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# Dual Class Capitalization: A Reply to Professor Seligman

George W. Dent, Jr.\*

Professor Joel Seligman's article, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*,<sup>1</sup> is an impressive accomplishment in many respects. It confirms his status as premier historian of our securities laws and markets.<sup>2</sup> It also provides a powerful analysis of, and the first serious argument against, dual class capitalization, and proposes a thoughtful solution to the problems it raises. Despite these formidable assets, some of Professor Seligman's conclusions are debatable. First, Professor Seligman argues that the Securities and Exchange Commission (SEC) can impose on the National Association of Securities Dealers (NASD) and the stock exchanges (collectively, the "securities markets") rules forbidding dual class common stock among companies listed for trading.<sup>3</sup> Further, Pro-

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1. Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

2. His status was established in J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (1982), and confirmed in J. SELIGMAN, *THE SEC AND THE FUTURE OF FINANCE* (1985); Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79 (1984); Seligman, *The Structure of the Options Markets*, 10 J. CORP. L. 141 (1984); and Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983) [hereinafter Seligman, *Mandatory Disclosure*].

3. Seligman, *supra* note 1, at 714-19.

fessor Seligman argues that such rules would be wise.<sup>4</sup>

This Reply argues that both his positions are ill-founded. Part I analyzes the SEC's power to forbid dual class capitalization. Part II discusses the concept of efficiency in corporate law and procedural safeguards to limit dual class capitalization to situations in which it is efficient. It further provides a theoretical discussion of the efficiency of dual class capitalization. Part III advances a counterproposal to Professor Seligman's position, as well as that of Professor Daniel Fischel. Although Professor Seligman is right that dual class capitalization creates dangers, new legislation can allow such capitalization, yet protect against these dangers. Unlike his proposed prohibition, this new legislation should permit dual class stock if it will not injure public shareholders.

### *I. The SEC's Power to Forbid Dual Class Capitalization*

Dual class capitalization (or dual class stock) refers to shares of common stock with different voting rights. This usually entails the issue of separate classes of stock with disproportionate voting rights, but may also arise through rules affecting the voting rights of shares of a single class.<sup>5</sup> As Professor Seligman accurately explains, dual class stock has been extremely rare among public companies since the late 1920s.<sup>6</sup> In the last few years, however, several companies have adopted dual class stock, apparently in most cases as a takeover defense.<sup>7</sup> Many more will undoubtedly do so if stock exchange rules prohibiting it are lifted.<sup>8</sup>

Professor Seligman argues that the SEC can require the stock exchanges and the NASD to forbid dual class capitalization among companies registered under section 12 of the Securities Exchange Act.<sup>9</sup> He finds authority in section 19(c) of the Exchange Act,<sup>10</sup> which empowers the SEC to impose rules that it "deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organizations, or otherwise in furtherance of the purposes of this chapter." Section 19(c), like any other statute, only authorizes the SEC "to police within the boundaries of the Act" but not "to expand its jurisdiction beyond the boundaries established by

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4. *Id.* at 720-24.

5. For a discussion of the ways in which dual class stock can be adopted, see *infra* text accompanying notes 111-41.

6. Seligman, *supra* note 1, at 693-707.

7. *Id.* at 701-03. Although on occasion takeover defense is clearly not the goal of a company's use of dual class stock, see *infra* note 123, often it is the goal, see *infra* text accompanying notes 142-45.

8. Seligman, *supra* note 1, at 701-03. The directors of the New York Stock Exchange have now voted to rescind its rule. See *infra* note 39.

9. Seligman, *supra* note 1, at 714; see also Karmel, *The SEC's Power to Regulate Stockholder Voting Rights*, N.Y.L.J., Aug. 21, 1986, at 1, col. 1, at 2, col. 4 [hereinafter Karmel, *SEC's Power to Regulate*] (also arguing that the SEC has such power).

10. 15 U.S.C. § 78s(c) (1982).

Congress."<sup>11</sup> The legislative history states that this section gives the SEC "plenary power over self-regulatory rules" and "the power to change the rules of a self-regulatory organization in any respect, not just with respect to certain enumerated areas."<sup>12</sup> Professor Seligman claims that three "purposes of this title" would be furthered by the rule he proposes.<sup>13</sup> One is the goal of neutrality in tender offers arguably contained within the Williams Act.<sup>14</sup> The second is the SEC's authority to "designate the securities or classes of securities qualified for trading in the national market" under section 11A(a)(2) of the Exchange Act.<sup>15</sup> The third is the commission's power to regulate the solicitation of proxies.<sup>16</sup>

Professor Seligman's reading of the SEC's statutory powers is far from compelling. He relies on such vague statements as "in furtherance of the purposes of this title" in section 19(c) and "plenary power over self-regulatory rules" in the legislative history.<sup>17</sup> In the last decade, however, the Supreme Court has often ruled that administrative agencies may act only under specific, well-defined grants of power. Neither pursuit of the public interest nor the "broad purpose" of a statute can support a rule not justified by the statutory language; if the statute is inadequate, Congress, rather than the agency, must correct the flaw.<sup>18</sup> An agency's interpretation of the statute it administers warrants judicial deference, but deference "cannot be allowed to slip into a judicial inertia which results in the unauthorized assumption . . . of major policy decisions properly made by Congress."<sup>19</sup> Careful judicial review thus extends both to an agency's rulemaking and to adjudi-

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11. Board of Governors v. Dimension Fin. Corp., 106 S. Ct. 681, 688 n.6 (1986) (referring to the powers of the Federal Reserve Board).

12. S. REP. NO. 75, 94th Cong., 1st Sess. 131, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 308. The broad terms "plenary power" and "in any respect" must, however, be read in light of the language of both section 19(c) itself, which permits rulemaking for certain enumerated purposes "or otherwise in furtherance of this title," and of the legislative history, which refers to rules "consistent with the objectives of the Exchange Act" or "in furtherance of the purposes of the Exchange Act." *Id.* at 31, 131, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 209, 308.

13. Seligman, *supra* note 1, at 714-19.

14. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982)).

15. 15 U.S.C. § 78k-1(a)(2) (1982).

16. Seligman, *supra* note 1, at 717-19.

17. *Id.* at 715.

18. Board of Governors v. Dimension Fin. Corp., 106 S. Ct. 681, 689 (1986) (stating that the Federal Reserve Board cannot rely on the "broad purposes" of legislation at the expense of specific provisions"; Congress must correct any statutory flaws); NAACP v. Federal Power Comm'n, 425 U.S. 662, 669 (1976) (stating that the statutory standard of the "public interest" . . . is not a broad license to promote the general public welfare. Rather, the words take meaning from the purposes of the regulatory legislation").

19. NLRB v. Financial Inst. Employees, 106 S. Ct. 1007, 1013 (1986) (quoting American Ship Bldg. Co. v. NLRB, 380 U.S. 300, 318 (1965)); see Securities Indus.

catory interpretation of a statute.<sup>20</sup>

Although the Supreme Court has never invalidated an SEC rule, it has often overruled the SEC's construction of federal securities statutes and of the SEC's own rules, especially rule 10b-5, on grounds that broader constructions would exceed the commission's rulemaking authority.<sup>21</sup> As the Court stated in *Ernst & Ernst v. Hochfelder*:<sup>22</sup> "The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'" <sup>23</sup> Such decisions show that the SEC's rulemaking power will be carefully scrutinized by the courts.

On close analysis, the specific purposes of the securities laws claimed by Professor Seligman do not exist, at least not in the form he ascribes to them. Citing Professor John Coffee, he argues that dual class stock defies the Williams Act's goal of neutrality in tender offers<sup>24</sup> — but the meaning of neutrality in this context is highly problematic.<sup>25</sup> Congress intended the Williams Act primar-

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Ass'n v. Board of Governors, 468 U.S. 137, 142-43 (1984) (stating that "deference is not to be a device that emasculates the significance of judicial review").

20. Securities Indus. Ass'n v. Board of Governors, 468 U.S. 137, 142-43 (1984).

21. The cases narrowing rule 10b-5 include: *Dirks v. SEC*, 463 U.S. 646 (1983) (requiring the breach of an insider's fiduciary duty before a tippee inherits the duty to disclose or abstain); *Aaron v. SEC*, 446 U.S. 680 (1980) (requiring scienter in an SEC suit); *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that mere possession of nonpublic information does not give rise to a duty to disclose); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (holding that only conduct involving deception or manipulation was reached by rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (requiring scienter in private actions); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (holding that a rule 10b-5 plaintiff must be a purchaser or seller of securities). Other cases rejecting the SEC's broad interpretations of the federal securities laws include: *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458 (1985) (rejecting broader definition of "manipulative"); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (rejecting the SEC's definition of "security"); *SEC v. Sloan*, 436 U.S. 103 (1978) (rejecting the SEC's broad interpretation of its power to suspend trading in a security); *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977) (discussing takeover bidder's standing to sue under the Williams Act); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975) (holding that a tenant's stock in a housing cooperative is not a security for purposes of the securities laws). For a list of other Supreme Court rejections of the SEC's interpretations, see *International Bhd. of Teamsters*, 439 U.S. at 566 n.20.

22. 425 U.S. 185 (1976).

23. *Id.* at 213-14 (quoting *Dixon v. United States*, 381 U.S. 68, 74 (1965) (quoting *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936))).

24. Seligman, *supra* note 1, at 717 (citing Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1266-67 (1984)).

25. Congress often proclaimed a goal of neutrality in tender offers when passing the Williams Act. See *Hearings on S.510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 178 (1967) (statement of Milton Cohen, Chairman, SEC) ("[W]e are not concerned with assisting or hurting either side."); S. REP. NO. 550, 90th Cong., 1st Sess. 3-4 (1967) (stating that the purpose of the law was to "place investors on an equal footing with the takeover bidder" without favoring either the tender offeror or existing management); 113 CONG. REC. 24,664 (1967) (statement of Sen. Williams) ("We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids."); see also *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 29-31 (1977) (emphasizing that neutrality between takeover bidder and management was intended to benefit the

ily to regulate tender offerors (raiders).<sup>26</sup> Companies subject to tender offers (targets) were regulated only as to disclosure and purchases of their own shares.<sup>27</sup> Moreover, section 14(e) applies only "in connection with any tender offer"; it does not apply unless a tender offer is actually pending.<sup>28</sup> Thus, the commission could not use section 14(e) to attack dual class stock except insofar as it entails material misrepresentation or nondisclosure during a tender offer. No other provision of the Williams Act provides better support.<sup>29</sup>

The Williams Act analysis collapses when pushed to its logical conclusion — if it is right, the SEC can prohibit, as a violation of neutrality, all takeover defenses, including staggered boards of directors, poison pill preferred stock, fair price charter provisions, golden parachutes, and perhaps even defensive mergers and the creation of employee stock option plans. Nothing in the legislative history suggests that Congress intended to grant such power. Furthermore, Professor Seligman's analysis of the Williams Act can apply only if dual class capitalization is adopted to hinder takeovers. But dual class stock is often adopted when management already owns a majority of the stock.<sup>30</sup> Because such companies

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investors); Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1267 n.369 (discussing Congress's purpose in its policy of neutrality).

26. 113 CONG. REC. 857-58 (1967) (remarks of Sen. Kuchel, cosponsor of the Williams Act, criticizing corporate raiders, whom he described as "takeover pirates"); see *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 28, 30, 37 (1977) (stating that raider is not an "intended beneficiary of the Williams Act" but "a member of the class whose activities Congress intended to regulate").

27. See *infra* note 29. Thus, the Supreme Court, in *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458 (1985), held that section 14(e) — the general antifraud provision of the Act — forbids only misrepresentation and nondisclosure, and not acts by target managements that are simply unfair to their shareholders. *Id.* at 2462-65.

28. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 283-84 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980); see T. HAZEN, *THE LAW OF SECURITIES REGULATION* 382-83 & n.36 (1985) (discussing *Panter v. Marshall Field & Co.*). According to the legislative history, the purpose of section 14(e) is to place those making or resisting a tender offer "under an obligation to make full disclosure of material information to those with whom they deal." H.R. REP. NO. 1711, 90th Cong., 2d Sess. 11, *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, 2821.

29. Section 13(d) only requires disclosures by raiders or potential raiders; it does not even apply to target managements. See *Warner Communications, Inc. v. Murdoch*, 581 F. Supp. 1482, 1501 (D. Del. 1984). If management pools efforts with third parties, however, the group must comply with section 13(d). *Id.* at 1499-1500; T. HAZEN, *supra* note 28, at 344 n.27. Section 14(d) does require certain disclosures by target managements, but its substantive requirements apply only to raiders.

30. As Professor Seligman notes, one study demonstrated that managers of companies adopting dual class stock already owned an average of 48.6% of the stock. Seligman, *supra* note 1, at 711 n.107. Many of these managers are obviously not threatened by takeovers.

are not subject to hostile takeovers, his reasoning could not logically apply to them.

Professor Seligman also cites the SEC's power under section 11A(a)(2) of the Exchange Act to "designate the securities or classes of securities qualified for trading in the national market system."<sup>31</sup> However, he and Milton Cohen, a former SEC official whom he quotes with approval, admit that the issue "is not free from doubt."<sup>32</sup> They could proclaim that this power knows no limits — that the SEC can impose on public companies any corporate governance rules it fancies. In fact, the SEC virtually made this claim during the 1970s when Chairman Harold Williams declared that the commission could require listed companies to remove all inside directors except the chief executive officer (who would not be the chairman of the board) and to create certain overview committees.<sup>33</sup> Wisely, Professor Seligman eschews this argument; he concedes that the SEC cannot "establish . . . a comprehensive federal corporation act."<sup>34</sup> The legislative history of the securities laws contains no hint that Congress intended to grant the SEC such power,<sup>35</sup> and Supreme Court decisions deny the SEC such power.<sup>36</sup> Moreover, if Congress had intended to grant such power, serious constitutional questions would arise.<sup>37</sup>

Professor Seligman must therefore steer between Scylla and Charybdis — he must define the commission's power broadly enough to encompass the rules he proposes, yet narrowly enough to avoid charges of unconstitutionality and lack of authority. In a search for limits, he argues that his proposal may be justified "to assure the equal regulation of all markets for qualified securities."<sup>38</sup> This argument collapses when, as now, the New York Stock Exchange (NYSE) has voted to rescind its rule against dual class stock.<sup>39</sup> Moreover, "equal regulation" is defined solely in

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31. *Id.* at 715-16; see also Karmel, *SEC's Power to Regulate*, *supra* note 9, at 2, col. 3 (making a similar argument).

32. Letter from Milton Cohen to John P. Wheeler, III, Secretary, Securities and Exchange Commission (Feb. 8, 1985) [hereinafter Letter to Wheeler] (regarding File S7-37-84, Release No. 34-21498, at 20-21), *quoted in* Seligman, *supra* note 1, at 716.

33. H. Williams, *Corporate Accountability and Corporate Power* (Oct. 24, 1979) (a paper presented in the Fairless Lecture Series, Carnegie-Mellon University), *described in* Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 *BUS. LAW.* 173, 178 (1981).

34. Seligman, *supra* note 1, at 715.

35. The Senate Report on the Exchange Act stresses that it was not intended "to invest a governmental commission with the power to interfere in the management of corporations." S. REP. NO. 792, 73d Cong., 2d Sess. 10 (1934). The House-Senate conference omitted a clause that expressly forbade "the Commission to interfere with the management of the affairs of an issuer" because it was "unnecessary, since it is not believed that the bill is open to misconstruction in this respect." H.R. CONF. REP. NO. 1838, 73d Cong., 2d Sess. 35 (1934); see Dent, *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 *MINN. L. REV.* 865, 903-09 (1983) [hereinafter Dent, *Ancillary Relief*].

36. See *infra* text accompanying notes 73-78.

37. See *infra* text accompanying note 82.

38. Seligman, *supra* note 1, at 715 (quoting S. REP. NO. 75, 94th Cong., 1st Sess. 105, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 282).

39. See NYSE Press Release, *New York Stock Exchange Directors Approve*

terms of regulation under the Exchange Act, not by self-regulatory organizations.<sup>40</sup> Because the SEC does not forbid dual class stock in any market, its regulation here is not unequal.

Does the NASD, by permitting dual class stock, deny "fair competition . . . among exchange markets" within the meaning of section 11A(a)(1)(C)(ii)?<sup>41</sup> In 1975, Congress decried certain noncompetitive practices, such as the off-board trading restrictions of the NYSE, as obstacles to "economically efficient execution of securities transactions."<sup>42</sup> The means Congress chose to solve this problem was the creation of a national market system. Congress charged the SEC to "facilitate the establishment" of such a system<sup>43</sup> and to remove obstacles to it, and the commission has since done so.<sup>44</sup> But dual class stock creates no such obstacle because, whatever its faults, it does not impair the "economically efficient execution of securities transactions" or the establishment of a national market system. Moreover, complaints about the unfairness of dual class stock have issued mostly from the NYSE, which Congress viewed as dominating the securities exchange markets.<sup>45</sup> By prohibiting dual class stock, the SEC would be enhancing competition less than protecting the NYSE from competi-

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Amendment to Allow Dual Classes of Common Stock for Listed Companies (July 3, 1986); Sterngold, *Big Board Ends Equal Vote Rule*, N.Y. Times, July 4, 1986, at D1, col. 1.

40. Securities Exchange Act of 1934, § 3(a)(36), 15 U.S.C. § 78(c)(a)(36) (1982).

41. 15 U.S.C. § 78k-1(a)(1)(C)(ii) (1982). Professor Seligman quotes Milton Cohen's statement that dual class stock produces "a serious form of discrimination among issuers, such as to result in unfair competition." Letter to Wheeler, *supra* note 32, quoted in Seligman, *supra* note 1, at 716.

42. Securities Exchange Act of 1934, § 11A(a)(1)(C)(i), 15 U.S.C. § 78k-1(a)(1)(C)(i) (1982). The rule, then identified as NYSE Rule 394, received harsh criticism from Congress in 1975. See S. REP. NO. 75, 94th Cong., 1st Sess. 8, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 185-86; R. JENNINGS & H. MARSH, CASES AND MATERIALS ON SECURITIES REGULATION 463, 489 (5th ed. 1982). Barriers to competition among securities markets were part of Congress's concern. See 15 U.S.C. § 78k-1(a)(1)(C)(ii) (1982) ("fair competition . . . among exchange markets"); *id.* § 78k-1(a)(1)(D) ("enhance competition"); *id.* § 78k-1(c)(4)(A) ("burden on competition").

43. Securities Exchange Act of 1934, § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (1982).

44. Rules 19c-1 and 19c-3 substantially eliminate off-board trading restrictions. 17 C.F.R. § 240.19c-1, .19c-3 (1986).

45. See *Coming to Blows Over One Share, One Vote*, BUS. WK., July 8, 1985, at 81-82 (NYSE Chairman John Phelan stated that the NYSE will continue to forbid dual class stock "only if 'competing markets' follow suit."). On Congress's hostility to the NYSE, see S. REP. NO. 75, 94th Cong., 1st Sess. 20, 62-65 (criticizing NYSE's Rule 394 and limited membership policy), reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 198-99, 240-44; H.R. REP. NO. 123, 94th Cong., 1st Sess. 47, 52-54 (1975) (criticizing NYSE's limited membership and fixed commission policies and "boycotts such as" NYSE Rule 394); 121 CONG. REC. 10,731 (1975) (remarks of Sen. Williams) ("[T]he principal stock exchanges . . . have resisted modernization."); 119 CONG. REC. 20,034 (1973) (remarks of Sen. Williams) (criticizing securities markets "run by a few for a few"); *id.* at 20,039 (remarks of Sen. Tower) (criticizing "the present distorted pricing system and increasingly privately oriented exchange network").



tion.<sup>46</sup> This does not mean that the SEC must sit by helplessly if competition forces the securities markets to the lowest common denominator.<sup>47</sup> The SEC may act, but only to preserve fair and orderly markets that are financially sound and free of manipulation and deception.<sup>48</sup> Dual class capitalization, however, does not infringe upon any of these legitimate concerns.

The primary reason for rejecting Professor Seligman's reading of section 11A(a)(2), however, is the statutory language itself. That section authorizes the SEC to designate securities qualified for trading "in the national market system."<sup>49</sup> At most, this means that the SEC can exclude securities from this system.<sup>50</sup> First, excluding companies with dual class stock would carry little clout. If these companies remained listed on the NASD automated quotation system (NASDAQ), the American Stock Exchange (AMEX) or the NYSE, their stock prices would not suffer. Section 11A(a)(2) cannot justify exclusion from trading in these markets, which are not the national market system but components of the fragmented trading network that Congress wanted to reform.<sup>51</sup> Moreover, Congress sought the creation of a national market system not to regulate the governance of public companies, but to assure execution of trades at the best available price.<sup>52</sup> Professor Seligman's proposal would be irrelevant, if not contrary, to this purpose.

What, then, is the meaning of the SEC's power to "designate the

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46. Congress did not consider uniformity synonymous with competition. "It would obviously be contrary to this purpose [to enhance competition] to compel elimination of differences between types of markets or types of forms that might be competition enhancing." S. REP. NO. 75, 94th Cong., 1st Sess. 8, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 186.

47. Of course, rule changes in the securities exchange markets resulting from competition are not necessarily detrimental. However, the argument of Professor Fischel that competition among the securities markets will necessarily lead to optimal rules, *see* D. FISCHEL, ORGANIZED EXCHANGES AND THE REGULATION OF DUAL CLASS COMMON STOCK 7-17 (1986), is not valid. *See infra* text accompanying notes 125-32.

48. These goals are consistent with the purposes of the Exchange Act, which the SEC may further under section 19(c) by imposing rules on the exchanges and the NASD. *See* Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1982) ("fair and honest markets"); § 6(b)(5), 15 U.S.C. § 78f(b)(5) ("free and open market"); § 6(c)(3)(A), 15 U.S.C. § 78f(c)(3)(A) ("financial responsibility"); § 7(a), 15 U.S.C. § 78g(a) ("preventing the excessive use of credit"); § 8, 15 U.S.C. § 78h (restricting borrowing by broker-dealers); § 9, 15 U.S.C. § 78i (prohibiting manipulation on securities exchanges); § 10, 15 U.S.C. § 78j (prohibiting manipulation and deception); § 11, 15 U.S.C. § 78k (limiting trading by exchange members for their own account); § 15(b)(4), 15 U.S.C. § 78o(b)(4) (SEC discipline of broker-dealers); § 15(c)(1), 15 U.S.C. § 78o(c)(1) (prohibiting manipulation or deception by broker-dealers); § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (prevention of fraud by securities association members); § 15A(g)(3)(A), 15 U.S.C. § 78o-3(g)(3)(A) (broker-dealer financial responsibility).

49. 15 U.S.C. § 78k-1(a)(2) (1982).

50. *See* Karmel, *Is One Share, One Vote Archaic?*, N.Y.L.J., Feb. 26, 1985, at 1, col. 1, at 2, col. 4 [hereinafter Karmel, *One Share, One Vote*].

51. "[T]he national market system has as its fundamental goal the elimination of fragmented markets for securities . . ." S. REP. NO. 75, 94th Cong., 1st Sess. 17, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 195.

52. *See id.* at 3, 7, 9-12, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 181-82, 185, 187-91.

securities or classes of securities qualified for trading in the national market system"? The SEC itself has aptly answered the question: "[T]he types of securities qualified to be included in the national market system . . . should depend primarily on their characteristics (e.g., trading volume, price and numbers of shareholders) . . . ." <sup>53</sup> The Commission has adopted rules reflecting this view. <sup>54</sup> Indeed, in 1975, the Conference Committee stated that "it is the intention of both houses that all securities, other than exempted securities, be eligible to be qualified for trading in the national market system." <sup>55</sup> Thus, Professor Seligman's proposed rule would, by disqualifying securities for trading, pervert the intention of Congress, especially because the reasons for disqualification would be extraneous to sound trading.

Professor Seligman also argues that the SEC may use its power to regulate proxies to forbid dual class capitalization because it impairs "the free exercise of the voting rights of stockholders." <sup>56</sup> The SEC's power to regulate proxies is limited, however, primarily to requiring full disclosure in proxy situations; the abuse Congress condemned was primarily the retention of control "by concealing or distorting facts." <sup>57</sup> This power may extend slightly further. For example, the Commission has required that proxy cards include spaces not only to vote for or against a proposal, but also to abstain. <sup>58</sup> Although many consider these rules silly, no one considers them beyond the Commission's power. I have argued elsewhere that the Commission cannot require inclusion of shareholder proposals in proxy statements, <sup>59</sup> but at least shareholder proposals concern the content of the proxy statement and matters to be voted upon by shareholders. By contrast, Professor Seligman's proposed rule deals not at all with proxies, but with a form of capitalization that might indirectly impair to some extent a

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53. Notice of Intent to Commence Rulemaking to Establish a National Market System, Exchange Act Release No. 14,416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,502, at 80,028 (Jan. 26, 1978).

54. SEC Rule 11Aa2-1, 17 C.F.R. § 240.11Aa2-1 (1986).

55. H.R. REP. NO. 249, 94th Cong., 1st Sess. 92 (1975).

56. Seligman, *supra* note 1, at 717 (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964)).

57. S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934); see Dent, *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1, 22-23 (1985) e [hereinafter Dent, *Regulatory Failure*]. The concept of disclosure is broad for this purpose. It includes, for example, strict limits on discretionary proxies. SEC Rule 14a-4(c), 17 C.F.R. § 240.4a-14(c) (1986). This is simply consistent with the requirement of full disclosure about matters on which shareholders are asked to vote.

58. SEC Rule 14a-4(b)(1), 17 C.F.R. § 240.14a-4(b)(1) (1985). Professor Homer Kripke has criticized this rule. Kripke, *supra* note 33, at 176 n.14.

59. Dent, *Regulatory Failure*, *supra* note 57, at 6-28.

mythical system of shareholder democracy.<sup>60</sup> It is doubtful that most securities law experts would accept so broad a definition of the proxy regulation power.

Professor Seligman argues that section 14(a) was intended to prevent "the recurrence of abuses which have frustrated the free exercise of voting rights of shareholders,"<sup>61</sup> and that "Congress presumably must have viewed nonvoting common stock or common stock with disproportionate voting rights as exactly such an abuse."<sup>62</sup> He cites no authority for the latter proposition in the Act's legislative history, however, even though dual class stock was not unknown in 1934.<sup>63</sup> Indeed, Congress expressly forbade dual class stock to certain companies in the Public Utility Holding Company Act and the Investment Company Act.<sup>64</sup> If Congress did consider dual class stock an abuse, the proxy rules were a strange weapon with which to attack it, and Congress certainly hid its intentions very well. Moreover, as with his discussion of section 11A(a)(2), even if Professor Seligman is correct in construing the proxy regulation power so broadly, his position would raise serious constitutional questions.<sup>65</sup>

Ironically, Professor Seligman's proposal is schizophrenic; he champions corporate democracy but would advance it by denying shareholders the franchise to approve dual class stock.<sup>66</sup> By contrast, the NYSE would permit dual class stock if approved by a majority of a company's shareholders.<sup>67</sup> Moreover, Professor Seligman opposes dual class capitalization even if shareholders obtain sweeteners so that the value of their shares does not then decline.<sup>68</sup> Who then suffers? Apparently, he properly limits his concern to shareholders.<sup>69</sup> If shareholders suffer no immediate loss, his concern must be future shareholders' welfare. But positing a delayed stock price reaction seems to conflict with principles

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60. "There has long been a consensus that this goal [of shareholder democracy] is not practicable." Kripke, *supra* note 33, at 176; see authorities cited in *id.* at 176 n.13.

61. Seligman, *supra* note 1, at 719 (quoting H.R. REP. NO. 1383, 73d Cong., 2d Sess. 14 (1934)).

62. *Id.*

63. As Professor Seligman indicates, the NYSE accepted nonvoting common stock until 1926. In 1934, it still listed previously accepted nonvoting issues, voting trust certificates, and disproportionate voting shares. *Id.* at 697-99. Congress did not prohibit any of these.

64. Public Utility Holding Company Act of 1935, § 11(b)(2), 15 U.S.C. § 79k(b)(2) (1982); Investment Company Act of 1940, § 18(i), 15 U.S.C. § 80a-18(i) (1982); see also 11 U.S.C. § 1123(a)(6) (1982) (plan of reorganization in bankruptcy may not provide for nonvoting stock and must provide for "an appropriate distribution" of voting power among classes of equity securities).

65. See *infra* text accompanying note 82.

66. See Seligman, *supra* note 1, at 717-18 (referring to "corporate suffrage" and "corporate democracy"). This inconsistency about shareholder competence is not unique; Professor Kripke has noticed the SEC's tendency to question shareholder competence in casting votes. Kripke, *supra* note 33, at 176 n.14.

67. See NYSE Press Release, *supra* note 39, Sterngold, *supra* note 39, at D3, col. 4.

68. Seligman, *supra* note 1, at 723 ("[I]f the basic economic effect of dual class voting structures is a loss in management efficiency, a payment to shareholders will not compensate society for that economic cost.").

69. See *infra* text accompanying notes 103-05.

of stock market behavior embodied in the efficient market hypothesis.<sup>70</sup> The skepticism about shareholder suffrage implicit in Professor Seligman's proposal may be well-founded; his own statistics on proxy fights justify suspicion.<sup>71</sup> But Professor Seligman cannot have it both ways; if he wants shareholder suffrage he must accept its consequences, including approval of dual class capitalization.

Professor Seligman's analysis ignores another major problem — the rule he proposes would invade an area generally governed by state law and displace laws of most states, which permit dual class capitalization.<sup>72</sup> In cases like *Burks v. Lasker*<sup>73</sup> and *Santa Fe Industries v. Green*,<sup>74</sup> the Supreme Court has held that corporate governance will be regulated by state law absent "a clear indication of congressional intent, . . . particularly where established state policies of corporate regulation would be overridden."<sup>75</sup> The Court's concern is consistent with the legislative history of the securities laws, which shows that Congress intended to leave corporate governance generally to the states.<sup>76</sup> Thus, "absent repealing or exclusivity provisions, [state law] should be preempted by exchange self-regulation 'only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act.'"<sup>77</sup> These decisions are but part of a growing concern for federalism that has influenced the Court in several areas.<sup>78</sup> Professor Seligman concedes that the SEC cannot preempt state corporate laws

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70. See *infra* text accompanying notes 117-22.

71. See Seligman, *supra* note 1, at 710.

72. Professor Seligman notes that a few state court decisions have barred the issuance of superior voting stock during a contest for control, and that the securities administrators of 18 states forbid public offerings by issuers with dual class stock. Seligman, *supra* note 1, at 712-14. However, the former situation is special and should be handled separately. Compare the situations described *infra* in text accompanying notes 112-24. The 18 states are not only a minority of the whole, but are also a minority of the important commercial states. Even if they were a majority, that would not justify the SEC in preempting the laws of the minority. Some states are now considering mandating disproportionate voting rights. See *infra* note 141.

73. 441 U.S. 471 (1979).

74. 430 U.S. 462 (1977).

75. *Id.* at 479; see *Burks*, 441 U.S. at 477-80 (maintaining that state law is the primary authority with respect to the powers of corporate directors). The Court also stated that "except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Santa Fe*, 430 U.S. at 479 (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

76. See Dent, *Ancillary Relief*, *supra* note 35, at 913-16.

77. Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117, 127 (1973) (holding that stock exchange rules did not preempt state employment law) (quoting *Silver v. New York Stock Exch.*, 373 U.S. 341, 361 (1963)).

78. See *Employees of Dep't of Pub. Health and Welfare v. Department of Pub. Health and Welfare*, 411 U.S. 279 (1973) (declaring unconstitutional federal legislation that infringed upon state interests); Goldstein, *A Swann Song for Remedies: Equitable Relief in the Burger Court*, 13 HARV. C.R.-C.L. L. REV. 1, 8-26 (1978) (discussing the growing consideration of federalism in fashioning constitutional remedies).

without express authority,<sup>79</sup> yet his proposal would do precisely that. Indeed, his proposal is more troublesome than the positions rejected in *Burks* and *Santa Fe* because it would preempt express state laws.<sup>80</sup> Although Professor Seligman adds that the SEC can preempt state law when it can demonstrate that the action is “necessary,”<sup>81</sup> he never explains what “necessary” means in this context.

Even if Professor Seligman could prove that the SEC’s authority is broad enough to bar dual class capitalization, he would only succeed in leaping out of the statutory pan and into a constitutional fire. His argument succeeds only if the SEC has virtually unlimited authority to bar corporate governance mechanisms it dislikes, even overthrowing state corporation laws in the process. But such power would be an unconstitutional delegation of legislative authority. As Professor David Schoenbrod has shown, the Supreme Court has recently appeared uneasy over the permissive delegation doctrine and may be seeking to give the doctrine some substance.<sup>82</sup> If adopted, Professor Seligman’s proposed rule would be a prime candidate for invalidation on delegation grounds. In any event, the Court may well construe the Exchange Act narrowly to avoid the delegation issue.<sup>83</sup>

A somewhat different question has arisen now that the SEC has been asked not to forbid dual class stock but to approve repeal of the NYSE’s rule against dual class stock. Under section 19(b), the Commission must approve a rule change only if it “is consistent with the requirements of” the Exchange Act and its rules. This language resembles the comparable language of section 19(c);<sup>84</sup> repeal would be consistent with the Exchange Act for the reasons discussed above with respect to section 19(c). Moreover, some of Professor Seligman’s arguments for a comprehensive prohibition against dual class stock would support repeal of the NYSE rule. For example, the arguments for equal regulation and against unfair competition among exchange markets<sup>85</sup> suggest that the NYSE should not have to sustain a rule not borne by the other securities markets.

I recognize the need to limit use of dual class stock.<sup>86</sup> Nonetheless, the SEC currently lacks authority to impose substantive limitations, at least in the form proposed by Professor Seligman. New

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79. Seligman, *supra* note 1, at 715.

80. As Professor Seligman recognizes, many state statutes expressly permit multiple classes of common stock. Seligman, *supra* note 1, at 712-13. In *Burks* and *Santa Fe*, the state law in question, if there was any, was mostly judge-made because in many states there was no statute on the issues in question (litigation committees in *Burks* and freeze-outs in *Santa Fe*).

81. See Seligman, *supra* note 1, at 715.

82. Schoenbrod, *The Delegation Doctrine: Could the Court Give It Substance?*, 83 MICH. L. REV. 1223, 1226 & n.15 (1985).

83. See *id.* at 1271-75.

84. Section 19(c) is quoted in pertinent part at *supra* text accompanying note 11.

85. See *supra* text accompanying notes 38-52.

86. See *infra* text accompanying notes 136-52 & 189-97.

legislation is therefore required if limitations are to be imposed.<sup>87</sup>

## II. The Desirability of Dual Class Capitalization

Professor Seligman cites economists' studies showing that, in cases of dual class capitalization, the stock with inferior voting rights commands a lower market price; he argues that this is inefficient and unfair to public shareholders.<sup>88</sup> Professor Fischel cites one study showing that announcement of a plan of dual class capitalization does not diminish the price of publicly held stock.<sup>89</sup> He seems to conclude that no federal regulation is needed.<sup>90</sup> Thus, even if the SEC can prohibit dual class stock, it is unclear whether it should do so. This part of the Reply discusses the concept of efficiency in corporate law and procedural safeguards to limit dual class capitalization to situations in which it is efficient. Finally, this part provides a theoretical discussion of why dual class capitalization may be efficient in some cases.

### A. Efficiency and Unfairness

Professor Seligman argues that dual class capitalization curtails the independence of outside directors and reduces management's incentives to satisfy public shareholders.<sup>91</sup> This diminishes the "sense of managerial accountability,"<sup>92</sup> and is both "inefficient . . . and unfair to public shareholders."<sup>93</sup> Any benefits from this arrangement through increased job stability for managers can be better achieved through the executive job market.<sup>94</sup> Accordingly, the SEC should prohibit dual class stock for section 12 companies.<sup>95</sup>

Professor Fischel reaches very different conclusions. He finds legitimate business reasons for dual class stock and therefore would not prohibit it.<sup>96</sup> He also claims that the states and stock exchanges have strong incentives to impose voting rules that maximize investors' welfare and seems to deny that dual class stock is an abusive takeover defense.<sup>97</sup> He concedes, however, that dual

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87. See *infra* text accompanying notes 189-97.

88. Seligman, *supra* note 1, at 711-12, 724.

89. D. FISCHEL, *supra* note 47, at 28-29 (citing M. Partch, The Issuance of Limited Common Stock and Shareholder Wealth (3rd Draft Sept. 1985) (Univ. of Oregon, College of Bus. Admin.).

90. See *infra* note 142.

91. Seligman, *supra* note 1, at 721-24.

92. *Id.* at 721.

93. *Id.* at 724.

94. *Id.* at 721.

95. *Id.* at 724.

96. D. FISCHEL, *supra* note 47, at 2-3, 6, 19-21, 25, 28-30, 34-35.

97. See *id.* at 7-9, 31-33; *infra* note 142 (quoting Fischel on dual class stock as a takeover defense).

class stock may not be advisable in all cases.<sup>98</sup> As such, his report is ambiguous on whether some federal regulation of dual class stock short of total prohibition is desirable.

One can quarrel with Professor Seligman's implication that the threat of takeovers always makes managers more efficient. He recognizes that managements of public companies often own a majority or near majority of their stock, although his analysis deems this inefficient because management is not threatened by takeovers.<sup>99</sup> Many commentators, most notably Professor Louis Lowenstein, contend that takeovers do not always replace less efficient managers with those who are more efficient.<sup>100</sup> Many successful raiders have not been well managed, and many of their targets have been well managed. Tax laws, rather than efficiency, often supply the incentive for takeovers.<sup>101</sup> Rather than prodding managers, the threat of a takeover may distract and demoralize them.<sup>102</sup> Other factors, such as stock ownership or compensation based on corporate performance, may motivate managers better than the threat of a takeover.

Professor Seligman also has an unusual concept of efficiency and fairness. Actions of managers, except those involving seizure of corporate opportunities, are generally considered unfair to shareholders only if they reduce the value of the shareholders' investment. Efficiency requires managers to maximize the value of the firm.<sup>103</sup> Although he does not say it explicitly, Professor Seligman's analysis depends on a different view — that dual class capitalization is "inefficient . . . and unfair to public shareholders" even if it increases their wealth.<sup>104</sup> Admittedly, efficiency is not determined solely by the value of shares held by the public. Dual class stock could be inefficient, even if public shareholders profited by it, if it also diminished the value of other interests in the firm by a greater amount, thereby depressing the value of the firm. Professor Seligman does not suggest that this is likely, however. Thus, arguments for greater consideration of other corporate constituents — such as creditors, employees, and communities containing corporate facilities — in connection with tender offers<sup>105</sup> seem to be irrelevant in this context. Similarly,

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98. D. FISCHER, *supra* note 47, at 14, 22, 23, 33.

99. Seligman, *supra* note 1, at 707-10.

100. See Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 289-94, 305-06 (1983); see also Coffee, *supra* note 25, at 1206-11.

101. See Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 759-64 (1985). Although Professor Lowenstein's discussion concerns the tax benefits of management buyouts, most of the tax benefits described are also available in third-party takeovers.

102. See Coffee, *supra* note 25, at 1234-43; *infra* text accompanying notes 159-64.

103. See Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-06 (1983) (stating that shareholders have the exclusive right to vote because, as residual claimants to firm income, only they have "the appropriate incentives . . . to make discretionary decisions" and "to maximize the wealth of the participants as a group").

104. See Seligman, *supra* note 1, at 724; see also *id.* at 723.

105. See Mintz, *Community Dislocations: A Painful Side Effect of Merger*, Wash.

dual class capitalization increases efficiency, even if it reduces the value of publicly held shares, if it increases the value of the firm. Because other corporate constituents generally bargain for fixed returns, however, efficiency generally dictates maximizing the interests of those entitled to residual income — the shareholders. Thus, efficiency and fairness are generally congruent goals.

Do empirical data confirm the efficiency and fairness of dual class stock? Professor Seligman points to studies showing that inferior voting stock trades at a lower price.<sup>106</sup> This no more proves inefficiency than would a showing that preferred stock or debentures trade at a lower price. Different securities of a single firm usually trade at different prices; inefficiency exists only if a recapitalization reduces the value of the firm. Professor Fischel cites one study showing that dual class recapitalizations have increased the value of public shares.<sup>107</sup> This is not conclusive either. The study conflicts with preliminary findings by SEC Chief Economist Gregg Jarrell that such recapitalizations depreciate public shares.<sup>108</sup> Moreover, Professor Fischel recognizes that, although the study he cites shows an aggregate net benefit to the public, public investors suffered losses in many of the cases studied.<sup>109</sup> Because some dual class recapitalizations generate gains for public investors and some generate losses, neither a total prohibition nor laissez-faire is ideal here. Rather, we must look more closely to separate the good from the bad, the sheep from the goats.<sup>110</sup>

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Post, Apr. 20, 1980, at A2, col. 1 (contending that takeovers often lead to plant closings and relocations, and arguing for government regulation of mergers likely to produce these effects); see also Coffee, *supra* note 25, at 1221-22.

106. Seligman, *supra* note 1, at 711-12.

107. D. FISCHEL, *supra* note 47, at 28-29 (citing M. Partch, *The Issuance of Limited Common Stock and Shareholder Wealth* (3rd Draft Sept. 1985) (Univ. of Oregon, College of Bus. Admin.)). Professor Seligman points out that Partch's study is of questionable value because of its "unusual sample group, with insiders controlling an average of 48.6% of the votes before the dual classification scheme is adopted." Seligman, *supra* note 1, at 712 n.107. The sample group may not be "unusual"; rather, dual class stock may be used primarily by companies with large insider holdings. Thus, the Jarrell study, *infra* note 108, may be more unusual in focusing on NYSE companies. If the NYSE and AMEX dropped their restrictions, however, companies with small insider holdings might adopt dual class stock more often, with results closer to those found by Jarrell than by Partch.

108. G. Jarrell, *The Stock Price Effects of NYSE Delisting for Violating Corporate Governance Rules* (Dec. 5, 1984) (unpublished manuscript) (copy on file at the *George Washington Law Review*). Jarrell's study covered only five cases of dual class recapitalizations and since NYSE delisting was threatened in these cases, the threat could explain some or all of the losses.

109. D. FISCHEL, *supra* note 47, at 14, 23, 33 (stating that shareholders can be, and often have been, harmed by dual class stock).

110. See *Matthew* 25:32-33 (King James) ("And before him shall be gathered all nations: and he shall separate them one from another, as a sheperd divideth *his* sheep from the goats: And he shall set the sheep on his right hand, but the goats on the left.").



*B. Separating Sheep from Goats in Dual Class Capitalization: Procedural Approaches*

A variety of procedures are used to install dual class stock. Each must be examined to gauge its effect on public shareholders. If a company is not publicly traded and consequently does not even have a market share price, adoption of dual class capitalization will not reduce share price, and therefore will not injure public shareholders. No public shareholders are injured because none exist. We may safely assume that insiders will not injure themselves; indeed, they may have good reasons to prefer dual class stock.<sup>111</sup> The only possible objection is that purchasers in a subsequent public offering will suffer. Investors and their advisors, however, can evaluate dual class voting rights as easily as they evaluate myriad other factors bearing on stock value. To disprove this, Professor Seligman must show that public issues in dual class arrangements tend to underperform the market. He makes no such showing, empirical or anecdotal; indeed, he concedes, indirectly at least, the contrary.<sup>112</sup> The arrangement is, therefore, unobjectionable.

The distribution of a second class of stock as a dividend is similarly irreproachable. Wang Laboratories did this to the benefit of public shareholders. The existing stock appreciated, and the new stock, with lower voting rights but a higher dividend, trades at a slight premium over the old stock.<sup>113</sup>

Dual class capitalization could also result from an exchange offer that each shareholder is free to accept or reject. Here again, management can take care of itself, and shareholders can assess the offer as well as they can assess any other exchange offer. An investor can be expected to consult a professional before responding to the offer.<sup>114</sup> Management, then, must propose a fair deal: if it offers stock with a reduced vote, it must add sufficient sweeteners to make the stock attractive, or no one will take it. Recapitalizations through exchange offers have not been a particular problem since the adoption of the securities laws, and this kind of recapitalization poses no special problems. Even an unsophisticated shareholder without professional advice can in effect rely on experts by selling into the market and letting arbitrageurs decide the value of the exchange offer. Insiders may prize voting power

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111. See *infra* text accompanying notes 161-82.

112. Seligman, *supra* note 1, at 712 ("Some managers may have avoided dual class capitalization because they could raise more money from the sale of a single class of common stock with equal voting rights than in a dual class capitalization.").

113. See *id.* at 704-05. Announcement of the Wang plan was "accompanied by a positive stock market reaction," though this may have been due in part to the simultaneous announcement of increased sales and earnings. G. Jarrell, *supra* note 108, at 21, app. 1, at 1; see also N.Y. Times, June 20, 1986, at D9, col. 6 (reporting the new Wang class B selling at a slight premium over class C).

114. See Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1165 (1970) (stating that "the intelligent investor . . . who tries to act in any informed way does so by getting at least part of his information second hand, filtered through professionals").

more than other shareholders do<sup>115</sup> and will therefore respond differently to the offer, but this is unimportant if full disclosure is given and all shareholders have the same choices.

A public company could offer the public new stock that bears voting rights different from the existing stock. This, too, is unexceptionable. Potential investors can appraise the new stock as well as any other; they are no more likely to pay more than the stock merits than they would be in any other case. Nor would existing shareholders be injured. If they feel that the offering price of the new stock is too low, they can protect themselves by buying some of it, just as they could with a new issue of preferred stock or debentures. More important, the shareholders are protected by management's lack of any incentive to injure them. Management has no reason to offer the new stock to the public at an inadequate price or to use the new issue to injure the corporation otherwise. Management would have to be prevented from allotting itself a disproportionate share of the new stock at an inadequate price, but this is nothing new. Management already has a temptation to issue itself shares of an existing or new class of stock or debt at an inadequate price. The law has handled this problem,<sup>116</sup> and dual classes of common stock present no unique difficulties in this regard.

To reject the foregoing transactions — dual class capitalization achieved through initial or secondary public offerings, dividends, or exchange offers — would raise implications reaching far beyond dual class stock. Professor Seligman suggests that inferior voting stock may not only trade at a discount from the moment of its issue, whether in a public offering or a later recapitalization, but that the gap may also widen thereafter.<sup>117</sup> Underlying much of the current theory of corporate and securities law is the efficient market hypothesis "which asserts that stock market prices react quickly and in an unbiased fashion to publicly available information."<sup>118</sup> A corollary of this hypothesis is that, once

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115. See *infra* text accompanying notes 169-80.

116. To some extent this problem is handled through preemptive rights, which give shareholders a right to subscribe to a proportionate share of any new issue of stock. See H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* §§ 174-175 (3d ed. 1983). Even when no preemptive right exists, fiduciary concepts may prohibit the sale of shares to insiders at an inadequate price. W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 1076, 1089-1102 (5th ed. 1980). If the sale involves any deception of minority shareholders, they could sue under rule 10b-5. See T. HAZEN, *supra* note 28, at 498-501.

117. Seligman, *supra* note 1, at 721-22.

118. See, e.g., Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 341-42 (1986).

absorbed, information cannot further influence security prices.<sup>119</sup> Although some have disputed other aspects of the hypothesis,<sup>120</sup> few question this corollary. Thus, in questioning whether the market fully and quickly responds to dual class capitalization, Professor Seligman questions, without explanation, an important tenet of corporate and securities law.<sup>121</sup> Given the wide, uncontested acceptance of the corollary, we should disregard Professor Seligman's agnosticism — at least until he justifies it. Furthermore, the philosophy of the federal securities laws is that investment decisions are best made by investors and their advisors after full disclosure.<sup>122</sup> If investors are too foolish to evaluate dual class stock, they can hardly be wise enough to make other investment decisions, and the fundamental premise of the securities laws must be wrong. On the other hand, acceptance of these dual class stock transactions is consistent with this premise.

Slightly more complicated is the issuance of a new class of stock not to the public but to third parties in a negotiated deal, such as a stock merger<sup>123</sup> or an employee stock ownership plan (ESOP) or similar plan. The problem here is whether the third party is genuinely unaffiliated with management so that the transaction is at arm's length. Disputes already arise when management issues voting stock for allegedly inadequate consideration to an ESOP whose trustees are chosen by management.<sup>124</sup> In such cases, management may place the shares in friendly hands expected to support management in a takeover fight. Because the problem already exists, use of a new issue of common stock arguably does

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119. See Kripke, *A Search for Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 311 (1975).

120. See, e.g., Lowenstein, *supra* note 100, at 274-309 (questioning the validity of the efficient market hypothesis for takeovers).

121. For example, if markets do not quickly absorb public information, we would have to question the SEC's integrated disclosure program, the use of market price to compute damages, portfolio theory, and so forth. The assumption of rapid absorption of information also underlies the broad acceptance of event studies. See D. FISCHER, *supra* note 47, at 36; Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 266 (1985). If Professor Seligman's implication is correct, event studies must be of little or no use.

122. See 1 L. LOSS, *SECURITIES REGULATION* 122-28 (2d ed. 1961). This philosophy prevailed over arguments of those, such as Professor (later Justice) William Douglas, who believed that investors could not understand business disclosure. See Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 521 (1934).

123. General Motors created a special class of common stock with inferior voting rights for its acquisition of Electronic Data Systems Corporation. The inferior vote was justified on grounds of its lower dividend and other rights and, consequently, its lower value. General Motors also used inferior voting stock to acquire Hughes Aircraft Company. See Brandow, *The NYSE's One Share/One Vote Rule*, N.Y.L.J., Dec. 9, 1985, at 33, col. 3; *Coming to Blows Over One Share, One Vote*, BUS. WK., July 8, 1985, at 81, 81-82; Sloan, *Alphabet Soup*, FORBES, Apr. 21, 1986, at 33.

124. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265-66 (2d Cir. 1984) (enjoining voting of stock issued to ESOP because evidence gave rise to strong inference that purpose of transaction was not to benefit the employees, but rather to solidify management's control of the company); *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 233 (9th Cir. 1975) (refusing to enjoin voting of stock even though the plan was established to defeat takeover); *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 633 F. Supp. 1066, 1070-74 (S.D.N.Y. 1986) (denying injunction against stock plan); *Podesta v. Calumet Indus.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433 (N.D. Ill. 1978).

not exacerbate the problem and so should not be barred. The difficulty of valuing a new issue of stock not publicly traded could, however, aggravate the already complicated problem of determining whether the transaction was fair to the corporation.

Professor Seligman does not directly address whether regulation by the states or the stock markets guarantees adequate protection of shareholders from victimization through dual class common stock. Nonetheless, by urging SEC action, he implies that the states and stock markets are not up to the task. Professor Fischel, in decrying accusations of a race to the bottom, proclaims a race to the top in which the states and stock markets compete to provide the most efficient regulation.<sup>125</sup> In general, there is no race to the bottom; competition among the states has generally improved corporate law.<sup>126</sup> Pointless and detrimental restrictions have been shed, and competition among the stock markets has precipitated technological innovation and sharply lower brokerage commissions.<sup>127</sup> Even exponents of this competition concede, however, that the states have not adequately policed takeover defenses.<sup>128</sup>

Managers generally submit to efficient rules in order to attract investors. States and stock markets can facilitate this by providing a standard set of efficient rules and enforcement thereof; in return the states receive franchise fees, and the stock markets (or, more precisely, their members) receive commissions from trading in listed securities. However, if a company is already publicly traded and does not need to raise more capital from public stock offerings, the managers may prefer rules that favor themselves over public shareholders. Because managers choose the market for trading, the stock markets will cater to the managers' preferences.<sup>129</sup> Takeovers so threaten managers that they will take steps contrary to shareholder interests to thwart them. Dual class stock may serve legitimate purposes, but it may also thwart takeovers. The states and stock markets cannot be expected to prevent this any more than they have prevented other takeover

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125. D. FISCHEL, *supra* note 47, at 7-17.

126. See Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS. 3, 17 (Summer 1977); see also D. FISCHEL, *supra* note 47, at 11 and authorities cited at 11 n.14.

127. See Wayne, *The Big Board's Fight to Stay on Top*, N.Y. Times, Oct. 14, 1984, § 3, at 1, col. 2 (competition has compelled the NYSE to adopt new technology).

128. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174-82 (1981) (criticizing all takeover defenses and advocating a rule of target management passivity).

129. The managers' desire to shift the state of incorporation is subject to shareholder approval, but this provides little protection for shareholders. See *infra* text accompanying notes 147-52.

defenses.<sup>130</sup>

Professor Fischel argues that an exchange will not permit abuse of shareholders because it would lose listings and commissions based on share price.<sup>131</sup> But managers prefer reduced investor confidence and share price to a takeover and will list their companies for trading on an exchange that permits them to avoid the unemployment line.<sup>132</sup> The exchanges will sacrifice far less in commissions from reduced share price than they would from loss of listings.<sup>133</sup>

The most perplexing question is whether shareholder approval alone should suffice to authorize dual class capitalization.<sup>134</sup> Shareholders must approve a charter amendment before any dual class recapitalization can be instituted.<sup>135</sup> In many cases the recapitalization requires for its implementation further steps, such as a secondary public offering or an exchange offer, that will automatically protect public shareholders.<sup>136</sup> In other cases this will not be true, so a proxy vote will offer the only shareholder protection. For example, often management seeks shareholder approval for a charter amendment authorizing new stock with superior voting rights.<sup>137</sup> Although not specified in the proxy solicitation, management generally plans to issue the new stock to itself or friends. Nor is it disclosed that these transactions generally damage share values because they obstruct potential raiders and thereby reduce the chance that shareholders will receive a takeover premium.<sup>138</sup> As a result, shareholders do not get a full picture of what they are approving. Moreover, shareholder approval often means little because management controls the proxy mechanism and owns many shares.<sup>139</sup>

As an alternative, management can orchestrate a charter revision that assigns different votes to shares of a single class depending on the identity of the holder. Some companies have provided that a purchaser of stock has one vote per share until he has held the stock for forty-eight consecutive months, after which he has ten votes per share.<sup>140</sup> A company could also set a ceiling on the

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130. On occasion, state courts will prevent gross abuses, including abuses of dual class stock. See *Packer v. Yampol*, No. 8432 (Del. Ch. Apr. 18, 1986).

131. D. FISCHEL, *supra* note 47, at 12.

132. It is widely accepted that the pressure on the NYSE to permit dual class stock has come from corporate managers who want to adopt it as a takeover defense. See Karmel, *One Share, One Vote*, *supra* note 50, at 2, col. 1; Wayne, *supra* note 127, at 12, col. 2.

133. Commissions are determined more by number of shares than by share price. Certainly, price declines on the order found by Jarrell, *see supra* note 108 and accompanying text, would not noticeably reduce commissions.

134. See Seligman, *supra* note 1, at 721-22.

135. The corporate charter must state the number of shares of each class authorized, and shareholder approval is required to amend the charter. H. HENN & J. ALEXANDER, *supra* note 116, §§ 123, 345.

136. See *supra* text accompanying notes 114-16.

137. See Brandow, *supra* note 123, at 47, col. 3.

138. See Seligman, *supra* note 1, at 710-12.

139. See *infra* text accompanying notes 189-91.

140. See Brandow, *supra* note 123, at 47, col. 3.

number of votes any shareholder may cast. To circumvent shareholder resistance, some managers are now seeking state laws that would limit the votes a raider could exercise.<sup>141</sup>

Dual class capitalization can injure shareholders in several ways.<sup>142</sup> Granting management extra votes can render a hostile takeover either mathematically impossible or prohibitively expensive. This not only precludes any takeover premium for the shareholders, but also reduces the discipline that the threat of takeovers exerts on management.<sup>143</sup> Similarly, management's extra votes may eliminate independent directors' ability to discipline inefficient managers.<sup>144</sup> Even if a takeover occurs, management can use its superior vote to grab much of the premium from public shareholders for itself.<sup>145</sup> Unlike dual class stock issued in a public offering, dual class stock instituted by shareholder vote is not already discounted by the market, so shareholders are not estopped to complain when it is instituted.<sup>146</sup>

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141. See 1985 Wis. Laws 195, § 6 (codified at WIS. STAT. ANN. § 180.25(9)(a) (West 1957 & Supp. 1986)) (providing that any person owning "in excess of 20% of the voting power in the election of directors shall be limited to 10% of the full voting power of those shares"; but the statute contains so many exceptions that it applies in effect only to raiders).

142. Professor Fischel states that "[t]he argument that dual class common stock is an abusive defensive tactic used to defeat takeovers is also flawed" and that "[t]o equate dual class common stock with defensive tactics in response to takeovers . . . is misleading . . ." D. FISCHEL, *supra* note 47, at 3, 32-33. Ironically, he also concedes that "[d]ual class common stock . . . makes transfers of control more difficult" and that "[t]hose with voting control . . . may anticipate a premium price for those shares in the event of a takeover bid." *Id.* at 19, 27.

143. The latter effect is not entirely negative. See *infra* text accompanying notes 159-64.

144. See DeAngelo & DeAngelo, *Managerial Ownership of Voting Rights*, 14 J. FIN. ECON. 33, 36 (1985).

145. Both management's sale of super-voting stock to itself and the agreement by managers to take an extra premium for that stock in a takeover could be attacked by minority shareholders as self-dealing and a breach of the duty of loyalty. Although these suits are not necessarily doomed to failure, experience to date gives little cause for optimism. At the least, a shareholder attacking such a transaction must, if it was approved by disinterested directors, bear the burden of proving it unfair to the corporation, and in many states he must prove fraud or bad faith. H. HENN & J. ALEXANDER, *supra* note 116, § 238. Moreover, the mere authorization of dual class stock by charter amendment may discourage bidders, and this involves no self-dealing by insiders. The cases have generally permitted these takeover defenses. See Coffee, *supra* note 24, at 1147 n.2, 1251 n.319.

146. It is argued above that dual class stock issued in an initial or secondary public offering is unobjectionable because investors know what they are getting and get what they pay for. See *supra* text accompanying notes 111-12 & 116. It could be argued that whenever an investor buys stock he knows that a later dual class recapitalization may occur, that he discounts for this possibility, and therefore he cannot complain if it occurs. This argument is factually faulty; dual class stock was rare until recently and was prohibited by the NYSE. Investors did not have reason to anticipate it; nor do they have reason to anticipate it now, as shown by the frequent share-price declines when dual class stock is adopted. See *supra* note 108. More important, if a contrary view were taken, companies would be forced to take special measures to promise not

Professor Seligman disparages shareholder approval as a prophylactic because "management has immense funding advantages in . . . a proxy contest" and lacks "organized opposition."<sup>147</sup> Professor Fischel at least indirectly endorses shareholder approval as a prophylactic.<sup>148</sup> Both positions are incongruous because Professor Seligman elsewhere champions corporate suffrage;<sup>149</sup> Professor Fischel deprecates it, characterizing shareholders as apathetic.<sup>150</sup> Skepticism about shareholder voting is justified. Professors Frank Easterbrook and Fischel properly argue that shareholders devote little attention to proxies because each shareholder, owning only a fraction of the stock, would gain only a fraction of the benefit to the corporation of a correct vote. Because his vote will not affect the outcome, the rational investment by most shareholders in information on proxy issues is zero.<sup>151</sup> Because shareholders generally trust management (or they would not retain their stock), most follow the Wall Street rule — vote with management or sell. Professor Fischel claims, however, that apathy disappears in contests for corporate control.<sup>152</sup> Even if he is right, clever management will install dual class stock long before a contest begins, thereby insuring that none ever will begin.

But why allow shareholder approval at all? To justify allowing such approval, it must be shown that dual class capitalization may be efficient and that it may increase shareholder wealth.

### C. *A Theoretical Justification of the Efficiency of Dual Class Capitalization*

A skeptic may well point out that the preceding discussion advocates only procedural safeguards. Even if the argument is superficially appealing, it gives no theory of why dual class capitalization may increase wealth. Without such a theory, one may doubt that any procedure, even if apparently fair, will generate fair and efficient results.

The very commonness of dual class stock and substitute arrangements suggests their utility. Shareholders often divide vot-

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to adopt dual class capitalization if they wanted to obtain a maximum price when issuing stock. Because corporate law is most efficient when viewed as a standard set of efficient rules, see Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982), it would be most efficient for the law to regulate dual class recapitalizations to prevent those that diminish share value.

147. Seligman, *supra* note 1, at 723-24.

148. "[T]he creation of dual class common stock is typically accompanied by procedural safeguards (such as a requirement of shareholder approval) that protect shareholders." D. FISCHEL, *supra* note 47, at 3; see also *id.* at 29, 33.

149. See Seligman, *supra* note 1, at 717-18.

150. Easterbrook & Fischel, *supra* note 103, at 395 ("Shareholders are apathetic in the best of times."). Ironically, Professor Fischel makes the same point in his study of dual class stock. See D. FISCHEL, *supra* note 47, at 17 (stating that "voting is a very imperfect monitoring mechanism"); *id.* at 19 (stating that "the collective action problem faced by dispersed shareholders ensures that voting will be relatively ineffective as a monitoring mechanism").

151. Easterbrook & Fischel, *supra* note 103, at 402; see also *supra* note 150.

152. D. FISCHEL, *supra* note 47, at 18.

ing power and right to profits differently, particularly in close corporations. For example, a minority shareholder may obtain board representation or even a veto over corporate actions through different classes of stock or through some substitute, such as a voting trust or pooling agreement. Similarly, a participant (not necessarily even a shareholder) may obtain a share of the cash flow larger than his voting rights.

Even without dual class stock or some substitute, the congruency of voting power and share of profits is more illusory than real. If one shareholder owns 51% of the stock, the minority shareholders in effect have no vote, even though they are entitled to nearly half of the profits. Professor Seligman's analysis suggests that this is inefficient because managers are not subject to the discipline of takeovers.<sup>153</sup> In seeming contradiction, however, he recognizes that dual class stock is not more common only because management of many public companies owns over or nearly half of the stock. As such, dual classes are unnecessary.<sup>154</sup> Thus, even in public companies, exposure to takeovers is more the exception than the rule.<sup>155</sup> At the same time, holders of securities with equity features (such as warrants and convertible securities) have a keen interest in profits, but no vote.<sup>156</sup> If these disparities are neither inefficient nor illegal, dual class stock should not be either. If Professor Seligman opposes dual class capitalization, he should also oppose majority stock ownership by management of public companies and the issuance of securities with equity features but no vote. He neither takes this position nor distinguishes these situations from dual class capitalization.

Even the NYSE's opposition to dual class stock is misleading. The NYSE has always permitted dual classes if their voting power is "in reasonable relationship to the equity interests."<sup>157</sup> Professor Seligman's proposed prohibition would apparently prevent even

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153. Seligman, *supra* note 1, at 721-22.

154. *Id.* at 707-10.

155. In addition to companies in which management owns a controlling block, some companies are so large as to be immune to takeover. The growing financial capabilities of raiders have whittled down the number of companies enjoying such immunity, but clearly some number of the largest remain invulnerable.

156. Similarly, preferred stock sometimes does have voting rights. Although reasonable people could disagree over which approach is better, Professor Seligman's analysis seems to suggest that only one structure of voting and earnings rights is efficient and that all others must be forbidden. It would follow that voting rights for preferred stock should be either forbidden or mandated, but not discretionary.

157. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 313.00(D) (1983), 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. 1141 (1985)* [hereinafter *Corporate Takeovers Hearings*]. The directors of the NYSE have now voted to repeal this rule. See *supra* note 39.



dual class stock of this kind, although there is no evident reason to oppose it.

Although the foregoing suggests that dual class capitalization may be efficient, it does not show why. It does not help to state, as does Professor Fischel, that "insiders may simply value control more than outsiders."<sup>158</sup> This reasoning merely forces us to restate the question: *Why* do insiders value control more? There are several plausible reasons.

First, Professor Seligman argues that dual class capitalization is undesirable because it deters or prevents tender offers — the threat of which makes management more efficient.<sup>159</sup> Although there is some truth in this, there are also problems with it. Takeovers do not always result in more efficient managers replacing less efficient managers.<sup>160</sup> The threat of a takeover may distract management rather than prod its efforts.<sup>161</sup> For example, management fearing a takeover may have to justify its business plans to uninformed shareholders and outside directors. Failure to do so produces an asymmetry of information between managers and investors that may diminish the company's stock price,<sup>162</sup> and thereby induce a takeover, even though management's plans are sound. Fear of this result may prompt managers to forego plans that they believe are profitable but cannot be adequately explained to shareholders because, for example, the relevant information is too expensive to verify or to disclose to the public, or because management's plans involve business secrets.<sup>163</sup> Many business people and commentators believe that for these reasons managers often stress short-term performance at the expense of long-range planning.<sup>164</sup> Thus, dual class capitalization may facilitate long-range planning. Management can be disciplined by other means, such as compensation tied to corporate performance.<sup>165</sup>

Dual class stock may also help to overcome a market flaw that may arise when a company goes public. The power to control a corporation carries a value independent of the right to cash flow contained in the stock; thus, a controlling block of stock usually

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158. D. FISCHEL, *supra* note 47, at 19.

159. Seligman, *supra* note 1, at 721-22.

160. *See supra* text accompanying notes 99-101.

161. *See* Coffee, *supra* note 25, at 1196 (the market may not appreciate management's efforts); *id.* at 1232-33 ("internal monitoring should ordinarily outperform external monitoring"); *id.* at 1238-43 (the threat of takeover may demoralize management); *id.* at 1243-50 (the threat of takeovers may induce management to incur excessive risk).

162. *See* Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575, 582-85 (1984) (suggesting that asymmetric information diminishes the price at which a corporation can sell its securities, especially equity securities).

163. *See* DeAngelo & DeAngelo, *supra* note 144, at 35.

164. *See* Altman & Brown, *Ridding Wall Street of a Short-Term Bias*, N.Y. Times, June 1, 1986, § 3, at 3, col. 1.

165. *See* Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 13 (1985) (finding that "corporate performance . . . is strongly and positively related to managerial remuneration").

commands a so-called control premium.<sup>166</sup> But when a company's stock is widely scattered among the public, control does not attach to anyone's stock; no purchaser will pay a control premium for any block of stock because no block possesses control.<sup>167</sup> Consequently, when a close corporation sells most of its voting stock to the public, management does not so much sell control as fritter it away, because it sells a majority of its stock but receives no control premium for it.

One way to avoid this is simply to keep a majority of the stock in management rather than selling it to the public. This may be undesirable because it would force management either to invest all its limited wealth in the company, thereby becoming dangerously undiversified (i.e., putting all its eggs in one basket), or to limit the capital it raises, thereby denying the company profitable opportunities.<sup>168</sup> A better solution is dual class stock. By selling stock entitled to most of the cash flow without surrendering control, management can raise needed capital without either becoming undiversified or frittering away the control premium. This solution is also efficient. Managers prize their votes, but as shown, public investors do not because their few shares will not affect shareholder votes.<sup>169</sup> Thus, a dual class arrangement can allocate votes to those who value them most, thereby maximizing the total value of the company's stock.

Further, dual class capitalization encourages managers to make

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166. See H. HENN & J. ALEXANDER, *supra* note 116, § 241, at 657.

167. The public investor who buys 100 shares fully realizes that he is not purchasing part of control in the usual sense. The only sense in which he controls is that a raider may offer a premium for his shares, because by pooling many small blocks the raider can put together a controlling block. But a takeover bid is uncertain and, even if one does occur, its price and success are also uncertain. Shareholders cannot assume that any substantial departure (whether accidental or venal) by management from profit maximization will trigger a takeover. The costs of a takeover — including search, premium, and the possibility of succumbing to a superior bid (most first bids fail) — are so high that only the grossest incompetence can by itself attract a raider. Target management can raise these costs and possibly defeat the raid with defensive maneuvers. More important, the incompetence of target management is only one of several major factors precipitating tender offers. Others are empire building by the bidder, *see* Coffee, *supra* note 25, at 1167-69, the potential fit between the target and the bidder, the vulnerability of the target, and the tax benefits of the takeover to the bidder. Thus, although the possibility of a tender offer will be a component in the value of virtually any widely held company, that component will be smaller than the actual value of control itself.

168. See DeAngelo & DeAngelo, *supra* note 144, at 52 (stating that limited wealth hypothesis is plausible because, in sample group of companies with dual class stock, median company value exceeded \$88 million); Seligman, *supra* note 1, at 721-22.

169. Shareholders are generally apathetic. *See supra* text accompanying notes 147-52. This does not mean that public shareholders consider voting rights worthless; voting shares do trade at a premium over nonvoting shares. *See* Seligman, *supra* note 1, at 711-12. But public shareholders value these rights less than those who have or seek control. This largely explains the premiums in tender offers, *see supra* note 167, and management buyouts.

a personal commitment to the company or, as economists put it, to invest firm-specific human capital in the company.<sup>170</sup> A hostile takeover can result in the firing of managers who have reduced the market value of their services by acquiring skills valuable to only one firm.<sup>171</sup> Takeover threats can force managers to leave firms for new positions that are less desirable except for the new firm's insulation from takeover risks, e.g., because the new employer is privately owned.<sup>172</sup> If the managers remain, the threat of a takeover may exact a psychological toll from them.<sup>173</sup>

A successful raider could retain an effective incumbent management. Indeed, one might argue that because the raider has an incentive to do so, only incompetent management would try to entrench itself with dual class capitalization. However, several factors work against the raider's retaining even effective managers. The incumbents' primary functions of strategic planning and budgeting tend to become redundant once there is a new controlling shareholder.<sup>174</sup> Takeover fights often breed enmity that prevents cooperation between old and new management. Finally, control has psychological benefits — feelings of worth, fulfillment, and such — that the incumbents lose in a takeover and for which the raider has no reason to reimburse them. Thus, a hostile takeover usually results in displacement of even effective managers, and the costs of this displacement go uncompensated.

Several devices can limit or eliminate the risk of management displacement. One is the golden parachute, which compensates the manager displaced by a hostile takeover.<sup>175</sup> Another device is dual class capitalization; it discourages or prevents hostile takeovers, thereby enabling the firm to retain valued managers and to assign them tasks they might otherwise refuse because of concern for the job market.

Finally, dual class capitalization may overcome the inefficiency that arises from managers having a smaller share of voting rights than of cash flow. Easterbrook and Fischel have argued that it is efficient for participants in the firm to have equal shares of voting rights and cash flow; they therefore support the rule of one share, one vote.<sup>176</sup> They argue that “[a]s the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary deci-

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170. See D. FISCHEL, *supra* note 47, at 20; DeAngelo & DeAngelo, *supra* note 144, at 36.

171. See Coffee, *supra* note 25, at 1234-50.

172. See *id.* at 1237.

173. Shareholders may be indifferent to this psychological toll on managers so long as it does not impair profits. Eliminating this toll could, however, be more of a benefit to managers than the corresponding detriment to shareholders. If so, managers should be willing to compensate shareholders for their loss. See *supra* text accompanying notes 68-69.

174. Coffee, *supra* note 25, at 1236.

175. See *id.* at 1263-64.

176. Easterbrook & Fischel, *supra* note 103, at 403-06, 409-10.

sions."<sup>177</sup> Their reasoning is sound, and it supports their conclusion in most, but not all, cases. If certain participants have a claim on residual cash flow larger than their share of votes, inefficiency would result. Reallocation of votes to remove the disparity would then be efficient, and dual class capitalization can achieve this. Common stock does not possess the only claims on residual income. Managers also have such claims through bonuses, stock appreciation rights, and other forms of compensation based on corporate performance. Salaries, pensions, and perquisites might also be added to this list to the extent that they exceed what the manager could obtain elsewhere in the job market.<sup>178</sup> But these claims carry no vote. If dual class capitalization merely raises the managers' voting rights to the same level as their claims to residual cash flow, it would enhance efficiency.

Professor Fischel argues that insider control — and, by implication, dual class capitalization — “may allow shareholders of a target corporation to obtain a higher price when a transfer of control does occur”; insider control may permit insiders to negotiate for shareholders, who “are unable to act collectively.”<sup>179</sup> Although this possibility exists, it also has a dark side; managers may use control to grab most or all of the control premium for themselves.<sup>180</sup> If the extra premium for management only matches its share of residual income, it is unobjectionable. If dual class stock originated when the company went public or in a later exchange offer, public shareholders either never paid for the control premium or agreed for consideration to surrender it. Again, public shareholders could not complain. But shareholders could justly

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177. *Id.* at 403. *But see* Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of “One Share, One Vote,”* 56 CORNELL L. REV. 1 (1970) (arguing that it might be better to limit the number of votes of large shareholders).

178. One problem is to distinguish payments that are residual from those that are not. To some extent all claims on corporate cash flow vary with profits, or are residual. Employees may be able to bargain for higher wages if the corporation is profitable, and creditors may not be fully paid if the corporation becomes insolvent. Yet neither employees nor creditors have voting rights; their rights are protected by bargaining and competition. Managers have similar protections, but these may be inadequate because of imperfections in the executive job market. *See* Coffee, *supra* note 25, at 1235-38; *supra* text accompanying notes 170-74. Moreover, the compensation of managers varies more with corporate performance than do the claims of employees and creditors.

179. D. FISCHEL, *supra* note 47, at 21.

180. Professor Fischel recognizes this possibility. *Id.* at 27. The legality of such a maneuver is unclear. In general, controlling shareholders may legally sell their shares for a premium. *See* H. HENN & J. ALEXANDER, *supra* note 116, § 241, at 657. However, in special circumstances they may not. *See* Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). Because courts have not clearly defined what constitutes special circumstances, and because cases involving sale of superior voting stock for a premium have rarely occurred, it is impossible to predict how courts will treat such sales.

complain if insiders grabbed most or all of the control premium without having given adequate consideration for the superior voting stock. Professor Fischel should recognize this.

Professor Seligman correctly argues that dual class capitalization does not always enhance efficiency. Nonetheless, one must beware of the Nirvana fallacy — the belief that if some flaw can be found in a state of affairs, some better state of affairs must be possible.<sup>181</sup> Dual class capitalization must be compared to the available alternatives, not to an unobtainable ideal. Dual class capitalization can thwart unsolicited takeovers, but if it were prohibited, management would seek other defenses. A universal prohibition against takeover defenses would be impossible because many defenses, such as mergers, employee stock ownership plans, and entry into regulated industries, also serve legitimate business purposes. The law cannot prohibit these.<sup>182</sup> Prohibiting some defenses would only increase the use of defenses not prohibited.

Takeover defenses are hard to factor into the equation. Clearly we should not surrender and allow management to do anything, however outrageous, to thwart tender offers; but we should at least be chary of barring defenses to tender offers if their inefficiency is not manifest. The linkage between dual class stock and other tender offer defenses is important, however. If the most abusive defenses, such as poison pills, lock ups, and greenmail, were barred, the probability of tender offers would rise, and with it would rise the control component of stock value representing that probability. The price gap between stocks with and without takeover potential would increase. Management would have to offer more attractive packages to induce shareholders to adopt dual class stock, and the creation of dual class capitalization by public offering would be more costly in that the discount for stock with inferior voting rights (which would be less attractive to a raider) would be greater. Thus, limiting tender offer defenses would also compel managers to make dual class stock more appealing to public shareholders.

In sum, dual class capitalization may or may not enhance efficiency, depending on the circumstances. The problem is to separate the sheep from the goats, to distinguish efficiency-enhancing from efficiency-impairing situations.

### III. *A Counterproposal*

Professor Seligman is wrong to advocate total prohibition of dual class capitalization, but neither is laissez-faire ideal here. The challenge lies in finding the golden mean. The ideal approach would be the most efficient, which means permitting managers to

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181. Easterbrook, *Breaking Up Is Hard To Do*, REGULATION, Nov.-Dec. 1981, at 26.

182. See Dent, *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U.L. REV. 777 (1986) (potential targets can deter raiders by making acquisitions, but no one advocates prohibiting this defensive maneuver).

do as they please so long as they do not impair the interests of public shareholders. One possible approach would permit managers to conduct the procedures for instituting dual class stock, but would enjoin the change if it caused a decline in the price of public shares. Although this approach has much to recommend it, it also has some shortcomings.<sup>183</sup>

The NYSE's proposal would require approval of a majority of both independent directors and independent shareholders.<sup>184</sup> One problem with this approach is that it would apply only to NYSE-listed companies. But even if adopted by the AMEX and NASDAQ as well, or imposed by the SEC, this approach would create problems. First, it would require shareholder approval for many transactions, such as secondary public offerings and exchange offers, that pose no threat. In most of these cases shareholder approval could be readily obtained, however, so that the only detriment would be the cost of a proxy solicitation. Further, the NYSE's proposal would not alter the inadequate disclosure in dual class recapitalizations.<sup>185</sup> It is not clear whether the proposal would even apply to some dual class schemes.<sup>186</sup> Most important, because of shareholder apathy, a majority vote of independent shareholders would not protect them.<sup>187</sup>

Many procedures require no new regulation because they pose no threat to shareholders. Thus, dual class capitalization adopted prior to going public or accomplished through an exchange offer or secondary public offering should be permitted.

As to shareholder votes, the SEC may be able to handle them by requiring additional proxy disclosure. Although shareholders often approve proposals detrimental to their interests, including dual class recapitalizations, shareholders have grown warier of shark repellants<sup>188</sup> and will probably reject them even more fre-

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183. See *id.* (advocating such a solution to the problem of unprofitable corporate acquisitions). Applied to dual class stock, this solution would have much greater problems than if applied to corporate acquisitions. The attraction of dual class stock as a takeover defense makes it even less likely that states would apply it to corporate acquisitions than to mergers. Problems of timing would be more acute. Management can stretch announcement and implementation of the recapitalization over a long period, thereby minimizing the impact of any single announcement. At the federal level, this approach would also depart radically from the traditions of the federal securities laws. An approach more in keeping with these traditions would be preferable.

184. NYSE Press Release, *supra* note 39.

185. See *supra* text accompanying notes 137-38.

186. The proposal refers to "a class or classes of common stock having more than one vote per share." NYSE, Proposed Rules Changes by New York Stock Exchange, Inc., SEC form 19b-4, file no. SR-NYSE 86-17, at 25 (Sept. 16, 1986). It is not clear whether this would include schemes varying the voting rights of a single class. See *supra* text accompanying notes 140-41.

187. See *supra* text accompanying notes 151-52.

188. See Gilson, *The Case Against Shark Repellent Amendments: Structural Limi-*

quently in the future than they do now. The SEC can promote this laudable trend by requiring full disclosure of the probable consequences of adopting dual class capitalization or other shark repellants. For example, the SEC could require issuers seeking approval of superior voting stock to disclose prominently that the new stock may be sold to insiders at less than its market value; that other shareholders may be excluded from purchasing it; that the very authorization of the new stock may discourage potential bidders who might otherwise offer a larger premium for the common shares; that approval will probably cause the value of existing shares to decline; and that insiders may use the superior voting stock to thwart a takeover or to divert much of the control premium to themselves.

Although such disclosures could help, they cannot completely solve the problem for several reasons. First, insiders have virtually unlimited access to the corporate treasury for proxy solicitations and can partly offset candid disclosures by intensifying their solicitations. They may even pressure large institutional shareholders to vote with them.<sup>189</sup> Second, in many cases insiders own a large portion of the stock, and state law permits them to vote even in matters in which they have a personal interest.<sup>190</sup> Third, if differential voting rights are instituted by state law,<sup>191</sup> the shareholders' views will become irrelevant.

Accordingly, Congress should prohibit the creation or sale by public companies of stock with disproportionate voting rights, whether by the issue of a new class of stock or by revising the voting rights of existing shares,<sup>192</sup> unless approved by a majority of disinterested shareholders. However, Congress should recognize an exception for the sale of shares to nonaffiliates, including an offering to the public or pro rata to all shareholders, in an arm's-length transaction. The SEC would be authorized to define such vague terms as arm's-length transaction, nonaffiliate, and disinter-

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tations on the Enabling Concept, 34 STAN. L. REV. 775, 826-27 (1982) (recognizing the large and growing opposition to shark repellants among institutional investors).

189. See Pickens, *Second-Class Stock Impairs Market*, Wall St. J., Feb. 13, 1986, at 30, col. 3; see also DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329, 334 (1983) (stating that institutional shareholders may support detrimental proposals "to maintain a working relationship with incumbent management").

190. In the study by Partch, insiders owned an average of 48.6% of the votes. See D. FISCHER, *supra* note 47, at 28-29. No state prohibits interested shareholders from voting. Directors are even permitted by many courts to vote as shareholders to ratify their own actions. See H. HENN & J. ALEXANDER, *supra* note 116, § 194, at 516.

191. See *supra* text accompanying note 141.

192. Somewhat different issues are posed by providing a greater vote for shares held for a long time. See *supra* notes 140-41. By discouraging raiders and arbitrageurs (and perhaps even large institutional investors), such provisions should diminish share price. Perhaps we can rely on shareholders to vote down such provisions. Such provisions, however, serve no valid purpose; any legitimate function of dual class stock can be better achieved by other approaches. Therefore, such provisions should be prohibited by federal law.

ested shareholders.<sup>193</sup> Such a law would override any state law to the contrary. The SEC could then demand disclosure of the identity of the proposed purchasers, the terms of sale, and perhaps opinions of the likely effect of the transaction on the value of public shares.<sup>194</sup>

This approach would leave corporations free, without shareholder approval, to adopt dual class stock before going public; to sell disproportionate voting stock to the public; to make an exchange offer of disproportionate voting stock to all shareholders; and to use disproportionate voting stock to make arm's-length acquisitions. Displacement of state law would be limited to requiring shareholder approval in certain other cases. Although such requirements are rare in the federal securities laws, they are not unheard of.<sup>195</sup> They are broadly consistent with the securities laws' emphasis on corporate suffrage and investor discretion as opposed to substantive regulation. As in other areas under the federal securities laws, shareholder-investors may make decisions that prove self-injurious, but on balance they will outdo a government agency in deciding what is in their best interests.<sup>196</sup>

This approach also surpasses the laissez-faire approach that Professor Fischel seems to prefer. The costs of requiring shareholders' approval are fairly small, and shareholders are unlikely to reject a proposal beneficial to them. Professor Fischel even praises shareholder review of dual class recapitalizations.<sup>197</sup> The proposal suggested in this Reply only ensures that such review is granted to disinterested shareholders, with full disclosure, for each important step of the recapitalization.

### *Conclusion*

Professor Seligman has impressively recounted the history of dual class capitalization and its regulation, but his reading of the SEC's power to regulate it is faulty. His analysis of the effects of dual class stock is also flawed, as is Professor Fischel's. Although the former errs in overlooking the possible benefits of dual class

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193. Perhaps the SEC should have authority to regulate voting by interested shareholders of public companies in other situations, too. This proposal, however, is limited to dual class stock.

194. See Rule 13e-100, 17 C.F.R. § 240.13e-100 (1985) (requiring management to disclose opinions on the fairness of proposed going private transactions). The SEC could require the issuer to obtain an independent opinion of the likely effect of the transaction on the value of public shares, or to disclose opinions prepared by qualified persons at the request of shareholders.

195. See Investment Company Act of 1940, § 15(a), 15 U.S.C. § 80a-15(a) (1982) (requiring shareholder approval of advisers' contracts with investment companies).

196. See *supra* text accompanying note 122.

197. See D. FISCHEL, *supra* note 47, at 3, 28-29, 33.



stock, the latter is blind to its detriments. This Reply has mapped out a middle path that draws on traditional approaches of the federal securities laws to minimize the dangers of dual class capitalization while preserving its benefits.