasis added), *analyzed in* Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL'Y J. 817, 843–47 (2007).

[178] Noam Wasserman, THE FOUNDER'S DILEMMAS 284–88, 291–96, 331–71 (2012); Noam Wasserman, *The Throne vs. the Kingdom: Founder Control and Value Creation in Startups*, 38 STRATEGIC MGMT. J. 255, 262, 271 (2017); *see also* Raphael Amit et al., *Does Money Matter?: Wealth Attainment as the Motive for Initiating Growth-Oriented Technology Ventures*, 16 J. BUS. VENTURING 119, 135–36 (2000) (interviews comparing entrepreneurs' motivation to that of similarly placed executives show "independence[-seeking] . . . and ego affect the decision to found a new high-technology venture" and that "money is [not] . . . the most important[] motive for entrepreneurs[]"). Founders may start out with this dream, but later abandon it. *See* Broughman & Fried, *supra* note 172.

[179] On sunsets, *see generally* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

This positive aspect of loyalty shares locking in control in ways that entice entrepreneurship resembles the foundational problem for patenting. If innovators get no patent protection and if copying is costless, then few businesses will innovate; the innovator will incur the costs of discovery, but others will copy the innovation. But patent protection can be too strong, if it overly stifles the economy from getting the full value of free access to the patented technology—the patentor is, after all, awarded a monopoly that allows it to charge a high price. Patent protection that is too strong will mean higher prices and less production.[180] How long and how sharply the protection should be to best maximize national well-being is not answered by theory but by empirical reality as to where the tradeoff line (innovation inducement versus monopoly protection) should be drawn.[181] In the absence of good evidence, the most plausible policy result would be to let investors and founders decide among themselves when the firm goes public.

This start-up channel that we raise—encouraging entrepreneurial activity in the first place—is abstractly important. But because it has not been brought forward before, as far as we can tell, it has not been measured nor is it the channel to long-term economic results for the American economy that loyalty-share advocates have brought forward. Its value is difficult to assess.

But if loyalty shares are to be justified, it is here—in encouraging startups—that the justification will come.[182]

CONCLUSION

Financial market short-termism is widely thought to induce large firms around the world to forgo socially beneficial research and development and to reduce the long-term investments that power the economy. Loyalty shares are widely thought in corporate governance circles to powerfully reverse this financial short-termism. By giving longer-term shareholders more votes, the

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[180] Full costs include probabilistic costs. If innovation in, say, drugs has ten companies chasing the innovation and only one can succeed, then the successful company should recover ten times its costs plus an appropriate profit.

[181] For classic analyses of the patent vs. competition trade-off, see Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Inventions*, *in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS 617 (Richard R. Nelson ed., 1962); WILLIAM D. NORDHAUS, INVENTIONS, GROWTH AND WELFARE: A THEORETICAL TREATMENT OF TECHNOLOGICAL CHANGE 76, 83–84, 88–89 (1969); Frederick M. Sherer, *"Nordhaus" Theory of Optimal Patent Life: A Geometric Reinterpretation*, 62 AM. ECON. REV. 422, 426 (1972); *cf.* Michele Boldrin & David K. Levine, *The Case Against Patents*, 27 J. ECON. PERSP. 3, 4 (2013) ("weak patent systems may mildly increase innovation [while] strong patent systems retard innovation with many negative side effects").

[182] This power, independence, and autonomy channel does not depend on the entrepreneurs having an idiosyncratic vision deserving of protection. *See* Goshen & Hamdani, *supra* note 19. No particular level of imagination or vision need be attributed to the entrepreneur. It need only be that we value entry and competition, even if done without any vision, panache, or forward-looking insight.

firm and its executives will more readily invest and manage for the long term.

Major proposals have emerged for instituting loyalty shares in the United States. The Securities and Exchange Commission has approved the LTSE promotors' plan to establish the so-called Long-Term Stock Exchange. And the LTSE's core goal has been to use loyalty shares in a sustained way. The Exchange announced plans to seek such authorization.

We have shown here that the impact of loyalty shares in bolstering the long term is far from assured. Insider-controllers will often capture the adoption machinery and will adopt loyalty shares when it favors the insiders, regardless of whether it favors the long term. Insider-controllers will seek or veto loyalty shares based on their self-interest, and combatting short-termism is a lesser element of their self-interest. Such players typically obtain private benefits from maintaining control and will seek that their firms use loyalty shares when doing so perpetuates their own control (even if that is not in the long-term interest of the organization) or allows them to diversify their stock and maintain their prior voting strength.

The results in nations where loyalty shares are more developed than in the United States are consistent. Insiders in Europe seem thus far to capture the extra votes to facilitate their goals in ways that are neither value-maximizing nor necessarily long term. The players obtaining the extra "loyalty" votes are *not* institutional investors who hold onto their stock for the long term. Widely-held firms—the most susceptible to quarterly capitalism—do not adopt loyalty-share programs in Europe as widely or as intensely as do firms with controlling shareholders who seem to be seeking to enhance and preserve their control. Loyalty shares lock in insider control and that structure is justified, without supporting evidence, as bolstering the long term. These results make us wary of how loyalty shares would be implemented in the United States, because the incentives in the United States are similar.

For the broad mass of public firms, loyalty shares will enhance the voting power of insiders and management, typically when they go public, while diminishing the eventual voting power of dedicated blockholders and of shareholder activists. Yet the former is central to academic analysis of what will enhance the long term and the latter is widely (but disputedly) thought important for sound long-term corporate decision-making.

A fundamental corporate governance quality may be in play: A problem is identified (here: short-termism). Academics and practitioners design a mechanism to mitigate the problem, but implementation (both in the legislature and in the corporate decision-making process) is captured by incumbents with authority in the corporation or the polity. That capture diminishes the reformers' desired impact and can even reverse it.

The value of loyalty shares is unlikely to lie in their reducing corporate short- termism. That analytic channel and justification should be dropped. The managerial and entrepreneurial literature shows, however, that many entrepreneurs value control, and trim their own wealth maximization to maintain that control. This channel could be loyalty shares' true value: having the loyalty-share option available motivates the founder to push ahead, because he or she is assured of being able to maintain control of the new business, even after it goes public with outside shareholders, for as long as the founder remains as a substantial owner. We should then expect to have more start-ups than otherwise.

Moreover, this loyalty-share structure has a "biodegradable" quality to it. The buyers in an initial public offering can price a structure that enables the current controllers to keep control over the long haul, by evaluating its advantages and its potential long-run disadvantages to the company's operating agility. With loyalty shares as the mechanism for continuing control (unlike with dual-class shares), the controller cannot readily sell control to an outsider, because upon the sale the loyalty shares' voting power shrinks, while the dual-class shares' voting power does not shrink. Those buying stock in the loyalty-share-IPO can more readily put a price on the current insiders having persistent control. The insiders can keep it but they cannot sell it.

The value here is not in fostering an idiosyncratic vision, especially if that vision comes midstream, after the firm goes public. When the firm is well along, there are trade-offs from fostering an inside vision versus suffering from sclerotic persistence—and the overall trade-off is hard to evaluate. The value here for loyalty shares is rather in bolstering the entrepreneurial *ex ante* motivation to start up a new firm—and depends on whether founders and their immediate successors value control for its own sake. Loyalty shares are well attuned to bolster this value, while minimizing later costs. The insider's control degrades over time, roughly corresponding to the controller's diminishing interest in the firm. The controller can maintain control for himself or herself but cannot sell it to an outsider. The difficulty in assessing policy here comes not in this feature weighing in as a positive—as it must—but in measuring its strength and importance, and in comparing it to the likelihood of later corporate rigidities before the controller leaves the scene. That weighing is the next task for this literature.

But the bottom line here is that there are strong reasons to be skeptical of loyalty shares having an important capacity to foster the corporate long term and diminish stock-market short-termism.