TIES THAT BOND:
DUAL CLASS COMMON STOCK AND THE PROBLEM OF SHAREHOLDER CHOICE

Jeffrey N. Gordon

Discussion Paper No. 38

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By Jeffrey N. Gordon*

INTRODUCTION

For Berle and Means in the 1930s the "separation of ownership and control" was a realpolitik account of the relationship between management and the widely dispersed shareholders of the public corporation.[1] In the 1980s the Berle-Means metaphor may become a structural fact for many major public firms. Over the past five years, and at an accelerating pace, more than 80 public firms have adopted, or proposed to adopt, capital structures with two classes of common stock.[2] One class, intended principally for public shareholders, carries limited voting rights; the second class, intended principally for management and its associates, carries enhanced, or "super," voting rights. Although proposals for "dual class

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1 See A. Berle & G. Means, **The Modern Corporation and Private Property** (1937). For a discussion of the continuing importance of this work 50 years after its publication, see the various papers in Conference on Corporations and Private Property, 26 **J.L. & Econ.** 235 (1983).

2 See SEC Office of Chief Economist, Update--The Effects of Dual-Class Recapitalizations on Shareholder Wealth: Including Evidence From 1986 and 1987, Table 1 (July 16, 1987) [hereinafter cited as July 1987 OCE Study].

common stock" vary in their details, their effect would be significantly to unbundle corporate governance from economic participation. Overall, the move toward dual class common stock portends the most important shift in the underlying structure of corporate governance since the rise of institutional stock ownership in the 1960s and 1970s.

Firms capitalized with dual, or even multiple, classes of common stock have been a well-known feature of the corporate landscape. Closely held corporations and public firms with significant dynastic family voices have frequently used the dual class common device. However, the dual class common has typically been part of these firms' capital structure since their initial public offerings ("IPOs"). It is no secret that the current popularity of dual class common among public firms is a response to the recent wave of hostile takeovers. Even the largest firms have become possible takeover targets because of the development of leveraged acquisition strategies that rely on "junk bond" financing. The current repertoire of defensive tactics--"poison pills," "shark repellant" charter amendments, assorted partial liquidation schemes, and defensive litigation--pale in effectiveness when compared to dual class common. For if management and its allies hold the voting stock necessary to elect directors, a hostile bid becomes practically impossible.[3] One crucial difference for firms now seeking to adopt

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[3] Whether managers/directors with voting control are free to turn down any bid for the firm, no matter how lucrative, is an interesting fiduciary duty question. Certainly the traditional view is that a shareholder may vote (or sell shares) as he pleases. See generally Sneed, The Stockholder May Vote as He Pleases: Theory and Fact, 22 **U. Pitt. L. Rev.** 23 (1960). There may nevertheless be limits on the majority's power to deny a favorable merger opportunity to the minority. See Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969) (breach of fiduciary duty in transfer of control bloc to holding company, which is then taken public, rather than a transaction in which all shareholders could participate).

Although inaugurated as an anti-takeover device, the dual class recapitalization could also become an acquirer's strategy as well. It is easy to imagine scenarios in which a bidder acquires a large position in a public firm

the dual class common structure is that the required corporate action is a recapitalization, rather than an initial public offering. In ways that will bear subsequent analysis, existing public shareholders must be induced to part with their voting stock in order for the scheme to work.

Different stock exchange policies on dual class common stock have complicated matters. The New York Stock Exchange ("NYSE"), which historically has forbidden dual class common, has the most restrictive policy.[4] The National Association of Securities Dealers ("NASD"), overseer of the over-the-counter market ("OTC"),[5] places no limitations on the use of multiple classes of common stock. The American Stock Exchange ("Amex") has permitted firms to issue multiple classes of common stock, but lists only those classes that have the right to elect at least 25% of the board of directors.[6]

The weakening competitive position of the NYSE in the provision of stock transaction services has put pressure on the exchange to abandon its single class

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through a partial tender offer or through open market purchases and then undertakes a dual class recapitalization to cement its control.

4 See NYSE, **Listed Company Manual**, Rule 313.00(A), (C) (subsection (A) prohibits the listing of non-voting stock, and subsection (C) prohibits the "[c]reation of a class of stock which has unusual voting provisions which tend to nullify or restrict voting").

5 The NASD administers the National Association of Securities Dealers Automatic Quotation ("NASDAQ") communications system for the over-the-counter market. This on-line quotation system has, for widely-traded securities, substantially replaced a system in which quotes were circulated by hand, on daily "pink sheets," or by a telephone query to a dealer in the security. Technically speaking, the NASD is not an "exchange," and firms are not "listed" on NASDAQ but rather "authorized" for quotation and/or transaction reporting. For expositional purposes, this article will ordinarily not draw the technical distinction.

6 See Am. Stock Ex. Guide (CCH) § 122. A recent SEC tally concluded that 54 of 785 Amex firms, and 110 of 4100 firms traded on NASDAQ, have two classes of common stock. See Hearings on Impact of Takeovers on Corporate Accountability Before the Subcomm. on Telecommunications, Consumer Protection, and Finance Concerning Tender Offers of the House Comm. on Energy and Commerce, 99th Cong., 1st Sess., 14-15 (May 23, 1985) (Statement of John S.R. Shad).

common rule. Formerly, the NYSE could insist on its rule because of the perceived benefits of an NYSE listing. The liquidity and market-making functions provided by the NYSE arguably lowered the firm's cost of capital.[7] A listing also carried prestige that probably entailed pecuniary benefits for the firm[8] and gratification for its principals. In recent years, however, advances in communications technology[9] and the regulatory efforts to create a "national market system"[10] have dramatically enhanced the competitive position of the OTC

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7 Stock price changes in response to events surrounding a listing have been a puzzle for financial economists. See, e.g., McConnell & Sanger, The Puzzle in Post-Listing Common Stock Returns, 42 **J. Fin.** 119 (1987) (summarizing prior studies as showing rise in stock prices upon listing application but partial decline following listing); Sanger & McConnell, Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ, 21 **J. Fin. & Quant. Anal.** 1 (1986) (after establishment of NASDAQ, reaction to listing application is not statistically significant); Ying, Lewellen, Schlarbaum & Lease, Stock Exchange Listings and Securities Returns, 12 **J. Fin. & Quant. Anal** 415 (1977) (during 1966-1968 firms qualifying for listing on either Amex or NYSE experienced a rise in the price of their shares). Earlier pre-NASDAQ studies conjectured the existence of a positive wealth effect but were unable to demonstrate it. See, e.g., Furst, Does Listing Increase the Market Price of Common Stocks?, 43 **J. Bus.** 174 (1970); Van Horne, New Listings and Their Price Behavior, 25 **J. Fin.** 783 (1970).

Certainly courts believe a NYSE listing to be important for liquidity and other reasons. See, for example, Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 267-69 (2d Cir. 1984) and cases cited therein. See also infra note 200.

8 The listing might signal the firm's creditworthiness to trade and bank creditors, and the firm's importance or dynamism to potential managerial employees. See Roderick, Where Companies Should List Their Stock, **Investment Dealers Dig.**, Jan. 6, 1986, at 17 (prestige "is the single, most mentioned reason for moving to the [NYSE]. Sometimes it is the only reason.")

9 See Langevoort, Information Technology and the Structure of Securities Regulation, 98 **Harv. L. Rev.** 747 (1985).

10 See Simon & Colby, The National Market System for Over-the-Counter Stocks, 55 Geo. Wash. L. Rev. 17 (1986); Macey & Haddock, Shirking at the SEC: The Failure of the National Market System, 1985 **U. Ill. L. Rev.** 315; Seligman, The Future of the National Market System, 10 **J. Corp. L.** 79 (1984); Werner, The SEC as a Market Regulator, 70 **Va. L. Rev.** 755 (1984). But see, Poser, Restructuring the Stock Markets: A Critical Look at the SEC's National Market System, 56 **N.Y.U. L. Rev.** 883 (1981) (objecting that the SEC has little experience or authority to create the National Market System).

market.[11] Recent empirical work has underscored the narrowing advantage of an NYSE listing.[12] Thus NYSE firms that desire to establish dual class common capital structures are able credibly to threaten a shift from the NYSE to the Amex or the OTC.

This threat has triggered an extraordinary series of actions. Rather than lose listings, listing fees, and commission revenue for its broker-dealer membership,[13] the NYSE Board of Governors proposed to substantially dilute its

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[11] See Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 **Colum. L. Rev.** 1145, 1257-58 (1984) (arguing that competition between NYSE and NASDAQ has created a race to the bottom).

[12] See, e.g., Sanger & McConnell, supra note 7. Counterevidence is presented in Roderick, supra note 8, which discusses a 1984 Data Resources Inc. study commissioned by the NYSE that showed greater liquidity on the NYSE. The study defined liquidity as the ability to buy or sell large blocks of stock with minimal impact on price.

The performance of NASDAQ during the stock market crash on October 19, 1987 may lead to a recalculation of the comparative benefits of an NYSE listing. It was widely reported that many NASDAQ market-makers refused to post prices and simply refused to answer telephone calls to avoid exposing their capital. E.g., "O-T-C Market Loses Luster," N.Y. Times, October 30, 1987, at D1, col. 3. A preliminary survey by Prof. Haim Mendelson also found wider bid-ask spreads on NASDAQ than on the NYSE on October 19. Id. Subsequently the NASD proposed certain changes to the operation of the over-the-counter market that would tend to assure small investor access even under adverse conditions. N.A.S.D. Acts to Widen Access to O-T-C Market, N.Y. Times, Nov. 17, 1987, at D1, col. 1.

[13] The losses could extend even further. NYSE members are currently restricted from trading in stocks not listed on the exchange, under Rule 390. NYSE, supra note 4, Rule 390. If a substantial number of firms abandoned the NYSE, broker-dealers might be tempted to follow. Moreover, a demonstration by a significant number of firms that an NYSE listing was not necessary to a liquid market in their securities would have significant economic and regulatory fallout. In the ongoing battle over the establishment of a "national market system" in which all exchanges, and conceivably all dealers, would be linked electronically, the NYSE has insisted on the importance of a central auction market, including specialists obligated to maintain a liquid market despite unevenness in buy and sell orders. A demonstration that such a market is unnecessary could threaten the NYSE's basic franchise.

single class common rule.[14] As overseer of the self-regulatory organizations,[15] the SEC was required to approve the NYSE rule change. Because of great interest in the matter, the SEC held public hearings in December 1986.[16] For several months thereafter the SEC attempted to broker an agreement on a uniform voting rights rule among the NYSE, the Amex and the NASD. However, these negotiations broke down, largely because of the Amex's insistence on a one share, one vote standard.[17]

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[14] In 1984 many NYSE firms began to propose dual class structures. In June 1984 the NYSE convened a special committee to examine the matter and imposed a moratorium on delisting for violation of its one share, one vote rule. In January 1985 this committee recommended a change in the NYSE listing standards that would permit continued listing of firms with disparate voting classes of common stock upon approval by a two-thirds shareholder vote and by the independent directors and upon the further condition that the ratio of voting differential could not exceed one to ten. The committee's recommendation also required that all classes of stock have substantially similar rights other than the difference in voting power. Initial Report of the Subcommittee on Shareholder Participation and Qualitative Listing Standards, Dual Class Capitalization, New York Stock Exchange, Dual Class Capitalization 4-5 (1985), reprinted in Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. 1149-50 (1985).

These events generated political controversy. Legislation that would require one share, one vote was introduced in both houses of Congress, and the NYSE, Amex and NASD tried to negotiate a uniform rule. These negotiations were not successful. In September 1986 the NYSE Board of Governors proposed a modified version of the committee's rule. The new NYSE proposal would permit continued listing of a firm following a dual class recapitalization upon approval by a majority of the firm's public shareholders and a majority of the independent directors. The voting ratio ceiling was eliminated.

[15] SEC authority to oversee the exchanges is derived from § 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78s(b)(1982).

[16] See Exchange Act Release No. 34-23803, 51 Fed. Reg. 41715 (1986) (setting forth background and history of NYSE proposal inviting comment on specific issues). NYSE Chairman John Phelan's testimony at the hearings indicated that the NYSE preferred its one share, one vote rule but could not resist competitive pressures from the Amex and NASDAQ. See N.Y. Times, Dec. 17, 1986, at D1, col. 1.

[17] See Stock Voting Rights Proposal Stalls; Amex Says It Didn't Agree to Compromise, 19 Sec. Reg. & L. Rep. (BNA No. 19) 667 (May 8, 1987). It is hard to ignore the incongruence of the Amex position in light of its permissive voting

In June 1987, after these negotiations failed, the SEC proposed a rule drawn somewhat more narrowly than the voluntary rule nearly agreed upon. Proposed Rule 19c-4 would prohibit the exchanges and the NASD from listing the stock of a firm "that issues any class of a security or takes other corporate action that would have the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders" of stock registered under the 1934 Act.[18] The proposed Rule would permit firms on all exchanges, including the NYSE, to issue limited voting common stock but would prohibit dual class recapitalizations that diminished the power of present shareholders. However, even if the SEC adopts this rule, the matter may not end, since Congress is considering legislation that would impose a uniform one share, one vote rule.[19]

If the proposed SEC rule is adopted, the NYSE single class common rule will not be preserved because the competitive pressure that triggered the initial NYSE

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rights listing standard, see supra note 6, and its subsequent proposal in November 1986 to eliminate all restrictions on the issuance of disparate voting rights stock. See Amex to Seek SEC Approval of Change to End Curbs on Unequal Voting Rights, 18 **Sec. Reg. & L. Rep.** (BNA No. 47) 1713 (Nov. 28, 1986). Some observers believed that the Amex was acting strategically to protect its competitive position vis-a-vis the NYSE. Amex's voting rights listing standard that permitted dual class structures was an important means of competing with NYSE. A permissive, uniform rule could cause the Amex significant competitive harm.

18 Exchange Act Release No. 24,623, Voting Rights Listing Standards--Proposed Disenfranchisement Rule, 52 Fed. Reg. 23,665 (1987), reprinted in [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 84,143. This release and Exchange Act Release No. 34-23803, supra note 16, are the sources of many of the details in the text.

19 One section of the Tender Offer Reform Act, H.R. 2172, 100th Cong., 1st Sess., introduced in 1987 by Congressman Dingell, would establish a one share, one vote standard. Legislation introduced in 1985 to address the issue, the Shareholder Protection Act, H.R. 2783, 99th Cong., 1st Sess., and S. 1314, 99th Cong., 1st Sess., was not reported out of committee.

proposal is likely to persist. Hence, the rule could facilitate a dramatic change in the ownership structure of large public firms.[20]

This article presents a framework for analysis of the dual class common issue that focuses on problems of shareholder choice and management opportunism in the large publicly held corporation. Dual class recapitalizations present these problems in a very powerful way because the triggering decision must be put to a shareholder vote.

Part I of this Article argues that dual class recapitalizations are likely to turn out badly for public shareholders. This claim is based on a critique of the purported benefits of these recapitalizations and is supported by empirical data that strongly suggest that the recapitalizations diminish public shareholder welfare.

I argue in Part II that managers can exploit a series of collective action and strategic choice problems faced by public shareholders to win approval of even welfare-reducing proposals. Firms that propose recapitalizations are likely to have an insider-dominated ownership structure that exacerbates collective action problems. The assertion that recapitalization is necessary to permit the exploitation of profitable investment projects sets up a strategic choice game, a variant of "chicken," that managers are well-situated to win.

Part III argues that because many of these problems are foreseeable ex ante, the costs of such potential managerial opportunism will fall on the

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20 In thinking about these issues, I have profited from a rich literature, including Coffee, supra note 11; Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock (March 1985), revised version, 54 U. Chi. L. Rev. 119 (1987); Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807 (1987); Seligman, Equal Protection in Shareholder Voting Rights: The One Common Shares, One Vote Controversy, 54 Geo. Wash. L. Rev. 687 (1986); Buxbaum, The Internal Division of Powers in Corporate Governance, 73 Calif. L. Rev. 1671 (1985); S. Grossman & O. Hart, "One Share/One Vote and the Market for Corporate Control" (mimeo, Feb. 1987).

insiders when they try to sell their stock. In particular, insiders who seek to lower the cost of capital will find it valuable to bond a promise that the firm's single class capital structure will not be renegotiated. The parties may agree that the defects of shareholder voting are so severe that voting should not be used to make certain decisions. The NYSE's traditional one share, one vote rule should be understood as means of bonding that agreement. The rule provides what I call a "bonded non-renegotiation right." Given present institutional arrangements, the NYSE rule is the only secure bond available for such a promise.[21]

Part III goes on to contend that the competition among the exchanges that has undermined the NYSE rule is more likely a race to the bottom than to the top. The limited number of exchanges and the high entry barriers belie the claim that the permissive rule that emerges from competition is necessarily the most efficient. Thus the basis for SEC intervention becomes clear. With such intervention, but not otherwise, parties can bond agreements that lower the cost of capital.

The argument then turns in Part IV to policy prescription. Two types of rules are possible. One type of rule permits non-uniform standards but offers competitve protection to an exchange adopting a shareholder-protective corporate governance regime. The second type of rule prescribes uniform voting rights standards across exchanges.

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[21] It is important to understand that even if dual class recapitalizations occasionally increased public shareholder wealth, this would not justify a change in the NYSE rule. The change would have significant spillover effects on firms that are not even considering a recapitalization. This is because those firms would lose the capacity to provide a secure bond of the single class common promise.

The essential element of a non-uniform rule is a restriction on migration by firms among exchanges to escape provisions that protect shareholders. On this approach, the SEC would require the Amex and the NASD to adopt a rule to prohibit the listing of any firm that has been delisted by the NYSE, voluntarily or involuntarily, because of a dual class recapitalization. This restriction on the other exchanges would permit the NYSE to maintain its rule.

Proposed Rule 19c-4 is a uniform rule that permits a dual class recapitalization on any exchange so long as the limited voting stock is issued through an initial public offering and existing shareholder voting rights are not diminished. It has the virtue of offering greater protection for shareholders of Amex or NASDAQ firms than is provided by the rules of those exchanges. Given the competition among exchanges, however, such a rule would make it very difficult for the NYSE to maintain its single class common rule. I argue that limited voting common stock imposes certain economic costs on public shareholders. The bond provided by the NYSE single class common rule thus has value to the firm and its elimination imposes a cost.

I therefore recommend the addition of a non-migration clause to the proposed SEC rule to prohibit a firm that moves between exchanges from adopting a voting rights structure that is prohibited by the exchange it is leaving. This approach has the additional virtue of setting in motion an experiment with limited voting common by Amex and NASDAQ firms that does not alter the governance structure of the largest firms, which will remain within the NYSE's one share, one vote regime.

I. THE IMPLAUSIBLE CASE FOR DUAL CLASS RECAPITALIZATIONS

A. The Purported Justifications

The intended effect of dual class common stock usually is to give management and its associates voting power disproportionate to their equity in the firm, i.e., disproportionate to their claim on residual cash flows. Indeed, the usual intention is to give management majority voting power. Several explanations have been offered as to why management values ownership of voting rights and why management's objectives are not inconsistent with the maximization of shareholder wealth.[22] The problem with these explanations is that while they may account for initial public offerings of dual class common, they are unlikely to justify a dual class common recapitalization. A dual class IPO does not require justification on shareholder wealth maximization grounds because the purchasing shareholders will be compensated for the costs associated with a dual class structure by an appropriate discount on the share price (assuming adequate disclosure and a reasonably efficient market).[23] In contrast, a dual class recapitalization ordinarily does require a shareholder wealth maximization justification. Otherwise, how are we to explain why public shareholders would vote for it?[24] But, as shall be developed, such justifications conflict in the

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22 See DeAngelo & DeAngelo, Managerial Ownership of Voting Rights, 14 **J. Fin. Econ.** 33, 34-38 (1985).

23 In other words, the costs of the dual class structure are borne by the entrepreneurs who sell the stock. Presumably the utility these entrepreneurs assign to the economic and non-economic advantages of assured control compensate for these costs. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 **J. Fin. Econ.** 305, 312-13 (1976).

24 Thus Prof. Fischel presents his justifications for dual class common recapitalizations in shareholder wealth maximization terms. Fischel, supra note 20, at 19-22; 54 **U. Chi. L. Rev.** 138-40. It is possible that a dual class recapitalization could be accompanied by a special payment to public

most basic way with the arguments on behalf of the market for corporate control. In short, recapitalization justifications must be defended as stories about market failure.

The common justifications fall into five categories: (1) protection against shareholder misjudgments because of inferior information; (2) protection of shareholders against predatory takeover tactics; (3) avoidance of shareholder opportunism with respect to deferred compensation and firm specific human capital investment; (4) protection of bargained-for management perquisites; and (5) compensation for greater firm specific risk. The first three justifications are arguably applicable to any firm; the last two seem applicable only to firms in which there is a dominant shareholder group at the time of the proposed recapitalization. Let us consider these justifications in turn.

1. Inferior shareholder information. Because of its inside position, management frequently will have better information about the firm than shareholders. The resulting information asymmetry is the basis for a bundle of shareholder wealth-maximizing justifications for dual class recapitalizations. In particular, managers may fear that shareholders will sell control of the firm to a hostile bidder because of mistaken beliefs, or misinformation, about management performance and the firm's prospects. Alternatively, the fear of such shareholder mistake may distort management decisions. For example, managers may not make investments that, although profit-maximizing, are difficult to explain to a relatively uninformed shareholder body, that require substantial secrecy for competitive reasons, or that are expected to show a profit only in the long-

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shareholders, equivalent to the discount found with an initial public offering ("IPO"), thus avoiding the need to make a shareholder wealth maximizing argument. Current transactions have generally not taken this form. See infra text accompanying notes 129-138.

term.[25] Similarly, management may be constrained in financing decisions by the optimistic or pessimistic signals that such choices transmit.[26] Another variant is that the need to explain decisions to uninformed shareholders diverts management from its mission of maximizing profits. Use of dual class common to give management voting control obviously avoids these problems. Thus, runs the argument, a dual class recapitalization may maximize shareholder wealth.

This justification for dual class common obviously proves too much, for it would validate a wide range of anti-takeover devices for virtually every kind of firm. The information asymmetry rationale for management control, a form of management paternalism, gives insufficient weight to the risks of management opportunism. The rationale is fundamentally at odds with any belief in allocatively efficient capital markets, which depend upon the ability of outsiders to assess accurately firm performance and potential. There is no evidence that shareholders make systematic mistakes in selling to third party bidders, or that acquirers are able to buy control at bargain prices.[27] In other

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[25] See, e.g., DeAngelo & DeAngelo, supra note 22, at 35.

[26] In the wake of the Modigliani-Miller "irrelevancy" theorem, which states that the capital structure of the firm is essentially irrelevant to the value of the firm, see, Modigliani & Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, **Am. Econ. Rev.**, June 1958, at 261, some financial economists have begun to explain elements of capital structure, such as financing and dividend payout decisions, as signals about the firm's prospects and management's intentions. See, e.g., Gonedes, Corporate Signaling, External Accounting, and Capital Market Equilibrium: Evidence on Dividends, Income, and Extraordinary Items, 16 **J. Acct. Res.** 26 (1978); Ross, The Determination of Financial Structure: The Incentive-Signalling Approach, 8 **Bell J. Econ.** 23 (1977). Managers may be constrained in their capital structure decisions by the signalling effects on stock prices. See also infra note 38.

[27] See generally, Bradley, Desai & Kim, Synergistic Gains from Corporate Acquisitions and Their Division between the Stockholders of Target and Acquiring Firms _____ **J. Fin. Econ.** _____ (forthcoming 1988); Jarrell, Brickley & Netter, The Market for Corporate Control: The Empirical Evidence Since 1980, _____ **J. Econ. Perspectives** _____ (forthcoming 1987); Jensen & Ruback, The Market for Corporate

words, this justification is based on an unstated and unproved assumption of widespread failure in the market for corporate control that most observers would reject.[28]

2. Predatory takeover tactics. In struggles for corporate control acquirers may use "predatory" tactics that arguably decrease shareholder welfare. Examples include two-tier, front-loaded, tender offers that coerce tenders at less than the optimum price, toehold acquisitions by "greenmailers" who threaten disruption unless paid to go away, and defensive counter-tender offers by a target (known as a "Pac Man" defense) that may thwart a desirable acquisition.[29] All of these tactics can be avoided by lodging voting control with management. In the case of a third party bid, management can coordinate negotiations on behalf of shareholders to obtain the highest price. Greenmail and the Pac Man defense become ineffective. Thus, the argument once again concludes that dual class common recapitalizations increase shareholder wealth.

Control: The Scientific Evidence, 11 **J. Fin. Econ.** 5 (1983) (the consistent evidence in these studies is that target shareholders do extrodinarily well, with average gains between 30% and 60%). See also Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy, 11 **J. Fin. Econ.** 183 (1983) (rejecting theory that bidders identify firms undervalued by the market, i.e., by outside shareholders, on basis of evidence that stock prices of targets defeating hostile bids eventually fall to pre-bid levels); infra note 47 (discussing recent evidence on synergy gains from acquisitions).

[28] Defenders of dual class recapitalizations might claim that serious information asymmetry problems could occur for a limited group of firms, even if not generally. The data do not suggest such unique characteristics for the recapitalizing NYSE firms and poorly fit such a claim for all recapitalizing firms. See infra text accompanying notes 61-112.

[29] For a description of the coercive effects of two-tier offers and greenmail, see Gordon & Kornhauser, Takeover Defense Tactics: A Comment on Two Models, 96 **Yale L.J.** 295 (1986). See also Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 **Harv. L. Rev.** 1693 (1985) (presenting a more elaborate view of distortions in share price).

This kind of argument is very frequently made in the management proxy statements of firms proposing recapitalizations.[30] It is not very persuasive in light of alternatives that protect shareholder interests without granting management voting control. Assorted "shark repellant" charter and by-law provisions are available to block many predatory practices. For example, "fair price" provisions can assure that shareholders on the back end of a two-tier offer receive equivalent compensation.[31] Other provisions can bar the payment of greenmail or prescribe shareholder meeting and voting rules that take the bite out of a Pac Man defense.[32] Moreover, management already has ample discretionary measures, including the issuance of "poison pill" stock or rights[33] and the

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30 Coastal and General Cinema specifically refer to the Pac Man defense problem. **The Coastal Corp., Proxy Statement** 4-5 (May 14, 1984); **General Cinema Corp., Offering Circular** 15 (Dec. 31, 1984).

31 See 1 **A. Fleischer, Tender Offers: Defenses, Responses, and Planning** 33-35 (1983); Smith, Fair Price and Redemption Rights: New Dimensions in Charter Provisions, 4 **Del. J. Corp. L.** 1 (1978).

32 The most famous Pac Man defense, Martin Marietta's counter-tender against Bendix, was tenable only because permissive features of Delaware law (in particular the shareholder written consent procedure under **Del. Code Ann.**, tit. 8, § 228 (1987)) and the Bendix charter permitted a new majority shareholder to obtain quick control of the firm. Comparable provisions under Maryland law and the Martin-Marietta charter made a new majority shareholder proceed more slowly. Thus the counter-tender, though later, could conceivably have prevailed, although other factors were decisive in this case. See A. Sloan, **Three Plus One Equals Billions: The Bendix-Martin Marietta War** 146-47 (1983). Management may avoid this possibility merely by placing appropriate limits in the charter and by-laws on the ability of shareholders to call a special meeting, to vote by written consent in lieu of holding a meeting, and to remove directors without cause.

33 See Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 **Harv. L. Rev.** 1964 (1984); Office of the Chief Economist, Securities and Exchange Commission, The Effects of Poison Pills on the Wealth of Target Shareholders (1986) [hereinafter cited as OCE Poison Pill Study]. See generally, P. Richter & H. Bloomenthal, Corporate Anti-Takeover Defenses: The Poison Pill Device (1987) (providing exemplars). The OCE study notes that of 30 hostile control contests that featured poison pill

initiation of defensive litigation,[34] to protect shareholders against a predatory takeover.[35] The virtual disappearance of the hostile two-tier bid over the past few years suggests the effectiveness of these devices.[36] Nor is there any reason to believe that a dual class recapitalization is a cheaper defensive tactic than

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defenses, 14 (46%) of the 30 targets defeated the hostile takeover attempt and remained independent. In 13 other cases the target was acquired after an auction that led to an improved bid. OCE Poison Pill Study at 25-27.

34 See Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?, 28 **J.L. & Econ.** 151 (1985); Rosenzweig, Target Litigation, 85 **Mich. L. Rev.** 110 (1986). Jarrell's study notes that of 89 hostile control contests that featured litigation defenses, 21 (23.5%) of the 89 targets defeated the hostile takeover attempt and remained independent. In 53 other cases the target was acquired after an auction or an improved bid. See, Jarrell, supra, at 161-72. The factor that usually accounts for these effects is not an injunction that blocks the offer but rather delay, which permits other defensive tactics and the entry of additional bidders.

35 From a shareholder perspective the best justification for shark repellents and other defensive tactics is that they provide a means of coordinating shareholder response to a takeover bid and may initiate an auction process that extracts a higher bid. See, e.g., **R. Gilson, The Law and Finance of Corporate Acquisitions** 765-784 (1986) (summarizing debate); Carney, Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties, 1983 **Am. B. Found. Res. J.** 341 373-84; Gordon & Kornhauser, supra note 29; Oesterle, Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 **Cornell L. Rev.** 53 92-93 (1985).

For an interesting discussion of the impact of shark repellant amendments on the decision process of a shareholder faced with a tender offer, see Romano, The Political Economy of Takeover Statutes, 73 **Va. L. Rev.** 111, 148-70 (1987).

36 A recent address by SEC Commissioner Grundfest reports that in all of 1985 and 1986 there were only 11 two-tier bids (other than those sponsored by management leveraged buyouts), accounting for about 3% of all tender offers. For 1987 SEC data reveal no two-tier bids through May. This contrasts with 1982 and 1983, the highpoint for two-tier bids, when there were 35 such bids accounting for 20% of all tender offers. Grundfest further notes that most two-tier bids are currently used by management, either in a leveraged buy out or in a management-sponsored stock buyback used to defend against a one-tier bid. J. Grundfest, Two-Tier Tender Offers: A Mythectomy, Address to the United Shareholders Association and the National Association of Manufacturers, Congress of American Industry (June 15, 1987 and May 27, 1987) (copy on file with author).

others in the management arsenal.[37] Finally, too much management coordination and negotiation is not necessarily a good thing for the shareholders. There is ample evidence that premiums for target shareholders are higher in hostile takeovers than in negotiated mergers.[38]

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[37] Just because dual class common may be a substitute for certain very costly "scorched earth" defensive tactics does not justify its substitution for other tactics that are less costly and very effective. Recent evidence has raised the question whether poison pills are "cheaper" (for shareholders) than dual class common. A recent study by the SEC's Office of Chief Economist reports that poison pill adoptions reduce shareholder wealth, as measured by stock price movements net of general market movements, by an average of about 1.7 percent. OCE Poison Pill Study at 5. The extent to which dual class recapitalizations have a negative impact on shareholder wealth is a matter of some question. See infra text accompanying notes 55-127. Making exact comparisons of the costs of dual class recapitalization and of other defensive tactics may be difficult. For example, the negative effect of pill adoptions by firms that are not subject to takeover speculation is not statistically different from zero. But this quiescent circumstance is ordinarily the case for firms proposing dual class recapitalizations. Moreover, the negative effects of dual class recapitalization may be blunted because the insider holdings in such firms are typically large enough to dampen takeover possibilities. See infra text accompanying note 144. By contrast, insider holdings of firms adopting poison pills are typically low (approximately 5%) and institutional holdings relatively high (45%), increasing the relative likelihood of a takeover. See, OCE Poison Pill Study, supra note 33, at 36-37. This suggests that for firms with comparable ownership structures, a dual class recapitalization could be expected to have a much more negative impact on shareholder wealth.

[38] Jensen & Ruback, supra note 27, at 7 (average gain for target shareholders is 20% in mergers, 30% in tender offers). The proper interpretation of these data is open to debate. Professor Leebron points out that the gain to acquirers in mergers is practically zero, but is approximately 4% in tender offers. From this, he concludes that target shareholders receive a greater percentage of the total gain in negotiated transactions. Leebron, Games Corporations Play: A Theory of Tender Offers, 61 N.Y.U. L. Rev. 153, 175-77 (1986). But the data might also be interpreted as showing that the circumstances in which target management may be able to force a negotiation, as through defensive measures, may also give rise to the ability to block some value-increasing transactions. An alternative explanation is that the apparent differences arise from the fact that in a merger the consideration is more frequently the bidder's stock, while in a tender offer the consideration is usually cash. Several empirical studies find that the issuance of stock typically produces negative stock market effects for the firm. This result is commonly explained in terms of the signal sent by a stock issuance that management believes the stock is over-valued by the market. See infra text accompanying notes 117-127. Thus the apparent absence of gains for the bidder in

3. Shareholder Opportunism. a. Deferred Compensation. It may be that the gains to target shareholders in a hostile takeover partially derive from breach of an implicit contract to pay deferred compensation to managers. On this view, managers want voting control to prevent such shareholder opportunism. Without such control, managers will insist on contracts that are ultimately less desirable for the shareholders. Thus, this argument also concludes that dual class recapitalization may increase shareholder wealth.

The argument requires some unpacking. Let us begin with the standard principal-agent model of the shareholder-manager relationship.[39] In simplest terms, the shareholder/principal may observe the firm's outputs (its profits or returns) but because the management/agent's effort is not directly observable, shareholders may be unable to determine the relative consequence of management effort as compared to other influences on firm performance. This problem affects the management compensation contract in several ways.

First, because managers' wealth is tied to a particular firm to a much greater extent than is that of well-diversified shareholders, managers have

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a merger may result from an entangling of the positive effects of the merger with the negative effects of the stock issuance. See Travlos, Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns, 42 **J. Fin.** 943 (1987).

39 Standard sources include Holmstrom, Moral Hazard in Teams, 13 **Bell J. Econ.** 324 (1982); Holmstr+uom, Moral Hazard and Observability, 10 **Bell J. Econ.** 74 (1979); Shavell, Risk Sharing and Incentives in the Principal and Agent Relationship, 10 **Bell J. Econ.** 55 (1979); Jensen & Meckling, supra note 23. A useful survey of the theoretical economic literature is provided in Hart & Holmstrom, The Theory of Contracts, Advances in Economic Theory: Fifth World Congress (T. Bently, ed.) (1987). A useful survey of the empirical economic literature, which focuses on the technology of contracting and control, is provided in Jensen & Smith, Stockholder, Manager, and Creditor Interests: Application of Agency Theory, in **Recent Advances In Corporate Finance** 93-131 (E. Altman & M. Subrahmanyam eds. 1985). The discussion in the text draws from these literatures.

different attitudes toward risk. When it comes to compensation, managers are typically risk averse and shareholders risk neutral. This is because a change in the compensation paid by the firm significantly affects the wealth of a manager but does not significantly affect the wealth of the well-diversified shareholder. Thus a risk-sharing contract that paid managers a fixed wage would be optimum, in the sense that otherwise managers would demand a higher salary for bearing the risk of a salary cut if firm performance fell, which could occur because of events outside the managers' control. A fixed-wage contract, however, would give managers insufficient incentive to increase firm output. Obviously some risk must be passed on to managers to produce the correct incentives, but ideally as little risk as necessary, since risk-bearing requires increased management compensation and thus reduces shareholder wealth.

One solution to this problem focuses on the period over which firm outputs are observed.[40] The "noise" of random events makes it difficult to monitor management effort with respect to a particular output. As the observation period increases, however, the influence of management effort on outputs becomes easier to discern because over time positive and negative events will tend to cancel one another out. Thus compensation contracts will often have a significant component of deferred compensation, which represents a "settling up" for previous managerial effort. Such contracts need not be explicit. Indeed, since the amount is determinable only sometime after performance and is not directly tied to outputs, writing an explicit ex ante deferred compensation contract may be

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[40] A formal model of a similar idea is found in Knoeber, Golden Parachutes, Shark Repellents, and Hostile Tender Offers, 76 Am. Econ. Rev. 155, 162 (1986). Knoeber models the problem in terms of a contract for the ideal amount of on-the-job consumption by management. The solution depends upon subsequent observation of such consumption and a settling up through deferred compensation.

impossible. Compensation may take the form of a cash bonus, a promotion, greater pension benefits, or even the retention of a now ineffective but once diligent manager.

Now let us examine the effect of a hostile takeover on this scenario. As long as the firm remains in business, concern about its reputation will lead it to honor such implicit deferred compensation contracts. Welshing will make it more costly to retain and recruit managers. Shareholder opportunism--installing directors who will welsh--will backfire.[41] A hostile takeover, however, changes this situation dramatically by removing the constraints on shareholder opportunism. In particular, shareholders can sell the firm to an acquirer free of any implicit contractual obligations. As long as the acquirer observes implicit contracts with its own managers, it will not suffer significant reputation effects. It reaps the rewards of the unpaid deferred compensation claims of target managers, which it may share with target shareholders.

The wheel does not stop here, however. Shareholders can fool only some of the managers some of the time. The potential for the expropriation of deferred compensation will lead to the reformulation of compensation contracts. Thus, on this account, the golden parachute agreement, in which top management receives special severance pay following a shift of corporate control, is an attempt to avert shareholder opportunism.[42] The problem is that golden parachutes are rife with moral hazards. If the payment exceeds the discounted present value of the

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41 Such contracts will be "self-enforcing." See Telser, A Theory of Self-enforcing Agreements, 53 **J. Bus.** 27 (1980).

42 Such an analysis of golden parachutes is offered by O. Williamson, **The Economic Institutions of Capitalism** 314-16 (1985); Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 73-81 (1986).

deferred compensation claim, managers will have an incentive to induce a hostile bid by, for example, poor performance that reduces the value of the firm. Similarly, once the takeover attempt is underway, the parachute may reduce management's incentive to obtain the highest price for the shareholders. In both these ways, golden parachute agreements may reduce shareholder wealth.[43] Thus, goes this rather elaborate argument, because dual class common stock will prevent takeover-related shareholder opportunism, it will eliminate costly contracting alternatives and thereby enhance shareholder wealth.

This argument is not persuasive. Let us assume that the only effect of dual class common is to route all decisions in respect of a bid for the firm through management (because a tender offer for non-voting shares cannot obtain control). The moral hazard problems associated with golden parachutes return: In negotiating to protect its deferred compensation claim, management can obtain excessive side payments from the acquirer and trade a reduced share price for increased side payments. In the heat of battle, such trade-offs may be harder to detect than abuse of the golden parachute. But our starting assumption is, of course, too limited. Dual class common gives rise to agency problems not only in merger negotiations but in the management of the firm generally. The negative consequences for shareholder wealth of such ongoing management insulation from

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43 One testable implication of this argument is that stock prices should fall upon announcement of the adoption of a golden parachute agreement. However, the only available empirical evidence shows an increase in stock prices. Lambert & Larcker, Golden Parachutes, Executive Decision-Making, and Shareholder Wealth, 7 J. Acct. & Econ. 179 (1985). These results, however, are subject to the confounding effects of an accompanying signal of an increased probability of a takeover bid. Id. at 189.

A very useful discussion of golden parachutes is provided in Note, Golden Parachutes: Untangling the Ripcords, 39 Stan. L. Rev. 955 (1987), which argues for an insurance perspective in evaluating golden parachutes.

shareholder control are likely to exceed the one time parachute costs or alternative compensation arrangements that may arise.[44]

b. Firm specific human capital. Another argument for dual class recapitalizations based on the costs of shareholder opportunism focuses on the need to induce managers to make the optimal investment in firm-specific human capital.[45] There are two distinct labor markets: the labor market within the firm, the "internal market," and the labor market across all firms, the "external market." Specialization by task or skill that brings rewards in the internal labor market may not lead to increased value in the external market.[46] Thus the situation resembles the shareholder opportunism problem discussed above.[47] Many

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[44] For example, there may be a decrease in the deferred element of compensation, i.e, salaries may rise; or pension benefits may vest sooner.

[45] See, e.g., DeAngelo & DeAngelo, supra note 22, at 35. The discussion that follows is drawn from M. Aoki, **The Co-operative Game Theory of the Firm** (1984); Becker, Investment in Human Capital: A Theoretical Analysis, 70 **J. Pol. Econ.** 9 (1962 Oct. Supp.); Klein, Crawford, & Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 **J. L. & Econ.** 297 313-19 (1978). Generally, these sources focus on joint decisions by the firm and the employee with respect to investments in human capital, in particular, the extent to which the firm and the employee share the costs and benefits of firm-specific training. For economy of exposition, the text focuses on the manager's decision only. Moreover, unlike the employee typically discussed in the literature, the manager has more control over the firm's decisions. See O. Williamson, supra note 42, at 312-14.

[46] Examples of such specialization, or firm-specific human capital investment, cover a vast range including: mastery of particular production processes used in a limited number of firms; historical knowledge of customer relations; development of a particular software configuration; and, know-how in maneuvering in a firm's culture.

[47] See supra text accompanying notes 39-44. Observe that nothing at this point turns on whether takeovers, net of third party effects, produce gains, only that shareholders are better off. Third party effects include the impact of employee layoffs and plant and office closings.

Empirical studies universally indicate large gains to target firm shareholders in an acquisition. The data on gains to acquiring firm shareholders

firm-specific human capital investments pay off only over time and thus entail a significant element of deferred compensation. Reputation effects induce firms to honor implicit contractual obligations to reward and protect with tenure those who make such human capital investments. As before, a takeover gives shareholders the chance to behave opportunistically with respect to such obligations.

Once again the wheel continues to turn: Managers will demand increased current compensation or will reduce their investment in firm-specific human capital. In more homely terms, loyalty suffers. Managers may prefer to undertake projects that increase their external labor market value. These

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has been more ambiguous. Depending on the sample of firms covered, the gains have ranged from approximately 5% to negative 1%. See Jarrell, Brickley & Netter, supra note 27, at 3-7, Table 1. The general assumption has been that target shareholder gains from acquisitions have been so large that overall shareholder wealth effects must be substantially positive even assuming negative effects in some cases for acquiring firm shareholders. This is open to the objection that because acquirers are usually larger than targets, it is not clear how a small (in percentage terms) the acquirer loss compares in absolute dollars to a large (in percentage terms) target gain. See, e.g., Roll, The Hubris Hypothesis of Corporate Takeovers, 59 **J. Bus.** 197 (1986) (suggesting wealth transfer form acquiring firm shareholders as a possible source of target shareholder gains).

To test this objection Bradley, Desai & Kim undertook a study of shareholder wealth effects for matched pairs of target and acquirers over the 1962 through 1984 period and three relevant subperiods, including the subperiod 1981 through 1984, during which other studies had suggested negative effects for acquirers. Bradley, Desai & Kim found that for the entire period the value-weighted average gain from an acquisition was 7.43%; or in absolute dollar terms, an average gain of $117 million. In other words, in an acquisition, the combined wealth of target and acquiring firm shareholders increased, on average, by 7.43%, or $117 million. Bradley, Desai & Kim, supra, note 27, at 11-13. For each of the subperiods, the percentage average gain from an acquisition is very similar, between 7% and 8%. Id. at 12, 15. The average dollar gains from an acquisition in the 1981 through 1984 period have been substantially larger, an average of $219 million. Id. In other words, taking into account the comparative sizes of target and acquirers, acquisitions substantially increased the combined wealth of target and acquirer shareholders. This is consistent with a synergy explanation for takeovers, in which acquisitions are motivated by a desire to better deploy target resources. See also J. Grundfest & B. Black, Stock Market Profits from Takeover Activity Between 1981 and 1986: $167 Billion is a Lot of Money (mimeo, Sept. 1987)

projects may not necessarily be the best projects for the firm, or those that would best advance the managers' careers within the firm. By this reasoning, shareholders are once again better off if they concentrated voting control in management and its allies.

One powerful argument against this scenario is that it fails to address the underlying agency problem: If managers can freely avoid shareholder wealth-maximizing activity when there is a threat of a hostile takeover, what will prevent even greater opportunism when that threat ends? Proponents of dual class recapitalizations must argue that eliminating the hostile takeover threat reduces agency costs because of a better alignment of management and shareholder interests. Such an argument might go as follows: Projects associated with firm-specific human capital investments ordinarily have a higher return to the firm than projects associated with general human capital investments. Thus, we can ordinarily expect managers to act to maximize their value on the internal labor market by pursuing projects that are shareholder wealth-maximizing projects. Returns to managers, however, consist of current and expected future compensation. The advantage to managers in making firm-specific human capital investment ordinarily derives from the expectation of higher future compensation. The prevalence of takeovers raises managers' discount rate for such future compensation and thus reverses the managers' ordinary ranking of firm-specific versus general human capital investment projects.

But notice where this argument goes: to the claim that takeovers are not the solution to managerial under-performance but frequently its cause. The fear of takeovers leads managers systematically to prefer projects that produce immediate compensation or that increase their value in the external labor market, rather than projects that maximize the value of the firm. Such a conclusion

radically contradicts the basic premises of the market in corporate control. It leaves unexplained why acquirers began to undertake takeovers in the first place and is contradicted by the empirical evidence that shows significant gains to shareholders from takeovers.[48] The most compelling explanation of the persistence of very large gains in these transactions is that the market believes that managers of acquiring firms can better deploy target assets. In short, the human capital argument seems unlikely to supply a shareholder wealth maximizing justification for dual class recapitalizations.

c. Some suggestive evidence. Justifications based on the costs of shareholder opportunism generate a prediction: Dual class recapitalizations should occur more readily in firms where managers have a small equity stake, because the risk of shareholder opportunism is greatest in such firms, and thus the savings to shareholders from such recapitalizations are also greatest. In contrast, where managers have large equity stakes, their losses as managers are recouped by their gains as shareholders.

This prediction is not borne out by the empirical evidence, however. My survey of NYSE firms undergoing recapitalizations in the past two years shows that the management/family bloc was almost always quite substantial. In 15 of 19 firms that proposed or undertook recapitalizations in that time, the family/management bloc owned more than 20% of the stock.[49] In only one case was

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48 See supra note 27.

49 See Table 1. Excluded from the survey were General Motors, Triangle, and Ciber, which underwent dual class recapitalizations in connection with mergers or acquisitions. The transactional patterns of these recapitalizations are quite different from the 19 surveyed firms, suggesting a quite different motivation. It would only confuse matters to lump these 3 firms with the others. For a discussion of General Motors, see infra text accompanying notes 206-208.

the family/management bloc less than 10%.[50] This finding lends support to the theoretical critique of shareholder opportunism justifications and strongly supports the view that shareholder efforts to reduce the costs of such opportunism do not play an important role in the current wave of dual class recapitalizations.

4. Protection of bargained-for management perquisites. Managers may want voting control to protect the management perquisites implicitly provided for in the initial management/shareholder contract. The typical case is the family enterprise that goes public in a dual class IPO. The founders may wish to assure continued family dominance, including the ability to employ and pay family members preferentially and to enjoy other economic and non-economic perquisites. These factors are presumably reflected in the price that outsiders pay for shares. It would be difficult to spell out such management perquisites by specific contract, so a dual class common capital structure may serve this purpose. Indeed, in the absence of such protection, the founders may be unwilling to take the firm public, which might limit the firm's ability to pursue otherwise desirable projects or force it to rely excessively on debt financing.

This classic justification for a dual class IPO does not justify a dual class recapitalization. A major problem for public shareholders in a family-dominated firm is the risk that insiders will divert a disproportionate share of firm cash flow. With a single class of stock, continued family control requires a relatively large equity stake, which at least partially bonds against discrimination against public shareholders. In a dual class IPO public shareholders will presumably demand a significant discount to compensate for the

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50 See Table 1.

risks of exploitation, including the risk that the family may reduce its equity stake while retaining control. Given a single class IPO, public shareholders would ordinarily refuse to consent to a dual class recapitalization that exposes them to these risks.[51]

5. Compensation for firm-specific risk. Many of the recent dual class common recapitalization proposals were made by firms in which family/management groups hold large blocks of stock. As stated above, in 15 of 19 NYSE firms that undertook recapitalizations in the last two years, the family/management ownership exceeded 20% of the stock.[52] Investments of this size indicate that

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[51] Conceivably, the recapitalization could be accompanied by a payment to public shareholders that represents a discount for these risks. Structuring such a discount would be rather difficult. Presumably the only payment that counts is one that transfers wealth from the management bloc to public shareholders. As is discussed below, one technique adopted in current recapitalizations--a dividend preference to public shareholders--only looks like a discount. It actually serves to coerce shareholder consent to management control. See infra text accompanying notes 152-156.

It is worth noting that the actual recapitalization proposals are inconsistent with a pure anti-dilution rationale. Of proposals from 19 NYSE firms studied in detail, all but 2 restrict the transferability of the super-voting common; if traded, the super-voting common converts into ordinary common. See Table 1. This means that as public shareholders trade the firm's securities, management's position becomes more entrenched whether or not new equity is issued; alternatively put, management's position may stay the same (or be strengthened) even if it sells some of its stock.

In some circumstances a preservation-of-bargained-for-perquisites rationale is not inconsistent with an increase in shareholder wealth. Let us assume that management believes additional equity will permit the firm to pursue profitable projects, but is unwilling or unable to increase its equity stake. To retain control and its perquisites, management may propose a dual class recapitalization and may threaten to forego the projects unless the public shareholders consent to that recapitalization. Shareholder consent may be coerced because of the strategic choice problems they face. See infra text accompanying notes 157-182. Even though shareholder wealth may increase, the recapitalization is not necessary to that end. If forbidden to pursue a recapitalization, the family/management bloc is likely to pursue profitable investment projects despite the risk to their control, because their share of the returns from those projects will often exceed the discounted value of the possible future loss of control.

[52] See Table 1; supra text accompanying note 49.

the holders are not diversifying, but rather choose to bear considerable firm-specific risk. Indeed, a recent study of ownership concentration in the largest American firms correlates concentrated ownership with greater than average instability in the firm's market environment, suggesting even higher firm-specific risk-bearing by such holders.[53]

Thus dual class capital structures can then be seen as securing extra compensation for such risk-bearing. This compensation can take different forms: assurance of continued exercise of what is believed to be a comparative advantage in managing the firm; or pecuniary and non-pecuniary benefits as discussed above,[54] including some diversion of firm cash flow. Such an account explains dual class IPOs but does not immediately suggest a benefit to public shareholders from dual class recapitalization. In what way could public shareholders benefit? One possibility is that continued concentration of ownership benefits public shareholders, who free-ride on monitoring by dominant shareholders. That is, assuming that diversion of cash flow is held within reasonable bounds, public shareholders benefit from the intense involvement of a dominant shareholder group, which has its fortune and reputation tied to the performance of the firm. Indeed, this is presumably a reason public shareholders buy shares in such firms. These benefits will be lost without dual class common, it is argued, because without compensation for risk-bearing, dominant shareholders will sell some of

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53 Demsetz & Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 **J. Pol. Econ.** 1155 (1985) (using ownership data as of 1980). Demsetz and Lehn state that this correlation suggests that concentrated ownership facilitates monitoring of management in "noisy" environments in which it is more difficult to separate management performance from exogenous factors. Id. at 1159.

54 See supra text accompanying notes 39-48.

their shares. The threat posed by dominant shareholders is, in effect: unless we are guaranteed control, we will diversify our holdings, and you will lose the benefit of our intense efforts on behalf of the firm, including our monitoring of managers.

This justification seems implausible. A recapitalization that assures the family/management group such control raises tremendous agency problems, including the possibility of an increasing diversion of cash flow, against which public shareholders would have little defense. These problems probably explain why the firm was initially capitalized with single class common. It seems unlikely that a controlling shareholder group would reduce its equity stake merely because it was not assured of control. This would only jeopardize control further. Indeed, once given such assurance through dual class common, the group would find it feasible to reduce its equity stake in the firm. Moreover, management's continuing belief in its comparative advantage in controlling the firm is not necessarily warranted. Presumably only when that belief is incorrect could a hostile bidder attract support from public shareholders.

Thus, the case that dual class recapitalizations enhance shareholder wealth seems implausible. There may be reasons why the joint utility of insiders and public shareholders is maximized in an initial public offering of dual class common stock. But it is very difficult to believe that the wealth of public shareholders is likely to be increased by a transaction in which their voting participation is dramatically reduced, generally without compensation. What is the bearing of the empirical evidence on this theory? To that evidence we now turn.

B. The Empirical Evidence

The available empirical evidence supports the view that dual class recapitalizations do not increase shareholder wealth. It suggests, but does not conclusively demonstrate, that such recapitalizations decrease shareholder wealth.

A study by Professor M. Megan Partch shows in general no statistically significant wealth effects.[55] A study presented in this paper generally confirms Partch's results, but suggests that certain dual class recapitalization mechanisms may decrease shareholder wealth.[56] The Office of the Chief Economist of the SEC has produced a series of studies.[57] The most recent and comprehensive study, released in July 1987, finds negative wealth effects of approximately 1% on average for recapitalizing firms.[58] Further analysis of the July 1987 OCE Study invites the conclusion that dual class recapitalizations in fact produce negative wealth effects of 3%. Negative wealth effects of 3%, or even 1%, are economically significant and their existence severely undermines the claim that

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55 Partch, The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth, 18 **J. Fin. Econ.** 313 (1987).

56 See Tables 1 and 2.

57 SEC Office of Chief Economist, The Net-of-Market Price Changes of Ten Firms that became Subject to Delisting by the NYSE for Disenfranchising Shareholders (Oct. 17, 1984) [hereinafter cited as October 1984 OCE Study] (An updated version of this study is reported in Dual Class Issues Depress Share Prices at NYSE, **Investment Dealers' Dig.**, Apr. 7, 1986, at 4); SEC Office of the Chief Economist, The Effects of Dual-Class Recapitalizations on the Wealth of Shareholders (June 1, 1987) [hereinafter cited as June 1987 OCE Study]; SEC Office of the Chief Economist, Update--The Effects of Dual-Class Recapitalizations on Shareholder Wealth: Including Evidence from 1986 and 1987 (July 16, 1987) [hereinafter cited as July 1987 OCE Study].

58 OCE July 1987 Study, supra note 57, at 1.

public shareholders are adequately protected from management abuses in recapitalizations by their opportunity to vote on the proposal.

There are strong reasons, however, to believe that these empirical studies understate the negative consequences for shareholders of dual class recapitalizations. First, the prior distribution of share ownership for the firms undergoing recapitalizations can be expected to dampen the immediate effects on shareholder wealth. Because many of the firms had large family/management blocs, it is likely that public shareholders had discounted the stock price prior to the recapitalization to reflect the improbability of a near-term takeover bid and the possibility of increased management exploitation. Second, the possible impact of a recapitalization is entangled with the favorable signal about the firm's prospects that a recapitalization proposal frequently carries. The available empirical evidence, therefore, may not resolve the ultimate question of the consequences of dual class recapitalizations for shareholder wealth.

Before discussing the studies, a word about methodology may be appropriate. The empirical evidence is generated using an "event study" methodology that has become commonplace in contemporary financial economics.[59] This methodolgy starts with the assumption that a particular event, such as a recapitalization proposal, can be identified with some precision. On the further assumption of market efficiency, the market price of the firm's shares will quickly impound the collective shareholder judgment as to the event's effect on the value of the firm. The problem is that the firm's stock price can be affected by marketwide

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[59] See, e.g., Romano, Law As a Product: Some Pieces of the Incorporation Puzzle, 1 J. Law, Econ. & Org. 225, 266-67 (1985). The following discussion draws from Romano's description of event study techniques.

factors as well as by an event particular to the firm. If such market effects can be eliminated, however, abnormal price changes (also known as abnormal returns) in the days around the event may be interpreted as a measure of the event's economic impact.

The simplest way to eliminate market effects is to subtract percentage price changes in the overall market, as reflected in a broad market index, from percentage price changes for the studied firms, to generate "net-of-market" returns. A more sophisticated technique is to use a "market model" to eliminate market effects, in which the responsiveness of the firm's price to market movements, its "beta," is estimated using historical price data.[60] Event studies then group all the firms subject to the event into a single portfolio. After adjustment for market effects, the key variable is the average abnormal price change, also known as the average abnormal return or average residual. The average is used to control for possible influences on stock prices apart from either the event or the market; on average, such extraneous effects should wash out.

Frequently, however, the announcement day of the event cannot be determined exactly, or there may be reason to believe that public dissemination occurred over more than one day. In this case, abnormal price changes in an interval surrounding the likely event day are cumulated for all firms in the study. The variable of interest, then, is the cumulative average abnormal price change, or cumulative average residual. Finally, the results are tested for statistical

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60 The net-of-market method in effect assumes a beta of one for identified firms. Recent work suggests that net-of-market studies using daily returns have almost the same power as market model studies. Brown & Warner, Using Daily Stock Returns: The Case of Event Studies, 14 **J. Fin. Econ.** 3 (1985).

For a critical analysis of event study methodology, see Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761, 770-86, 834-46 (1985).

significance, which examine the pattern of price changes for the sampled firms to determine the likelihood that the particular results could arise solely by chance.

1. The Partch study. Partch examines shareholder wealth effects associated with 44 dual class recapitalizations over the 23-year period from 1962 through 1984.[61] Of the firms involved, six were listed on the NYSE, 15 on the Amex, and 23 on the OTC market. Partch measured wealth effects by an event study using the market model. The results are somewhat ambiguous, but in general show no statistically significant wealth effects from dual class recapitalizations.[62]

Partch generates three measures of shareholder wealth effects from dual class recapitalizations. The first is based on abnormal price changes (she calls them "prediction errors") in response to the initial public announcement of the recapitalization proposal. The second is based on a sum of abnormal price changes surrounding dates of board meetings, proxy statements, shareholder meetings, and reports in The Wall Street Journal relating to the recapitalization. The third is based on the sum of abnormal price changes over the period from the announcement of the recapitalization proposal to shareholder approval. For all three measures, the results do not show any statistically significant wealth effects.[63]

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61 Partch believes that this sample represents all firms with publicly traded common stock prior to the creation of a class of limited voting shares during this period. Partch, supra not 55, at 316. The recapitalizations were concentrated in the 1980 through 1984 period, however, only 7 of 44 preceded 1980. Id. at 316, Table 1.

62 Id. at 326-28.

63 Id. at 326-32. Although for the first two measures, the average abnormal price changes are positive, and apparently statistically significant, further examination shows that a few positive outliers skew the distribution.

Partch also examines shareholder wealth effects for several subsamples, based on, for example, the different mechanisms of the recapitalization, the firms' stated intention to issue new equity following the recapitalization, and the extent of insiders' control. She finds conflicting wealth effects where the recapitalizations produced a class of limited voting stock with a dividend preference.[64] Where management had sufficient votes to assure passage of the recapitalization proposal (as was the case in nine of these firms) she finds positive and statistically significant wealth effects on the first two measures.[65] All other subsamples show no wealth effects statistically different from zero, including a subsample of six NYSE firms.

2. The study herein. My study attempts to evaluate the effect on shareholder wealth of dual class recapitalizations during the period from 1984 through 1986 by 19 NYSE firms that are subject to the NYSE moratorium on

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For the initial public announcement test, the average abnormal price response is a positive 1.237%, but the median is negative and only 44% of the firms show positive responses. Similarly for the second test, which sums abnormal returns surrounding significant dates, although the average abnormal price response is 2.125% and statistically significant, the percentage of positive responses is only 51%. For the third test, which sums the returns during the entire period from announcement to approval, the average abnormal price response is -1.755%, but is not statistically significant. Id. at 326-28.

64 Id. at 330-31. On her first two measures of wealth effects, recapitalizations in which limited voting shares receive a dividend preference are associated with statistically significant positive effects of 2.760% and 3.850% respectively; on the third measure of wealth effects (sum of abnormal price changes during the period from announcement to approval), the results are -4.90% and statistically significant.

65 Id. at 332. The gains were 2.177% and 4.967% on these two measures. Partch interprets her results as showing that "the market responds positively to proposals to issue limited voting common stock when the motivation of the plan is not to gain control of the firm, but rather to maintain control of the firm." Id.

delisting.[66] The exclusive focus on this group of firms was motivated by three factors. First the dual class recapitalization issue is particularly important to the NYSE because of the pressure in that exchange to abandon its single class common rule. Because of that rule, which had previously been enforced by delisting, shareholders of NYSE firms were least likely to have discounted the share price paid against the possibility of a dual class recapitalization.[67] Second, NYSE firms typically have larger market capitalizations and thus percentage wealth effects are economically more significant. Examining recapitalizations subject to the moratorium was a way of separating out shareholder wealth effects attributable to expected changes in firm cash flows from those associated with delisting. Third, the October 1984 OCE study reports very large negative wealth effects (-11.97%) for a group of nine NYSE firms that violated NYSE rules as to single class common or as to shareholder approval of

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66 See Tables 1 and 2. As an increasing number of firms proposed dual class recapitalizations in 1984, the NYSE adopted a "moratorium" on its previous practice of delisting such firms for violation of its one-share/one vote policy, pending a possible change in the policy. My study includes all firms that were both identified by the NYSE staff as undertaking recapitalizations that presented challenges to the NYSE single class common rule, as of July 31, 1986, and, according to the firm's proxy statement, had taken such action at least partly for anti-takeover purposes. Thus the study excludes General Motor's issuance of Class E and Class H stock in connection with its acquisitions of Electronic Data Systems and Hughes Aircraft Company respectively, and the recapitalizations of Triangle and Clabir, which stem from complicated financial restructurings for acquisition purposes. A survey of the recapitalizations is presented in Table 1. None of the firms in the survey proposed a recapitalization in the midst of a takeover bid, and, because of the moratorium, none of the firms has been delisted.

67 Of course, once the NYSE announced its moratorium shareholders may promptly have discounted for the possibility of dual class recapitalization. This effect seems virtually impossible to measure by standard econometric means.

the issuance of a large amount of stock during the 1976-1984 period.[68] But shareholders of such firms should have anticipated the probability of delisting, which occurred for six of these firms.[69] The announcement of a moratorium should have changed shareholder expectations about a delisting following a dual class recapitalization.

I performed an event study using net-of-market returns. Since recapitalization proposals have invariably been accepted by shareholders, I regarded the relevant event as the announcement of the proposal.[70] As described above, price change percentages for days around the event were calculated for each firm and then subtracted from the percentage change in the Standard and Poors 500 Stock Index for the same period.[71] These net-of-market results eliminate price change associated with the market generally, almost as effectively as the market model for studies of this sort.[72]

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68 October 1984 OCE Study, supra note 57, at Table 2.

69 Id. at 2.

70 In even a relatively efficient market the price effects of a recapitalization proposal should impound the likelihood of the proposal's acceptance. Nevertheless I used the shareholder approval day as the relevant event in several tests, calculating net-of-market returns for the five day periods before and after the event day. No wealth effects statistically different from zero were found. See infra, Table 3, Study C.

71 Daily stock prices and the Standard & Poor's 500 Stock Index were taken from the Standard & Poor's Daily Stock Price Guide.

72 See supra note 60. Net-of-market studies may have problems where the returns have cross-sectional dependence--for example, were all recapitalization proposals to have been announced on the same day. My study may conceivably have run into this problem in that most of the firms probably have high betas and the recapitalizations were proposed during a period of overall market rise. The results may thus understate the negative shareholder wealth effects. The July 1987 OCE Study is a market model study that should test and correct for this

The study examines two different event intervals. In Study A, I adopted the assumption that the event (the recapitalization proposal announcement) could be precisely identified, that no prior information had leaked to the market, and that the impact of this event, if any, would be rapidly reflected in prevailing prices. Thus, I collected price change data respecting three days: the second day before the announcement day (the benchmark), the announcement day, and the day following the announcement day.

The assumption of a precisely identifiable event day was not entirely realistic for this sample, however. For literally half of the firms there was no apparent mention of the recapitalization proposal in The Wall Street Journal. For these firms the date relied upon was the day following the proxy mailing date or the date corporate personnel said that an announcement was made. Information disseminated in this way might be more slowly reflected in prices. Moreover, information might well leak to the market in advance of the nominal event day. Thus for Study B I collected price change data respecting five days prior to the event and five days after. For both studies net-of-market price change percentages over the event interval for all firms in the sample were cumulated and averaged. The standard tests of statistical significance were then applied. For both Study A and Study B, as Table 2 indicates, I found no shareholder wealth effects statistically different from zero for the sample as a whole.[73]

On the other hand, I did find statistically significant negative effects

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possibility.

[73] See Table 2.

for subsamples based on the recapitalization mechanism employed.[74] In my 19 firm sample three mechanisms are used: 1) the exchange offer, in which shareholders have the right to exchange their ordinary common stock for shares of "super-voting" stock, carrying typically ten votes per share but with a 10% lower dividend rate (eight cases); 2) the special distribution, in which all shareholders receive shares of super-voting stock (six cases); and 3) the voting rights alteration, in which shares held for the "long-term" have super-voting status (five cases). In the case of voting rights alteration, Study A found a negative 3.42% change in shareholder wealth at the .05 confidence level.[75] Study B partially confirms this finding, indicating wealth changes of negative 4.36%, but only at the .15 confidence level.[76]

Somewhat contrary to Partch's results[77] in the case of the exchange offer, both Study A and Study B (see Table 2) reveal no shareholder wealth effects different from zero with strong statistical significance.[78] On the other hand,

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74 See infra text accompanying notes 129-138.

75 See Table 2. Technically, this means that there is only a one in 20 chance that the results arose solely by chance. Practically, it means that the price changes in my small (n=5) sample were consistently negative. It should be noted that tests based on such small samples are suspect, irrespective of significance levels.

76 See Table 2. This means that there are three chances in 20 that the results arose by chance.

77 Cf. Partch, supra note 55, at 330-31.

78 See Table 2. Study B shows positive wealth effects of 3.34% at the .20 confidence level. This may be suggestive, although Partch's finding was at the .05 confidence level. Partch, supra note 55, at 333. Partch's category was somewhat differently constructed, i.e. "limited voting shares [that] receive preferential dividends," but this would describe virtually all of the exchange

Study B provides some suggestive evidence that shareholders fare better with an exchange offer than with the other two mechanisms.[79] This is not surprising, since the exchange offer provides at least some dividend preference for the limited voting shares that public shareholders invariably obtain.[80]

The results of Study A and Study B are also contrary to Partch's finding of statistically significant positive wealth effects for firms where the family/management bloc had sufficient votes to force the recapitalization.[81] For such cases study B finds shareholder wealth effects of negative 13.62% at the .10 confidence level, the largest economic effect registered in the study.[82]

One important implication of my study is to question the evidence in the October 1984 OCE Study of large negative effects (-11.97%) on shareholder wealth in dual class recapitalizations by NYSE firms.[83] The most straightforward

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offers in my sample as well.

79 Partch, supra note 55, at 330-31.

80 See infra text accompanying notes 131-136.

81 See supra text accompanying note 65.

82 See Table 2. These firms did not show a preference for voting rights alteration mechanisms: Two used exchange offers; two used a special distribution; and, one used a voting rights alteration. One way to interpret these results is to say that shareholders are particularly disturbed by the "cram down" recapitalization, for it is a signal that the family-management group is prepared to use its power at the expense of minority shareholders.

83 October 1984 OCE Study, supra note 57, at Table 2.

explanation is that these negative effects resulted from the anticipated delisting rather than changes in firm cash flows.[84]

3. Studies by SEC Office of Chief Economist. The SEC's Office of the Chief Economist has produced three studies on the dual class recapitalization issue, beginning with the October 1984 study and culminating with the July 1987 study.[85] The results of these studies vary in interesting ways. The suggestion of large negative wealth effects from dual class recapitalizations in the October 1984 study has not been borne out by later, more comprehensive studies. The later studies support the view that shareholder's fear of delisting outweighs their concerns with respect to firm cash flows. On the other hand, the July 1987 study, which includes virtually all recent dual class recapitalization cases (97 firms, through May 1987), finds negative wealth effects of nearly 1% for firms that recapitalized after the NYSE moratorium.[86] This is evidence of significant shareholder concern for cash flows. The July 1987 study contrasts with the findings of an earlier study released in June 1987 (63 firms, through February 1986) that indicated no negative wealth effects.[87] The comparison between the

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84 This conclusion, which is reinforced by the subsequent OCE studies distinguishing between pre-moratorium and post-moratorium recapitalizations, see infra text accompanying notes 88-112, has a nice ironic edge. It was the claim that the NASDAQ provided competitive listing services that led the NYSE to seek to alter its rule. It should also be noted that the October 1984 OCE study involved a small sample and provided no tests of statistical significance. See October 1984 OCE Study, supra note 57. It may well be that its results were overstated.

85 The studies are identified supra in note 57.

86 July 1987 OCE Study, supra note 57, at 5.

87 See, June 1987 OCE Study, supra note 57, at 33.

June 1987 study and the July 1987 study (and the essentially identical finding of my study) raises the possibility that the negative wealth effects of dual class recapitalizations have been increasing over time as shareholders have come to understand their ultimate impact on the firm. Thus, the actual negative wealth effects may considerably exceed 1%.

a. June 1987 OCE Study. The June 1987 OCE Study undertook a net-of-market event study of 63 firms on the NYSE, Amex, and OTC undergoing dual class recapitalizations during the period from 1976 through May 1986.[88] Three quarters of these recapitalizations occurred during the last four years of the period.[89] For the sample as a whole, the study finds no statistically significant shareholder wealth effects.[90]

The study provides subsamples of NYSE firms that recapitalized before and after the moratorium on delisting. The study replicates the October 1984 OCE

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88 See id. The study tested five different trading intervals centering around the event, known as "event windows." The trading windows were twenty days before and twenty days after the event, ten days, five days, three days, and one day, respectively. Shorthand notation for such intervals is, e.g., -20,20). In addition, the study examined net-of-market returns for the year preceding the recapitalization proposal, the percentage of share ownership by insiders and by institutions, and the discount against super-voting stock at which limited voting stock traded in the secondary market. See June 1987 OCE Study, supra note 57, at Table 2-4.

89 June 1987 OCE Study, supra note 57, at 2-3.

90 Id. at 4. The study provides no support for the conjecture that wealth effects would be greater for NYSE firms than for Amex or OTC firms because of the greater disappointment of shareholder expectations. No statistically significant wealth effects were found that would distinguish the subsample of post-moratorium NYSE firms from the subsamples of Amex or OTC firms. Id. at Table 2. On the other hand, as noted above, the value of any bond against dual class recapitalizations provided by the NYSE single class common rule might have been eroded by the announcement of the moratorium, which would eliminate potential differences in wealth effects across exchanges. See supra note 67.

finding of economically important negative wealth effects for firms that violated the NYSE share issuance rules prior to the moratorium.[91] For one particular event window (three days before to three days after the event) the effect is -5.41% and statistically significant.[92] By contrast, for NYSE firms that proposed recapitalizations after the moratorium (15 cases) there are no statistically significant wealth effects.[93] This reinforces the suggestion that the threat of delisting has an important wealth effect.

The June 1987 OCE Study also provides subsamples based on the method of recapitalization.[94] There are no statistically significant wealth effects for any of the subsamples.[95] However, across most of the event windows, the wealth effects for plans in which limited voting stock has a dividend preference are more favorable than for plans without a dividend preference.[96] This corresponds with the suggestion in my study.[97]

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91 October 1984 OCE Study, supra note 57, at Table 2.

92 June 1987 OCE Study, supra note 57, at Table 2. This particular window covered three days before and three days after the announcement, hence the notation in the text.

93 Id.

94 Id. at Table 3. The June 1987 OCE Study uses slightly different nomenclature than my study. What I call "special distribution" plans it calls "dividend" plans; what I call "voting rights alteration" plans it calls "length of time" plans.

95 July 1987 OCE Study, supra note 57, at 25, Table 3.

96 Id.

97 See supra text accompanying notes 78-80 and Table 1.

The June 1987 OCE Study presents two particularly intriguing results. The first is that for a very large event window (twenty days before to twenty days after the event), announcements of dual class recapitalization proposals tend to be associated with economically large positive wealth effects of some statistical significance.[98] These results could simply be artifacts of the testing methodology. Over a relatively long event window, the failure to correct for a stock's beta could produce distorted results that understate the negative consequences of a recapitalization during a time of general stock market rise. Alternatively, it might well be that managers time the recapitalization announcement to coincide with favorable news about the firm. This would explain the pattern of positive wealth effects during the 40-day event window but no net wealth effects upon the announcement itself.[99]

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[98] June 1987 OCE Study, supra note 57, at Table 2. The results are these: for post-moratorium NYSE firms, 8.46% (t= 1.68); for Amex firms, 2.31% (t= 0.51); for OTC firms, 10.62% (t= 1.49), and for the sample as a whole, 6.87% (t= 2.00). Id.

[99] See id. The June 1987 OCE Study also reports the differences in the trading prices of super-voting stock and limited voting stock for the year following the recapitalization. Id. at 4. The sample for these purposes was limited to 26 OTC and Amex firms, because for many firms (including virtually all NYSE firms, see supra note 51) the super-voting stock was not readily transferrable, and for other firms a year had not elapsed since the recapitalization. Id. at 32 n.25. The study used end-of-month average prices. June 1987 OCE Study, supra note 57, at 4. The discount for limited voting stock was approximately 8% for the 10 cases where the two classes of stock received equal dividends and approximately 2% for the 16 cases where the limited voting stock received preferential dividends. Id. Overall, the average discount for limited voting stock was 4-5%. Id. at 32.

One way to interpret these results is to say that they demonstrate a wealth transfer. The argument is straightforward. Any differential in favor of super-voting stock reflects the capitalized value of the expected future diversion of cash flows or consumption of additional non-economic perquisites. See Lease, McConnell & Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. Fin. Econ. 439, 440-41 (1983). Prior to the recapitalization, shares held by the family/management block traded at the same price as shares held by public shareholders. Thus, the new differential reflects a wealth transfer.

Another intriguing set of results is that recapitalizing firms exhibit economically very large, statistically significant, positive net-of-market stock price changes for the year preceding announcement of the recapitalization proposal, 45% for the sample as a whole.[100] To the extent these results are not affected by the testing methodology, they are consistent with the typical management justification for dual class recapitalizations: Additional capital is needed for expansion, but insiders' control should not be diluted.[101] The June 1987 OCE Study purports to find a "(weak) positive relation between returns on announcement and prior growth" that suggests that the recapitalization announcement signals an end to constraints on the capacity of a high-growth firm to obtain financing.[102]

Nevertheless, even for the firms with the highest growth rates, there are no statistically significant positive wealth effects upon the recapitalization

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A persuasive counter-argument is that the price differential between the two classes of stock is indeterminate on the question of wealth transfer. This is because any differential will reflect the pre-existing control premium of the family/management bloc as well as any wealth transfer. In other words, the trading price prior to the recapitalization does not impound the control premium that the family/management bloc would have obtained upon sale of its interest. See Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955). Separating the firm's common stock into control and non-control stock will make apparent the pre-existing premium. Since the prior value of the premium is not known, no inference can be drawn about whether the differential reflects any other factor, including a wealth transfer. Any comparison of market capitalization of public shares to family/management shares before and after the recapitalization poses this same difficulty.

100 June 1987 OCE Study, supra note 57, at 32. Strictly speaking, the period covered ends twenty days prior to the announcement to avoid overlap with the forty day event window. The wealth effects are: NYSE post-moratorium firms, 37.6% (t= 1.84); Amex firms, 39.9% (t= 4.94); OTC firms 54.5% (t= 3.27); all firms, 44.6% (t= 5.11). Id. at Table 2.

101 Id. at 30.

102 Id. See also id. at Table 4.

announcement.[103] If the end of financing constraints is a plus, then the governance effects of a dual class recapitalization must be a minus.[104]

b. July 1987 OCE Study. The July 1987 OCE Study expands the June Study's sample to include 34 dual class recapitalizations from March 1986 through May 1987, for a total of 97 firms.[105] More than half of the sample recapitalized in the 1985-87 period[106] and three-fifths of the additional recapitalizations (20 of the 34) were NYSE firms.[107] The July Study employs a market-model methodology that should be more precise than the simple net-of-market methodology of the June Study. The addition of the most recent recapitalizations led to an important difference from the earlier work. Excluding firms for which data could not be obtained or which faced possible delisting from the NYSE for recapitalizing, the July Study found statistically significant negative shareholder wealth effects of 0.93%.[108]

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103 Id. at Table 4.

104 This pattern also supports the argument made below, see infra text accompanying notes 157-172, that shareholders might vote for a dual class recapitalization as losers in the game of "chicken," in which management can credibly threaten to forego favorable investment projects.

105 July 1987 OCE Study, supra note 57, at Table 1.

106 Id.

107 This is derived from a comparison of the June 1987 OCE Study, Table 1, with the July 1987 OCE Study, Table 1.

108 Id. at 1. The July Study also finds statistically significant stock returns of -0.89% for 62 firms that recapitalized since the NYSE moratorium in June 1984. Id. at 5. Nearly two-thirds (35 of 62) of the firms were listed on the NYSE. Id. at 4-5. The July Study also revealed negative, but not statistically significant, returns of -1.05% for pre-moratorium firms. Id. at 5. This result is somewhat contrary to Partch's findings of positive but not statistically significant returns. Partch's study, which examines recapitalizations beginning in 1962, includes five recapitalizations between 1962 and 1975 that are not included in the July 1987 OCE Study. Partch, supra note 55, at 316, Table 1.

The principal difference between the 62-firm post-moratorium sample and the

The results of the July Study, the most comprehensive evaluation of the recent wave of recapitalizations, are important because they strongly suggest that dual class recapitalizations reduce shareholder wealth by an economically significant amount. The study also allows the inference that the negative shareholder wealth effects of dual class recapitalizations are increasing over time. The most likely explanation of the difference between the June and the July studies is that firms that recapitalized between March 1986 and May 1987 experienced sufficiently large negative returns to change the results of the general sample.[109] One rough estimate is that these recent recapitalizations experienced negative returns of approximately -3%.[110]

97-firm sample (excluding NYSE firms facing delisting) is the latters inclusion of the OTC and Amex firms that recapitalized during the 1976-1984 period. There is no apparent reason why the NYSE moratorium should have affected returns for these firms.

[109] The same point could be made about the differences between the July Study and my study, which corroborates the June study for an earlier sample of NYSE firms.

The change between the July and the June studies does not seem attributable to any technical differences in methodology. Although the June Study used a simple net-of-market methodology rather than the market-model, the July Study recalculates the June results using the more sophisticated methodology and substantially reproduces the earlier results. July 1987 OCE Study, supra note 57, at 4 n.5. The July Study draws its conclusions from a focus on a very specific two-day window, i.e. price changes from the day preceding the announcement to the day afterward. Id. at 4. By contrast, the June study computes results for several different event windows, including a comparably short window. June 1987 OCE Study, supra note 57, at 20-22. Given the nature of this particular announcement and the problem of confounding effects over longer event windows, the July Study's shorter event window is probably the most reliable.

[110] The recent recapitalizations constitute approximately one-third of the entire sample. July 1987 OCE Study, supra note 57, at 2. Since returns respecting the original sample were, on average, zero, the average for the recent firms must have been close to -3% to produce an average for the entire sample of approximately -1%. Ideally, one would want to test this hypothesis with a direct study of the February 1986-May 1987 subsample. The July 1987 OCE Study did not provide sufficient detail to permit a quick, direct test.

The most compelling explanation for the apparent increase in negative wealth effects over time is the existence of a learning process in which shareholders have come to realize the negative impact of the recapitalizations over time.[111] It is very difficult to test directly the actual impact on the

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[111] An alternative explanation is that the nature of the recapitalizing firms changed over time. One hypothesis is that firms that recapitalized earlier had larger family/management blocs than firms that recapitalized later. Such differences would produce different expectations about possible near-term takeovers and increases in agency costs. The evidence for this explanation seems unpersuasive. The July 1987 OCE Study reports a statistically significant difference in insider holdings over time: For pre-moratorium firms, the median insider ownership is 51.5%; the mean is 49.4%. For post-moratorium firms, the median is 41.0%; the mean is 41.4%. Id. at Table 4. Nevertheless, the average insider bloc for post-moratorium firms is still quite substantial, and certainly would ordinarily be viewed as a control bloc. The OCE reports no evidence to suggest that the firms added to the June OCE Study, ie., firms that recapitalized during March 1986-May 1987, possessed dramatically different patterns of share distribution. Moreover, in my study of NYSE firms that recapitalized in the period from 1984 through July 1986, the median insider ownership was approximately 30%, substantially lower than for firms in the July 1987 OCE Study, and yet no negative wealth effects appeared. This suggests that comparative size of the insider bloc does not account for the change in wealth effects.

Another hypothesis is that the firms added to the original sample by the July 1987 OCE study had experienced slower growth in the time preceding the recapitalization than the original sample. Perhaps investors have less confidence in managers of such firms and are more likely to believe that managerial entrenchment will be costly. The July 1987 OCE Study reports lower net-of-market growth for the year preceding the recapitalization for the larger sample than for the original sample. The July Study finds average positive returns of 37.5% mean, 22.4% median. July 1987 OCE Study, supra note 57 at Table 4. By contrast the June Study finds average positive returns of 44.6% mean (no median is given). June 1987 OCE Study, supra note 57, at Table 2. This is not a dramatic difference. Moreover, the June Study finds a much lower rate of preceding-year growth for NYSE firms, 37.6%. Id. NYSE firms, which thus are typified by slower rates of growth, make up the majority of the recapitalizations added in the July Study. On the other hand, the July Study finds significant differences in the rate of the growth depending on whether the recapitalization occurred before or after the moratorium. For the pre-moratorium firms, net-of-market returns for the preceding year were 62.2% (mean), 53.0 (median); for post-moratorium firms, the net-of-market returns were 26.5% (mean), 14.0 (median). July 1987 OCE Study, supra note 57, at Table 4.

The different growth rates might not be relevant to the impact of dual class recapitalization on shareholder wealth. As dual class recapitalizations became more common, firms that had not delivered as much good news to shareholders in the preceding year might have felt they could act nonetheless.

Finally, even if the recently recapitalizing firms are in fact somewhat different, and raise questions for a learning theory, this does not gainsay the

firm of corporate action like a recapitalization. Announcement day returns merely provide the market's best unbiased estimate of the effect; however, consensus investor expectations may prove wrong. Ideally, one would want to observe firm stock prices for a significant period after the event to compare realizations against expectations. Such observations, however, are subject to "confounding effects"--other important events that may have equal or greater consequence for the firm than the studied action--that can interfere with econometric tests.[112] The two OCE studies provide an alternative way to test realizations, namely, by observing subsamples that are somewhat separated in time. Investors can assess whether the management justifications in the earlier recapitalizations were borne out; for example, did management use its independence from takeovers to raise new equity and aggressively pursue new projects? The market's reaction to later recapitalizations will reflect investors' assessments of earlier recapitalizations. In other words, investors learn, and the wealth effects from a maneuver employed by many firms may change over time. The July OCE Study offers strong evidence that investors have indeed learned that recapitalizations generally turn out badly for the firm. Thus the 1% negative wealth effects of the 1976-1987 sample, which is an average of announcement effects, may understate the evidence of negative effects from

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important fact that recent recapitalizations have had a significant negative impact on shareholder wealth.

112 There are particular problems in determining realizations for firms undergoing recapitalizations. To determine ex post wealth effects, some adjustment is required to account for the division of shareholder wealth into two separate classes. Yet for many firms, especially the NYSE firms, see infra text accompanying notes 131-138, the super-voting shares are not readily transferrable. This makes valuation highly speculative. Even where super-voting shares are traded, their price may reflect factors such as a control premium, that were not manifested in the trading price of the pre-recapitalization stock. See infra text accompanying note 131.

recapitalizations by a significant measure. As noted above, the actual negative effects may be closer to -3%.

4. Limits of the empirical research. The July 1987 OCE Study offers important evidence that dual class recapitalizations bring about economically significant negative shareholder wealth effects. Other evidence is more ambiguous. Nevertheless, even if the empirical evidence did not reveal negative wealth effects, this would not disprove their existence.[113] This is because several factors may obscure the negative consequences of these recapitalizations.

First, one common characteristic of firms that have undergone dual class recapitalization is a large family/management bloc. In Partch's study, for the quartile of firms with the largest family/management blocs, the median percentage of inside ownership was 62.4%; the median for the lowest quartile was 32.7%.[114] In my study, the median inside stock ownership (for the entire sample) was

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[113] Professor Gilson criticizes both Professor Partch and me for focusing on the extent to which the empirical tests demonstrate negative wealth effects or not. Gilson, supra note 20, at 839-40. Gilson argues that public shareholders could be unfairly treated by exclusion from the gains created by the dual class transaction, all of which might be captured by the insiders, without any negative impact on stock prices. Id. at 835. Gilson's objection contradicts the central argument of his paper, namely, that a dual class recapitalization is simply one of a number of competitive substitutes for centralizing control in management, including, for example, the leveraged buyout. Id. at 809-10. If his claim about substitutes is correct, then dual class recapitalizations deprive public shareholders of potential alternative transactions, such as the leveraged buyout, which allow them some share of the gains. The possibility of such a gain-sharing transaction should be reflected in the firm's stock prices; the loss of this possibility would register as a negative shareholder wealth effect. Thus the absence of negative wealth effects suggests either that there is no management appropriation of gains, or, contrary to Gilson's hypothesis about substitutes, the gains could be generated in no way other than a dual class recapitalization or some other transactional form that denies a share of the gains to public shareholders. But if the latter is true, then it would seem that shareholders would have no complaint.

[114] Partch, supra note 55, at 320, Table 3.

approximately 30%.[115] In the July 1987 OCE Study, the median was 46.2%.[116] Given this prior ownership distribution, public shareholders would have already discounted the stock price to reflect the improbability of gains from a near-term takeover bid or losses from any near-term increase in agency costs. In such cases, the negative consequences of the recapitalization are more likely to be felt in the future: Therefore, the effects, when discounted to present value, may not measurably register on current prices.

Even more importantly, the immediate negative effects of a recapitalization are likely to be washed out by a positive signal carried by the recapitalization proposal, namely, that the firm has profitable investment opportunities to exploit. For nearly two-thirds of my 19 NYSE firm sample, the proxy statement linked the proposed recapitalization to the firm's desire to issue new equity to take advantage of new opportunities, and to the concomitant desire of the family/management bloc to maintain its control undiluted.[117] For other firms,

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115 See infra note 144.

116 July 1987 OCE Study, supra note 57, at Table 4. The July 1987 OCE Study also reports statistically significant differences in insider ownership between pre-moratorium firms (49.4% mean) and post-moratorium firms (41.4% mean).

117 For 11 of the 19 firms, the connection was explicit. In a 12th case, the company made the recapitalization proposal in the same proxy statement in which it sought authority to issue additional equity for growth purposes, but did not link the issues explicitly. See, **American Family Corp., Proxy Statement** 8-9 (Mar. 14, 1985).

Typical language for the 11 firms appears in these two examples:

"The Giordano family . . . has advised the Corporation of its concern that transactions which the Board of Directors determine to be in the best interests of all the stockholders might make the Corporation vulnerable to a hostile takeover attempt. Under such circumstances, the Giordano family might not give its support to any such transactions for which its approval might be required unless steps were taken to secure its voting position in the Corporation.

"The Proposal is being submitted for the purpose of enabling the Corporation to achieve long term objectives and grow through the issuance of Common Stock or other equity securities in connection with possible acquisitions and to allow the

the connection between a recapitalization and the issuance of additional equity may be implicit. Thus it would not be surprising that an event study of recapitalization proposals shows no negative shareholder wealth effects. The good news is entangled with the bad.[118]

A problem for this argument is posed by the recent empirical evidence that suggests that in other contexts announcements of equity offerings are associated with negative effects on shareholder wealth.[119] One common explanation of this data is that the decision to raise funds by equity as opposed to debt signals management's belief, based on its superior information, that the firm's stock is

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Corporation to engage in the broadest range of operating and investment activities, if determined by the Board of Directors to be in the best interests of all the stockholders, without diluting the power of the Giordano family to participate in and exert influence over corporate decisions, and without making the Corporation vulnerable to a hostile takeover attempt." **Fedders Corp., Proxy Statement** 10 (Mar. 26, 1985).

"The purpose of the [recapitalization] proposal is to enable the Company to issue Common Stock or other equity securities and to allow the Company to engage in the broadest range of operating and investment opportunities without diluting the power of the Fisher family . . . and without making the Company vulnerable to an unsolicited or hostile takeover attempt." **The Gap, Inc., Proxy Statement** 15 (May 1, 1986).

118 This general argument is buttressed by the curious pattern in the June OCE Study of large net-of-market returns for the year preceding the recapitalization but no positive wealth effects associated with the recapitalization itself. See supra text accompanying notes 100-104.

119 See, e.g., Miller & Rock, Dividend Policy Under Asymmetric Information, 40 **J. Fin.** 1031 (1985); Myers & Majluf, Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have, 13 **J. Fin. Econ.** 187 (1984); Leland & Pyle, Informational Asymmetries, Financial Structure, and Financial Intermediation, 32 **J. Fin.** 371 (1977).

over-priced.[120] Accordingly, investors should consider an announcement of the firm's intention to issue equity to be bad news.

There is strong reason, however, to believe that any such signaling phenomenon should be reversed in the case of firms that undertake a dual class recapitalization to issue equity. All the firms in my NYSE sample are dominated by family/management blocs.[121] The managers of such firms strongly value control; many claim in the proxy statements that they would reject profitable investment opportunities rather than dilute control. Issuing debt may present a greater threat to control than issuing equity. Debt may entail restrictive covenants regarding operations and distributions. Moreover, in the event of financial distress, management may lose control of the firm altogether. For these managers, the choice is not between equity and debt, but between equity and no investment. Empirical evidence that dual class common firms are very conservatively leveraged[122] supports the view that such managers are averse to issuing debt for control-related reasons.[123] Thus, for these firms, the decision to issue equity should signal favorable investment opportunities, without necessarily signaling any bad news.

This argument also draws empirical support from the dual class recapitalization event studies. Partch generated a subsample of firms that sold

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120 The studies in the preceding note suggest that the information conveyed by new equity offerings lowers the stock price. Other studies have a different explanation: the negative price effects derive from less-than-perfect elasticity in demand for the shares. See, e.g., Mikkelson & Partch, Stock Price Effects and Costs of Secondary Distributions, 14 **J. Fin. Econ.** 165 (1985); Hess & Frost, Tests for Price Effects of New Issues of Seasoned Securities, 37 **J. Fin.** 11 (1982).

121 See infra note 144.

122 DeAngelo & DeAngelo, supra note 22, at 41 (study of 45 firms with dual class common outstanding as of 1980).

123 Jensen & Meckling, supra note 23, at 340 n.52.

equity or announced the intention to do so in connection with the recapitalization. Contrary to the expected pattern of negative effects, she found no shareholder wealth changes that are statistically different from zero.[124] I generated two subsamples, the first consisting of firms that connected the recapitalization to the issuance of additional equity (12 cases), the second consisting of firms that expressed no intention to issue new equity (7 cases). In neither subsample did I find shareholder wealth effects statistically different from zero.[125] Nevertheless, the results were provocative. In both Study A and B, the second subsample showed greater negative effects. This is a possible suggestion that the firms announcing an equity issuance do better.[126] It would be interesting to see if a market model test with a larger sample could substantiate this difference with statistical significance. In any event, both Partch and my study are consistent with the view that the issuance of equity does not carry a negative signal for firms undertaking a dual class recapitalization but may even carry a positive signal instead.

In sum, the empirical evidence suggests, but does not demonstrate, that dual class common recapitalizations decrease shareholder wealth across a broad range of firms. One interpretation of the evidence suggests that the negative wealth effects might be quite large, approximately 3% on average.[127] Moreover, the studies also show that despite announcement of desirable investment opportunities, firms that concurrently undertake a dual class recapitalization do not experience an increase in value. This suggests that the recapitalization is

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124 Partch, supra note 55, at 328-32.

125 See Table 2.

126 Id.

127 See supra text accompanying note 110.

an offsetting negative factor. In any event, the empirical work and its interpretation certainly offer little comfort to the competing claim that shareholders are better off.

The puzzle, of course, is that firms nonetheless make such proposals and shareholders adopt them. How can it be that shareholders approve proposals that do not increase, and may reduce, shareholder wealth? To that problem we now turn.

II. THE PROBLEM OF SHAREHOLDER CHOICE

This article contends that shareholder approval of a dual class common recapitalization--even by a majority of public shareholders--does not necessarily support a belief that these actions increase shareholder wealth.[128] Indeed, such approval can be elicited even if the recapitalization almost certainly reduces shareholder wealth. This is true because of collective action and strategic choice problems associated with shareholder voting. In order to understand this claim, it is first necessary to examine the recapitalization mechanisms that firms propose and their impact on shareholder choice.

A. Recapitalization Mechanisms

As discussed above,[129] my survey of 19 NYSE firms that recently recapitalized shows that three mechanisms are commonly used: exchange offers,

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[128] Perhaps it goes without saying that "shareholder wealth" refers to wealth as shareholders. Excluded from this definition are actions that increase the wealth of shareholders as managers. The empirical discussion above uses the firm's stock price to represent shareholder wealth.

[129] See supra text accompanying notes 75-76.

special distributions, and alteration of voting rights.[130] It is useful to consider each in turn.

1. Exchange offers. In the typical exchange offer recapitalization, shareholders must first approve a charter amendment that authorizes the issuance of a new class of common stock carrying several votes per share, most frequently, ten. In most cases this super-voting stock receives reduced dividends, most commonly, 10% less than is paid to limited-voting stock. In almost all cases the super-voting stock may not be transferred, other than to family members or trusts of the beneficial owner. An impermissible transfer works an automatic conversion from super-voting common to ordinary common.[131] After the new class of common is authorized, the firm conducts a one time exchange offer, in which shareholders may exchange their ordinary common for the super-voting common, typically on a one-for-one ratio. For reasons explained below,[132] public shareholders are very unlikely to make this exchange where the ordinary common is given any dividend preference.

Super-voting common fortifies the position of a management bloc in at least three ways. First, the super-voting common votes with the ordinary common in the

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130 The general descriptions of the different mechanisms that follow are drawn from an analysis of the proxy statements of the firms in my study. More particular information about the mechanism employed by a specific firm is provided in Table 2. The June and July OCE Studies, the broader samples of which included Amex and OTC firms, also use these three mechanisms as the basis for analysis and provide descriptions consistent with those provided here. June 1987 OCE Study, supra note 57, at 12-19; July 1987 OCE Study, supra note 57, at 3. The OCE nomenclature is somewhat different. What is here called a "special distribution" is there labeled a "dividend"; the "voting rights alteration" is there referred to as a "length-of-time plan." See June 1987 OCE Study, supra note 57, at 12-17; see also id. at Table 3.

131 The firm will convert the super-voting stock to ordinary common for disposition. Upon an unauthorized transfer, the super-voting stock automatically converts into ordinary common.

132 See infra text accompanying notes 139-175.

election of directors and other matters, such as merger proposals, that come before the common shareholders.[133] Thus if no public shareholders exchange their stock, an insiders' bloc of 9.091% of the firm's common equity could incontrovertibly control the firm.[134] Second, even if public shareholders did exchange, the transfer restrictions mean that such super-voting shares could not be transferred to a hostile acquirer. The only risk to management's control is a proxy battle mounted by the exchanging shareholders. This limited possibility is cut back further by transfer restrictions that are often written so broadly as to suggest that the formation of a dissident shareholder group would trigger an automatic conversion of their super-voting common.[135] Third, the recapitalization terms typically provide for stock dividends and stock splits by class. This provides an easy avenue to repeatedly fortify the super-voting class. Thus no matter how much ordinary common the firm subsequently issues, it

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133 This is the usual pattern. In some cases the limited voting class is entitled to a minimum percentage of directors. See Table 1. For example, the limited voting shareholders of the Hershey Foods Corp. (an exchange offer) elect 1/6 of the directors; the limited shareholders of Dow Jones (a special distribution) elect 1/3 of the board.

134 The following calculation illustrates this point. Assume the firm has 100,000 common shares. The insiders' 9.091% bloc is 9,091 shares, which yields 90,910 votes. The public shareholders' 90.909% bloc is 90,909 shares, which yields 90,909 votes.

135 These transfer restrictions are typically drafted in terms of changes in "beneficial ownership," a term of art referring to the power to dispose of or vote securities. Pursuant to S S 13(d)(3) of the 1934 Act, 15 U.S.C. S S 78m(d)(3) (1982), which some firms mentioned explicitly, and the regulations thereunder, 17 C.F.R. SS 240.13d-3(a), (b) (1987), the agreement by shareholders to act in concert constitutes a transfer of beneficial ownership to the "group" formed thereby.

should be possible to maintain the control of the holders of super-voting common.[136]

2. Special distributions. In the typical special distribution recapitalization, shareholders must first approve a charter amendment that authorizes the issuance of a new class of common stock carrying several votes per share, most frequently, ten. The super-voting stock usually takes no dividend reduction. In most cases it may be transferred only to family members or trusts, and the stock automatically converts to ordinary common upon an impermissible transfer.[137] After authorization of the new class of common, the firm distributes the super-voting common, most frequently on a one-for-one ratio.

The distribution does not itself alter the relative voting power of public shareholders and the management bloc. Thus it differs from the exchange offer, where any public shareholder preference for the superior dividends of the ordinary common stock immediately shifts voting power to management. Nevertheless, the overall entrenchment effect is similar. As public shareholders begin to adjust their portfolios and dispose of stock, management's voting percentage will increase. Most importantly, the transfer restriction is protection against a hostile takeover. The possibility of a proxy battle by public shareholders may last longer in a distribution recapitalization because,

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136 In some cases, the board can issue shares of super-voting stock to a third party without further shareholder action. E.g., **Alberto-Culver, Inc., Proxy Statement** 3 (Mar. 17, 1986). This provides a low cost way of securing a white knight during a control contest. In some cases, shares of super-voting stock may issued on the exercise of employee stock options. E.g., **Lee Enterprises, Inc., Proxy Statement** 10-11 (Dec. 26, 1985). This obviously enhances the control position of the management bloc. In most cases, however, the issuance of additional super-voting stock, other than for stock splits or stock dividends, requires the approval of limited voting stockholders and super-voting stockholders, each voting as a class.

137 As with super-voting stock obtained through an exchange offer, the firm will convert super-voting stock received in the distribution to ordinary common.

unlike an exchange offer recapitalization, all public shareholders automatically receive super-voting shares. Given a substantial family-management bloc, however, this threat is limited. Moreover, as noted above, broadly written transfer restrictions may discourage the formation of a dissident shareholder group.

3. Voting rights alterations. The third mechanism is not, strictly speaking, a recapitalization. Rather, shareholders must approve a charter amendment that simply alters the voting rights of the firm's outstanding common to give multiple votes (typically ten) to "long term shares" while retaining one vote for "short term shares."[138] Long term shares are those shares acquired before the amendment date and held continuously thereafter, or subsequently-acquired shares, held continuously for a particular period, typically forty-eight months. Because all shares are of the same class, they participate equally in dividends. Shares are freely transferrable, but any transfer will divest them of their super-votes. A narrowly-drawn exception is generally made for transfers to family members.

This voting rights alteration enhances the voting power of a management bloc even more powerfully than a distribution of super-voting shares. Any portfolio adjustment by a public shareholder--not just a decision to dispose of super-voting shares--reduces the voting power of public shareholders as a group. Like a direct transfer restriction, the voting rights alteration makes a hostile acquisition virtually impossible. Similarly, proxy battles by public shareholders, even long-term holders, may be chilled by the concern that

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138 For this reason the OCE refers to this mechanism as a "length-of-time" plan. See supra note 130.

formation of a dissident shareholder group would itself trigger the voting rights alteration.

B. Collective Action and Strategic Choice Problems

The effect of each of these recapitalization mechanisms on the balance of power between public shareholders and insiders is apparent. The proxy statements issued by the firms make relatively candid disclosures that the proposals will tend to entrench the management bloc and, in particular, will make a hostile takeover bid at a premium price very difficult.[139] Despite this candor, these

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[139] The following examples are typical:

"Since following the proposal and the proposed exchange offer, the Broad interests will own a majority of the voting power of the Company if no other holder of Common Stock exchanges such shares for Class B stock, it will be impossible for a third party in such circumstances, to acquire a majority of the voting power of the company without consent of the Broad interests. In such circumstances and without such consent, the Company would be a less attractive target for a takeover bid or merger proposal, including bids or proposals in the best interests of shareholders other than the Broad interests, and a successful proxy contest to remove current management would be impossible, even if such actions were favored by the Board and shareholders of the Company other than the Broad interests." **Kaufman & Broad, Inc., Proxy Statement** 2 (Apr. 2, 1985).

"While the board of directors is of the opinion that the proposed Amendment, including the Recapitalization, is in the best interest of the Company and all of its stockholders, the board recognizes that there may be some disadvantages to certain stockholders. For example, the fact that the Class A Common Stock will have less voting power than the Class B Stock might have an adverse effect on the market price of the Class A stock. In addition, the proposed Amendment may have significant effects on the ability of stockholders to change the board of directors or to benefit from transactions that are opposed by the holders of Class B Common Stock. In addition, since voting control will be primarily vested in the holders of Class B Common Stock, particularly the members of the Lavin family, the Reclassification would render more difficult or discourage a merger proposal, a tender offer, a proxy contest or the removal of incumbent directors or management, even if such actions were favored by the holders of a majority of the Class A Common Stock. Also, the board of directors may issue authorized but unissued Class B shares without further action by stockholders, except as required by law, and thus might place the higher voting Class B shares in the hands of parties who would support the Lavins in a control contest. Accordingly, the proposed Amendment and Reclassification might deprive stockholders of an opportunity to sell their shares at a premium over prevailing market prices, since the proposed Amendment might make more difficult or discourage the acquisition of the Company by others." **Alberto-Culver Co., Proxy Statement** 7

plans apparently have been adopted whenever proposed. Further scrutiny, however, reveals two sorts of problems--concerning collective action and strategic choice--that undermine the claim that shareholders approve these plans in the belief that they will produce an increase in shareholder wealth.

1. Collective action problems. The reliability of shareholder voting as a decision mechanism for the public corporation has come under sharp attack on the grounds that widely dispersed shareholders face severe "collective action" problems in dealing with managers who control the proxy machinery.[140] There are two main elements to the attack. First, shareholders are likely to be "rationally apathetic." The cost of informing oneself sufficiently to cast an intelligent vote on a management proposal frequently exceeds the expected payoff, even assuming one's vote will be determinative. Thus the shareholder compliantly returns the management proxy.[141] Second, even where some shareholders have determined that a particular proposal will reduce shareholder wealth, "free rider" problems will discourage their organizing an opposition. Each shareholder may gain from opposition, but each will gain even more if other shareholders bear

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(May 17, 1986).

[140] The point is very effectively made by Professor Clark, who applies an analysis of collective action to shareholder voting that is drawn from M. Olson, **The Logic of Collective Action** (2d ed. 1971), and A. Hirschman, **Exit, Voice, and Loyalty** (1970). R. Clark, **Corporate Law** 390-96 (1986).

[141] For example, let us assume that the shareholder receives a wide variety of management proposals through the proxy machinery, of which only some may reduce shareholder welfare. The shareholder must expend a certain sum, $x, to hire an expert to analyze the proposal or expend a comparable amount in the foregone opportunity cost of the shareholder's own time. Unless the shareholder anticipates many bad proposals with a sizable effect on the share price--or unless she holds a very large block of a firm's stock--the shareholder will probably conclude that the expected gains are less than $x. Rational apathy follows, even where the shareholder's vote would determine the matter.

the costs. Because no compulsory cost-sharing mechanism exists in these circumstances and because no single shareholder can capture the whole gain to shareholders generally from the proposal's defeat, there will be insufficient incentive to organize opposition.[142] If a shareholder's stake is large and the expected negative impact is high, then her expected payoff from opposition may warrant some expenditure against the proposal, but not the optimum amount.[143]

These collective action problems that pertain generally are exacerbated by the distribution of share ownership in the firms that have proposed dual class recapitalization. In all cases surveyed in my study, there was a significant

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[142] Let us hypothesize a firm with 1,000 shares of common stock, currently trading at $100 per share and assume that management's proposal will reduce shareholder wealth by 10%, or $10,000. Assume further that the shares are widely-dispersed among the public but that the expenditure of $5,000 in organizational efforts will with certainty defeat the proposal. It will be difficult, if not impossible, to collect a voluntary $5 per share charge because each shareholder would prefer to free ride on the efforts of others and realize a $10 per share gain, rather than $5 per share ($10 gain minus the $5 charge). Thus no opposition will be organized.

These free-rider problems result from two corporate law norms. First, the rules regarding reimbursement of proxy expenses, which could operate as a compulsory cost-sharing mechanism, work unfavorably in these circumstances. Even the rule most favorable to reimbursement of insurgents seems to require board action. A battle against a management proposal, even if successful, leaves in place the incumbent directors, who are unlikely to respond to a defeat (or a victory) with magnanimity. See generally E. Aranow & H. Einhorn, **Proxy Contests for Corporate Control** 569-77 (2d ed. 1968); R. Clark, supra note 140, at 394-95.

Second, the benefit of defeating the proposal flow equally to all shareholders on a per share basis. No opposing shareholder can capture disproportionate gains, except by buying more shares prior to the battle.

[143] Let us hypothesize as in the preceding note that the management of a firm with 1,000 shares of common stock currently trading at $100 per share makes a proposal that will reduce shareholder wealth by $10 per share or $10,000. Now let us assume that S owns 250 shares and that the remaining 750 shares are widely-dispersed among the public. Assume further that the expenditure of $1,000 on organizational efforts has a 50% chance of defeating the proposal and a $5,000 expenditure will defeat the proposal with certainty. The net expected gain to S from a $1,000 expenditure is positive $1,500 ($2,500 expected gain minus the $1,000 cost) but the gains from a $5,000 expenditure will be negative. Organizational effort may occur but not in the optimal amount. (This example assumes that S is "risk neutral," i.e., that S does not demand a higher expected payoff in light of the risk of losing.)

family/management bloc committed to the recapitalization. The median percentage of family/management ownership was approximately 30%.[144] In only one case was the family/management bloc smaller than 10%.[145] In virtually all cases, the vote for recapitalization required by state law and the firm's charter was a simple majority of outstanding stock.[146] Thus, in most cases, approval of the recapitalization required affirmative votes of less than a majority of the stock held by public shareholders. Moreover, only a handful of the surveyed firms reported significant stock ownership positions (blocs of 5% or more held by

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144 By dectile, the family/management ownership was as follows:

Ownership	No. of firms
less than 10%:	1
10-20%:	2
20-30%:	6
30-40%:	3
40-50%:	3
greater than 50%:	4

See Table 1. The July 1987 OCE Study reports the median family/management bloc as 46.2% for 87 firms that proposed recapitalizations from 1976 through May 1987. July 1987 OCE Study, supra note at Table 4. For post-moratorium firms (62 firms), the median is 41.0%. Id. This suggests that the initial distribution of ownership in recapitalizing firms provides even more powerful explanatory factor than my survey indicates.

145 See supra note 144. This is the case of American Family Corp., which reported 8.9%. See Table 1. Coastal Corp. reported a family/management bloc of approximately 9%, but also an Employee Stock Option Plan ("ESOP") of approximately 17%. Id. Since management appoints the ESOP trustees, it seems reasonable to aggregate the blocs for these purposes.

146 This fact is drawn from the proxy statements. E.g., **Lee Enterprises, Inc., Proxy Statement** 5 (Dec. 26, 1985); **Dow Jones & Co., Inc., Proxy Statement** 12 (Mar. 16, 1984); **Potlach Corp., Proxy Statement** 9 (Oct. 22, 1985).

particular institutions or by individuals not allied with the management group).[147]

These conditions give rise to severe collective action problems. The only concentrated stock ownership is that of a family/management bloc; the remaining shares are widely dispersed. In light of the insiders' position, defeat of the proposal would require negative votes by a very large proportion of the public shareholders,[148] so even significant public shareholder opposition has no effect on outcome. In these circumstances the payoff to public shareholders for informing themselves about the proposal will rarely be positive. Thus the typical public shareholder facing a proposal exhibits rational apathy and votes with management.

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147 These firms were: General Datacom, Industries, Inc., one holder of 5%; Kaufman & Broad, Inc., six holders, total of 31%; The North American Coal Corp., three holders, total of 17.6%; Helene Curtis Industries, Inc., one holder, 6.1%. The firms' proxy statements report these figures as based on Forms 13D-G and 13F, which individuals and institutional investors are required to file under S SS 13(d),(f), and (g) of the 1934 Securities Exchange Act; 15 U.S.C. S SS 78m (d), (f), (g) (1982).

This is not to say that institutional ownership has been wholly lacking in firms that have proposed recapitalizations. The July 1987 OCE Study reports an average (mean) institutional ownership for the full sample of 19.9%, and for the post-moratorium sample, of 23.9%. July 1987 OCE Study, supra note 57, at Table 4. The reason to focus on reportable institutional positions is that dispersed institutional ownership suffers from as many of the collective action problems as dispersed individual ownership. A considerable degree of institutional ownership may derive simply from diversification strategies that spread large amounts of money across the marketplace. It is nevertheless noteworthy that the averages reported by the OCE are below average for institutional ownership generally; for example, estimates of current institutional ownership of NYSE firms range upward from 50%. See, e.g., J. Heard & H. Sherman, **Conflicts of Interest in the Proxy Voting System** 10 (1987).

148 For example, if the family/management bloc was 35%, the required approval percentage was 50.1%, and if all shareholders vote, then approximately 77% of the public shareholders must cast negative votes to defeat the proposal (77% of 65% of the available votes yields approximately 50.1%). If, as is likely, all of the insiders vote but many of the public shareholders do not, the required percentage negative vote of public shareholders increases accordingly.

The pattern of share ownership heightens the free-rider problem in a number of ways. First, the size of the family/ management bloc, and the resulting need to obtain a very high percentage of public shareholder votes, sharply reduces the probability of a successful battle and thus lowers the expected payoff. Second, the absence of public shareholders with large stakes has a number of consequences. Costs of opposition increase, because communicating with and coordinating actions among a dispersed group are more expensive than in a more concentrated group. Efforts to share costs are more difficult, because free-riding in large groups is harder to overcome than in small groups.[149] It is less likely that a single shareholder would reasonably expect to benefit by an amount sufficient to cover the organizational costs of even less than the optimal amount of opposition. Thus, even if defeat of the proposal would increase public shareholder welfare, these free-rider problems make opposition unlikely.

The pattern of proposed recapitalizations--almost exclusively by firms with a significant family/management ownership bloc and without reportable institutional ownership--undercuts the asserted shareholder wealth maximization rationales. If such recapitalizations produce the most efficient contractual terms with respect to shareholder opportunism, to cite one rationale with at least surface plausibility, we would expect to see such proposals in firms where managers are most exposed--i.e., where their ownership stake is smallest--not the

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149 For example, let us assume that a small number of institutional investors each owns a significant bloc of stock in firms proposing dual class recapitalizations. It is easy to monitor the level of expenditures of each institutional investor in a particular proxy contest. Moreover, since such investors will be "repeat players" in a successive series of proxy contests, reputation effects and the desire to secure reciprocal assistance of other investors will help overcome free rider problems. See generally R. Axelrod, **The Evolution of Cooperation** (1984).

reverse. As discussed above,[150] the motivations for recapitalization by managers with large stock positions, such as protection of bargained-for perquisites, or compensation for firm-specific risk, are unlikely to be associated with increasing the wealth of public shareholders.

Moreover, if dual class recapitalizations increased shareholder wealth, we would not see the evident reluctance to make such proposals in firms with reportable institutional holdings. Institutions are presumably easier to persuade of the sophisticated arguments that support the wealth increase claim than would be dispersed, and perhaps unsophisticated, public shareholders. Institutions have a large enough stake and sufficient staff to take these complex arguments seriously. The pattern of recapitalization proposals suggests instead that firms are attempting to exploit the collective action problems of dispersed shareholders with measures they know would likely be rejected by institutional shareholders.[151]

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150 See supra text accompanying notes 51-53.

151 This is not to suggest that voting by institutional investors is free of problems. Institutional investors, particularly bank trust departments, insurance companies, and pension funds sponsored by particular companies, face significant conflict-of-interest problems that may undermine their willingness to vote against a management proposal that is likely to reduce shareholder welfare. Bank trust departments vote shares in companies that may be customers, or potential customers, of the commercial departments of the banks. See generally Herman, Commercial Bank Trust Departments, in Twentieth Century Fund, Abuse on Wall Street: **Conflicts of Interest in the Securities Markets** 72-79 (1980). A similar problem exists for insurance companies.

Pension fund managers may be pressured by the sponsoring companies to vote in favor of management proposals, on the basis of a corporate tit-for-tat. For example, the College Retirement Equity Fund (CREF), a pension fund for college teachers nationally, initiated a campaign to obtain a shareholder vote on a firm's adoption of a "poison pill" anti-takeover measure. The crucial test case was a proxy contest at the annual meeting of the International Paper Co. in April 1987. One of the company's tactics was a letter to the chief executives of more than 300 companies urging them to instruct their pension fund managers to vote against the CREF proposal. New York Times, Apr. 15, 1987, at D1, col. 3.

Even apart from pressure on specific issues, the competition for corporate pension business may lead pension fund managers to vote for management

2. Strategic choice problems. Management control of the structure and timing of a dual class recapitalization proposal permits strategic behavior vis-a-vis public shareholders. First, management can bundle the recapitalization with a "sweetener," an unrelated proposal that shareholders may independently desire. In addition, management can play "chicken" by credibly threatening to pursue less than optimum strategies for the firm if the recapitalization proposal is defeated. Finally, management can exploit defects in the regulatory process to increase the likelihood of approval. All of these elements enhance management's ability to obtain shareholder approval of measures that may reduce shareholder wealth.

a. Sweeteners. Management can "sweeten" a proposal that decreases shareholder wealth by bundling it with an unrelated proposal that increases wealth. For example, many firms announce plans to increase cash payouts to shareholders if the recapitalization is adopted but not otherwise.[152] These plans include substantially higher dividends and even open market repurchases of stock. Exchange offer recapitalizations offer the possibility of a dividend preference upon exchange for limited voting shares. Even if the recapitalization reduces shareholder wealth, these "sweeteners" produce offsetting gains for

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proposals. The much greater shareholder rights activism of general pension plans, such as CREF, and public pension plans, such as the California State Employees Pension Plan, than by specific firm plans or pension fund managers is consistent with this analysis. For a useful discussion of the problem of institutional investor voting with some thoughtful suggestions for reform, see generally J. Heard & H. Sherman, supra note 147; see also Chairman of the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess., Restructuring Financial Markets: The Major Policy Issues, 273 (Comm. Print 1986); Subcomm. on Oversight of Government Management of the Senate Comm. on Governmental Affairs, 99th Cong., 2d Sess., The Department of Labor's Enforcement of the Employee Retirement Income Security Act, 99-144 (Comm. Print 1986).

152 See Table 1.

public shareholders. Where distributions are increased, the gain includes not only the cash payout but also the reduced agency costs associated with a reduction in free cash flow.[153]

Adding a sweetener to the recapitalization proposal complicates the shareholder choice problem considerably and in the end distorts the choice in management's favor. First, as a matter of mechanics or law, nothing requires an increased cash payout or a dividend preference, or provides a financial reason to reconsider the firm's payout policy. Yet the increased payout is conditioned on approval of the recapitalization. If the recapitalization itself served shareholder interests, presumably a simple shareholder vote would suffice.[154]

Second, public shareholders may find it difficult to value the sweetener. The value of increased dividends depends upon their expected duration and the likelihood of a further increase. But management is not obligated to continue a particular level of dividend payments.[155] Within the bounds of fraud, its

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153 See Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 **Am. Econ. Rev.** 323 (1986). Jensen defines "free cash flow" as cash flow "in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital." Id. at 323. When a firm generates free cash flow, there is often a conflict between shareholder desire for payouts and management desires for growth, even if uneconomic, and for non-economic consumption.

154 One response is that shareholders might still reject the bundled proposal in the belief that the sweetener is a signal of high agency costs that will attract a hostile bidder. The sweetener is a noisy signal, however because it is difficult to ascertain what portion of the gains from a potential takeover it represents. A potential bidder may have difficulty taking account of this uncertainty. Moreover, dual class recapitalizations have thus far been proposed principally where the size of the family/management bloc would make a near-term hostile takeover unlikely. Thus, to reject a bundled recapitalization on the grounds that a subsequent takeover could force an unbundling is an unlikely move for the public shareholders.

155 This is Jensen's point in suggesting that debt avoids the agency problems of dividends by bonding the cash payout promise. Jensen, supra note 153, at 324; see also Grossman & Hart, Corporate Financial Structure and Managerial Incentives, in **The Economics of Information and Uncertainty** 108-09 (J.

ultimate intentions are hidden at the time of the shareholder vote. After approval of the recapitalization proposal, management could presumably lower the dividend with impunity.

At this point an objection might be raised: Approval of a sweetened recapitalization proposal means only that management and public shareholders have engaged in a mutually beneficial trade. Each side can calculate the benefits and risks of its concession. Proposal and approval reflects a decision that the recapitalization package is mutually worthwhile, even assuming that the recapitalization alone would reduce shareholder wealth. However, to conceive of the transaction as a simple pareto improvement ignores the context. In particular, it ignores the impact of a significant insider bloc in a context in which only a simple majority vote is required and in which calculation is difficult.

Ordinarily when public shareholders evaluate a management proposal there will be a distribution of predictions as to its effect. Shareholders may disagree on the effect, as to the amount and even as to whether it will be positive or negative; disagreement widens if calculation is difficult. If the median point of the distribution is negative--that is, if holders of a majority of shares believe that the proposal decreases shareholder welfare--then the proposal will be defeated even if a substantial number of shareholders "get it wrong." Insider control of a significant block of stock radically changes this scenario. In order to prevail in a simple majority vote regime, the insiders need to obtain the votes of only a minority of public shareholders. Thus even if the median belief of public shareholders is negative, the proposal is likely to

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McCall ed. 1982)

pass.[156] The addition of a sweetener to the recapitalization proposal makes a calculation of its effect on shareholder wealth more difficult. This increases the likelihood that a sufficiently large minority will believe the package is wealth increasing even if the median shareholder belief is otherwise. In this way, a sweetener operates less as a basis for a trade and more as a means for distorting shareholder choice.

b. Strategic games. Management asserts in most cases that the dual class recapitalization proposal stems from a desire to issue equity to pursue profitable projects without diluting management's control. If the projects are pursued, public shareholders benefit, but so does management, because it has large holdings. Conversely, if the projects are not pursued, managers and public shareholders will lose. This set of outcomes makes recapitalization a variant of the game of "chicken." In the stylized game two parties face each other on a collision course. If one party yields, the other party is better off, but if neither party yields, both are worse off.[157]

In the recapitalization context, management can employ a combination of incentives, credible threats, and bluffs to increase its chances of winning the game. It may be that the value of the firm increases because of profitable projects pursued upon the issuance of limited voting common. Nevertheless, public shareholders may be worse off in comparison to a scenario in which the

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156 This strategic choice problem is exacerbated by collective action problems. If public shareholders were not widely dispersed, or if there were no free-rider problems hampering organization and coordination, shareholders could form a consensus view prior to the actual shareholder vote. That is, public shareholders could learn the median of the distribution of their predictions, and agree in advance to be bound by that consensus. As it is, shareholders ordinarily become aware of the distribution only after management announces the results of the vote.

157 See S. Brams, **Game Theory and Politics** 39-40 (1975).

recapitalization had not been permitted. Thus even without strong collective action problems, approval of a recapitalization can be driven by strategic considerations that distort shareholder choice rather than by a collective judgment that approval is optimal for public shareholders.

This point can best be illustrated by an example of the game structure. Let us begin with the following assumptions:

(1) management holds a significant block of stock;

(2) the firm has profitable investment projects (which may include acquisitions) for which financing is required;

(3) the value of the firm will be maximized if the projects are financed by additional equity rather than by debt;

(4) the firm's charter permits the issuance of additional single class common;

(5) management consumption of perquisites will not increase if the recapitalization is approved;[158]

(6) management consumption of perquisites will be reduced if its control position is diluted;[159]

(7) recapitalization will lock management in control; i.e., it will assure management's ability to consume perquisites throughout the existence of the firm

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158 This is an assumption highly favorable to management. In effect, it provides that the recapitalization will not increase agency costs. This is unlikely, as I have argued strenuously above, both as a matter of theory and in light of the empirical evidence. See supra text accompanying notes 153 & 155. The point of this example, however, is to demonstrate that management strategic behavior is a problem even when shareholder wealth is not necessarily reduced.

159 This might result when dilution of control would make management more vulnerable to a hostile take-over bid.

and will virtually eliminate possible gains to public shareholders from a hostile takeover bid;[160]

(8) disapproval of the recapitalization proposal will demonstrate public shareholder willingness and ability to oppose management; that is, it is effectively a "no confidence" motion. This will enhance the possibility of a proxy battle or a hostile takeover and thus is assumed to increase the wealth of public shareholders.

An illustration with particular numerical assumptions may be instructive, although it is possible to generalize the results more formally. Therefore let us make these further assumptions:

(9) management ("M") owns 25% of the stock; the public shareholders ("S") own 75%;

(10) the value of the new investment projects to the existing shareholders (including management in its role as shareholder) is $100;

(11) management consumption of economic perquisites stemming from its control position (both before and after recapitalization) is valued at $15;[161]

(12) the consequence of assured management control is identically valued by M and S at $10;

(13) the consequence of a vote of no confidence is identically valued by M and S at $5.

The game is not a simultaneous game; rather, there are two sequential moves. First, the shareholders vote on the recapitalization. Then, management

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160 A merger might occur with management approval, but side payments to managers would reduce shareholder gain.

161 This is consistent with assumption (5) above.

decides whether to issue equity: limited voting common if the proposal is approved, ordinary common if it is not.

The payoff structure is as follows:

	Public Shareholders: Approve	Public Shareholders: Not approve
Issue equity	(1) 35/65	(2) 5/95
Management: **Not issue equity**	(4) 5/-25	(3) -10/-10

The explanation for this payoff structure is as follows:

Cell (1). Shareholders approve the recapitalization, and management issues new limited voting equity to finance new projects or an acquisition. This produces a $100 gain for the firm, which is allocated among public shareholders and managers in accordance with their stock ownership percentages; thus shareholders gain $75 and managers gain $25. The assurance of management control benefits managers by $10 and produces a $10 loss for public shareholders. The net result is that public shareholders gain $65 and management gains $35.[162]

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[162] It would be easy to visualize a scenario in which the payoff to public shareholders in Cell (1) was negative. It need only be the case that the projects to be financed by new equity are relatively small, and that contrary to

Cell (2). Shareholders disapprove the recapitalization but management nonetheless issues equity (single class common) to finance new projects or an acquisition. This produces a $100 gain for firm, which generates a $75 gain for the public shareholders and a $25 gain for the managers. The dilution of management's control position by the issuance of additional common stock eliminates its ability to consume perquisites. This results in a wealth transfer from managers to public shareholders. Public shareholders gain $15, and managers lose $15. The rejection of the proposal is a vote of no confidence, which increases the likelihood of a hostile takeover bid and results in a gain to public shareholders of $5 and a loss to managers of $5. The net result is that public shareholders gain $95 and management gains $5.[163]

Cell (3). Shareholders disapprove the recapitalization and management does not issue equity to finance the investment. The value of the firm declines because future expected growth will be lower due to the need to finance investments with internally-generated funds, or with debt, which is not optimal by hypothesis. We will assume that this produces a loss to the firm of $20. Based on the allocation of share ownership, this results in a loss to public shareholders of $15 and a loss to management of $5. The rejection of the proposal is a vote of no confidence, which results in a gain to public shareholders of $5 and a loss to managers of $5. The net result is that public shareholders lose $10 and management loses $10.

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assumption (5), management consumption of perquisites and other agency costs will increase significantly.

163 The actual numbers are not crucial. To make the point it is necessary only that public shareholders are relatively better off in Cell (2) (disapproving, if management then issues single class equity) than in Cell (1) (approving, if management then issues limited voting equity), and vice versa for managers.

Cell (4). Shareholders approve the recapitalization but management does not issue new equity. The value of the firm declines because of either the suggestion of management incompetence or deception of public shareholders in order to assure management control. If we assume this results in a loss to the firm of $20, public shareholders will lose $15 and managers, $5. The assurance of management control produces a gain to managers of $10 and a loss to public shareholders of $10. The net result is that public shareholders lose $25 and management gains $5.[164]

Assuming that all parties are rational, have identical beliefs as to the payoff structure, and are not subject to collective action problems, this game has a simple solution.[165] Shareholders will always disapprove the recapitalization proposal, because they realize that management does best by then issuing single class common (which has a payoff to management of $5) rather than by refusing to issue any equity (which has a payoff to management of -$10). Yet public shareholders invariably approve the recapitalization proposals. One reason apart from collective action problems is that management can take steps to change the payoff structure.

The most potent change is an attempt to eliminate Cell (2), issuance of ordinary common following shareholder disapproval. In that case, the best

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164 Once again the actual numbers are less important than the magnitudes. Both managers and public shareholders are worse off in Cell (3), because profitable projects have been foregone. In terms of the classic formulation of "chicken"--two teenagers headed toward one another in their cars--this is the cell where they crash. Public shareholders are worst off in Cell (4), because managers have used the ruse of potential projects to obtain assured control.

165 Management and public shareholders may have different beliefs about the payoff structure. For example, management may have much less faith that profitable projects exist and thus will assign a much lower value to its payoff in Cell (1), conceivably below its payoff in Cell (4). Adding asymmetric beliefs obviously would make this paradigm very complex.

outcome for shareholders would be approval, Cell (1). Management can explicitly or implicitly threaten not to issue ordinary common. To make such a threat credible, management might make a hands-tying declaration in a liability-creating document. At least five of the surveyed firms explicitly asserted in recapitalization proposal proxy statements that the dominant family groups valued control so highly that they would not permit dilution through the issuance of additional ordinary common, even for profitable investments.[166] The threat gains force from Mills v. Electric Auto-Lite Co.,[167] in which the U.S. Supreme Court held that liability for misrepresentation in a proxy statement did not turn on damage to shareholders caused thereby. Thus a proxy violation could be found in such a case even if the firm benefited from management's subsequent issuance of ordinary equity.

The payoff structure described above assigns no value to the non-economic perquisites of control. Yet management may value such perquisites highly, perhaps more than the potential gains from future investment projects. In the illustration above, if shareholders believe that management assigns a value of more than $15 to such perquisites, then the outcome of the game shifts dramatically. Shareholders will realize that upon disapproval of the proposal,

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166 **Kaufman & Broad, Inc., Proxy Statement** 18 (Apr. 2, 1985); **The Gap, Inc., Proxy Statement** 34 (May 1, 1986); **General Cinema Corp., Offering Circular** 8 (Dec. 31, 1984); **Fedders Corp., Proxy Statement** 10 (Mar. 26, 1985); **Jack Winter, Inc., Proxy Statement** 9-10 (May 23, 1986). Many other firms might have made such explicit threats but for Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986), which held that an explicit threat by a controlling shareholder to block transactions in the best interests of the firm if shareholders failed to approve a dual class recapitalization voided the shareholder vote.

167 396 U.S. 375 (1970).

management will choose not to issue equity, Cell (3).[168] In this case, the optimal shareholder strategy will be approval followed by management issue of new equity, Cell (1).[169] Management will promote this result by fostering the belief that it does indeed value non-economic perquisites highly. Several of the surveyed firms made especially strong claims of this sort in proxy statements. They asserted the importance of the legacy of the founder and his family;[170] their obligation to protect the integrity of the news media[171] and the unique responsibilities of a charitable trust.[172]

Note that both in the case of the threat not to issue ordinary common and in the case of non-economic perquisites, management has powerful incentives to bluff. The bluff can succeed even if it does not convince most public shareholders in firms where management controls a substantial bloc of stock and only a simple majority is required for approval.

Another important factor bearing on the payoff structure is the effect of a no-confidence vote. Because the recapitalization proposal becomes a test of

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168 This is because the management payoff in Cell (2) falls from +$5 to less than -$10 (gain of $5 minus loss of non-economic perquisites that exceeds $15) and thus Cell (3) becomes more desirable to management than Cell (2); management will not issue the stock and will instead forego the new projects.

169 This is true even if Cell (1) provided a negative payoff to public shareholders, as long as this payoff is a smaller loss than -10, the payoff in Cell (3).

170 E.g., **Dow Jones & Co., Inc., Proxy Statement**, 13, 18 (Mar. 16, 1984); **The J.M. Smucker Co., Proxy Statement**, 8-9 (July 25, 1985); **Jack Winter, Inc., Proxy Statement**, 9 (May 23, 1986); **North American Coal Corp., Proxy Statement**, 19-20 (Mar. 28, 1986); **Wm. Wrigley Jr. Co., Proxy Statement**, 10-11 (Feb. 13, 1986).

171 **Dow Jones & Co., Inc., Proxy Statement**, 18 (Mar. 16, 1984).

172 E.g., **Hershey Foods Corp., Proxy Statement** 1 (Aug. 27, 1984) (relationship between Milton Hershey School, an orphanage, and the corporation is "unique in American corporate history").

management's control, public shareholders know it will be costly for management to issue ordinary common (and thereby risk dilution) if the proposal is defeated. The no-confidence phenomenon makes approval more likely because it adds credibility to management's threat that it will not issue ordinary common if the proposal is disapproved. Management thus partially bootstraps its way to shareholder approval.

This can be illustrated in terms of the payoff structure. Let us assume that management places a value of more than $15 on non-economic perquisites of control. Then, if shareholders disapprove the recapitalization, the effect of the no-confidence vote (a $5 loss for management) will make the refusal to issue ordinary common, Cell (3), a better choice for management than an issuance, Cell (2). This follows because the Cell (2) management payoff will fall from $5 to less than -$10 because of the loss of non-economic perquisites while the Cell (3) management payoff remains unchanged at -$10. Perceiving this, shareholders will vote to approve, leading to the inferior outcome for them of Cell (1). Thus, as throughout these strategic choice problems, management's ability to set the agenda and to affect the pay-off structure can radically alter the public shareholders' decisions.

c. Supplementary approval requirements. A third important factor bearing on the shareholder choice problem is the whipsaw effect of supplementary approval requirements that attempt to address these issues. The best example is the rule proposed by the NYSE, which would have conditioned continued listing upon approval of a recapitalization by a majority of the public shareholders, which means that management's votes would not count.

The problem is that the NYSE rule would have supplemented, not supervened, state regulation in a way that would have only exacerbated the shareholder choice

problem. In most cases, state law requires only a simple majority of outstanding shares to approve the charter amendment that triggers recapitalization.[173] Management might announce that continuation of the firm's NYSE listing requires a special super-majority vote but that it will go forward with the recapitalization even if only a simple majority approves. If the public shareholder believes that simple majority approval is likely and that management is not bluffing,[174] she faces a Hobson's choice: a vote against the recapitalization may further reduce her wealth by causing delisting.[175] The strategy that minimizes loss is to vote

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[173] This assertion is derived from the proxy statements. See supra note 146; see also **Del. Code Ann.** tit. 8, S_S 242(b)(1) (1987). One interesting question that remains open is whether there is a fiduciary overlay to state statutory requirements for achieving the recapitalization. A comparison might be made to the statutory procedures for sanitizing an interested director contract. Despite strong arguments based on statutory provisions that pre-approval of the contract by disinterested directors or by shareholders is sufficient, courts nevertheless have insisted on "fairness" review. Moreover, the mode of approval--whether by a disinterested shareholder majority, for example--becomes an element in determining where the burden of demonstrating "fairness" of the contract rests. See, e.g., Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App.2d 405, 241 P.2d 66 (1952); Flieger v. Lawrence, 361 A.2d 218 (Del. 1976). It would be incongruous for an action with a significant risk of conflict of interest and with much greater impact than an interested director contract to be immune from the fiduciary review required for such contracts.

[174] Management might believe that delisting will not reduce shareholder wealth, or more plausibly, that its net gains from the recapitalization, which include gains as managers and losses as shareholders, exceed the losses from the delisting.

[175] This, of course, assumes that delisting will have a negative impact on shareholder wealth. Although recent empirical studies suggest that a NYSE listing may not be as important as previously, see supra notes 11-13, the general willingness of firms to subject themselves to the general NYSE regime suggests it has some value.

Firms proposing dual class common recapitalizations have frequently appended an investment banker's opinion on the possible effects of delisting. These opinions are carefully hedged. The standard language is to the effect that a transfer to the NASDAQ National Market System "would not have a material adverse effect upon the existing market liquidity of the [firm's] Common Stock, upon the ability of investors to buy and sell the Common Stock or upon the [firm's] ability to raise equity capital through an offering or offerings of Common Stock." E.g., **Helene Curtis Industries, Inc., Proxy Statement**, Exhibit B (may 16, 1986) (opinion of Solomon Brothers). On the other hand, the standard

for the recapitalization. Thus the supplementary NYSE requirement will increase the likelihood of simple majority approval, because the shareholder might have incorrectly calculated the likelihood of majority approval or failed to realize that management was bluffing. Moreover, this whipsaw effect reduces the value of a public shareholder vote as a reliable measure of support for the proposal. In these circumstances, a majority vote does not necessarily mean that public shareholders have been persuaded that the recapitalization is in their collective welfare.

3. Post-approval collective action problems. Some might argue that even if collective action and strategic choice problems elicit approval of the recapitalization, the result is not necessarily to the detriment of individual shareholders. The issue is put most acutely in the case of an exchange offer recapitalization, in which shareholders may choose between super-voting shares and ordinary common shares with a 10% dividend differential. Even if a majority of shareholders can impose the recapitalization on dissenters, each shareholder independently chooses whether to exchange. Why doesn't the outcome of this choice simply reflect shareholder judgment about the value of the vote in a particular firm? Or, otherwise put, why isn't the shareholder choice a fair comparison of the possibility of increased agency costs and diminished takeover gains versus the discounted present value of an increased dividend stream?

The reason is that the public shareholder choice is a not a free vote on wealth maximization but rather a game in which the dominant strategy will be to

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language continues that "the market prices of the Common Stock will depend upon many factors" and no opinion is expressed on the price of the common stock following delisting. Id. Management, of course, retains the opining bankers. See Stein Investment Banking's Dirty Little Secret, N.Y. Times, June 8, 1986, at F2, col. 3.

refuse the exchange. In other words, there is a free-rider problem: Each public shareholder would be better off if enough shareholders chose to exchange for super-voting stock to prevent management entrenchment. Each public shareholder individually, however, is even better off exchanging a vote for a dividend preference and letting other shareholders bear the burden of preventing management entrenchment. Given the absence of coordination among public shareholders, this problem predictably leads to a general refusal to exchange and thus to management entrenchment.

This argument can be usefully illustrated with another game matrix. Let the percentage of family/management shares equal x, all of which will be exchanged for super-voting shares in accordance with the intention expressed in the proxy statements. The percentage of remaining shares, the public shareholder shares, equals 100 - x. Let us assume that the transfer restrictions on super-voting shares are unenforceable.[176] If the exchange by public shareholders (PE) equals or exceeds x (PE $\geq$ x), public shareholders end up with a majority of votes and management is constrained. Agency costs will be no greater than before and the possibility of takeover gains will be no less. The game looks as follows (where payoffs are changes in relative welfare):

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[176] This may be unrealistic, but it illustrates the shareholder problem even in relatively favorable circumstances.

		Public shareholder strategies	
		E	Not E
Result of choices of other public shareholders	PE $\geq$ x	0	10%
	PE < x	<0	<10%

Assuming that no single public shareholder believes she can change the outcome and that public shareholders cannot coordinate their response, the game reveals that the dominant strategy is to refuse to exchange ("Not E"). If the individual shareholder believes that enough public shareholders will exchange such that management is constrained (PE $\geq$ x), she is better off refusing the exchange and taking the 10% dividend differential. This restates the free-rider problem: every public shareholder would be better off if management were constrained, but each would be best off if others bore the burden. On the other hand, if the individual shareholder believes that too few public shareholders will exchange (PE < x), she is again better off refusing the exchange. Increased agency costs and reduced takeover possibilities may reduce the value of her shares, but at least she receives a 10% dividend preference.[177]

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[177] The game is a prisoner's dilemma if the payoff to the public shareholder in the lower righthand box is also less than zero (i.e, if the agency costs from family/management control following the refusal of the exchange reduce the value of the firm by more than the 10% dividend preference). In this case the collective action problems force public shareholders to choose a pareto inferior outcome. For a description of "prisoner's dilemma," see S. Brams, supra, note 157, at 30-39.

The model also points to other important factors. If the management bloc is greater than 50% prior to the exchange offer, then public shareholders can never hold more votes than management (i.e., PE > x can never be satisfied) and public shareholders should always refuse the exchange. In that case, nothing can be gained by foregoing the dividend differential. If institutional holdings were significant, shareholder coordination might be possible; nevertheless, since public shareholders can always convert from super-voting common to ordinary common (but not the reverse), cheating would make an agreement very hard to sustain. Reversing the assumption that the limitation in transferability will be held void virtually precludes coordination agreements, since all will know that normal portfolio adjustment decisions will reduce the number of public super-voting shares (PE). Thus, even assuming some ability to coordinate, public shareholders will not delay receipt of the 10% dividend differential if management is likely to attain a majority within a short time.

It is also apparent that the 10% differential in no way corresponds to the actual decrease in public shareholder welfare, i.e. to the "value of the vote." This should be no surprise. It would be an amazing coincidence if a ten fold increase in votes could be recompensed by a 10% reduction in dividends. It would be even more extraordinary were the compensatory amount identical across differently situated firms.[178] The absence of any real economic rationale for the 10% differential confirms that it is merely a sweetener that triggers the

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[178] If the empirical evidence shows anything, it is that the value of the vote should vary widely across firms, depending on, among other factors, the initial distribution of shares. Differential beliefs about agency costs and takeover potential are also presumably relevant to the value of the vote.

It should be noted as well that even in cases where the limited voting common receives a dividend preference, it still trades at an approximately 2% discount to super-voting stock. June 1987 OCE Study, supra note 57, at 32; id. at Chart B.

dynamic described above. In other words, the differential is not primarily a compensatory measure designed to elicit public shareholder approval of the recapitalization proposal. Approval flows instead from the collective action and strategic choice problems described above. The differential is designed to elicit the choice of limited voting common.[179]

The model also provides some insight into the motivation of an exchange offer recapitalization, which imposes on management the cost of the dividend differential. The exchange offer provides greater speed and certainty to management's entrenchment. If public shareholders do not opt for the super-voting stock in the one-time exchange, management has an immediate voting majority.[180] In addition to sure control, this allows management immediately to reduce its holdings in the firm in order to diversify. A reduction in firm-specific risk would at least partially compensate management for the dividend differential. By contrast, the special distribution and the voting rights alteration give management its majority only over time, as shareholders sell their positions. Although the firm is immediately safe from a tender offer because of the transferability restrictions, a proxy battle remains possible for

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179 For a mathematically formal analysis of some of the points developed here and an elaboration of the shareholder choice problem in an exchange offer, see R. Ruback, Coercive Dual Class Recapitalizations (Working Paper, Sloan School of Management, MIT, Dec. 1986), submitted to the SEC as part of the testimony of Institutional Investor Services, Inc. The limitation of Professor Ruback's analysis is that while it explains the coercive effects of the exchange offer, it does not account for the initial shareholder action in approving the recapitalization, given the coercion to follow.

180 Note also that in an exchange offer recapitalization, which invariably requires shareholders to act affirmatively within a relatively short time frame to exchange ordinary common for super-voting common, management benefits from shareholder passivity or lack of knowledge. In the two other recapitalization mechanisms, shareholders automatically receive super-voting shares.

a long period.[181] Thus to assure control, management must retain its holdings during this period.

Perhaps more important, these two mechanisms would be undone by a judicial determination that restrictions on the transfer of common stock are unenforceable. By contrast, in an exchange offer recapitalization, most public shareholders will never have held super-voting shares, because of the game dynamic discussed above. Thus management retains its majority even if the transfer restriction is voided. Finally, the downside of an exchange offer for management, the dividend preference in favor of public shareholders, may be only a temporary cost. Once entrenched, management will have a freer hand to divert cash flow.

All of these factors, then, strongly suggest that approval of dual class recapitalization does not necessarily reflect the considered judgment of public shareholders that such an action serves their collective interests. Collective action and strategic choice problems could readily explain such approvals in many recent recapitalizations.[182] In light of the inherent implausibility of dual

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[181] This depends in part on the whether formation of a "group" constitutes an impermissible transfer under the charter provision, see supra text accompanying note 135, and whether a court would be willing to enforce such limitations on the ability of shareholders to act collectively. The existence and duration of a proxy battle threat also depend upon the initial distribution of shares.

[182] One arguably contrary piece of evidence as to the importance of collection action effects in securing shareholder approval should be noted. For approximately half of the firms, the super-voting shares automatically convert to ordinary common should the number of outstanding super-voting shares fall below a certain amount, typically between 10% and 20% of the outstanding equity. See Table 1. Such a provision can be taken as at least a partial bond against excessive diversion of firm cash flow by the management bloc, in the effort to persuade public shareholders that the recapitalization serves their interest. Were collective action effects dispositive, the management bloc would not need to constrain itself in this way.

Another explanation seems more plausible. The real risk to dual class recapitalizations in these firms derives from regulatory rejection, rather than

class recapitalization as a device to increase shareholder welfare, the negative wealth effects suggested by the empirical evidence, and shareholder choice problems, the recent wave of recapitalizations appears abusive.

III. BONDED NON-RENEGOTIATION RIGHTS

The previous section has presented some of the defects of shareholder voting as a means of expressing collective shareholder judgment. Opportunistic managers can exploit these defects to obtain approval of plans that may reduce or fail to maximize shareholder wealth. These problems, however, are foreseeable to a significant extent at the time a firm issues stock. At that time shareholders and managers may make mutually beneficial agreements concerning the possibilities of management opportunism. Shareholders may demand a premium, in the form of a discount on the stock price, for bearing the risk of certain forms of opportunism. To reduce this premium, management may accept certain constraints on its subsequent behavior. The supervisory authority of a board of directors elected by shareholders can be understood as one sort of constraint.[183] An

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shareholder disapproval. The original 1926 NYSE rule was triggered by a recapitalization of Dodge Bros. that gave control over the firm to shareholders with only 2% of the equity. Seligman, Equal Protection in Shareholder Voting Rights: The One Common share, One Vote Controversy, 54 **Geo. Wash. L. Rev.** 687, 694-97 (1986). The automatic conversion cutoffs are to assure regulators (and the courts) that such pyramiding could not happen again and to avoid a populist backlash. This explanation is supported by the rather limited bond that the management bloc is willing to offer. In every case with such a provision, the management bloc is still free to reduce its present equity share by more than 50%. Such a small equity share is a poor bond against diversion of cash flow.

183 See Williamson, Corporate Governance, 93 **Yale L.J.** 1197, 1210 (1984) (board is a governance structure to protect shareholders, "who face a diffuse but significant risk of expropriation because [their investment in the firm] cannot be protected in a well-focused, transaction-specific way").

undertaking to maintain a capital structure with a single class of common can be understood as another.

The problem for the firm is this: given the flaws of shareholder voting, how can the firm provide convincing assurances that specific constraints, such as single class common, will have continuing effect? In this context, the NYSE one share, one vote rule may be understood as a way of bonding the firm's promise to maintain the single class capital structure without renegotiation. The ultimate argument of this section is that, given present institutional arrangements, the NYSE rule continues to provide the most secure bond of that promise.[184]

A. Non-Renegotiation Rights

Let us develop these arguments. Assume a family/management group has established a firm and is contemplating a public offering. If they create a dual class capital structure, in which the public can purchase only limited voting stock, the group would reasonably anticipate that investors will demand a discount on the stock price. A dual class ownership structure will ordinarily signal lower expected returns and higher risk. Expected returns will be lower, all other things being equal, because of management perquisites and other agency costs. Risks will be higher, all other things being equal, because a poorly performing management team will be more difficult to oust except through an internal coup. Another way of characterizing the resulting discount in share price is to say that the firm's cost of capital will be higher. The costs associated with a dual class structure will undoubtedly vary depending on the particular firm, the firm's history, and its management.

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184 The argument draws from O. Hart & B. Holmstrom, supra note 139 at 128-148, (ability to bond against a subsequent opportunistic renegotiation of a long term contract is important); Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure, 3 **J. Fin. Econ.** 305 (1976) (entrepreneur bears costs of potential opportunism in capital structure).

As discussed in part II,[185] the family/management group that controls the firm at the time of the public offering may have various reasons to bear these costs rather than dilute its control. On the other hand, it may have different preferences. The increased cost of capital may limit the firm's ability to undertake investments it regards as desirable. The discount on the shares may be objectionable to family members who wish to cash out some of their holdings. A capital structure with only a single class of common stock will avoid these costs. The problem for both the firm and the prospective public shareholder is how to provide assurances that the firm will not undergo a welfare-reducing dual class recapitalization at some future time. In other words, unless public shareholders can be protected against an opportunistic dual class recapitalization in the future, they will demand a discount on the purchase of the firm's single class common in the present.

In this regard it is helpful to think of the firm's capital structure as part of a long term contract between managers and shareholders. A recapitalization is a renegotiation of certain contractual terms. Where opportunistic renegotiation is possible, the parties to a long term contract may be better off ex ante if they can agree that particular terms may not be renegotiated. This gives the exposed party what I call a "non-renegotiation right."[186]

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185 See supra text accompanying note 166.

186 Observe how a non-renegotiation right would operate in the context of the strategic choice game described in the previous section. Many strategic choice problems would disappear. For example, such a rule eliminates the problem of the no-confidence vote that tilts the payoff structure against the issuance of single class common. Such a rule also eliminates management's ability to bluff. However, in those cases in which management's payoff--because of its high valuation of non-economic perquisites of control--is truly higher in Cell (3) than in Cell (2), such a rule may have negative effects for public shareholders, since the firm will not issue single class common to pursue profitable projects.

B. Bonding a Non-Renegotiation Right

On the argument thus far, a non-renegotiation right with respect to a single class capital structure is desirable because it lowers the cost of capital to the firm. The problem is how to bond, or guarantee, such a right. A non-renegotiation term that is itself subject to change or renegotiation does not have the desired effect. Thus, for example, a management declaration at the time of a public offering that it has no intention ever to propose a dual class recapitalization is not an effective bond: intentions change. Four mechanisms of establishing a bond are worth considering in the recapitalization case: the firm's charter, state law, federal law, and a stock exchange rule. In present institutional circumstances, the only satisfactory bond is provided by the last mechanism, and then only if supported by a federal rule against migration.

1. Corporate charters. The traditional means of setting forth the relationship between managers and shareholders is a firm's charter. Under state enabling regimes of corporate law, customized charters may be seen as permitting, but not requiring, managers and shareholders to bargain for provisions that will lower the firm's cost of capital. Charters, however, do not offer very secure bonds for such provisions. As a contract, a charter may be changed by mutual consent of the parties.[187] Even a provision barring the renegotiation of an

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Management persistence in such a strategy seems unlikely over the long term, however. Widespread knowledge of the strategy may generate takeover pressure, even in a family-dominated firm. As the controlling family expands in size, there is likely to be significant pressure to increase the size of the firm.

The more general point is that even if for a particular firm at a particular time shareholders would be better off having the recapitalization option (because Cell (1) truly is the better choice), across all firms, shareholders will be worse off. Therefore, ex ante shareholders and firms will want a way to create and bond a non-renegotiation right.

[187] See, e.g., H. Henn & J. Alexander, **Laws of Corporations** §§ 345 (3d ed. 1983).

element of the firm's capital structure can be renegotiated.[188] Under the corporate law of most states, including Delaware, charter amendments ordinarily require the approval of only a simple majority of the outstanding common shares, and dissenters have no appraisal rights.[189]

Special charter provisions that require a super-majority vote for amendment are no solution to the bonding problem, however. As an initial matter, they must be protected by statutory or charter "lock-in" provisions that forbid amendment of the super-majority requirement itself except by the stated super-majority. Second, a super-majority requirement applicable to all charter amendments must be relatively low, to avoid giving a veto to an obstreperous minority over many significant actions that might be taken by the firm. However, a low super-majority requirement (67%, for example) may not be sufficient to avoid significant collective action and strategic choice problems in many firms.

Even a high super-majority requirement (90%, for example) targeted at a non-renegotiation right regarding the firm's capital structure does not provide a secure bond. Strategic choice problems persist. More importantly, the firm can avoid this constraint by reorganizing, typically through a reorganization such as a holding company merger. In such a transaction shareholders receive shares of a firm with a new charter that can provide for dual class common. Yet it would be very unlikely that the charter would subject such a reorganization to a high super-majority requirement. Such transactions serve many useful corporate

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188 Delaware law, for example, contemplates the possibility that a shareholder protective provision could be amended through normal means. The only exception is for a provision requiring a super-majority vote for certain transactions. In that case, an affirmative vote of the same super-majority is needed to amend the required percentage. **Del. Code Ann.** tit. 8, § 242(b)(4) (1987).

189 See, e.g., H. Henn & J. Alexander, supra note 187, at § 345.

purposes, including, for example, the creation of a limited liability shield as the corporation expands into new lines of business.[190] Allowing a small minority to veto such transactions creates the potential for costly holdup problems. On balance, such a provision is unlikely to improve shareholder welfare because the costs of an effective bond will outweigh its benefits. In light of the variety of possible corporate maneuvers,[191] charter provisions may be unable to produce a bond against a dual class recapitalization without substantial overbreadth.[192]

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190 It would also be virtually impossible to draft a charter provision that effectively distinguishes between a "sham" reorganization, done solely for purpose of a dual class recapitalization (to which the high super-majority would apply), and a reorganization with a "legitimate business purpose."

191 The history of corporate law is filled with examples of corporate maneuvers that eliminate apparent contract claims, much to the surprise of common shareholders, preferred shareholders, and bondholders. E.g., Federal United Corp. v. Havender, 11 A.2d 331 (Del. 1940) (elimination of preferred stock dividend arrearages through merger); Bove v. Community Hotel Corp., 249 A.2d 89 (R.I. 1969) (same); Barrett v. Denver Tramway Corp., 53 F. Supp. 198, aff'd 146 F.2d 701 (3d Cir. 1941) (elimination of preferred stock accruals through recapitalization plan that creates prior but non-cumulative preferred stock and offers exchange); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (elimination of liquidation preference of common stock through redemption followed by liquidation); Everett v. Phillips, 43 N.E.2d 18 (N.Y. 1942) (elimination of fairness review of interested director contracts through charter provision that such contracts were not per se invalid); Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir. 1981) (elimination of conversion rights of debentures through merger); Wood v. Coastal States Gas Corp., 401 A.2d 932 (Del. 1979) (elimination of preferred stock participation rights in recapitalization through partial spin-off). In certain instances such maneuvers may even overcome the explicit contractual efforts of the parties. See Langfelder v. Universal Laboratories, Inc. 163 F.2d 804 (3d Cir. 1947) (liquidation payoff for preferred stock may be eliminated by merger).

192 The argument in the text explains why even ex ante a charter would be a poor medium for bonding the promise of a single class capital structure. In the world ex post, charters fail because of management control over the chartering process. The typical state corporate statute provides for a two-step process for charter amendment, first, approval of the amendment by the directors and, second, submission of the amendment to shareholders. See H. Henn & J. Alexander, supra note 187, §§ 345, at 975. It is highly unlikely that a family/management bloc would propose a charter limitation on future dual class recapitalizations after the sale of stock to the public. In other words, the abandonment of the NYSE single class common rule would transfer wealth from public shareholders to the insiders. see infra text accompanying note 202; there is no reason to believe

2. State law. If external constraint is necessary for a satisfactory bond, a possible source is state law. By incorporating in a state with a particular prescriptive rule, the firm could attempt to bond against opportunistic changes as to matters covered by the rule. The states, however, are not well suited to provide a bond against dual class recapitalizations. At present virtually all states permit dual class common stock,[193] and most states where large firms typically incorporate permit such recapitalizations.[194] To those who would rely on a market in corporate law, this is not a problem. If the NYSE single class common rule has significant value, upon its abandonment by the NYSE, some state will adopt it to attract incorporations.

Several difficulties attend such an argument, however. First, since the goal is not to prohibit dual class common altogether, but to bond a non-renegotiation right, the rule of a single legal regime may be an inherently unsatisfactory tool. More simply, if the state prohibits dual class common, then many corporations that use such a capital structure in a legitimate way will incorporate elsewhere. If the state does not prohibit this capital structure, then the possibility of corporate maneuvers, such as the holding company

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that the insiders would gratuitously return the transfer by way of a hands-tying charter amendment.

193 A few state statutes and constitutions restrict the use of non-voting stock, see H. Henn & J. Alexander, supra note 187, at §§ 189 n.33, but would not apply to the recapitalization plans here, which use limited voting stock.

194 It should be noted, however, that the blue sky administrators of eighteen states, including California, Florida, and Texas, have adopted prohibitions against the offering of non-voting or limited voting stock in their states. See Seligman, supra note 182, at 713-14. Such restrictions generally apply only where the issuer is subject to blue sky regulation. Ordinarily, a listing on the NYSE or the Amex provides an exemption from such regulation, although some state administrators have suggested that abandonment of the NYSE single class common rule could bring an end to this exemption. See id., at 705 n.93; Exchange Exemptions Endangered by Listing Standards Changes, 18 Sec. Reg. & Law Rep. 1718 (Nov. 28, 1986).

reorganization discussed above, will significantly reduce the security of the bond.[195] More generally, this suggests that the interests of flexibility and certainty--separately desirable but often incompatible--are best served through multiple levels of legal regimes. This point is developed more fully below.[196]

A second problem is that a corporation can avoid the effect of a particular state's law simply by reincorporating in a state without the restriction. Such a reincorporation can be effected through a holding company merger, in which the holding company is incorporated in the new state.[197] A statute that attempts the problematic distinction between "legitimate" recapitalizations and dual class recapitalizations would be ineffective against interstate evasion. This is because the Commerce Clause is likely to forbid state restrictions on the ability

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195 Another perhaps less serious problem is that the savings associated with the bond may not outweigh the costs of reincorporation in another state. For example, let us assume Alaska adopts a statute that prohibits dual class common, but does not otherwise modernize its corporate law. Firm X, now incorporated in Delaware, believes the bond would lower its costs of capital. Reincorporation, however, has costs--not only out-of-pocket costs, but the loss of Delaware's flexibility and its stock of precedents. If these costs exceed the benefits of the bond, the firm will not reincorporate and the benefit of Alaska's bond will be lost.

196 See infra text accompanying notes 205-210.

197 For example, two of the firms in the survey used holding company mergers to facilitate recapitalizations: The North American Coal Corp. (as part of an exchange offer) and Carlisle Corp. (as part of a voting rights alteration).

of a firm to migrate to another state.[198] In other words, a state law regime is an inadequate bond because the firm can simply slip away from its constraints.[199]

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[198] The statement in the text could have been offered with greater assurance before the recent Supreme Court case of CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987), which sustained an Indiana law styled as a "control share acquisition" statute that was in fact an anti-takeover law. Before CTS it seemed plain that an effort by one state to restrict corporate interstate migration would have been regarded as discriminatory economic localism that the Court routinely strikes down. See, e.g., Lewis v. B.T. Investment Managers, 447 U.S. 27 (1980) (access of out-of-state business to local markets); Hughes v. Oklahoma, 441 U.S. 322 (1979) (transfer of local resources out of state); New England Power Co. v. New Hampshire, 455 U.S. 331 (1982) (same); Hunt v. Washington State Apple Advertising Comm'n, 432 U.S. 333 (1977) (access to local markets); Shafer v. Farmer's Grain Co., 268 U.S. 189 (1925) (direct regulation of interstate commerce is prohibited).

Even after CTS, a state's ban on interstate corporate migration seems unlikely to prevail. The key factor for the CTS Court was that the Indiana statute, which set the conditions on which an acquirer of a large bloc of the corporation's stock could vote those shares, was simply state regulation of a corporation's "internal affairs." A state statute that prohibits any transaction, such as a merger or a sale of assets, and that has the effect of moving the corporation's state of incorporation, is more blatant economic protectionism.

Following Exxon Corp. v. Governor of Maryland., 437 U.S. 117 (1978), it might be possible to argue, however, that the Commerce Clause applies only to the movement of goods and services, not to questions of corporate organization. Exxon sustained a state statute that prohibited vertical integration of retail gasoline stations in the state with producers or refiners, principally on the grounds that the statute was facially neutral (out-of-staters other than producers or refiners could own a Maryland gas station) and that the interstate flow of gasoline products would be unaffected. Similarly one could argue that the firm's state of incorporation has no substantial impact on interstate production or activity, since location of a firm's offices and plants does not depend upon the state of incorporation. Still, a statute restricting migration is not facially neutral.

Note that a state law that tried to avoid the interstate discrimination problem by prohibiting any merger, be it with an in-state corporation or an out-of-state corporation, that accomplished a dual class recapitalization would not be effective to create a satisfactory bond. The corporation could simply move first and recapitalize later.

[199] This point may have significance in the state competition debate. The "race to the top" theorists claim that firms will pick the legal regime providing the shareholder/management contract that lowers the cost of capital for the firm. See, e.g., Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913, 919-20 (1982); Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6. J. Legal Stud. 251 (1977). Thus the spread of innovations that increase management prerogatives, for example, is because of their efficiency aspects, not

3. Federal law. The reflexive response to the interstate migration problem is a federal rule. Although a federal rule on dual class common would bond against the firm's ability to shift jurisdictions, ultimately it may not solve the problem. As with the rule of a particular state, a federal rule faces the problems of flexibility and certainty. A federal rule that banned dual class common would surely bond against such recapitalizations, but only by denying dual class structures to those firms in which it is mutually advantageous to management and shareholders. If the goal is only to bond a non-renegotiation right, such a rule is clearly overbroad. A more narrowly tailored federal rule that barred "illegitimate" recapitalizations, however, would have severe design and application difficulties that would reduce its effectiveness as a bond.

4. Stock exchange rule. We now are in a position to understand the virtues of a stock exchange rule on the dual class common issue, and in particular, of the NYSE single class common rule. The existence of a stock exchange rule that prohibits dual class common stock will permit, but does not require, a firm to select a legal regime, an external rule, that bars recapitalization. The availability of multiple levels of legal regimes allows the firm to decide, first, if it wants dual class common, immediately or as an option, and second, whether it is prepared to bond its choice of single class common against a subsequent renegotiation. This serves the interests of

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because of a "race to the bottom." The inability of any state to bond a firm's adoption of its "shareholder protection"-style corporate governance makes this argument less compelling. Depending on its anticipated external capital needs, a firm may move from one state to another with relative impunity. More to the point, shareholders will understand the fragility of the firm's shareholder-protection undertaking and will not accord the firms's choice of such a state law regime much value. This reduces the incentive of a state to compete by offering such a regime--if you can't beat 'em, join 'em. In other words, one state's choice of a lax regime has spillover effects on other states because of the threat of opportunistic regime shifts by firms.

flexibility, in that different firms can organize in different ways, and certainty, in that a particular firm can opt for a legal regime with an absolute prohibition and thus a secure bond.[200]

The virtues of the NYSE rule are conditional, of course, on the inability of firms to migrate to exchanges with less strict rules. Otherwise the NYSE rule will have no more effect than the law of a particular state. Until recently, marketplace forces made such migration highly unlikely. As noted above,[201] an NYSE listing once provided unique liquidity and reputational benefits. Sacrificing these benefits entailed very significant costs for the firm, both in terms of subsequent efforts to raise capital and in the loss of the pecuniary and non-pecuniary rewards of being an NYSE firm. These costs, borne by management both as shareholders and as beneficiaries of the firm's prestige, were sufficiently great to bond the firm's choice of the NYSE corporate governance requirements, and in particular, the rule against dual class common. Indeed, the costs to shareholders of delisting were thought so great as to provide a basis for judicial intervention against action that put the NYSE listing at risk.[202]

The success of NASDAQ's National Market System ("NMS") has obviously changed this situation. The costs of losing an NYSE listing have diminished to

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200 A binary rule--yes or no on dual class common--is easier to administer. A layered set of legal regimes permits sorting. Thus the stock exchange rule in addition to state enabling laws provides a system that possesses both flexibility and certainty.

201 See supra text accompanying notes 7-8.

202 See, e.g., Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 267-69 (2d Cir. 1984); Van Gemert v. Boeing Co., 520 F.2d 1373, 1381 (2d Cir. 1975), cert. denied, 423 U.S. 947 (1975); Sonesta Int'l Hotels Corp. v. Wellington Associates, 483 F.2d 247, 254 (2d Cir. 1973). In Norlin Judge Kaufman identified three reasons for maintaining an NYSE listing: liquidity, the assurance of fair dealing in corporate matters, and financial stability and prestige that make the sale of stock easier. 744 F.2d at 268.

the point that they are no longer sufficient to bond the choice of single class common.[203] This allows managers to behave opportunistically with regard to public shareholders. The importance of the SEC's backstop for the NYSE rule therefore becomes clear. Market forces have eroded the ability of any exchange to bond a non-renegotiation right against dual class common. Yet such a bond previously existed and presumably had value. An SEC rule that barred the listing by the Amex or the NASD of a firm delisted by the NYSE because of a dual class recapitalization would simply provide a different mechanism for a bond that previously existed. Put otherwise, a federal rule aimed at migration between exchanges is one effective way that a firm could be given both the opportunity to choose its capital structure and the ability to bond its promise to maintain single class common stock.

C. Stock Exchange Competition and Shareholder Welfare

The claim thus far has been that a secure bond for a non-renegotiation right as to dual class common has value to a firm because the bond can lower the firm's cost of capital. A change in the NYSE rule would thus have three negative effects on public shareholder wealth. First, shareholders of NYSE firms would bear a greater risk of opportunistic recapitalizations by management. They paid for security and now it is gone. Second, shareholders of those NYSE firms would lose because the inability to bond the firm's capital structure makes subsequent trips to the public equity markets more costly. Third, and perhaps most seriously, founders and shareholders of new enterprises face an increased cost of capital. Even before listing on the NYSE, such firms could hold themselves out

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[203] This appears evident from the actions of NYSE firms in proposing dual class recapitalizations at the risk of their NYSE listing and the arguments made in proxy statements that delisting would not impair liquidity or make raising capital significantly more difficult. For a discussion of the empirical data on the value of exchange listings, see supra notes 55-126.

as on a trajectory that would lead them quickly to the NYSE, and thus offer a "bridge" bond against recapitalization. The first effect is arguably only a wealth transfer between shareholders and managers. The latter two consequences would have negative GNP effects: As the cost of capital increases, marginal projects will not be funded.

These negative effects would be difficult to demonstrate by the empirical evidence that financial economists commonly examine. The first shareholder wealth effect probably could not be tied to any specific event, since the possibility of a change in the NYSE rule and its implications have emerged over an extended period of time. Nor are conventional econometric methods well suited to discern systematic effects, effects that cut across almost all firms.[204] The second shareholder wealth effect (and perhaps the third) could conceivably be discerned by comparing the cost of equity capital for NYSE firms and new ventures well before intimations of the possibility of the rule changes and the costs that prevail currently. Unfortunately, such effects are likely to be swamped by much more basic economic factors--interest rates, inflationary expectations, etc. One possible test might compare the cost of equity capital for NYSE, Amex, and NASDAQ/NMS firms before and after the possibility of rule changes arose. A relative increase in the cost of capital for NYSE firms would arguably demonstrate the wealth effect suggested here.

A critic of these ideas about bonded non-renegotiation rights would respond that there already is a test, a market test, that demonstrates that the alleged

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[204] As explained at supra text accompanying notes 59-60, event studies attempt to isolate the impact of similar events on portfolios of firms in comparison to the overall market. Since all firms are affected by systematic events, it is not possible to make such a comparison.

bond has minimal value. Exchanges, it is said, will compete in the offering of transaction and other services that investors demand:

> Exchanges do not compete for listings per se, but rather seek to maximize the volume of trade, which is a function of the number of listings and the amount of trading in listed securities. . . . If an exchange allows managers of some firms to exploit investors, investors will lose confidence in the exchange, as a whole causing all firms on the exchange to face higher costs of capital. This is in turn will decrease the amount of listings in the future and thus also will reduce the amount of trade.[205]

In effect, we have a repetition of the "race to the top" argument, applied here to exchanges rather than states; that is, that the optimal rule of law will emerge from competition. Whatever the validity of the argument in the state competition context,[206] it has no validity for exchanges. There are too few national exchanges--three--for effective competition and the barriers to entry are simply too high to make potential competition a real threat. Moreover, the argument fails to address the fact that migration among exchanges makes it simply impossible for any exchange to offer a secure bond.

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[205] Fischel, supra note 20, at 12; 54 **U. Chi. L. Rev.** at 129-30. In fairness to Professor Fischel, since the main point of his paper is that the one-share, one-vote rule should not be extended to NASDAQ firms, he might well agree with virtually everything said in this paper. We part company insofar as his argument rests on the belief that competition among exchanges necessarily produces the best legal regime. In that regard, there are revealing differences between his argument that competition among states produces optimal corporate law regimes and his argument that competition among exchanges produces an optimal dual class common rule. For the argument as to states, Fischel (following Winter) relies on the driving force of the market in corporate control. Incorporation in a state that permits management expropriation of shareholder wealth will increase the firm's cost of capital and will lead to a takeover bid. Fischel, supra note 197, at 919; Winter, supra note 197, at 257. For the argument as to exchanges, Fischel has a problem: By hypothesis, a dual class recapitalization removes the market for corporate control as a factor. Instead, he proposes a weakly-motivated connection between increased capital costs and a decreased number of exchange listings. It is hard to believe that this animating force could produce optimal rules.

[206] See supra note 197.

There is a further reason to believe that abandonment of the NYSE rule is not the happy result of a race to the top. Let us assume that the NYSE holds fast to its rule against dual class common and that the SEC does not forbid migration. We can then assume further that some firms will migrate to other exchanges for recapitalizations, because managers prefer secure jobs to the lowest cost of capital. The decrease in listings is bound to hurt the NYSE, if only because of the loss in listing fees and the lost commissions to members. The NYSE may also believe that a significant loss of listings over time will undermine its position in the center of the securities markets. It is not credible that investors will refuse to trade in the securities of firms whose managements behaved opportunistically, or on the exchanges that harbor such malefactors. The price may be lower, but the volume will be the same, and this volume will be lost to the NYSE.

Now let us assume that the NYSE abandons its dual class common prohibition. Presumably no firm would leave the NYSE. Firms that wish to pursue recapitalizations would have no need to do so. But firms that prefer a bonded, non-renegotiation right as to a single class capital structure would have no choice but to remain. The expense of starting an exchange makes such an alternative quite unlikely. More importantly, even a new exchange could not offer the bond, because of the ever-present possibility that firms would simply return to the NYSE. The point is that, at least in the exchange context, in the absence of a marketplace or rule-based barrier to migration, the competition seems to push toward the bottom.

IV. POLICY RESPONSES

A. Non-Uniform Rules

The previous section has explained the evolution and current function of the NYSE one share, one vote rule as a bond of a promise by firms to maintain single class capital structures. Two policy responses to the argument above are apparent. The first is a rule that permits non-uniform standards across exchanges but protects one exchange's continued capacity to bond the single class promise. The second establishes uniform voting rights standards across all exchanges.

Thus one response to the current problem is a federal rule, presumably authored by the SEC, that permits the NYSE to continue to offer such a bond. This rule should restrict the capacity of firms to migrate among exchanges. In particular, this minimal rule should require the Amex and the NASD to adopt rules to prohibit the listing of any firm that has been delisted by the NYSE, voluntarily or involuntarily, because of a dual class common recapitalization.[207]

A minimum proposal should also include an exception for dual class recapitalizations in the case of certain arms-length mergers that present little reason for concern. These are mergers in which the limited voting common pays

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[207] More technically, the rule should prohibit the NASD from authorizing trading of the firm's stock on the NASDAQ National Market System. Only NASDAQ's National Market System offers sufficient over-the-counter liquidity to compete with the NYSE of Amex.

One possible objection to this proposal is that there is no need to tie the firm's bond of a certain capital structure to its choice of trading market. Why deprive firms that are too small for an NYSE listing or that believe that NASDAQ provides superior transaction services of the opportunity to provide such a bond? Or why require firms that desire the NYSE transaction services to offer such a bond? An alternative is for the SEC to establish two categories of firms, "A" firms and "B" firms. The "A" firms commit irrevocably to a single class structure, subject to any appropriate exceptions. The SEC could require all present NYSE firms to enroll as "A" firms. One response is that such a system would place a large administrative burden on the SEC that the exchanges could handle more easily.

dividends that are substantially linked to the performance of assets acquired in the merger, and where the equity represented by all limited voting stock issued by the firm does not represent more than 25% of the firm's total equity (as measured by market value). In this limited case, the NYSE should be permitted to list all classes of the firm's stock.

The justifications for such an exception are perhaps most easily explained in the context of a specific case, General Motors' acquisition of EDS.[208] At least three factors led the parties to adopt a dual class common structure. First, to preserve the entrepreneurial culture of EDS, in which managers and employees were significant shareholders, it was important to give former EDS shareholders a security that directly participated in the success of the GM-EDS subsidiary. A class of common stock, Class E, whose dividend rights were tied exclusively to GM-EDS profits accomplished this. Second, to assure sufficient liquidity for the Class E shares and to work out the financial details of the transaction, GM issued Class E shares in numbers that would, at least initially, trade at a price substantially below the ordinary common (perhaps by as much as 50%). Third, stock ownership in EDS was highly concentrated. The founder, H. Ross Perot, controlled nearly 50% of the stock.[209] A one share, one vote structure would have given him at least 1.6% of the overall GM vote, and perhaps as much as 3.2%.[210] This would have made Perot the largest individual holder of GM votes and would arguably have positioned him to assume control of the firm.

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208 For a description of the transaction, see **General Motors Corp., Proxy Statement** 33 (Sept. 21, 1984).

209 He owned 28% percent of EDS stock and had established trusts that held another 16.9%. Id. at 60-61.

210 This depended on whether other EDS shareholders elected to receive all cash for their shares or a package of Class E shares and cash. See **General Motors Corp., Proxy Statement** 33, 51, 60-61 (Sept. 21, 1984).

In these circumstances, it seemed appropriate to assign each Class E share a one-half vote.

It is particularly important that the context in which this recapitalization occurred made management opportunism improbable. The transaction was an arms-length merger between an acquirer with dispersed shareholders and a target with concentrated share ownership. As part of the overall bargain the parties sought to assure that the stock received as consideration did not cause an immediate shift in control of the acquiring firm. But neither management pursued entrenchment tactics at the expense of its existing shareholders. In such cases acquiring management, if anything, dilutes its control by offering stock as consideration in the transaction. Target managers will presumably try to maximize the control potential of the stock received in a way that will benefit all target shareholders.

It may nevertheless be important to establish some limit on such use of dual, or multiple, classes of common stock, in order to protect the integrity of the basic rule. Even confined to its terms, the arms-length mergers argument would permit any fraction of a vote, and even no vote at all, to be given to the limited voting common issued in the merger. It would also be possible to imagine a series of transactions resulting in control of the firm by the holders of a small equity stake. In addition one could also imagine a transaction in which the acquiring firm quickly disposed of the assets of the target for cash, giving the merger the effect of a public offering of limited voting common. Such practices would undermine the general prohibition of dual class common.

Several limits are possible. As a threshold requirement, the issuance of a limited voting class could be restricted to mergers in which dividends on the new common are substantially linked to the performance of the target. This helps

establish the necessity for the new class. To avoid pyramiding, I would propose a 25% ceiling on the firm's equity represented by limited voting stock, as measured by market value. Other requirements could be added or substituted. For example, voting rights for the limited voting common could be linked to a ratio of its market price to that of the ordinary common. A rule could require that firms periodically adjust voting rights to reflect the relative market values of the classes of common stock. The point is that a narrowly drawn exception for certain mergers could accommodate legitimate business needs without undermining the basic dual class common prohibition.[211] As a practical matter, such an NYSE rule could conceivably dampen the competitive threat of other exchanges even without an SEC backstop.[212] B. Uniform Rules

The recently proposed SEC Rule 19c-4 would require the NYSE, Amex, and NASD to bar the continued listing of any firm that "issues securities or takes other

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[211] I am aware that much of the argument in this essay has turned on the difficulty of drafting complex, narrowly tailored rules which do not undermine the security of a bond. No unitary legal system can provide a satisfactory set of rules in this area, I have claimed, because distinctions between legitimate and illegitimate recapitalizations are so manipulable; only layers of regimes offering binary choices would provide real security. Nonetheless, in the mergers area I think it possible to draft a narrow exception. Moreover, a stock exchange rule with an exception may be less susceptible to evisceration than a comparable state or federal rule because the exchange can provide an expert enforcement body that has a special interest in maintaining the rule. SEC monitoring would also be helpful.

[212] There may be some question whether the competitive threat to the NYSE is as great as some have argued. The survey of NYSE firms proposing dual class recapitalizations shows that aside from General Motors, few are "major" NYSE firms. The firms have below average institutional ownership, surely one of the important benchmarks. Investment bankers might opine that these firms would not lose liquidity or the ability to raise capital because the market for their stock may not be particularly deep even on the NYSE. The NYSE listing may have much greater value for a heavily traded firm with significant institutional ownership. Moreover, insofar as an NYSE listing increases the likelihood of inclusion in a market-basket index, a firm's stock price may increase solely because of increased demand by indexed institutional portfolios. See Harris & Gurel, Price and Volume Effects Associated With Changes in the S&P 500: New Evidence for the Existence of Price Pressure, 41 J. Fin. 815 (1986).

corporate action that would have the effect of nullifying, restricting or disparately reducing the voting rights" of holders of the firm's common stock.[213] The rule, according to the SEC's gloss, would not allow any of the three dual class recapitalization mechanisms that have been recently employed. On the other hand, the rule would permit a firm to recapitalize to issue limited voting stock on initial public offering, on the grounds that willing purchasers will buy with knowledge of the limitations while present shareholders will not be disenfranchised.

This is obviously a uniform federal rule that purports to distinguish between "good" and "bad" recapitalizations. As argued above, such a rule will inevitably face problems of design and application. In the accompanying release, the SEC begins a process of exegesis, elaboration and loophole-plugging that will undoubtedly continue if the rule is adopted.[214] Although the exchanges presumably are responsible for applying the rule in first instance, the competition for listings will generate erosive pressure, the "'disintegrating erosion' of particular exceptions."[215] The SEC should anticipate long-term involvement in the production of no-action letters if it wishes to protect the

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213 Exchange Release No. 24,623, supra note 18 at 23,665.

214 There may be unintended implications as well for "poison pill" rights and stock issuances and state statutes based on the Indiana control share acquisition statute sustained in CTS Corp. v. Dynamics Corp., supra note 196. These implications raise interesting questions. Presumably the SEC did not intend to cover poison pills generally as corporate action that "disparately reduced" voting rights, nor to trump state statutory law. On the other hand, one could imagine specific poison pill plans that do in fact achieve the results of a dual class recapitalization. Surely if such moves are regarded as abusive even given a shareholder vote, then management fiat should also lead to delisting. I think it bears study whether a poison pill plan that engrafts a schema modeled on the Indiana statute (but without a state legislative enactment) should be considered a disparate reduction.

215 Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, J.).

policy behind the rule. But the need for regulatory vigilance is simply a cost, not necessarily a dispositive objection.

Proposed Rule 19c-4 applies both to exchanges that had no prior one share, one vote policy and to the NYSE, which did. Thus consideration of its merits divides into two branches.

1. Application to NYSE firms. As to "abusive" recapitalizations of NYSE firms, in which present shareholders suffer a diminution in voting rights, Proposed Rule 19c-4 is consistent with the bonding theory developed in this article. The proposed Rule sustains the bond provided by the NYSE against such management opportunism by subjecting the firm to an identical rule on any other exchange. The firm gains nothing from migration. On the other hand, the bond is not complete, because the SEC rule would permit the firm to issue limited voting stock in initial public offerings.[216]

The SEC's justification for permitting limited voting IPO's is that new purchasers are not harmed because they get what they pay for.[217] The bonding perspective leads us to ask, is there harm to current public shareholders? I want to suggest that there may be harm and that therefore the capacity of the NYSE to bond against any deviation from a single class structure has value. The principal focus of the proposed Rule 19c-4 has been on the dilution of voting participation; the proposal is aimed directly at that problem. But the proposed rule does not address another harm to public shareholders from the issuance of limited voting common--the costly dilution of economic participation. This harm follows from the market's insistence on compensation for the additional risk

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216 In light of competition among exchanges, the limits permitted by the SEC are likely to become the rule for all exchanges.

217 Exchange Release No. 24,623, supra note 18, at 23,673.

associated with the inferior status of limited voting common. Such stock couples a residual economic claim coupled with a limited governance role. This means vulnerability to opportunistic behavior by the regular voting common shareholders, especially in recapitalizations and in sales of control.[218] Presumably purchasers of such stock will demand compensation for such risk in the form of higher expected returns, either through a dividend preference or a discount, that is, a lower price for an equivalent participation in expected returns.

In other words, to raise a given amount of capital the firm will have to sell a larger number of limited voting common shares than ordinary common or give limited voting common greater than pro rata dividends. But there is no reason to think that the costs of this economic dilution will fall equally on the inside and the public shareholders of the firm. Indeed, one can predict that the insiders will use this financing tool only where the increased value of control, through diversion of cash flow and otherwise, exceeds the costs of economic dilution of their stock. But public shareholders receive no such compensation for their economic dilution costs. In short, where insiders control the firm, it seems likely that they will attempt to recoup the dilution costs of issuing limited voting common at the expense of public shareholders.[219]

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218 The possible opportunism may arise either in ordinary business operations or upon sale of control. Participating preferred stock presents similar problems.

219 One objection to this argument is the possible implications for the firm's issuance of preferred stock and debt: how are those non-voting securities different from limited voting common stock? There are several answers. First, debt and preferred stock to a lesser degree have fixed contractual claims on firm cash flows, not residual claims. Such securities frequently contain various financial and operational covenants to reduce management discretion over firm cash flows. The greater safety of these securities is reflected in a lower rate of expected return. For example, over the past 50 years, returns on long-term

A firm that is making a single class common IPO may wish to assure prospective purchasers against the possibility of this scenario. Eliminating such risk will lower the cost of capital. The consequence, however, of Proposed Rule 19c-4, in light of the competition for listings, is likely to be the end of a securely bonded single class common promise. The SEC's efforts to create a uniform standard will make it impossible for any exchange to maintain a one share, one vote standard, even though an exchange might desire to do so and even though this standard may serve shareholder interests.[220]

The nub of the problem is the ability of firms to migrate among exchanges in search of the least restrictive corporate governance standards. Ideally we would like to bar both the most abusive recapitalizations for all firms, which Proposed Rule 19c-4 should accomplish, while at the same time making it possible

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corporate bonds, at approximately 4%, have been significantly lower than returns on common stocks at approximately 9%. B. Malkiel, **A Random Walk Down Wall** Street 190 (2d. ed. 1981). In other words, contrary to limited voting common, preferred stock and debt should not be a higher cost way of raising capital for the firm, i.e., there will not be economic dilution costs for the insiders to shift onto existing public shareholders.

Second, existing outsiders will benefit from the way that financial and operational covenants in senior securities reduce agency costs. Preferred stock, for example, typically provides that incumbent management loses control of the firm upon failure to make the preferred dividend payment for a certain period. Default on debt of course carries serious implications. The potential loss of control from these contingencies brings pressure on management with respect to its diversion of firm cash flows. Moreover, specific financial and operational covenants provide further limitation. See generally Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L. J. 49, 68-76 (1982).

In regard to both of these points it is noteworthy that firms undergoing dual class recapitalizations are very conservatively leveraged, which suggests that for control-related reasons their managers are adverse to issuing debt. See supra notes 122-123 and accompanying text.

220 Once again the argument is both ex post--that in disrupting settled expectations the rule change would transfer wealth from public shareholders to insiders; and ex ante--that the rule change would prevent the formation of optimal contracts.

for a particular exchange to maintain a more stringent rule. Proposed Rule 19c-4 sets a floor. We need a way to avoid its becoming a ceiling as well.

The general approach I recommend is an addition to Proposed Rule 19c-4 that would prohibit a firm that switches its listing from adopting a capital structure that is prohibited by the exchange it is leaving. More technically, the rule would prohibit an exchange (or the NASD for the NASDAQ/NMS) from listing a firm that does so. This addition could be tailored to focus on capital structure elements that bear specifically on shareholder voting, or could be made subject to a time period. Observe that such an approach would not mandate one share, one vote but would merely permit the NYSE to maintain a rule it desires to maintain.[221]

2. Application to Amex and NASD firms. Application of Proposed Rule 19c-4 to the Amex and the NASD may trouble born-again contrarians. From the ex ante perspective, shareholders of such firms could foresee at the time of their purchase the possibility of a dual class recapitalization, the possibilities of collective action and strategic choice problems, and the resulting possibility that some recapitalizations might result from management opportunism. Nevertheless, the terms agreed upon between managers and shareholders did not include any promise or any bond to maintain a single class structure. Thus the proposed rule is an ex post adjustment that ignores the parties' earlier optimal bargain.

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221 One question raised by this approach is, why should NYSE firms be deprived of the opportunity to issue limited voting common? The answer, of course, is that this is what these firms promised their public shareholders at the time they listed on the NYSE. The only thing that has changed is the unforseen success of the NASDAQ and the National Market System, which makes feasible the surrender of an NYSE listing.

The questions raised by such arguments are first, how much could the parties possible have foreseen, and second, what is the appropriate background rule where foresight is limited and information asymmetries may favor managers: Is it caveat shareholder or caveat manager?[222] The variables bearing on an opportunistic recapitalization may be very hard to predict when the firm's stock is first offered. Collective action problems are a function of the distribution of the firm's stock. Public shareholders are unlikely to have any reliable projection of whether the management bloc will remain stable and cohesive or the extent of future institutional ownership. Nor is any projection about the range of strategic carrots and sticks available to management at any given time likely to be close to the mark. Moreover, from the shareholder perspective, one could argue that the likelihood of a regulatory response to opportunistic recapitalizations was also part of the parties' ex ante bargain. In these circumstances, it would be consistent with contractual norms to require managers, as the drafters of the contract with shareholders, to bear the burden of uncertainty.

The more important issue, however, is whether "caveat manager" is a more efficient rule than "caveat shareholder." "Caveat manager" has this to recommend it: It will discourage investment in ingenious methods of cheating and will thus reduce a systematic risk of investment.

All of this argues in favor of the application of the SEC proposal to the Amex and the NASD. The collective action problems are severe; the likelihood of negative shareholder wealth effects is substantial. Intervention to bar abusive

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222 This formulation I owe to Lewis Kornhauser. The general problem is the subject of an on-going joint project between Professor Kornhauser and myself. Victor Goldberg also provided very helpful discussion on these points.

recapitalizations therefore seems appropriate. On the other hand, there seems to be little basis to argue that shareholders in such firms should also be entitled to protection against the IPO issuances of limited voting stock.

In sum, Proposed Rule 19c-4 is the basis for addressing the dual class recapitalization problem, it should be modified to prohibit a firm from migrating among exchanges in search of the most permissive rule. This modification solves a number of problems. It permits, but does not require, the NYSE to maintain its single class common rule and thus its bond. It will set in motion an experiment with limited voting common by Amex and NASDAQ firms. The experiment will answer a number of important questions: How difficult is it to administer a rule that attempts to distinguish between "good" and "bad" issuances of limited voting common? Is limited voting stock, stripped of managerial entrenchment effects, a useful financing tool?[223] Will Rule 19c-4 serve only as an invitation to investment bankers and corporate lawyers to devise entrenchment schemes that thread the rule? Such an experiment will provide additional data and time for a consensus to emerge without risking a major alteration in the governance structure of the most significant firms.[224]

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223 In this regard the limited practical importance of participating preferred stock bears notice. In many respects participating preferred is functionally identical to the limited voting stock permitted by proposed Rule 19c-4: A residual claim is bundled with a very limited corporate governance claim. Its limited use in contemporary corporate finance suggests that purchasers insist on too great a discount. It further suggests that future issuances of limited voting common, with narrow exceptions, are likely to arise from the managerial entrenchment motives that the proposed rule was aimed to frustrate.

224 The SEC proposal owes much to the analysis developed in Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes," 73 Va. L. Rev. 807 (1987). Professor Gilson argues that dual class recapitalizations and leveraged buyouts should be regarded as transactional substitutes, at least in perfect capital markets, because both generate gains for public shareholders by "shifting or fixing control." Id. at 810-15. Then the question becomes whether

in actual markets the transactional choice reflects "efficient" or "inefficient self-selection." On an efficient self-selection story, mature, stable firms that generate substantial free cash flow, i.e,, "cash cows," would choose leveraged buyouts, which generate gains because of the required disgorgement of excess cash to service debt and because of the incentives of managerial ownership. Id. at 824-27. Young entrepreneurial firms with capital needs, i.e, "question marks," would choose dual class recapitalizations, which generate gains because of the profitable projects that could be financed without imposing additional costs on the entrepreneur/managers. Competitive product markets will force managers of question mark firms to operate the firm efficiently and thus align the interests of managers and shareholders. Id. at 824-28. By contrast, the inefficient self-selection story, the argument developed in this Article, focuses on the ability of dominant shareholders to "impose a wealth transfer from public shareholders to themselves." Id. at 833. Gilson finds that the empirical data is consistent with both self-selection accounts, Id. at 840. He proposes to eliminate the opportunity for inefficient self-selection by a rule that permits the issuance of a new class of limited or non-voting common stock but prohibits the conversion of existing voting common into the new class. Id. at 841.

Gilson's proposal appears to be motivated by the belief that many dual class recapitalizations may increase shareholder welfare and therefore a rule distinguishing such cases is the solution. In the text I've argued that such a rule may not exist because of entrenched management's ability to shift the financing costs associated with limited voting common onto public shareholders. Nevertheless it is worthwhile to scrutinize the story that motivates Gilson's (and perhaps the SEC's) proposal.

Gilson's argument on behalf of some dual class recapitalizations is based on the substitutability of recapitalizations and leveraged buy-outs ("LBO's") in perfect capital markets. I find this a puzzling place to begin. Most transactional forms arise to solve problems that exist precisely because capital markets are not perfect. Indeed, the agency cost explanation for LBO's accepted by Gilson assumes imperfect capital markets. In the real world recapitalizations and LBO's are radically different. Dual class recapitalizations entrench managers and permit them to reduce their residual risk. In an LBO, the managers may gain a large percent of the equity, but they are subject to intense monitoring by creditors. An LBO also dramatically concentrates management's residual risk.

Gilson's apparent answer to the potential increase in agency costs of a dual class recapitalization is to posit that for certain firms, question mark firms, competitive product markets will enforce management efficiency and align shareholder and management interests. This is not a satisfactory answer. Management can efficiently triumph in product market competition and still divert cash flows away from public shareholders. After all, Jensen and Meckling's famous article, see supra note 23, discusses capital structure as a means of reducing agency costs in a firm where the entrepreneur is selling stock to the public, the quintessential question mark firm. The logic of Gilson's position is that public shareholders of such firms are indifferent to basic capital structure issues. This can not be right. In other words, even accepting Gilson's explanation that insiders of a question mark firm want a dual class recapitalization to expand the firm without diluting control or adding to

CONCLUSION

It is tempting at this point to refer the reader to the introduction and say, "I have done what I set out to do" and end. But a few things further should be said. First, this paper is based on what some may regard as a narrow assumption--the importance of the shareholder wealth maximization criterion. This is not because I think that value exhausts the field in the regulation of large publicly held corporations, but because I think it is the value with which there is greatest agreement. If a set of transactions does not maximize shareholder wealth, this is cause for greatest suspicion.

But one may be troubled by a gathering wave of dual class recapitalizations out of legitimacy concerns as well. The formal unbundling of corporate governance from residual economic participation claims may create the fact or appearance of a self-perpetuating managerial elite wielding unaccountable authority over tremendous economic resources. Legitimacy concerns, of course, have their instrumental side. For example, a populist backlash, such as that triggered by the first appearance of dual class common stock in large public firms in the 1920s, could conceivably lead to enormous reductions in managerial authority. In another example, courts could alter the business judgement rule if managers are no longer perceived as accountable to shareholders. In this sense, firms' forbearance with regard to dual class common may be seen as a kind of public good that the NYSE rule supports. But I believe the legitimacy point has normative weight. Even if "shareholder democracy" is more illusory than real,

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undiversified risk, we are left without a convincing explanation of why public shareholders would approve in the absence of coercion.

If one now believes Gilson's proposal, as adopted by the SEC, to have a faulty motivation, this is further reason to be skeptical of it.

the notion that high corporate office is earned and retained on the sufferance of marketplace scrutiny is a comforting one. We need no corporate princes here.

EXCHANGE OFFERS

TABLE I

Firm	Votes/SVS	Transf/ SVS	Div Pref. for LVS	Sweetener	Termination of SVS a) min % b) bd action c) sunset	With full convs or exch, min % for control	With full convsn or exch, % Fam mg control	% o'shp before recap fam/mg	Maj. of outstanding stock Req. for Approval	% voting for recap (% of outstanding	% voting ags recap (% of outstanding	% abstaining (% of outstanding)	% of non-mgt/fam shareholders voting for recap
Fedders	10 (vs. outsider only & class vtg)	no xc fam	11% (but no div pd since '74)		a) if svs <5% all os common b) bd + maj of svs	9%	78%	26.72%	simple of common	51.6%	13.6%	not disclosed	33.9%
The Gap	6 (2 for busn comb)	no xc fam	11%	higher div.	a) if svs <12.5% all os common	<15%	81.3%	46.4%	simple of common	71.5%	6.9%	not disclosed	46.8%
Gen'l Cinema	- 10 (vs. outsider only & class vtg)	no xc fam	11%	increased div for lvs	a) if svs <12% of all os common b) bd + maj svs	<10%	80%	29.6%	simple of common	x	x	x	x
General Datacom	10 (vs. outsider only)	no xc fam	11%		a) if svs os <5% all os b) Bd + maj svs	10%	70%	21.2% (+ESOP= 3.7%)	simple of common	66.9%	17.3%	10.6%	55.9%
Helene Curtis	10	no xc fam	lVS gets $.10 more, here: $.10 vs. $.20, =50%	div for 1st time since '64 but may reduce if not approved	a) if svs <10% all common & pref. c) 5 yr terms subject to indep. dir decis.to convert	<10%	85.65%	41.23	simple of common	68.3%	7.8%	not disclosed	45.9%
Hershey	10 (1/6 of dirs xlvs)	yes	11%	increased div-10% for lvs	a) if Trust <50% svs + <15% of all os common	10%	90%	50.1	simple of comm (except Bd is req. maj. of public shares)	81.5%	5.6%	2.9%	62.9%
Kaufman & Broad	10	no xc fam (subject to NYSE)	11%		a) if svs <10% all os common	16%	63%	32.5%	2/3, of common & preferred together	84.7%	10.8%	not disclosed	77.3%
Jack Winter	10	no xc fam	11%	expansion of business. resumption of div (none since 1981)	a) if svs <2% of all os common	10%	94%	60.4%	simple of common	not disclosed NA	not disclosed NA	not disclosed NA	x

SPECIAL DISTRIBUTIONS

Firm	Votes/SVS	Transf/ SVS	Div Pref. for LVS	Sweetener	Termination of SVS a) min % b) bd action c) sunset	With full convs or exch, min % for control	With full convsn or exch, % Fam mg control	% o'shp before recap fam/mg	Maj. of outstanding stock Reg. for Approval	% voting for recap (% of outstanding	% voting ags recap (% of outstanding	% abstaining (% of outstanding)	% of non-mgt/fam shareholders voting for recap
Alberto Culver	10 (in effect)	yes (but greater markt. in lvs will lead to conversion by pub svs.	lvs >=svs (expect equal)	Raise equity thru sale of lvs	bd action	11%	86%	45% (+ allies= 14.3%)	simple of common (but Bd requires 2/3 of common for NYSE)	81.5%	6.7%	0.05%	54.5%
Coastal	100 25% of divs x lvs	no	>svs & no present intention for div on svs; in effect, 11% pref	poss. increased div of 10%	b) bd action	+1%	90%	9.1% (+ ESOP=17%) (adj. for preferred=8.8 O&D; 16.66 ESOP)	simple, of common & preferred together	65.5%	16.8%	not disclosed	53.7%
Dow Jones	10 (1/3 of dirs x lvs)	no xc fam	equal		a) if svs <12mm (or 37.5% of prvsly issued svs)	9%	84%	56.2%	simple of common	81.2%	8.2%	1.8%	57.1%
Lee Enterprises	10	no xc fam	equal	incrs div if approv	a) if <20% orig issued svs os	10.5%	55%	10.51%	simple of common	75.8%	11.2%	1.3%	72.9%
North Am Coal	10	no xc fam	equal	poss. of higher div & open mkt, repurchase of common; holding co. structures to protect vs liability		<10%	70%	36.8%	2/3 of common	77.2%	6.7%	not disclosed	63.9%
Wrigley	10	no xc fam	equal	increased div by 60%	a) if Wrigley <18% all os common b) Bd + maj svs	10% but see termin	75%	38.62%	simple of common	79%	8.7%	5.1%	65.7%

VOTING RIGHTS ALTERATION

Firm	Votes/SVS	Transf/ SVS	Div Pref. for LVS	Sweetener	Termination of SVS a) min % b) bd action c) sunset	With full convs or exch, min % for control	With full convsn or exch, % Fam mg control	% o'shp before recap fam/mg	Maj. of outstanding stock Req. for Approval	% voting for recap (% of outstanding	% voting ags recap (% of outstanding	% abstaining (% of outstanding)	% of non-mgt/fam shareholders voting for recap
American Family	10	no xc fam; 48 mos reqmnt.	equal	increased divs (notes NYSE = 2/3 + co. can vote ESOP if delisted)		9%	<50%	8.9%	simple of common	71.7%	7.3%	0.9%	68.2%
Carlisle	5	No xc fam; 48 mos reqmnt	equal	holding co. structures to protect vs. liability		19%	55%	19.65%	simple of common	65.8%	14.7%	2.9%	57.4%
Cincinnati Milacron	10	no xc fam; 36 mos reqmnt	equal		a) if svs <15% all os common (excluding subseq. issuances)	<10%, but see termin.	>90%	>50% (incl. O&D=13.76%)	simple, of common & pref. sep & together	73%	not disclosed	not disclosed	<46%
J. M. Smucker	10	no xc fam 48 mos reqmnt.	equal			<10%	78%	26.7%	2/3 of common	69.6%	14.5%	1.5%	58.2%
Potlach	4 (xc where 80% req.)	no xc fam (Bd) 48 mos reqmnt	equal			25%	>72%	>40% (incl. long-term shrs of predecessor cos. (incl.O &D=13.3%	simple of common	58.8%	21.4%	not disclosed	<31.3%

Table 2

Average Net of Market Returns for
19 NYSE Firms Undergoing
Dual Class Recapitalizations, 1984-86

Sample	Study A 3 day average returns % AD-2, AD, AD+1	Study B 11 day average returns % AD-5 thru AD+5
	Average Returns % (t-statistic) [Proportion positive]	Average Returns % (t-statistic) [Proportion positive]
1. Entire sample (n=19)	-.59 (-.55) [.32]	-1.86 (-.84) [.58]
2. Recap by Exchange Offer (n=8)	-.38 (-.23) [.25]	3.34 (1.36) [.75]
3. Recap by Special Distribution (n=6)	1.55 (.88) [.50]	-6.71 (-1.40) [.50]
4. Recap by Voting Rights Alteration (n=5)	-3.42 (-2.09) [.20]	-4.36 (-1.57) [.40]
5. Firm Expressed Intention to issue New Equity (n=12)	.06 (.04) [.25]	-1.06 (-.35) [.50]
6. Firm expressed no Intention Regarding Issuance of New Equity (n=7)	-1.14 (-.70) [.43]	-3.23 (-1.06) [.71]

Sample	Study A 3 day average returns % AD-2, AD, AD+1	Study B 11 day average returns % AD-5 thru AD+5
	Average Returns % (+-statistic) [Proportion positive]	Average Returns % (+-statistic) [Proportion positive]
7. Percentage of Votes Controlled by Insiders Is Sufficient to Obtain Approval (n=5)	-.37% (-.15) [.20]	-13.62 (-1.63) [.20]

Table 3

Average Net of Market Returns for
19 NYSE Firms Undergoing
Dual Class Recapitalizations, 1984-86

Sample	Study C 11 day average returns Shareholder Approval Day-5 through SAD+5 Average Returns % (t-statistic) [Proportion Positive]	Study D Sum of 11 day Proposal Effect and 11 day Approval Effect Average returns % (t-statistic) [Proportion Positive]
1. Entire Sample (n=19)	-.26 (-.14) [.63]	-2.12 (-1.02) [.42]
2. Recap by Exchange Offer (n=8)	-2.56 (-.74) [.50]	.33 (.16) [.375]
3. Recap by Special Distribution (n=6)	2.39 (.70) [.83]	-1.37 (-.53) [.50]
4. Recap by Voting Rights Alteration (n=5)	.24 (.19) [.6]	-1.08 (-.88) [.40]

EXCHANGE OFFERS

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General Datacom	10 (vs. outsider only)	no xc fam	11%		a) if svs os <5% all os b) Bd + maj svs	10%	70%	21.2% (+ESOP= 3.7%)	simple of common	66.9%	17.3%	10.6%	55.9%
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Hershey	10 (1/6 of dirs xlvs)	yes	11%	increased div-10% for lvs	a) if Trust <50% svs + <15% of all os common	10%	90%	50.1	simple of comm (except Bd is req. maj. of public shares)	81.5%	5.6%	2.9%	62.9%
Kaufman & Broad	10	no xc fam (subject to NYSE)	11%		a) if svs <10% all os common	16%	63%	32.5%	2/3, of common & preferred together	84.7%	10.8%	not disclosed	77.3%
Jack Winter	10	no xc fam	11%	expansion of business. resumption of div (none since 1981)	a) if svs <2% of all os common	10%	94%	60.4%	simple of common	not disclosed NA	not disclosed NA	not disclosed NA	x

SPECIAL DISTRIBUTIONS

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North Am Coal	10	no xc fam	equal	poss. of higher div & open mkt. repurchase of common; holding co. structures to protect vs liability		<10%	70%	36.8%	2/3 of common	77.2%	6.7%	not disclosed	63.9%
Wrigley	10	no xc fam	equal	increased div by 60%	a) if Wrigley <18% all os common b) Bd + maj svs	10% but see termin	75%	38.62%	simple of common	79%	8.7%	5.1%	65.7%

VOTING RIGHTS ALTERATION

Firm	Votes/SVS	Transf/ SVS	Div Pref. for LVS	Sweetener	Termination of SVS a) min % b) bd action c) sunset	With full convs or exch, min % for control	With full convsn or exch, % Fam mg control	% o'shp before recap fam/mg	Maj. of outstanding stock Req. for Approval	% voting for recap (% of outstanding	% voting ags recap (% of outstanding	% abstaining (% of outstanding)	% of non-mgt/fam shareholders voting for recap
American Family	10	no xc fam; 48 mos reqmnt.	equal	increased divs (notes NYSE = 2/3 + co. can vote ESOP if delisted)		9%	<50%	8.9%	simple of common	71.7%	7.3%	0.9%	68.2%
Carlisle	5	No xc fam; 48 mos reqmnt	equal	holding co. structures to protect vs. liability		19%	55%	19.65%	simple of common	65.8%	14.7%	2.9%	57.4%
Cincinnati Milacrom	10	no xc fam; 36 mos reqmnt	equal		a) if svs <15% all os common (excluding subseq. issuances)	<10%, but see termin.	>90%	>50% (incl. O&D=13.76%)	simple, of common & pref. sep & together	73%	not disclosed	not disclosed	<46%
J. M. Smucker	10	no xc fam 48 mos reqmnt.	equal			<10%	78%	26.7%	2/3 of common	69.6%	14.5%	1.5%	58.2%
Potlach	4 (xc where 80% req.)	no xc fam (Bd) 48 mos reqmnt	equal			25%	>72%	>40% (incl. long-term shrs of predecessor cos. (incl.O &D=13.3%	simple of common	58.8%	21.4%	not disclosed	<31.3%

Table 2

Average Net of Market Returns for
19 NYSE Firms Undergoing
Dual Class Recapitalizations, 1984-86

Sample	Study A 3 day average returns % AD-2, AD, AD+1	Study B 11 day average returns % AD-5 thru AD+5
	Average Returns % (t-statistic) [Proportion positive]	Average Returns % (t-statistic) [Proportion positive]
1. Entire sample (n=19)	-.59 (-.55) [.32]	-1.86 (-.84) [.58]
2. Recap by Exchange Offer (n=8)	-.38 (-.23) [.25]	3.34 (1.36) [.75]
3. Recap by Special Distribution (n=6)	1.55 (.88) [.50]	-6.71 (-1.40) [.50]
4. Recap by Voting Rights Alteration (n=5)	-3.42 (-2.09) [.20]	-4.36 (-1.57) [.40]
5. Firm Expressed Intention to issue New Equity (n=12)	.06 (.04) [.25]	-1.06 (-.35) [.50]
6. Firm expressed no Intention Regarding Issuance of New Equity (n=7)	-1.14 (-.70) [.43]	-3.23 (-1.06) [.71]

Sample	Study A 3 day average returns % AD-2, AD, AD+1	Study B 11 day average returns % AD-5 thru AD+5
	Average Returns % (+-statistic) [Proportion positive]	Average Returns % (+-statistic) [Proportion positive]
7. Percentage of Votes Controlled by Insiders Is Sufficient to Obtain Approval (n=5)	-.37% (-.15) [.20]	-13.62 (-1.63) [.20]

Table 3

Average Net of Market Returns for
19 NYSE Firms Undergoing
Dual Class Recapitalizations, 1984-86

Sample	Study C 11 day average returns Shareholder Approval Day-5 through SAD+5 Average Returns % (t-statistic) [Proportion Positive]	Study D Sum of 11 day Proposal Effect and 11 day Approval Effect Average returns % (t-statistic) [Proportion Positive]
1. Entire Sample (n=19)	-.26 (-.14) [.63]	-2.12 (-1.02) [.42]
2. Recap by Exchange Offer (n=8)	-2.56 (-.74) [.50]	.33 (.16) [.375]
3. Recap by Special Distribution (n=6)	2.39 (.70) [.83]	-1.37 (-.53) [.50]
4. Recap by Voting Rights Alteration (n=5)	.24 (.19) [.6]	-1.08 (-.88) [.40]