Governance by Dividends

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ABSTRACT: For dual-class companies, which offer two or more classes of stock with differential voting rights, stock dividends have become a potent weapon for corporate boards to reallocate voting control without shareholder intervention. For example, the board of CBS Corporation proposed to distribute voting stock to all shareholders to drastically dilute the controlling shareholders' voting power. In contrast, the Google board issued new non-voting stock to all shareholders to perpetuate the controlling shareholders' lock on control. In both cases, the proportional distribution of the identical stock seemingly treats all shareholders equally, but it has a starkly unequal impact on each class's voting power. Are such governance changes by stock dividends within board discretion?

The level of board discretion in making stock dividends is primarily governed by each company's corporate charter. This Article presents the original, hand-collected data of charter provisions on stock dividends from 237 dual-class companies. The analysis of the charter provisions shows diverse approaches to stock dividends across companies, and it is unclear how much contractual freedom on stock dividends should be allowed. At the same time, courts have long treated dividends as subject to boards' business judgment and declined to second-guess their substantive merits if they are allocated pro rata. Given the potential impact on corporate governance, the need for a distinctive treatment of stock dividends is long overdue.

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Building on these findings, this Article also offers normative suggestions. First, as an ex-ante mechanism, state corporate statutes can provide a set of default provisions on stock dividends to guide companies. Second, as an ex-post remedy, the business judgment rule protection should be limited to the narrowly defined pro rata stock dividends (i.e., proportional distribution within the same class of stock) and non-pro rata stock dividends approved by each class of shareholders separately.

I. INTRODUCTION

On May 14, 2018, the board of CBS Corporation ("CBS"), one of the largest national media companies, proposed a special stock dividend to its shareholders.[1] While the board's proposal to pay a dividend to shareholders was hardly surprising, the effect of the proposed dividend was.[2] CBS, as a dual-class company, had two classes of common stock, Classes A and B, and only the former carried voting rights.[3] National Amusements Inc. ("NAI") owned most of the voting stock and controlled approximately 79.7 percent of the voting power, while holding only about 10.3 percent of the economic interest in the company.[4] Although the CBS board's proposed distribution of *voting stock to all* shareholders would not change the economic interests of any CBS shareholders, including NAI's, it would drastically dilute NAI's voting power

1. CBS Corp., Current Report (Form 8-K) Exhibit 99 (May 14, 2018) [hereinafter CBS Form 8-K May 2018]. A stock dividend is a company's payment to its shareholders in the form of the company's stock instead of cash. *See* Lynam v. Gallagher, 526 A.2d 878, 882 (Del. 1987).

2. *See* Matt Levine, *CBS Wants to Get Rid of a Shareholder*, BLOOMBERG (May 15, 2018, 9:36 AM), https://www.bloomberg.com/view/articles/2018-05-15/cbs-wants-to-get-rid-of-a-shareholder [https://perma.cc/7V5H-ES9C]. ("The traditional remedy to this problem would be that the special committee, and the board of directors, would say no [to the controlling shareholder's plan to merger]. . . . But CBS's board is not limiting itself to the traditional remedy [and planned a special dividend]."); Jessica Dye, *CBS Board Seeks Court Approval for Special Dividend*, FIN. TIMES (May 17, 2018), https://www.ft.com/content/81db7e00-5a26-11e8-b8b2-d6ceb45fa9d0 [https://perma.cc/694E-G7XG] ("CBS's board of directors said it will ask a Delaware court to approve its move to dilute the voting interest of the Redstone family's National Amusements, its controlling shareholder . . . .").

3. CBS CORP., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION, art. IV(2)(a). The presence of dual-class stock structure with differential voting rights, although prohibited in many other countries, has been spreading in the United States. Such a structure is especially common among new technology companies, such as Alphabet, Facebook, Snap, Inc., but also prevalent among older, more established companies, such as CBS, Berkshire Hathaway, Ford, and the Coca-Cola Bottling Co. *See* COUNCIL OF INSTITUTIONAL INVS., DUAL CLASS COMPANIES LIST (March 2021), https://www.cii.org/files/Formatted%20Dual%20Class%20List%203-22-21.pdf [https://perma.cc/N9RE-3Y44].

4. *See* Amended Verified Complaint at 4–5, CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB (Del. Ch. May 23, 2018) [hereinafter CBS Amended Verified Complaint]. The wide gap between voting rights and cash flow rights may generate more governance risks. *See* Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1471–73 (2019); Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1054 (2010). For the costs and benefits of dual-class stock structure, see Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 714–16 (2019); Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. REV. 1057, 1057–58 (2019); Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 2018 COLUM. BUS. L. REV. 852, 854–60 (2018); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 587–93 (2017); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 605–08 (2016) [hereinafter *Idiosyncratic Vision*]; Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 3–8 (1988).

from approximately 80 to about 20 percent.[5] The board argued that the proposed special stock dividend was a "necessary step for protecting the Company and its majority economic stockholders."[6]

This unprecedented preemptive strike by a board against a controlling shareholder sent a shock wave throughout the corporate community.[7] The board's use of stock dividends as a governance weapon to eliminate voting control was highly controversial.[8] In a single-class stock company, where all shareholders are sharing the same type of stock, stock dividends do not affect corporate governance as long as stock dividends are made proportional to the number of stocks each shareholder owns.[9] By contrast, in dual-class stock companies with differential voting rights for each class of stock, stock dividends can become a governance weapon, as demonstrated in the CBS case.[10] Given that pro rata dividends have long been treated as the subject of

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5. CBS Amended Verified Complaint, *supra* note 4, at 6. Whether such dividend is legally and equitably valid was not clear, and the CBS board made the special stock dividend pending until the Delaware courts decide it permissible. *See id.* at 6, 8. Despite the high anticipation, Delaware court did not decide on the validity of the stock dividend because the case was settled. *See* CBS Corp., Current Report (Form 8-K) Exhibit 99 (Sept. 9, 2018) [hereinafter CBS Form 8-K Sept. 2018].

6. *See* CBS Amended Verified Complaint, *supra* note 4, at 47. CBS argued that the controlling shareholder was trying to force a merger with Viacom Inc. against CBS's special committee's objection, and the merger was not in the best interest of other CBS shareholders. *Id.* at 2–3. The controlling shareholder, however, claimed that it had no intention to force the merger or replace the board. *See* Defendants' Brief in Opposition to Plaintiffs' Motion for a Temporary Restraining Order at 1, CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB (Del. Ch. May 15, 2018) [hereinafter Defendants' Brief]. Following multiple sexual harassment allegations, CBS' then-chief executive officer and chairman, Les Moonves, who spearheaded the stock dividend to oppose the merger, exited the company in September 2018. *See* In re CBS Corporation Stockholder Class Action and Derivative Litigation, No. 2020-0111-JRS, 2021 WL 268779, at *9 (Del. Ch. 2021) A year later, a merger between Viacom and CBS was completed, and the combined company has been trading under the name ViacomCBS. *Id.* at *12–14.

7. For a discussion of the conflict between boards and controlling shareholders from the fiduciary duty perspective, see Lefteri J. Christodulelis, Note, *Seizing the First-Mover Advantage: Resolving the Tension in Delaware Law Between Boards of Directors and Controlling Shareholders*, 120 COLUM. L. REV. 431, 458–61 (2020).

8. Meg James & Samantha Masunaga, *CBS Chooses 'Nuclear Option' Against Shari Redstone: It Sues to Thwart Viacom Merger*, L.A. TIMES (May 14, 2018, 7:36 AM), https://www.latimes.com/business/la-fi-ct-cbs-viacom-shari-redstone-20180514-story.html (last visited July 20, 2021) ("The suit . . . is Moonves' way of communicating to shareholders that CBS is on a strong trajectory under his leadership and should not be saddled with Viacom's troubles.").

9. *See infra* Section II.A.3; *see also* MODEL BUS. CORP. ACT § 6.23(b) official cmt. (AM. BAR ASS'N 4th ed., 2013) ("A share dividend is solely a paper transaction: no assets are received by the corporation for the shares and any 'dividend' paid in shares does not involve the distribution of property by the corporation to its shareholders.").

10. MODEL BUS. CORP. ACT § 6.23(b) (AM. BAR ASS'N 4th ed., 2013). The Model Business Corporation Act was on point in envisioning the problem.

> Share dividends may create problems when a corporation has more than a single class of shares. The requirement that a share dividend be 'pro rata' only applies to shares of the

the board's business decisions,[11] the CBS episode presents a new question: How should the law treat a board action that is a business decision *in form* but a governance decision *in substance*?

Current corporate law offers few answers to address the question.[12] Even the CBS board was uncertain about the validity of its proposed dividend, and conditioned the dividend payment on the Delaware Court's approval.[13] Despite the legal uncertainties, it is clear that the validity of boards' unilateral reallocation of voting rights through a stock dividend has become a salient corporate law and governance issue.[14] Addressing such issues revealed by the CBS episode, before we encounter other innovative uses of stock dividends in dual-class companies, would help reduce costly litigation surrounding such stock dividends.

Focusing on the analysis of cross-class stock dividends that distribute identical classes of stock to all shareholders, this Article reveals that this *seemingly equal treatment* of shareholders has an *essentially unequal impact* on each class of shareholders due to the underlying difference between classes. Two representative types of cross-class stock dividends are: (1) the distribution of an existing class of stock to different classes of stockholders; and (2) the distribution of a newly created class of stock.

Boards can either dilute or perpetuate corporate control using such cross-class stock dividends. While the CBS board made a pro rata distribution of the

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same class or series; if there are two or more classes entitled to receive a share dividend in different proportions, the dividend will have to be allocated appropriately.

Id. official cmt. Nevertheless, Delaware statutory and case law are silent on stock dividends on dual-class companies. *See infra* Section II.B.2.

11. *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810 (Sup. Ct. 1976) ("[T]he question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the Board of Directors."). It is worth noting that the Securities and Exchange Commission ("SEC") Rules also acknowledge that dividends should be made at boards' discretion. For instance, a company can request the SEC's no-action letter to exclude a shareholder proposal dealing with specific amount of cash or stock dividends from proxy materials for shareholder voting. 17 CFR §240.14a-8 (i)(13)(2013). But the appropriateness of shareholders' proactive proposals on dividends should be distinguished from the need of protecting shareholders' voting right from boards' unilateral stock dividends.

12. This is partly because most cases on this issue have been settled. On September 9, 2018, CBS announced the settlement with its controlling shareholder NAI. As a part of the settlement, CBS board abandoned the stock dividend plan to dilute control vote and NAI undid the recent bylaw amendment that added a ninety percent of supermajority voting requirement on the board's action on certain material issues including dividend in stock. This settlement again denied the Delaware Chancery Court the chance to rule on board's use of stock dividends for significant governance changes. *See* CBS Form 8-K Sept. 2018, *supra* note 5; Keach Hagey & Joe Flint, *CBS Chief Leslie Moonves Steps Down Amid Sexual Misconduct Allegations*, WALL ST. J. (Sep 9, 2018, 8:31 PM), https://www.wsj.com/articles/cbs-ceo-leslie-moonves-expected-to-resign-1536525335 [https://perma.cc/BCB3-DT92].

13. *See* CBS Amended Verified Complaint, *supra* note 4, at 8.

14. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 COLUM. L. REV. 941, 945 (2020) [hereinafter *Limits of Judicial Review*].

voting class of stock to all shareholders to drastically dilute the controlling shareholder's voting power, in 2014, the Google board distributed a new, non-voting class of stock to all shareholders to preserve the controlling shareholders' lock on control. The controlling shareholders mostly owned Class B stock with ten times more voting power per share than Class A stock, which could stop the erosion of their voting control by using the new, non-voting class of stock instead of their initial high-vote class B stock as currency for stock-based acquisitions and compensation.[15] In both cases, the distribution of identical stock seemingly treats all shareholders equally, but it has a starkly unequal impact on each class's voting power.[16] To what extent boards have the discretion to make such cross-class stock dividends remains uncertain.

To mitigate the uncertainty, this Article proposes a new definition of a pro rata distribution for stock dividends. Stock dividends are pro rata only when each class of shareholders receives the same *amount* per share in the same *type* of stock they own. (i.e., in-class stock dividends). In such a case, the legal consequence of such stock dividends is a de facto stock split and has no impact on governance arrangements. The definition of a pro rata distribution is vital because of corporate law's long-standing protection of pro rata dividends as "business decisions," which are subject to the deferential business judgment rule. As one of the most important foundations of U.S. corporate law, the business judgment rule provides directors with ample discretion when making business decisions.[17] While the scope and boundary of what constitutes

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15. *See* Verified Class Action Complaint at 2, In re Google Inc. Class C Shareholder Litigation, No. 7469-CS (Del. Ch. 2012) [hereinafter Google Verified Compl.] ("[A]ll shareholders will receive a dividend of non-voting 'Class C' stock in what amounts to a 2-for-1 stock split, while keeping voting proportions unchanged. This distribution of non-voting stock will allow Google to purchase other companies or issue stock to employees without diluting the Founders' voting power or diminishing their iron-clad grip over Company management and operations (which includes the ability to appoint the entire Board of Directors)."); Eric Lam, *New Google Share Classes Issued as Founders Cement Grip*, BLOOMBERG (Apr. 3, 2014, 4:09 PM), https://www.bloomberg.com/news/articles/2014-04-03/new-google-shares-hit-market-as-founders-cement-grip-with-split [https://perma.cc/8TMM-E9EP]. Although the Google's recapitalization is often referred to "stock split" in media, technically it is a stock dividend that has an effect of stock split. Google Inc., Proxy Statement (Form DEF 14A) at 82 (May 9, 2012) [hereinafter Google 2012 Proxy Statement] ("If the Dividend is declared and paid, we believe that the market price for the shares of Class A common stock will generally reflect the effect of a two-for-one stock split once the Dividend is paid, accordingly, the market price of the Class A common stock will decrease by approximately 50%.").

16. *See generally* Kirby Smith, *The Agency Costs of Equal Treatment Clauses*, 127 YALE L.J.F. 543 (2017) (analyzing how the equal treatment clauses, despite its benign appearance, can be detrimental to minority shareholders in the context of an acquisition).

17. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (declaring that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." (citations omitted)). The applicable judicial review is oftentimes the most important determinant of the trial outcome. *See Idiosyncratic Vision*, *supra* note 4, at 606 ("Under Delaware law, for example, this distinction determines whether a lawsuit challenging a transaction is

a business decision are not always clear,[18] boards are generally understood to have significant discretion when declaring and paying dividends.[19] However, relevant legal scholarship and court decisions are almost exclusively based on cash dividends, and are therefore not applicable to stock dividends because the nature of board discretion is substantially different between the two.[20] Unlike cash, each stock comes with its rights and limitations, including voting rights and the attendant rights of control. Therefore, it does not seem to make much sense to extend the rationale we have used for cash dividends to stock dividends that potentially alter the control and voting rights of the shareholders in a company with more than one class of stock.

This Article proceeds as follows. Part II discusses the existing legal framework for corporate dividends, including the three main types of dividends and associated legal issues and the legal uncertainties about cross-class stock dividends. Part III explores the use of stock dividends in dual-class stock companies and presents an empirical analysis that is grounded in original, hand-collected data from 237 dual-class companies' corporate charters.[21] This analysis confirms the need for a narrower definition of pro rata stock dividends and for a class vote in dual-class companies. Part IV then proposes normative implications for state legislators and courts. As an ex ante mechanism, this Article argues that state corporate law should offer a default set of rights and obligations to apply when a company's charter provision is

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carefully reviewed under the plaintiff-friendly entire-fairness standard or quickly dismissed under the defendant-friendly business-judgment rule.").

18. In particular, when a business decision simultaneously affects both the operational aspects and the corporate governance structure within a company, it remains a bit unclear to what extent the business judgment protection should still be applied. At least in the hostile takeover context, the Delaware courts have determined that unconditional application of the business judgment rule is not justified. When directors decide to resist a hostile takeover attempt, not only does that decision constitute a business decision of not selling the company to a hostile buyer, but also the decision raises the specter of managerial entrenchment. In such cases, the courts have determined that a more heightened judicial scrutiny is proper. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) and *infra* Part IV for more detailed analysis.

19. *See infra* Section II.A. Dividends are generally paid in cash, but they can also be paid using property other than cash (e.g., in-kind dividends), or the distributing company's stock (i.e., stock dividends). It is important to distinguish "stock dividends" from "dividends in stock." While "stock dividends" refer to the distribution of a company's *own* stock to its shareholders only, throughout the paper, we will use the term "dividends in stock" to indicate dividends payable more broadly in *any* stock, including other company's stock or even the right to receive or purchase stock in the future.

20. In cash dividends, academic scholarship and court decisions raise the basic question of how much of the company's earnings should be distributed to the shareholders, as opposed to being retained within the company for future investment. Stock dividends, on the other hand, tend to have broader implications, in that they can lead to substantial changes to a company's governance structure due to various rights attached to each stock and can be used for governance reasons in addition to, or sometimes instead of, business reasons.

21. *See infra* Section III.B.

silent on the issue, or unclear.[22] The state default law will also facilitate each company's design of its corporate charter that best suits its needs.[23]

This Article suggests specific standards of ex post judicial review, arguing that courts should limit the application of the business judgment review to pro rata stock dividends that proportionally multiply the number of the same class of stock each shareholder owns and preserve each class's relative voting power (i.e., in-class stock dividends), but should review disparate stock dividends in dual-class companies that distribute the same class of stock to *all* shareholders (i.e., cross-class stock dividends) without class voting, under enhanced judicial scrutiny.

II. EXISTING LEGAL FRAMEWORK FOR CORPORATE DIVIDENDS

This Part provides a general overview of corporate dividends. Because the existing literature and case law have mostly dealt with cash dividends, in-kind and stock dividends are not as well understood. The regulations on these non-cash dividends also have less coordination and consistency. Section A presents and clarifies three different types of corporate dividends and explains how each of them raises a distinct set of legal questions. Section B reviews the evolution of academic literature on dividends and describes how current corporate law doctrine, namely the business judgment rule, protects directors' dividend policies.

A. *TYPOLOGY OF DIVIDENDS AND ASSOCIATED LEGAL ISSUES*

"[A] dividend is a distribution by a corporation to its shareholders of a share of the earnings of the corporation."[24] When a company performs well during a year and generates a large amount of earnings or surplus,[25] directors

22. The set of default law provisions will serve as template provisions (i.e., a "menu") for dual-class companies. *See generally* Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3 (2006) (exploring the potential impact of regulating contractual menus); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUD. 279 (2009) (finding the stickiness of corporate default laws that favor management).

23. *See infra* Section IV.A.

24. Fulweiler v. Spruance, 222 A.2d 555, 558 (Del. 1966). Unlike the U.S. federal tax code, the current corporate law does not distinctively define the relationship between the terms "dividend" and "distribution." *See, e.g.*, I.R.C. § 316(a) (2010) ("[T]he term 'dividend' means any distribution of property made by a corporation to its shareholders."). Also, the distinction under the tax code does not necessarily fit the usage under corporate law. Since the paper mainly focuses on corporate law analysis, while I follow the exact expressions on each relevant original provision, two terms are used interchangeably in this Article.

25. The term "surplus" is defined as "[t]he excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital . . . ." DEL. CODE ANN. tit. 8, § 154 (2021). The term "net assets" means "the amount by which total assets exceed total liabilities." *Id.* For stock with par value, capital consists of the par value plus any additional amount (out of the consideration received for stock) the board determines to be capital. For stock without any par value, only the latter portion counts. *See* Wright v. Heizer Corp., 503 F. Supp. 802, 810 (N.D. Ill. 1980). So, for instance, if a corporation issues and sells one share of stock, with par

of the company have two options: (1) retain the earnings in the company for possible future reinvestment; or (2) distribute the earnings to shareholders, typically on a pro rata basis.[26] Directors have a near-absolute right to make such distributions and they have ample discretion when deciding whether to pay a dividend, how much to pay, and in what form.[27] Despite the heavy focus on cash dividends, a dividend can refer to a distribution of cash, other non-cash property (in-kind), or a corporation's own stock to its shareholders.[28] Each distribution type will trigger different issues under corporate, [29] securities, and tax law.[30] The following Subsections provide a brief overview of these different issues by dividend type.

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value of $1, at $10, capital would consist of at least $1. When the corporation's net assets attributable to that single share is $12, assuming that the directors did not assign additional capital amount, the corporation can distribute up to $11 as dividend.

26. If the company has some preferred stock outstanding, i.e., different tiers of equity, which is subject to preferential dividend distribution, the company will have to satisfy such obligations first before making any pro rata distribution to the common stockholders. Also, while the primary focus of this Article will be on dividends, another common way for a corporation to return the investment to the shareholders is through share repurchases (or redemptions). Under a share repurchase, instead of paying cash dividends (on a pro rata basis), a corporation will buy back the outstanding stock (on a pro rata basis) likely at a premium. *See* DEL. CODE ANN. tit. 8, § 151(b). It used to be the case that because capital gains tax rate was substantially lower than the ordinary income tax rate, this gave a strong incentive to the corporation to engage in share repurchases rather than cash dividends. However, when Congress substantially reduced the ordinary income tax rate with respect to dividends ("qualified dividend income"), this differential incentive has substantially (but not completely) disappeared.

27. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170(a); MODEL BUS. CORP. ACT ANN. § 6.40(a) (AM. BAR ASS'N 4th ed., 2013).

28. Stock dividends only indicate a distribution of the company's own capital stock and a distribution of all the other stock (e.g., subsidiary's stock) constitutes an in-kind dividend. *See, e.g.*, DEL. CODE ANN. tit. 8, § 173; MODEL BUS. CORP. ACT ANN. § 6.40(a) (Distributions), § 6.23(a) (Share Dividends).

29. While the SEC does not take an active role in regulating cash and stock dividends because a stock dividend does not constitute "sale" of a security and thus does not require registration, the SEC conducts a substantive review of Form 10, a registration statement for a spin-off transaction pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934. Spin-off transactions are usually done by distributing a subsidiary company's stock to shareholders of a parent company (in-kind distribution). *See*, Sec. Act Release No. 929 (July 29, 1936), Letter of General Counsel, 11 Fed. Reg. 10957 (1969), 1 Fed. Sec. L. Rep. (CCH) ¶ 1121; 17 C.F.R. §§ 240.12b, 240.12g (2020). Also, major stock exchanges require notifications when listed companies pay dividends. *See* NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL §§ 204.12, 204.21 (2017); NASDAQ Listing Rule 5250(e)(2) (2009); 17 C.F.R. § 240.10b-17 (a)(1) (2020) (untimely announcement of record dates).

30. The differences in tax treatment have been a major consideration for deciding the methods of dividend. As a general rule, a cash dividend to a shareholder must be treated as taxable income to the recipient to the extent of a distributing company's current or accumulated earnings and profits ("E&P"). In case the corporation is making a non-cash dividend, such as property or non-stock securities, the fair market value of the property received must also be included as taxable income for the recipient. When a non-cash dividend is stock of a subsidiary (e.g., in the case of a spin-off), so long as the distribution meets the requirement to be part of a plan of reorganization, the dividend qualifies to be non-taxable. By contrast, stock dividends (i.e.,

1. Cash Dividends

The most common form of dividend is cash.[31] Partly due to this ubiquity, state statutory and case laws tend to focus on cash dividends. State corporate statutes, for instance, tend to assume, as a matter of default, that a corporation distributes cash dividends. Oftentimes, the term "dividend" refers to a cash dividend unless there is an express, contrary expression, such as a "stock dividend." For example, Delaware General Corporation Law Section 170 deals with dividends generally, but it focuses on cash dividends.[32] It stipulates that directors can declare and pay dividends only from two legally available sources: surplus and net profits.[33] This requirement is most relevant for cash dividends since the distribution of cash to shareholders would reduce a company's net assets and its surplus by the amount of cash transferred to shareholders.[34] The legal issues and prior scholarship on cash dividends are discussed in more detail in Section II.B.

2. In-Kind Dividends

A company can also pay dividends to shareholders using its own property other than cash.[35] For instance, if a company owns some marketable securities of third party, such as the U.S. Treasury bonds or another company's stock, the company can distribute such securities to its shareholders. The effects and legal issues of such in-kind dividends would be largely similar to cash

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when a corporation is distributing its own stock to its shareholders) generally are not included in the taxable income until they are sold. When a shareholder receives a company's own stock, only the basis of each share changes and the total basis of the stock of the holder remains the same. *See*, I.R.C. § 301(b)(1), (c)(1), 316 (a), 354(a)(1) (2010).

31. *See e.g.*, *Dividends*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/dividend [https://perma.cc/PL5G-9XV3].

32. *See* DEL. CODE ANN. tit. 8, § 170 (a)(2021). *See supra* note 25 for a statutory definition of "surplus."

33. DEL. CODE ANN. tit. 8, § 170 (a). The possibility that a corporation can make a dividend even when it does not have a sufficient "surplus," so long as it has positive net profits is known as the "nimble dividend rule."

34. *See* EDWARD P. WELCH, ROBERT S. SAUNDERS, ALLISON L. LAND & JENNIFER C. VOSS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 170.01 (2021). By contrast, as we will see shortly, when a company is making a stock dividend, the company's total surplus is unaffected. While an in-kind distribution can also affect the corporation's surplus, if the distributed asset is subject to certain obligations (such as debt), distributing the asset to the shareholders will also affect the company's liabilities.

35. *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809–10 (N.Y. Sup. Ct. 1976) (distributing a third-party company's stock as dividends). The Internal Revenue Service ("IRS") enlists useful examples of the in-kind dividends. *See Topic No. 404: Dividends*, IRS, https://www.irs.gov/taxtopics/tc404 [https://perma.cc/K2BA-9VSP] (Mar. 12, 2021) ("A shareholder of a corporation may be deemed to receive a dividend if the corporation pays the debt of its shareholder, the shareholder receives services from the corporation, or the shareholder is allowed the use of the corporation's property . . . . Additionally, a shareholder that provides services to a corporation may be deemed to receive a dividend if the corporation pays the shareholder service-provider in excess of what it would pay a third party for the same services.").

dividends in the sense that shareholders can easily sell those marketable securities and turn them into cash. [36]

Certain types of in-kind dividends, however, could raise more complex legal issues. First, when a company distributes a *right* to purchase its own voting stock (e.g., a poison pill) rather than a stock to its shareholders with a condition that only a subset of shareholder-recipients may exercise this right (e.g., a poison pill selective trigger), this in-kind dividend can tilt the voting power in favor of one shareholder group to the exclusion of others. [37] Second, when a company distributes a *stock of a wholly-owned subsidiary* to its shareholders as part of a corporate spin-off transaction, such in-kind dividends present opportunities to alter governance arrangement of the spun-off company without shareholder voting or market check.[38] Often times, a new, spun-off company's corporate charter would add director-empowering provisions (e.g., anti-takeover provisions) on top of the verbatim copy of the parent

36. *See Kamin*, 383 N.Y.S.2d at 809–11.

37. This is a form of governance intervention with directors' in-kind dividend deals with a shareholder rights plan, more colloquially known as a "poison pill." Here, a company distributes to its shareholders the right to purchase its stock subject to various trigger thresholds. At the time of adoption of the shareholder rights plan, the company will distribute warrants (i.e., rights to acquire the company's stock) to all of its existing shareholders with an exercise price, or the price at which the recipient can purchase the company's stock. Initially, the warrant will attach to the outstanding stock and the exercise price will be highly unattractive (i.e., the warrant is very "out of the money"). When a triggering event happens, however, there is an adjustment to the strike price (i.e., "dilution factor") that makes the warrant sufficiently attractive to exercise (i.e., make the warrant "in the money"). What distinguishes this type of warrant is that: (1) the triggering event takes place when a hostile buyer (i.e., "acquiring person") acquires more than a trigger threshold of the company's outstanding stock, without the approval of the company's board; and (2) the adjustment does not happen for the acquiring person. For instance, when a typical poison pill is triggered, all rights-holders, except for the hostile buyer, have an option to purchase the company stock at a lower price than the market price. By doing so, a poison pill can dilute the hostile buyer's ownership and voting power in the company. In short, what the poison pill example shows is that corporate boards are using their power to make distributions to affect shareholders' control. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d. 1346, 1348 (Del. 1985) (distributing "the Preferred Share Purchase Rights Plan" which gives common shareholders one Right to purchase a preferred stock under certain triggering conditions); Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 703 (2011).

38. A corporate spin-off entails a transaction that separates one company into two or more stand-alone companies. This separation typically occurs when a parent company distributes all the shares of a wholly owned subsidiary to its shareholders as a dividend. Under the current legal regime, a corporate spin-off offers a unique opportunity for a parent company's directors to amend a spun-off company's charter without being subject to traditional monitoring mechanisms such as shareholder approval or market check. *See generally* Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-offs*, 10 U.C. IRVINE L. REV. 1 (2019) (challenging the lack of monitoring mechanism on governance changes via spin-off transactions and providing tax law and corporate law solutions to the issue); Robert Daines & Michael Klausner, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs*, (Stanford L. & Econ. Olin Working Paper No. 299, 2004), https://ssrn.com/abstract=637001 [https://perma.cc/NP4J-4GEH] (addressing the similar lack of monitoring mechanism in equity carve-outs); WACHTELL, LIPTON, ROSEN & KATZ, SPIN-OFF GUIDE 21-27 (2021), https://www.wlrk.com/docs/Spin-Off_Guide_2021.pdf [https://perma.cc/CVY4-FTDX].

company's charter.[39] Those amendments are possible because (the parent company) directors have the sole power over a corporate spin-off by dividends as a business decision. As such, unlike cash dividends, such in-kind dividends are vulnerable to managerial or controlling shareholder's opportunism.

3. Stock Dividends

Stock dividends refer to a company's dividend to shareholders in the form of its shares rather than in cash or other property.[40] The legal treatment and the impact of stock dividends are often compared to but different from that of cash dividends. As with other dividends, the putative purpose of stock dividends is to share earnings with shareholders. This characterization serves as the foundation for the Delaware statutory law on stock dividends,[41] and the general limitation applies to them: The amount of the dividend shall not exceed the amount of surplus or net profits.[42] From this view, stock dividends are useful for companies that experience a cash-flow shortfall because stock dividends ordinarily do not result in a transfer of the company's assets. Stock dividends preserve the company's cash position while honoring its shareholders' demand for dividends. However, stock dividends provide more flexibility to the shareholders than cash dividends. A shareholder-recipient can decide whether to keep or to sell the company's shares received through a stock dividend on the market to turn that dividend into cash.[43] Also, as a

39. *See* SPIN-OFF GUIDE, *supra* note 38, at 23. ("In many spin-offs and IPOs, the spin-off company has more antitakeover provisions in its charter and bylaws than the parent.") For instance, upon its spin-off from ConocoPhillips, Phillips 66's charter included a classified board provision, which is known to be one of the most effective protections for directors, without the approval from ConocoPhillips shareholders. *See* AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF PHILLIPS 66, art. V, https://www.sec.gov/Archives/edgar/data/1534701/000119312512200916/d341711dex31.htm [https://perma.cc/YW2D-AWGK]; AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF CONOCOPHILLIPS, art. V, https://www.sec.gov/Archives/edgar/data/1163165/000095012908004130/h58804exv3w1.htm [https://perma.cc/3ULX-EB2E].

40. *See* Lynam v. Gallagher, 526 A.2d 878, 882 (Del. 1987) (defining a stock dividend as "a dividend payable in stock instead of cash").

41. FRANKLIN A. GEVURTZ, CORPORATION LAW 177 (2000) ("The traditional theory behind a stock dividend is that it constitutes a dividend like any other, except paid in shares of the corporation's own stock. This means complying with a mix of the statutory requirements for both stock issuance and dividends.").

42. DEL. CODE ANN. tit. 8, § 170 (2021) ("Dividends; payment; wasting asset corporations."); *id.* § 173 ("Declaration and payment of dividends.").

43. While the stockholder can purchase additional shares when a cash dividend has been paid, this may be more difficult when the share price remains high; and an immediate tax consequence will also follow, regardless of whether she purchases additional shares with distributed cash.

general matter, stock dividends are not taxable until the shareholder sells them,[44] while cash dividends are considered taxable income.[45]

It is also common to characterize stock dividends as stock splits. In *Lynam v. Gallagher*, the Delaware Supreme Court described a stock split as "dividing up of the outstanding shares of a corporation into a greater number of units, without altering the stockholder's proportional ownership in the corporation."[46] Hence, a stock split is merely a change of form driven by business purposes and "does not alter [the company's] capital or surplus accounts."[47] The Delaware Supreme Court has stated that "a stock dividend does not distribute property to the stockholders; it merely changes the form of their investment by increasing the number of their shares, thereby diminishing the value of each share and leaving the aggregate value of their stock in the corporation the same."[48] For example, suppose a company has 100 common shares outstanding, and each share is valued at $10. As such, the company's total equity market valuation would be $1,000. If the company were to distribute one share of identical common stock to each outstanding stock as a stock dividend, the total number of outstanding shares would become 200, and the share price would decrease to $5. The company's total equity market valuation would remain unchanged. Therefore, stock dividends are like stock splits, under which a company decides to "split" a single share into multiple shares. Consistent with the above description, a stock dividend has sometimes been used to effect a stock split and decrease a company's share price.[49] When a publicly traded company's stock price becomes substantially high, the company may decide to split each share into multiple shares, with a

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44. *See* I.R.C. § 305(a) (2019) ("Distributions of stock and stock rights"). I.R.C. § 305(b) lists five exceptions to the general rule. Stock dividends are taxable when they are: "(1) Distributions in lieu of money[,] . . . (2) Disproportionate distributions[,] . . . (3) Distributions of common and preferred stock[,] . . . (4) Distributions o[f] preferred stock[, and] . . . (5) Distributions of convertible preferred stock." *Id.* (b). Professor Zohar Goshen claims that the first exception should be removed because it discourages companies from giving shareholders the option between cash and stock dividends. *See* Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 907 (1995) ("Even in the absence of an election, if some shareholders receive a cash dividend and other shareholders receive a stock dividend, the shareholders who receive the stock dividend are taxed *as if* they received a cash dividend. . . . Under the current tax system, firms will regard granting a dividend option as equivalent to distributing cash dividends . . . [and] it would create tax liability as if the firm distributed all of its earnings.").

45. *See* I.R.C. § 301(a). The term "property" in this tax provision includes "money, securities, and any other property" except stock of a distributing company or rights to acquire such stock. *See* I.R.C. § 317(a).

46. *See* Lynam v. Gallagher, 526 A.2d 878, 882 (Del. 1987).

47. *Id.*

48. *Id.*; *see also* MODEL BUS. CORP. ACT ANN. § 6.23 cmt. (AM. BAR ASS'N 4th ed., 2013) (explaining that a stock dividend is a mere paper transaction because, unlike stock issuance, "no assets are received by the corporation for the shares and," unlike cash dividends, any dividends paid in stock "do[] not involve the distribution of property by the corporation to its shareholders").

49. JAMES D. HONAKER & ERIC S. WILENSKY, DIVIDENDS, REDEMPTIONS AND STOCK PURCHASES 1–3 (2012), https://www.mnat.com/files/1-519-2507.pdf [https://perma.cc/YUR9-XY5M].

proportionate lowering of the stock price, to attract a broader group of investors and increase the liquidity of the company's stock.[50] For instance, in 2014, Apple Inc. split one share of the company's common stock into seven shares and dropped the price of each share to one-seventh of the previous price[51] to make the shares more accessible to retail investors.[52] Then, a puzzling question arises: What incentivizes companies to make stock dividends rather than stock splits if they "merely change the form" of the shareholders' investment?

A stock dividend and a stock split are different on shareholder approval requirements. To effectuate a stock split, a company needs to distribute authorized but unissued shares to its shareholders. More importantly, a stock split requires shareholder approval. In 2010, then-Vice Chancellor Leo Strine clarified that a stock split (both forward and reverse) requires shareholder approval because it requires a charter amendment, under Delaware General Corporation Law Section 242(a)(3),[53] to effectuate a proposed subdivision (i.e., forward split) or combination (i.e., reverse split).[54] By contrast, the

50. Daisuke Wakabayashi, *Apple Boosts Buyback, Splits Stock to Reward Investors*, WALL ST. J. (Apr. 23, 2014, 7:45 PM), https://www.wsj.com/articles/apple-reports-profit-increase-1398285550 [https://perma.cc/7C79-JRP2] ("[A stock split] doesn't affect the value of the company, but it does put the shares within reach of more individual investors, potentially boosting demand for the stock."). But other companies have not been favorable to stock splits because the more accessible stock price might attract a different set of investors. *See* Erik Holm, *Three Reasons Why Warren Buffett Never Split Berkshire's $250,000 Stock*, WALL ST. J. (Feb. 15, 2017, 9:23 AM), https://www.wsj.com/articles/BL-MBB-56224 [https://perma.cc/U8S7-ZFGJ] (quoting Mr. Buffett's letter to shareholders in 1984, "[w]ould a potential one-share purchaser be better off if we split 100 for 1 so he could buy 100 shares? Those who think so and who would buy the stock because of the split or in anticipation of one would definitely downgrade the quality of our present shareholder group").

51. Paul Vigna & Steven Russolillo, *Apple's 7-for-1 Stock Split Is 'Very Unusual'*, WALL ST. J. (Apr. 23, 2014, 6:37 PM), https://www.wsj.com/articles/BL-MBB-20072 [https://perma.cc/G26G-AHT6] ("At Wednesday [Apr. 23, 2014]'s closing price of $524.75, the split would price shares at $74.96 (dividing the current price by seven). That's slightly below the $77.91 average price of the stocks in the S&P 500.").

52. *See* Wakabayashi, *supra* note 50.

53. DEL. CODE ANN. tit. 8, § 242(a)(3) (2021).

54. David N. Feldman, *One for the Lawyers: Forward Split in Delaware Requires Shareholder Approval*, LEXISNEXIS LEGAL NEWSROOM (Apr. 6, 2011), https://www.lexisnexis.com/LegalNewsRoom/corporate/b/blog/posts/one-for-the-lawyers-forward-split-in-delaware-requires-shareholder-approval [https://perma.cc/2GL2-8FT9] ("Section 242 of the DGCL says you *may* amend your certificate of incorporation to reflect splits, which has been the source of the confusion. [In] a new case in Delaware, Blades v. Wisehart . . . it appears the court interprets the word "may" above to "must" and says that forward splits require one to go through the charter amendment procedure in Section 242."); Blades v. Wisehart, No. 5317-VCS, 2010 WL 4638603, at *10 (Nov. 17, 2010) ("[I]t is crucial to distinguish an amendment to the certificate of incorporation that merely increases a corporation's authorized but unissued capital stock, as expressly authorized under the first clause of § 242(a)(3), from an amendment that changes the number of outstanding shares, as expressly authorized under . . . the last clause of § 242(a)(3) that contemplates a distinct charter amendment that would have the effect of 'subdividing or

power to make a stock dividend is expressly granted to the directors under Delaware General Corporation Law Sections 170 and 173, without any shareholder approval requirement.[55] Not surprisingly, in order to avoid the cumbersome shareholder approval process, stock splits are commonly done as stock dividends.[56] In such cases, a stock dividend is a de facto stock split, rather than a return on shareholders' investment.[57]

Neither of the foregoing characterizations of stock dividends (i.e., the return of profits or a stock split) pays enough attention to the stock's unique and powerful trait: Unlike cash or property, *stock comes with voting and other rights.* Further, each share of stock can be many different things depending on the rights attached to it. In companies with only one class of stock, the characterization of stock dividends as a stock split can still be valid because all shareholders will receive the *same type* of stock, only in a different amount proportionally to the number of shares they own. In dual-class stock companies, however, stock dividends suddenly gain power as a weapon that can drastically reallocate voting rights among shareholders.[58] In dual-class stock companies, different classes already have unequal voting rights and sometimes even unequal dividend rights.[59] Hence, a stock dividend can lead to a disparate impact on each class, depending on how that dividend is structured in corporate charters.[60] Especially for Delaware companies, directors have the sole discretion in deciding on stock dividends.[61] Unless a distributing company's charter expressly requires shareholder approval, directors can decide the timing, the form, and the number of stock dividends.

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combining the outstanding shares of any class or series of a class of shares into a greater or lesser number of outstanding shares.'").

55. DEL. CODE ANN. tit. 8, §§ 170, 173.

56. For example, Nike Inc.'s board of directors declared a two-for-one stock split in the form of 100 percent stock dividend payable on December 23, 2015. Nike Inc., Current Report (Form 8-K) (Nov 19, 2015). Since the company was structured with a dual-class stock, Class A stockholders received two Class A shares per stock and Class B stockholders received two Class B shares per stock respectively. *Id.*

57. The fact that a stock dividend could be used to realign shareholders' control rights relates to the questions of whether a stock dividend is used as a return on investment, or a tool for a stock split, or something else such as a corporate action that implements changes in the company's governance structure. Identifying the reasons behind a stock dividend and making the proper distinction is crucial for determining the validity of a stock dividend. Such an issue could also arise when there is a relevant provision over stock dividends in a company's charter (certificate or articles of incorporation) and the court is asked to decide on what the reasonable interpretation of that provision is. *See infra* Section IV.A.

58. *See infra* Section III.A.

59. *See e.g.*, BERKSHIRE HATHAWAY INC., RESTATED CERTIFICATE OF INCORPORATION, art. V § 2.B. (Allocating dividends to the holders of low-vote Class B Common Stock, "whether in cash, in kind, in stock, or in any other means, equal to one-fifteen-hundredth ($1/1{,}500^{th}$) of the amount per share" for the holders of high-vote Class A Common Stock).

60. *See infra* Section III.B.

61. DEL. CODE ANN. tit. 8, § 170 (2021) ("Dividends; payment; wasting asset corporations."); *id.* § 173 ("Declaration and payment of dividends.").

Accordingly, in dual-class stock companies, a stock dividend is no longer a de facto stock split or a simple distribution of profit. Given such differences and potential impact on corporate governance, the need for a distinctive treatment of stock dividends is long overdue.

B. LEGAL UNCERTAINTY ABOUT STOCK DIVIDENDS

As discussed in the previous Section, stock dividends are distinct from cash dividends, but legal discourse on dividends has focused almost exclusively on cash dividends. This Section analyzes why the prior scholarship and the existing corporate law doctrines on dividends should be updated to deal with stock dividends.

1. Prior Scholarship on Dividends

Prior research on corporate dividends has addressed potential agency problems, but exclusively with respect to *cash* dividends, specifically on management's decisions regarding the payout ratio (i.e., the ratio of the accumulated earnings that are distributed to the shareholders rather than retained for reinvestment). While Professors Merton Miller and Franco Modigliani argue that a company's dividend policy is not relevant information for shareholders in calculating the company's value because they always have an option to sell their stock when they need cash,[62] the Honorable Frank Easterbrook claims that a dividend policy is relevant to the distributing company's stock price because it may effectively address management's two sources of agency costs: monitoring cost and risk-aversion cost.[63] According to

62. In 1961, Professors Merton Miller and Franco Modigliani (two Nobel laureates, famous for the Modigliani and Miller propositions) put forth a dividend irrelevance theory, claiming that a company's declaration and payment of dividends will not affect its stock price (or the company's market value), unless the dividend policy affects the corporation's investment decisions. *See generally* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961) (outlaying dividend irrelevance theory). According to the theory, this is because shareholders can realize a cash return from their stock by simply selling it or using it as collateral to borrow. If shareholders are really in need of cash, they do not need to rely on cash dividends. *Id.* at 414. The dividend irrelevance theory extended later to consider tax effect. *See, e.g.*, Merton H. Miller & Myron S. Scholes, *Dividends and Taxes*, 6 J. FIN. ECON. 333, 334–45 (1978); Merton H. Miller & Myron S. Scholes, *Dividends and Taxes: Some Empirical Evidence*, 90 J. POL. ECON. 1118, 1118–19 (1982). While quite powerful, the irrelevance theory is unable to explain why allegedly irrelevant and costly cash dividends are being made by almost all companies. *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 651 (1984) ("Even if most investors are irrational most of the time, dividends would go away if their costs exceeded their benefits to investors.").

63. *See* Easterbrook, *supra* note 62, at 652–58. Also focusing on the agency cost associated with management's decision over the payout ratio, in 1986, Professor Michael Jensen introduced the free cash flow hypothesis. *See generally* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986) (developing the theory). The hypothesis deals with the conflicts of interest between shareholders and management when a company has some "free cash flow," which the management can deploy at its pleasure. *Id.* at 323. To reduce the agency cost created by the management when they invest the cash at below the cost of capital

the theory, it is too costly for dispersed shareholders to effectively monitor management ("monitoring cost").[64] And management prefers a safer project with a lower expected return to a riskier one with a higher expected return, which is the opposite of what dispersed shareholders would prefer ("risk-aversion cost").[65] In such a setting, dividends may usefully address both dimensions of the agency problem: a high payout ratio keeps the company constantly (or frequently) in the market for new capital, while the monitoring of management and the adjustment of management's risk level is available at a lower cost.[66]

Legal academics have also recognized the agency costs associated with management's unchecked discretion over dividend policy and have proposed tangible policy reforms. In 1980, Professor Victor Brudney criticized courts' reluctance to interfere with corporate decisions on dividends or dividend policies, even when there are clear conflicts of interest between a company's management and shareholders.[67] A year later, in response to Brudney's criticism over judicial deference, Professor Daniel Fischel defended the court's application of the business judgment rule to dividend decisions based on the assertion that managers are more informed and experienced than judges or shareholders, especially with respect to decisions such as whether to pay out the surplus as dividends or to retain them to make certain investments.[68] In 1995, Professor Zohar Goshen also argued that management's control over a dividend policy should be shifted to the capital market and,

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or waste it, rather than distributing the cash to the shareholders, Professor Jensen suggested an increase of the debt-to-equity ratio (company's leverage) through financial restructuring. *Id.* at 324. The basic idea is that, by making the company borrow more (i.e., take on more debt), the company will be obligated to pay its cash as required interest payments and this, in turn, will reduce the amount of "free cash-flow" that the management can potentially waste. *See id.* at 323 (defining free cash flow as "cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.").

64. Easterbrook, *supra* note 62, at 653.

65. *Id.*

66. *See* id. at 652–58.

67. Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 104 (1980) ("[T]he prevailing legal doctrine holds dividend policy to be a matter of managerial discretion or business judgment . . . ."). As a solution, he proposed a new rule under federal securities regulation that would require disclosure of the reasons for adopting a dividend policy or any significant changes to the dividend policy in specific circumstances. *Id.* at 120.

68. Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 716–17 (1981) ("Management may base the dividend decision on a variety of factors . . . includ[ing] whether funds are needed for investment, payment of creditors, or maintenance and upkeep of existing facilities, and whether needed funds can be cheaply or readily obtained from the capital market. . . . Decisions based upon these factors are particularly within the competence of management, . . . any judicial second-guessing of the dividend decision is likely to reduce shareholder welfare.").

ultimately, to shareholders.[69] A decade later, as part of a larger initiative for shareholder empowerment, Professor Lucian Bebchuk expressed concern regarding management's sole authority over dividend decisions and the fact that their decisions are almost always protected by the business judgment rule, regardless of their economic significance.[70]

The agency costs discussed in the foregoing theories, published more than three decades ago, have been mitigated, at least in part. The corporate governance environment and ownership structures have changed significantly since then, and the high ratio of institutional ownership has likely lowered the cost of shareholders' monitoring of management.[71] When courts decline to second guess a company's business decision, activist hedge funds can also interfere.[72] Along this line, one of the agenda items that activist shareholders now push for is the increase of dividend payments.[73]

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69. *See* Goshen, *supra* note 44, at 884. Professor Goshen proposed a legal reform both in the tax code and in state corporate law to require companies to provide shareholders with the option of being paid either in cash or in stock. *Id.* at 907.

70. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 847 (2005) ("Corporate law does not view decisions about distributions, however economically important, as involving the kind of fundamental change that calls for shareholder veto power. Rather, such decisions are viewed as part of the ordinary conduct of business delegated to the sole prerogative of management."). *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 812 (Sup. Ct. 1976). As a solution, Professor Bebchuk proposed a corporate charter provision that bestows shareholders the power to make a binding shareholder resolution, which involves decreasing a company's size through cash or in-kind distributions ("scaling-down" decision). He emphasizes that the presence of such a charter provision itself could incentivize management to distribute a company's excess cash or assets even before shareholders actually pass such a resolution. Bebchuck, *supra*, at 901-02.

71. *See* Easterbrook, *supra* note 62 at 654. *See generally* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013) (emphasizing the role of shareholder activists in increasing the value of shareholder voting by potentiating institutional investors' voice); Geeyoung Min, *Shareholder Voice in Corporate Charter Amendments*, 43 J. CORP. L. 289 (2018) (empirically showing the rise of charter amendments along with the institutional investors' engagement).

72. *See e.g.*, Starboard Value started accumulating Darden Restaurant's stocks after Darden ignored Starboard's recommendation to spin off the Red Lobster and Olive Garden Chains. *See* Alexandra Stevenson, *Activist Hedge Fund Starboard Succeeds in Replacing Darden Board*, N.Y. TIMES: DEALBOOK (Oct 10, 2014, 7:40 PM), https://dealbook.nytimes.com/2014/10/10/activist-hedge-fund-starboard-succeeds-in-replacing-darden-board [https://perma.cc/QG6S-KJ4U] ("[A] group of disgruntled investors [including Starboard Value] first called for Darden to create a separate company for its Red Lobster and Olive Garden chains. Instead, Darden ignored their recommendation and sold Red Lobster for $2.1 billion in May despite shareholder misgivings, resulting in a fierce war of words between the activist investors and Darden.").

73. *See e.g.*, Vipal Monga, David Benoit & Theo Francis, *As Activism Rises, U.S. Firms Spend More on Buybacks Than Factories*, WALL ST. J. (May 26, 2015, 10:30 PM), https://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805 [https://perma.cc/8VM7-VX4F] ("Data show a broad array of companies have been plowing more cash into dividends and stock buybacks, while spending less on investments such as new factories and research and development. . . . More businesses sitting on large piles of extra cash are deciding to satisfy investors by giving some of it back."); Leonard Chazen, *How the Influx of Dividend-Minded Shareholders Will Impact Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 22, 2016) https://

More importantly, prior theories do not address the agency problem in stock dividends in dual-class stock companies. Due to the rise and popularity of concentrating ownership using dual-class stock, controlling shareholders are able to exercise a higher number of votes than the number of shares they own. As payment of stock dividends is proportional to stock ownership, a company's distribution of high-vote stock to low-vote stock as a stock dividend (cross-class stock dividend) can vastly dilute the controller's power over the corporation.[74] Also, stock dividends in dual-class stock companies introduced a new type of conflict among corporate actors. Historically, conflicts between directors and dispersed shareholders or between controlling shareholders and minority shareholders have long been at issue, and the recent case of atypical conflict between directors and *controlling* shareholders was a shock to the corporate community.[75] The issuing of stock dividends, especially in the context of dual-class stock, has been largely overlooked despite its potential explosiveness to corporate voting.

2. Existing Corporate Law Doctrine on Dividends

A long-standing tenet of U.S. corporate law is that directors have largely unfettered discretion over a company's dividend policy, so long as the dividend decision is consistent with a company's charter or any relevant statute.[76] Directors' decisions over how much cash should be returned to

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corpgov.law.harvard.edu/2016/11/22/how-the-influx-of-dividend-minded-shareholders-will-impact-shareholder-activism/#:~:text=How%20the%20Influx%20of%20Dividend%2DMinded%20Shareholders%20Will%20Impact%20Shareholder%20Activism,-Posted%20by%20Leonard&text=2016%20has%20been%20the%20year,the%20movement%20of%20stock%20prices [https://perma.cc/6FC5-YFW3] ("Over the years, shareholder activists have done well at gaining investor support for campaigns to get companies to return more money to shareholders, but their success at winning proxy contests has not won them comparable respect in the corporate governance literature.").

The most common type of dividends pushed by activist shareholders is distribution of cash, and a stock repurchase (a.k.a., stock buyback) is a prevalent form they advocate. *See e.g.*, Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1119–20 (2011) ("[E]xecutives will often have an incentive to prefer repurchases over dividends. In particular, any executive whose payoff is tied to the stock's future value will get a larger payoff by engaging in a bargain-price repurchase than by issuing a dividend.").

74. *See supra* note 2 and accompanying text.

75. *See* Michael J. de la Merced & John Koblin, *Shari Redstone and Leslie Moonves Have Starring Roles in a Corporate War*, N.Y. TIMES (May 17, 2018), https://www.nytimes.com/2018/05/17/business/media/cbs-shari-redstone-les-moonves.html [https://perma.cc/FT2K-UYUH] ("They were once allies, if not friends. The entertainment mogul Shari E. Redstone and the CBS chief executive Leslie Moonves, whose careers have been entwined for nearly 20 year . . . find themselves at an impasse because of Ms. Redstone's desire to merge the two companies. . . . Mr. Moonves, for his part, is firmly against the proposed merger.").

76. *See* DEL. CODE ANN. tit. 8, § 170 (2021); MODEL BUS. CORP. ACT ANN. § 6.40(a) (AM. BAR ASS'N 4th ed., 2013) ("A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the

shareholders and how much should be kept within the company for other purposes have been treated as "business decisions" because directors are in the best position to decide what would be in the best interest of the company and its shareholders.[77] As long as the payment decision complies with the applicable charter provisions, statutes, and precedents, courts will not second guess the dividend policy merely because shareholders allege that the payments were "excessive."[78]

A possible justification for giving directors such a significant level of control is that shareholders' reactions to and preferences over dividends vary. While shareholders generally prefer stock that yields high dividends,[79] they do not always favor dividends over reinvestments. In fact, many companies —especially so-called "growth" and other "value-oriented" companies—are not keen on paying cash dividends. As an example, Berkshire Hathaway Inc. has rarely paid any dividends largely because its Chief Executive Officer and largest shareholder, Mr. Warren Buffet, believes that it would be more beneficial for shareholders in the long run if the company were to reinvest its earnings.[80] The shareholders of Berkshire Hathaway seem to largely agree with Mr. Buffett's policy. At the company's 2014 shareholder meeting, more than 98 percent of the company's shareholders endorsed the company's no-dividend policy by voting against a shareholder proposal that requested a dividend increase.[81]

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limitation in subsection [§ 6.40](c)."); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810 (N.Y. Sup. Ct. 1976).

77. *See* Smith v. Smitty McGee's, Inc., No. 15668, 1998 WL 246681, *8 (Del. Ch. May 8, 1998).

78. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971) ("Since it is admitted that the dividends were paid in strict compliance with 8. Del. C. §170, the alleged excessiveness of the payments alone would not state a cause of action."). Nevertheless, the court can still interfere with the board's dividend decision when a plaintiff successfully proves that the decision "cannot be grounded on any reasonable business objective," which would be the main focus of this paper. *See id.*

79. In general, investors tend to prefer companies with generous dividend policy. *See* Akane Otani, *Consumer-Staples Rally Underscores Investor Wariness*, WALL ST. J. (Aug 16, 2018, 4:38 PM), https://www.wsj.com/articles/consumer-staples-rally-underscores-investor-wariness-153441720 1?mod=searchresults&page=1&pos=2 [https://perma.cc/E3MD-RWAQ] ("Part of staples' allure has stemmed from their dividend payouts, which have become increasingly attractive to investors .... The S&P 500 consumer-staples sector recently carried a dividend yield of around 2.85%, exceeding the broader S&P 500's 1.79% dividend yield and floating just below the 10-year Treasury note's 2.871% yield Thursday.").

80. Jen Wieczner, *Warren Buffet Says Berkshire Hathaway Stock May Start Paying Dividends*, FORTUNE (May 6, 2017, 10:36 PM), http://fortune.com/2017/05/06/warren-buffett-berkshire-hathaway-stock-dividend [https://perma.cc/K7BT-XU4M] ("Buffett's logic is straightforward: The Oracle of Omaha thinks he can make more money for shareholders by investing their money than they can make for themselves with it."). As of June 2021, Berkshire Hathaway has still neither paid dividends nor repurchased stocks.

81. Since the sponsor of the shareholder proposal did not attend the meeting, the shareholder resolution was not officially proposed nor voted. Still, the proxy votes were counted, and 98 percent of voting shares voted against the dividend proposal. Letter from Warren Buffet, to Berkshire Hathaway Inc. Shareholders, 38 (2015), http://www.berkshirehathaway.com/

This does not mean that shareholders have not tried to challenge any board's decision on dividends. Although it is extremely difficult to overcome the business judgment rule, shareholders may still challenge dividend policies in general or a specific dividend decision. This raises the question: To what extent will a court second-guess directors' decisions concerning dividends? The case of *Sinclair Oil v. Levien* is illustrative. [82] There, the minority shareholders of Sinclair Venezuelan Oil Company ("Sinven") sued Sinclair Oil Corp.—which was a controlling shareholder with about 97 percent of the outstanding stock of Sinven—for distributing "excessive" dividends rather than reinvesting Sinven's earnings for future projects. [83] The minority shareholders argued that the "excessive" dividends distributed by Sinven's board (under the influence of Sinclair Oil) were used as a vehicle to deliver the company's cash to the controlling shareholder, constituting self-dealing.[84] The court, however, largely rejected the plaintiffs' argument, ruling that so long as the dividend was paid on a pro rata basis so that minority shareholders received a portion of the distribution and absent a specific, fact-based allegation of self-dealing, the board's decision was protected by the business judgment rule even in the presence of a dominant controlling shareholder.[85]

Prior cases on dividends have largely centered on cash dividends made by a company with a simple, single-class equity structure. This Article brings the discussion on corporate dividends a step further by exploring the extent to which courts should protect the use of stock dividends in dual-class stock companies to affect the corporate governance arrangement of a company.[86]

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letters/2014ltr.pdf [https://perma.cc/KV8K-W5CD]. Buffett interpreted the voting result as, "Don't send us a dividend but instead reinvest all of the earnings," adding, "To have our fellow owners – large and small – be so in sync with our managerial philosophy is both remarkable and rewarding." *Id.*

82. *See Sinclair Oil Corp.*, 280 A.2d at 721 ("We do not accept the argument that the intrinsic fairness test can never be applied to a dividend declaration by a dominant board, although a dividend declaration by a dominated board will not inevitably demand the application of the intrinsic fairness standard.").

83. *Id.* at 719–20.

84. *Id.* at 721. The entire membership of Sinven's board was appointed by the controlling shareholder Sinclair Oil Corp. and was likely to be under its influence

85. *Id.* at 720; *see also* Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811-12 (Sup. Ct. 1976).

86. For publicly traded companies, additional federal securities regulations and major stock exchange rules may also come into play. It is noteworthy to address that the various level of regulations on stock dividends are not always consistent and need to be streamlined. For example, the New York Stock Exchange ("NYSE") Listed Company Manual defines and distinguishes stock dividend and stock split: a stock dividend is "[a] distribution of less than 25% of the outstanding shares," and a stock split is "[a] distribution of 100% or more of the outstanding shares" both as calculated prior to the distribution, which is not recognized under corporate laws. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL, § 703.02 (PART 1) (2013).

III. STOCK DIVIDENDS IN DUAL-CLASS STOCK COMPANIES

This Part analyzes how stock dividends are used in dual-class stock companies with unequal voting rights. As each stock carries its own rights for the shareholders (e.g., voting rights, dividend rights), directors can widen or narrow the gap between each class of stock through stock dividends. This Part focuses on the distribution of existing and new classes of stock to all shareholders and examines companies' charter provisions to show how they can be used to control stock dividends.

A. STOCK DIVIDENDS AS GOVERNANCE MECHANISM

In a stock dividend, a company distributes either its existing or a newly created class of stock to its shareholders. Because stock, unlike cash or other property, carries certain rights for the shareholders, stock distribution confers power to the directors to influence or alter corporate governance arrangements, especially when a corporation is capitalized with more than one class of stock. For the distribution of an existing class of stock, the primary legal question is whether one class of shareholders can receive the other class of stock as a dividend. When a company distributes a newly created class of stock as a dividend, while the problems tend to be somewhat different, concerns over governance changes can nevertheless arise.

1. Distribution of Existing Class of Stock

In a single-class company, a pro rata distribution of existing stock as stock dividends will make the practically identical effect to that of a stock split: the number of shares increases and the price of each share decreases, without changing the total value of the company's equity capital.[87] The aggregate market capitalization of the company stays the same because the total number of shares outstanding increases, but the price of each share decreases at the same rate.[88] In a dual-class stock company, however, stock dividends can raise important and unresolved issues, including the definition of pro rata distribution of stock. The definition is legally significant because the courts have decided that boards' pro rata dividends do not constitute self-dealing and have shielded them from shareholders' fiduciary duty challenges.[89] But case law deals mostly with cash dividends, and the current statutory and judge-made laws are silent on how to define a pro rata distribution of stock and

87. *See supra* Section II.A.3 for technical distinctions between a stock split and a stock dividend.

88. Total aggregate market capitalization is calculated by multiplying the total number of shares outstanding by the market price of each share. For example, if a company makes 100 percent stock dividends in a single-class company with the total market capitalization of $100,000, calculated by multiplying the number of shares (10,000) times the price of each share ($10), the total number of stock will increase by 100 percent (20,000), and the price for each share will decrease by 50 percent (to $5), which will preserve the total market capitalization before and after the stock dividend.

89. *See Sinclair Oil Corp.*, 280 A.2d at 721.

whether a stock dividend in the same amount but in a different type from the underlying stock can be deemed a pro rata dividend.[90]

For instance, when a company has two classes of stock, low-vote Class A and high-vote Class B, there are at least three options for structuring a stock dividend: (1) in-class stock dividends in which Class A stock is distributed to Class A stockholders and Class B stock to Class B stockholders, (2) cross-class stock dividends in which Class A stock is distributed to both Class A and Class B stockholders, or (3) cross-class stock dividends in which Class B stock is distributed to both Class A and Class B stockholders.

Suppose the company previously issued 3,000 Class A shares and 1,000 Class B shares. Class A stock has one vote per share and Class B stock has five votes per share. For an in-class dividend as described in option (1) above and illustrated in Table 1, the effect of the stock dividend will be identical to a stock split, and each class will retain the same voting rights before and after the dividend.

Table 1. In-Class Stock Dividends and Governance Change

	Pre-Dividends	Intra-Class Dividends	Post-Dividends
Low-Vote Stock (1 vote per share)	1 vote * 3,000 shares = 3,000 votes (37.5%)	1 vote * 3,000 shares = 3,000 votes	6,000 votes (37.5%)
High-Vote Stock (5 votes per share)	5 votes * 1,000 shares = 5,000 votes (62.5%)	5 votes * 1,000 shares= 5,000 votes	10,000 votes (62.5%)
Total Votes	8,000 votes	8,000 votes	16,000 votes

In a cross-class dividend, as described in options (2) and (3), the distributing company seemingly treats all shareholders equally by paying the same stock in proportional numbers. But in fact, relative voting rights will be altered. As illustrated in Table 2, if a company distributes low-vote stock to all shareholders, high-vote class stockholders will receive an *inferior* stock than their initial voting arrangements. Then, given that there are a smaller number of high-vote stock outstanding, the high-vote stockholders' voting power as a class will decrease.[91] As a result of a cross-class low-vote stock dividend, Class B's voting power decreased from 62.5 percent to 50 percent.

90. *See supra* Section II.A.3. Alternatively, a pro rata distribution can be limited to a proportional distribution of the same type of stock to what each shareholder already owns.

91. The Supreme Court of Delaware has distinguished fairness and equal treatment, noting that shareholders "need not always be treated equally for all purposes" in reasoning whether "fairness necessarily requires precise equality." Nixon v. Blackwell, 626 A.2d 1366, 1376–77 (Del. 1993). Here, the court held that unequal treatment can still be fair, but the question associated

Table 2. Cross-Class Stock Dividends of Low-Vote Stock and Governance Change

	Pre-Dividends	Dividends: One Low-Vote Stock Per Share	Post-Dividends
Low-Vote Stock (1 vote per share)	1 vote * 3,000 shares= 3,000 votes (37.5%)	1 vote * 3,000 shares = 3,000 votes	6,000 votes (50%)
High-Vote Stock (5 votes per share)	5 votes * 1,000 shares = 5,000 votes (62.5%)	1 vote * 1,000 shares = 1,000 votes	6,000 votes (50%)
Total Votes	8,000 votes	4,000 votes	12,000 votes

More potently, if the company distributes high-vote stock to all shareholders, low-vote class stockholders will receive a *superior* stock than what they initially own, and their voting power as a class will be boosted, in a potentially dramatic way.[92] Per Table 3, the high-vote Class B's voting power gets significantly diluted from 62.5 percent to 35.7 percent, and the Class B shareholders lose the majority voting power.

Table 3. Cross-Class Stock Dividends of High-Vote Stock and Governance Change

	Pre-Dividends (Voting Power)	Dividends: One High-Vote Stock Per Share	Post-Dividends
Low-Vote Stock (1 vote per share)	1 vote * 3,000 shares = 3,000 votes (37.5%)	5 votes * 3,000 shares = 15,000 votes	18,000 votes (64.3%)
High-Vote Stock (5 votes per share)	5 votes * 1,000 shares = 5,000 votes (62.5%)	5 votes * 1,000 shares = 5,000 votes	10,000 votes (35.7%)
Total Votes	8,000 votes	20,000 votes	28,000 votes

with stock dividends is whether "equal" treatment can be unfair. The Court's answer to that question is uncertain.

92. The CBS Board's proposed stock dividend to dilute the controlling shareholder's voting block is an example of this. *See* CBS Amended Verified Complaint, *supra* note 4, at 6.

The cross-class dividends thus make stock dividends quite distinct from a stock split, which can divide one share into a larger number of shares without altering the allocation of voting rights across the class. The courts are not clear on whether the boundary of the pro rata distribution can extend to the *seemingly proportional treatment yet essentially disproportional impact* caused by cross-class distributions.[93]

A recent, high-profile case illustrates how directors can substantially impact the respective voting powers of Class A and B shareholders depending on which structure they choose. CBS was one of the largest public broadcasting corporations in the United States. The company had a dual-class stock structure: Class A Common stock provided one vote per share and Class B Common stock had no voting power. Both Class A and B Common shares were publicly traded on the NYSE.[94] As of December 31, 2017, National Amusements, Inc. ("NAI"), a closely-held corporation, directly or indirectly owned approximately 79.5 percent of CBS's Class A Common stock.[95] NAI was, in turn, controlled by Sumner M. Redstone National Amusements Trust, which owned 80 percent of the voting interest of NAI, and this voting interest was "solely [controlled] by Mr. Redstone until his incapacity or death."[96] Shari Redstone, Mr. Redstone's daughter, then obtained control of NAI and effectively controlled approximately 79.7 percent of voting power in CBS, although NAI owned only about 10.3 percent of the economic interest in CBS.[97]

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93. *C.f. Sinclair Oil Corp.*, 280 A.2d at 721–22.

94. CBS Corp., Annual Report (Form 10-K) II-1 (Feb. 19, 2018) [hereinafter CBS Form 10-K]. Item 5. ("CBS Corporation . . . voting Class A Common Stock and CBS corporation non-voting Class B Common Stock are listed and traded on the New York Stock Exchange ("NYSE") under the symbols "CBS.A" and "CBS", respectively."). In other dual-class companies, super voting class stocks, which are mostly owned by insiders, are not publicly traded. For instance, Alphabet, Inc. has three classes of stock with unequal voting rights: Class A (one vote per share), Class B (10 votes per share), and Class C (no votes). Only Class A and C common stock are publicly traded on NASDAQ at almost the same price. On Feb. 28, 2020, Class A common stock traded at $1,339.25 NASDAQ: GOOGL, https://www.google.com/finance/quote/GOOGL:NASDAQ?window=5Y (last visited July 21, 2021) and Class C common stock traded at $ 1,339.33 NASDAQ: GOOG, https://www.google.com/finance/quote/GOOG:NASDAQ?window=5Y (last visited July 21, 2021). *See* John Divine, *GOOG vs. GOOGL: Differences in 2 Classes of Stock*, U.S. NEWS MONEY (Sept. 27, 2019, 11:34 AM), https://money.usnews.com/investing/investing-101/articles/goog-vs-googl-key-differences-between-share-classes (last visited July 21, 2021) ("Class B shares do exist, they just aren't traded publicly. Owned by founders and important insiders, Class B shareholders get 10 votes per share. In effect, this was done to allow existing company insiders, particularly cofounders Larry Page and Sergey Brin, to retain 51% ownership. If the company can take advantage of public markets without actually giving up any meaningful control of the company, why wouldn't existing shareholders want to take advantage of that?").

95. CBS Form 10-K, *supra* note 94, at I-2.

96. *Id.* at I-25.

97. CBS Amended Verified Complaint, *supra* note 4, at 5. As of Feb 12, 2018, the rest of Class A Common Stock was held by 1,437 record holders and Class B Common Stock was held by 19,541 Class B record holders. CBS Form 10-K, *supra* note 94, at II-1.

For some time, NAI pushed for a merger between CBS and Viacom, another company under NAI's control. CBS (led by its Chief Executive Officer, Leslie "Les" Moonves) resisted the idea. Amidst this conflict over the merger, CBS's board scheduled a special meeting on May 17, 2018. At the meeting, the directors discussed a special stock dividend that would distribute voting Class A shares to both Class A and Class B stockholders on a "pro rata" basis. This special dividend would drastically dilute NAI's voting power from almost 80 percent to approximately 17 percent because Class B shares had no voting rights, and there were a large number of outstanding Class A and B shares. Since the dividend was done on a pro rata basis, and both classes were entitled to the same economic rights, the special dividend would not change the economic interests of any stockholders. The board declared that the implementation of the dividend payment was conditional on the court's approval.[98]

CBS is a Delaware company and Delaware General Corporation Law Section 170 (a) stipulates that directors' dividend payments are "subject to any restrictions contained in its certificate of incorporation."[99] CBS has a charter provision specifically on stock dividends, and the key issue is whether distributing the high-vote Class A stock to *both* Class A and Class B stockholders comply with CBS's corporate charter provision on the issue. The relevant provision on dividends states:

> The Board of Directors may, at its discretion, declare a dividend of any securities of the Corporation or of any other corporation . . . (a "Share Distribution") to the holders of shares of Class A Common Stock and Class B Common Stock (i) on the basis of a *ratable distribution of identical securities* to . . . Class A Common Stock and Class B Common Stock or (ii) on the basis of a distribution of *one class* . . . [to] Class A Common Stock and *another class* . . . [to] Class B Common Stock . . . provided that the securities so distributed . . . do not differ in any respect other than . . . Class A Common Stock receiving the class or series of such securities having the *higher relative voting rights* . . . .[100]

While this charter provision explicitly contemplates differential stock dividends under parts (i) and (ii), it does not define the "ratable distribution of identical securities." CBS directors argued that the distribution of "one kind of identical stock to all shareholders" was allowed under the provision.[101]

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98. CBS Amended Verified Complaint, *supra* note 4, at 6–8.

99. DEL. CODE ANN. tit. 8, § 170 (a) (2021).

100. CBS CORP., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION, art. IV § 2(b) (emphasis added).

101. CBS Amended Verified Complaint, *supra* note 4, at 15 ("[t]he plain language of the Certificate authorizes the Board to issue a stock dividend of either 'identical' securities to both classes of stockholders, or different securities to the different classes. The Certificate thus clearly vests in the Board the power and authority to grant a stock dividend that would provide voting

NAI claimed that the distribution of two kinds of stock identical to each class of stock was the correct interpretation of the provision, and the CBS board's plan to distribute high-vote Class A common stock to both classes violates the charter provision.[102]

As part (ii) of the provision stipulates the distribution of *different* kinds of securities to Class A and Class B Common stockholders, one could argue that CBS directors' interpretation is more reasonable to avoid surplusage. Yet alternative interpretations are also possible. One could argue that part (ii) only applies to the distribution of two entirely different classes of stock to Class A and Class B stockholders. For instance, under NAI's interpretation, part (ii) would allow CBS's directors to distribute Class C stock to Class A shareholders and Class D stock to Class B shareholders. Under part (i), the word "identical" could apply to each class, meaning that CBS could only distribute Class A stock to Class A shareholders and Class B stock to Class B shareholders, given that NAI's intent to retain voting control has been disclosed in the corporate filings and also expressed in part (ii) of the provision.[103] As such, the existence of a corporate charter provision on stock dividends does not necessarily reduce or avoid the dispute. This is in part because the Delaware statute is silent on the issue.[104] While the corporate community eagerly waited for the Delaware Chancery Court's decision, the case was settled, and proper interpretation of this provision and legality of the CBS board's stock dividend to eliminate the insiders' voting control was never fully resolved.[105]

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power to the non-voting stockholders provided only that identical voting shares so issued are issued ratably to the Class A and Class B stockholders.").

102. Defendants' Brief, *supra* note 6 ("In fact, where the Charter refers to holders of Class A Common Stock and Class B Common Stock receiving 'identical' securities . . . 'identical' refers back to the underlying Class of Common Stock held by each such holder (*i.e.*, Class A holders must receive Class A Shares and Class B holders must receive Class B Shares in any such dividend). This reading is consistent with the second clause of the dividend provision of the Charter, which permits dividends of other securities so long as thereafter the relative voting rights of the holders of Class A Common Stock and Class B Common Stock are respected. [This] interpretation of the Charter also is consistent with CBS's repeated disclosure that 'NAI will be in a position to control the outcome of corporate actions that require shareholder approval, including the election of directors.'").

103. *Id.*

104. Currently, the Delaware statute contemplates only how much increase in capital should be reflected on a company's books when it makes a stock dividend. The board can increase capital by any amount the board designates as long as the amount is "not less than the aggregate par value" of the shares distributed as a stock dividend. *See* DEL. CODE ANN. tit. 8, § 173. However, the MBCA offers a detailed default provision on stock dividends. *See supra* note 10.

105. *See* CBS Form 8-K Sept. 2018, *supra* note 5. After this stock dividend saga in 2018, Les Moonves departed from the company and a merger of Viacom and CBS was completed on December 4, 2019. As of June 2, 2021, ViacomCBS Inc., a new combined company, keeps the same dual-class structure and the verbatim charter provision on stock dividends as CBS had. *See* VIACOMCBS INC., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION, art. IV, § 2(b).

As the CBS case demonstrates, directors' power to declare a stock dividend, if unchecked, confers significant power to the board and management to impact a company's governance structure. This power only increases when a company is capitalized with multiple classes of stock with differential voting power. Under existing law, directors' decisions regarding stock dividends, similar to decisions involving other types of dividends, are protected by the business judgment rule. Cases like CBS raise two interesting questions: (1) To what extent should decisions around stock dividends be treated as a "business decision," and (2) if such decisions are not "business decisions," whether monitoring mechanisms through either the legislature or the courts are necessary. These questions are explored further in Part IV.

2. Distribution of New Class of Stock

When a company distributes a new class of stock, the company theoretically has more discretion to designate the rights and limitations of the class.[106] Unlike the distribution of an existing class of stock, if the company were trying to create a new class of common stock, it would normally have to amend the charter and present the amendment proposal to the existing shareholders for approval.[107] When a distributing company has a dual-class stock structure, the impact of this distribution on corporate governance becomes quite consequential. The creation and distribution of a new class of stock without voting rights has grown in popularity among dual-class stock companies, particularly in the tech industry. These companies use new non-voting classes of stock to acquire other start-up companies or pay their employees, without having their controller (often, the founder of the company) lose control.[108] As the following example illustrates, companies often use stock dividends as part of this process.

In 2004, Google, Inc. (now a wholly-owned subsidiary of Alphabet, Inc.) went public for the first time.[109] Back then, it was unusual that the company was capitalized with two classes of stock with differential voting rights: Class A stock with one vote per share and Class B stock with ten votes per share.[110]

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106. *See* DEL. CODE ANN. tit. 8, § 151(a).

107. *Id.* § 242(a).

108. *See* Peter Ladig, *When a Pro Rata Dividend Triggers Entire Fairness*, MORRIS JAMES LLP: DEL. BUS. LITIG. REP. (Dec. 15, 2017), https://www.morrisjames.com/blogs-Delaware-Business-Litigation-Report,when-a-pro-rata-dividend-triggers-entire [https://perma.cc/QU2N-Z3A3] ("One way to avoid the loss of control . . . is to create a class of non-voting stock that the company or founders can use as currency for acquisitions or donations that will not dilute the founders' control.").

109. On October 2, 2015, Google executed an internal holding-company reorganization and became a wholly-owned subsidiary of a newly created public company called Alphabet, Inc. For the sake of avoiding confusion, we will use the company name Google as shown in the case filings discussed here.

110. *See* James Fallows, *"Two-class" Corporate Ownership Structure: Not Just For Media Dinosaurs Any More!*, THE ATLANTIC (July 31, 2007), https://www.theatlantic.com/technology/archive/

While Class A stock was being offered to the public, Class B stock was owned primarily by the company's founders, Sergey Brin and Larry Page, and the company's CEO, Eric Schmidt.[111] This structure allowed the founders to exercise more than 66 percent of the voting power while "own[ing] less than 32 % of [Google's] outstanding stock."[112] Unsurprisingly, investors had serious concerns over the dual-class initial public offering ("IPO") and, in response, the company's founders circulated an assuaging "Letter from the Founders."[113] In an attempt to justify why the dual-class structure would be beneficial for the firm and minority shareholders in the long-term, the founders explained that dual-class stock would enable them to manage the firm with a "long-term" perspective.[114] While it is uncertain whether the letter was able to placate potential investors' concerns, the initial public offering was a resounding success that would be emulated by other companies.[115]

What is important for our purposes is not the fact that Google successfully executed a dual-class IPO, but what happened afterward.[116] The company, partly out of necessity and design, used Class A stock to acquire various companies and pay its employees and executives. As the company continued to issue more of its Class A stock, the voting power of Class B stockholders gradually declined. It was projected that by late 2011, Class B stockholders would lose their majority voting power altogether.[117] In response, Class B stockholders decided to amend the company's charter to create a new class of stock with no voting power (Class C) and distribute this stock to its existing stockholders.[118] After amending its charter to create Class C stock, Google made a one-to-one distribution of newly created Class C stock to both Class A

2007/07/-quot-two-class-quot-corporate-ownership-structure-not-just-for-media-dinosaurs-any-more/7682 [https://perma.cc/8WMW-RX2Q].

111. *See* Google Inc., Registration Statement (Form S-1) at 84–86 (Apr. 29, 2004) [hereinafter Google Registration Statement].

112. Albert H. Choi, *Concentrated Ownership and Long-term Shareholder Value*, 8 HARV. BUS. L. REV. 53, 54 (2018).

113. *See* Google Registration Statement, *supra* note 111, at i–vii, 3.

114. *Id.*

115. *See* Daniel Klausner, *Dual Class IPOs Are on the Rise: Tech Unicorns Jump on Board This New Trend*, PWC (Jul. 18, 2018), https://www.pwc.com/us/en/services/deals/blog/dual-class-ipos-on-the-rise.html [https://perma.cc/5326-Y4T8].

116. *See* Google Verified Compl., *supra* note 15, at 7 ("The dual class stock structure had its intended effect and solidified management and the Founders' domination of Google; allowing them a certain level of insulation from dissenting views. At the time of the IPO, however, there was certainly no plan announced to perpetuate the Founders' domination if they lost such dominance due to share sales or otherwise. Nor was there a plan announced to allow the Founders to remain in control through a Reclassification that would turn half the public Class A shares into non-voting shares, under a plan in which all detriments would be borne by the Class A shareholders, and all benefits would be enjoyed by the Founders.").

117. *Id.*

118. *See* Google 2012 Proxy Statement, *supra* note 15, at 56–58, 76–82 (May 9, 2012); Google Inc., Current Report (Form 8-K) (June 21, 2012).

and Class B stockholders.[119] Class C stockholders do not have voting power but were entitled to receive the same dividend rights as Class A stockholders,[120] making the distribution a de facto stock split. From the founders' perspective, the company could use the newly distributed non-voting stock for acquisitions and compensation, while eliminating the unpleasant possibility of having their voting power fall below 50 percent.[121]

Concerned with the founders' attempt to protect their voting control through the issuance and distribution of non-voting Class C stock, certain low-vote Class A stockholders sought to either enjoin the proposed recapitalization or recover damages if an injunction was denied.[122] The low-vote class stockholders claimed that the stock dividend of Class C stock would entrench the controlling shareholders' power and insulate them from the rest of the shareholders.[123] While the case was settled without a decision on the merits,[124]

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119. *See* Google Verified Compl., *supra* note 15, at 2.

120. *See* AMENDED & RESTATED ARTICLES OF INCORPORATION OF ALPHABET INC., art. V, § 5(e) (2015).

121. *See* Google Verified Compl., *supra* note 15, at 7–8.

122. *Id.* at 1-4. A few years later, Facebook, Inc. attempted to follow the same path by issuing non-voting Class C stock. However, the company wasn't as successful. Due to various other reasons, including the possibility that the company was insufficiently diligent in policing against foreign (especially Russian) influences in the 2016 US Presidential election (by allowing the creation of Facebook pages and circulating untrue or unreliable news). Facebook ultimately dropped its plan to issue non-voting Class C. *See generally* Consolidated Verified Class Action Compl., Facebook Class C Reclassification (June 6, 2016) (discussing Facebook's plan to create a new class of stock, which plaintiffs characterized as a "self-interested transaction" on Zuckerberg's part). In 2015, NRG Yield, Inc. created two new classes of low-voting stock (Class C and Class D Common, both with 1/100 of one vote per share) and executed a stock split of its existing two classes of stock (Class A and Class B Common). Under the proposal, each share of Class A was to split into one share of Class A and one share of Class C, and each share of Class B were to split into one share of Class B and one share of Class D. While both Class A and Class B stock had one vote per share, all of Class B stock were held by NRG and gave NRG control over NRG Yield. Certain Class A stockholders brought suit and argued that the creation of two new classes of very-low-vote stock was a conflicted transaction and gave NRG a "unique benefit" of being able to retain its perpetual control over NRG Yield. When the defendant (NRG) moved to dismiss the claim, the Delaware Chancery Court, after accepting plaintiffs' all factual allegations as true, granted the motion. According to the Court, while the creation and stock split allowed NRG to receive "something uniquely valuable" as a controlling shareholder, thereby rendering it a conflicted transaction, NRG's use of independent negotiating committee (named the Conflicts Committee) and subjecting the proposal to the majority of the minority consent condition cleansed the conflicts issue, thereby subjecting the transaction to deferential business judgment review under MFW Global. *See generally* IRA Tr. FBO Bobbie Ahmed v. Crane, No. 12742–CB, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017).

123. *See* Google Verified Compl., *supra* note 15, at 1–2.

124. For detailed terms of the settlement agreement approved by the Delaware Court of Chancery, see Google Inc., Short Form Registration Statement (Form 8-A), 5. (March 26, 2014). Google's reclassification resulted in a settlement, valued at $522 million. *See* United Food and Commercial Workers Union v. Zuckerberg, 250 A. 3d 862, 870 (Del. Ch. 2020); Reuters Staff, *Google Settles Class Action Lawsuit over New Class C Stock*, REUTERS (June 17, 2013, 10:15 AM), https://www.reuters.com/article/google-stockplan-settlement/google-settles-class-action-lawsuit-over-new-class-c-stock-idUSL2NoETOIO20130617 [https://perma.cc/Z7YU-JKQT].

it exemplifies how a stock dividend involving a newly created class stock can be used to impact a company's governance structure.[125]

It is worth noting that another way to challenge this type of stock dividend would be to tackle the definition of pro rata distribution.[126] Even though all stockholders received the identical new class of stock as a dividend, the impact was unequal. The high-vote class stockholders maintained their majority voting control, and the low-vote class stockholders permanently lost their influence in the company's voting. Then-Delaware Supreme Court Chief Justice pointed out this issue during the settlement hearing for the case:

> What you're telling me now, though, that the principal economic benefit of this is to provide price support for these C shares which nobody in the class actually wanted, or very few people; right? . . . And that rather than the founders funding any of it or even the transactional cost of negotiating this thing, it's *essentially everybody treated pro rata, except it's not really pro rata,* because the only ones who actually get something different than they already have out of it are the founders whose ability to retain voting control in the future is perpetuated.[127]

As the excerpt above depicts, the definition of "pro rata" stock dividend is uncertain even when a company distributes an identical new class of stock. In *Williams v. Geier,* with respect to a charter amendment to adopt a tenure voting system, which is another way to classify the common stock into more than one class by giving more voting rights to loyal shareholders who owned the stock longer,[128] the courts upheld the tenure voting even though the system

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125. The central question here is whether a shareholder can challenge prospective entrenchment. Although Google's founders admitted their intention of executing a stock dividend, their insulation was a potential risk and not yet realized at the time of distribution. This separation between the pro rata distribution and its potentially harmful future effects is similar to the adoption of a poison pill, in that the board's decision to distribute a dividend payment creates future risks that might be too remote to be challenged. *See* Google Verified Compl., *supra* note 15, at 2. ("The Founders have openly admitted that the Class C issuance will (and is intended to) entrench them in power, and insulate from having to pay attention to the views of the shareholders who own the vast majority of shareholder equity."); The low-vote class stockholders argued that "this ploy will harm Plaintiff and the class by further distancing them from Google's corporate governance and leaving them without meaningful voice on important issues that the Company will face in coming years." *Id.* at 14.

126. *See infra* Section III.B.2.

127. Settlement Hearing Transcript at 15–16, In re Google Class C Shareholder Litigation (Del. Ch. 2013) (No. 7469-CS), 2013 WL 6735045 (emphasis added).

128. Williams v. Geier, 671 A.2d. 1368, 1370 (Del. 1996). The Delaware Supreme Court upheld a charter amendment to adopt "tenure voting," which is approved by the controlling shareholders. The new charter provision grants 10 votes per stock to the existing shareholders on the record date, and whenever the stock is transferred to new owners, the voting rights attached to the stock reduces to one vote per stock. That inevitably favors the controlling shareholders over outside investors who will receive one vote per share. The court applied the business judgment rule to the charter amendment because the tenure voting system's

conferred a disproportionate advantage to the majority shareholders in practice.[129] The court implied that an unequal *effect* without an upfront unequal *treatment* can still be fair.[130] However, in the Google case, the disproportionate effect on voting rights was a primary purpose of the board action, rather than merely incidental.[131] In that sense, stock dividends that were specifically planned for the governance change that disproportionately favors one class over the other class should not be a business decision, nor a pro rata distribution.

In dual-class stock companies, the validity of shareholder approval for charter amendments can also be questioned.[132] Oftentimes, controlling shareholders wield a majority voting power, and a charter amendment that favors the controlling shareholders will pass when the controlling shareholders are allowed to vote.[133] Hence, even when a dual-class company has a charter provision on stock dividends, separate class voting to approve each stock dividend will be useful and necessary to prevent unequal impact on classes.[134]

B. EMPIRICAL ANALYSIS OF CHARTER PROVISIONS ON STOCK DIVIDENDS

As discussed above, directors have ample discretion in making dividends, but the discretion is not unlimited. Both the Delaware law and the Model Business Corporation Act stipulate that the board's discretion to make dividends is subject to the restrictions in corporate charters.[135] In that light, a corporate charter is the main source of restricting the board's discretion, and this Section presents the original hand-collected data of 237 dual-class

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disproportional advantage to one class (i.e., the long-term investors) is the "incidental effect" rather than the primary purpose of the system. *Id.* at 1373 n.10.

129. *Id.* at 1384.

130. *See* James D. Cox, *Equal Treatment for Shareholders: An Essay*, 19 CARDOZO L. REV. 615, 619–20 (1997). (The court "reasoned that self-dealing was not implicated by a transaction which was not disproportionate on its face, even though its effects over time would give rise to disparate results between minority and majority stockholders.").

131. *See* Google Verified Compl., *supra* note 15, at 2.

132. *See* DEL. CODE ANN. tit. 8, § 242 (b)(1) (2021). But the compliance with the technical mandates of the statute does not necessarily fulfill boards' fiduciary duties because "inequitable action does not become permissible because it is legally possible." *See* Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437, 439 (Del. 1971); Williams 671 A.2d. at 1387.

133. *Id.*

134. Companies increasingly adopt class voting requirements for stock dividends in their corporate charters. *See infra* Section III.B.2.

135. *See* DEL. CODE ANN. tit. 8, § 170 (a) ("The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares."); MODEL BUS. CORP. ACT ANN. § 6.40(a) (AM. BAR ASS'N 4th ed., 2013) ("A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection [§ 6.40](c).").

companies' charter provisions on stock dividends to describe how companies attempt to circumscribe boards' discretion on cross-class stock dividends.[136]

1. Overview of Charter Provisions on Stock Dividends

The reallocation of voting rights is quite meaningful in dual-class companies, where a company has multiple classes of stock with unequal voting rights. This Article examines the 237 dual-class companies listed on the Council of Institutional Investors' Dual Class Companies List, which was published in March 2021.[137] The list covers all "US-incorporated companies [that] have at least $200 million in market capitalization, at least two outstanding classes of common stock, and unequal voting rights that create a wedge between ownership and voting interests."[138] Corporate charters for the 237 companies were hand-collected from the companies' annual report (Form 10-K) filed with the U.S. Securities and Exchange Commission ("SEC").[139] The analysis shows that the charter provisions on stock dividends are highly customized and vary substantially across companies. It may reflect the companies' acknowledgment of the power of stock dividends as a corporate governance weapon. The following is a brief description of the sample companies.

State of Incorporation: The sample companies are incorporated in 24 different states, and the top five states of incorporation are: Delaware (173 companies, 73 percent of the sample companies), Maryland & New York (eight companies, 3.38 percent respectively), Nevada (7 companies, 2.95 percent), and Pennsylvania & Wisconsin (5 companies, 2.11 percent respectively).[140]

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136. As of August 15, 2021, 40 companies were excluded from the entire 277 dual-class companies on the 2021 CII list because of their recent status changes including merger, going private transaction, collapse of dual-class, delisting, bankruptcy, etc.

137. As of this publishing, the March 2021 list is the most up-to-date version. *See generally* COUNCIL OF INSTITUTIONAL INVS., *supra* note 3.

138. *Id.* The list was constructed based on the SEC filings, meaning that the companies are public companies. As the list covers all U.S. public dual-class companies above a certain market capitalization threshold, the sample companies were systematically selected. For each class with voting rights, the wedge represents the gap between the class's percentage of total voting rights and the class's percentage of total outstanding equity. *Id.* A recent study finds that the founders' wedge gets bigger as their bargaining power at the state of IPO grows. *See* Dhruv Aggarwal, Ofer Eldar, Yael V. Hochberg, & Lubomir P. Litov, *The Rise of Dual-Class Stock IPOs*, 39–40 (Nat'l Bureau of Econ. Rsch., Working Paper No. 28609, 2021).

139. The SEC EDGAR is the source to collect e-filings of the companies. *EDGAR Company Filings*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/edgar/searchedgar/companysearch.html [https://perma.cc/JFE7-A4VW]. Corporate charters are located under Exhibit 3.1.

140. *See generally* COUNCIL OF INSTITUTIONAL INVS., *supra* note 3 (listing the companies that were analyzed); *EDGAR Company Filings*, *supra* note 139 (providing the 10-Ks that list the states of incorporation for the companies). The other states include Georgia (3 companies), Indiana (3), Massachusetts (3), Ohio (3), Florida (2), North Carolina (2), New Jersey (2), Ohio (2), Oregon (2), Washington (2), Colorado (1), Kansas (1), Kentucky (1), Michigan (1), Montana (1), Nebraska (1), Texas (1), and Virginia (1). *Id.*

Years since IPO: The years since their IPO indicates how long the company's stock has been trading on an exchange. It ranges from zero years since IPO (IPO in 2021) to 102 years (IPO in 1919).[141] The average number of years since a company's IPO is 18 years, and the median is 14 years. It means that about half of the companies went public in or after 2008. Companies around 20 years since IPO indicate the IPO boom between 1995-1999 (often called the "dotcom" or "tech" bubble), which makes up about 15 percent of the entire sample.[142]

Super-class Voting Control: The primary purpose of a dual-class stock is to make controlling shareholders exercise more voting control than their equity interest in the company. Super-class voting control shows the fraction of total voting power held by the high-vote class.[143] Notably, in 85.65 percent of the companies, the high-vote class occupies the majority voting control. In companies where only one class of stock carries voting rights, holders of voting class stock exercise 100 percent of voting control. In the sample companies, 29 companies (12.24 percent) have such voting vs. non-voting class of stock.[144]

Based on the internal affairs doctrine,[145] each company's internal affairs, including voting rights, dividend payments, and fiduciary duties, are governed by the law of the state of incorporation.[146] As the U.S. state corporate laws have a fairly small number of mandatory provisions and are mostly comprised of default provisions,[147] any company has abundant contractual freedom to customize its own corporate contract.[148] Nevertheless, some companies do not

141. *See* COUNCIL OF INSTITUTIONAL INVS., *supra* note 3. One company (Affirm Holdings) on the list went public in 2021. Coca-Cola Bottling went public in 1919. The next oldest company on the market from the sample is Ford Motor that went public in 1956. *Id.*

142. *Id.*

143. Super-class control of vote is calculated by (number of shares of high-vote stock * number of voting rights per share of high-vote stock) / [(number of shares of high-vote stock * number of voting rights per share for high-vote stock) + (number of shares of low-vote stock * number of voting rights per share of low-vote stock)].

144. *See* COUNCIL OF INSTITUTIONAL INVS., *supra* note 3.

145. The internal affairs doctrine is a principle that "recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands." Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

146. *Id.* at 644–45.

147. Delaware, the most dominant state of incorporation for companies, has a minimal number of mandatory statutory provisions. *See* e.g., Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOK. L. REV. 1637, 1671 (2016); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 674 (2005) ("[T]he Delaware approach to corporate law keeps statutory mandates to a minimum. And even some of the mandatory terms are subject to being overridden through charter and bylaw provisions.").

148. *See e.g.*, Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CAL. L. REV. 373, 379 (2018); Albert H. Choi & Geeyoung Min, *Contractarian Theory and Unilateral*

exercise contractual freedom and fill their corporate charters only with a minimal number of provisions (e.g., only the provisions that are required or mandated under the state corporate law).[149] When the charter is silent on an issue, state statutory law fills the silence using default law.[150]

The 237 corporate charter provisions on stock dividends vary substantially across companies. This may be partly because Delaware, the state of incorporation for 73 percent of the sample companies, does not have any statutory provision for the companies to use as a model on the issue.[151] Nevertheless, it is puzzling why all dual-class companies have charter provisions on stock dividends in the first place. As dual-class companies, they are likely to have a better understanding of the power of voting stock and to appreciate the need for a charter provision on stock dividends. The purpose of these charter provisions seems to be different from other charter provisions because, while some favor the high-vote class stockholders, others disfavor them. It is a vivid counterexample to those other charter provisions that rely largely on state default law,[152] or that share boilerplate language across companies.[153] The existence and customization of a charter provision on stock dividends imply that dual-class companies are aware of the potential impact of stock dividends on corporate voting. But the current level of customization may make the provisions too costly to evaluate or interpret by

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Bylaw Amendments, 104 IOWA L. REV. 1, 11–13 (2018); Megan Wischmeier Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, 60 WM. & MARY L. REV. 985, 993–95 (2019).

149. For instance, Delaware state law lists six mandatory charter provisions: "(1) [t]he name of the corporation . . . ; (2) [t]he address . . . of the corporation's registered office;" (3) the nature or purposes of the business; (4) the total number of stock; "(5) [t]he name and mailing address of the incorporator;" and (6) "the names and mailing addresses of . . . directors until the first annual [shareholder] meeting." DEL. CODE ANN. tit. 8, § 102(a) (2021).

150. Accordingly, two similarly "empty" corporate charters can be substantially different from each other if their states of incorporation offer substantially different sets of default law provisions. Due to these unique characteristics, to fully understand the meaning of each company's charter, its state default law should be considered at the same time. *See, e.g.*, Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1340–46 (2013); Scott Hirst, *Frozen Charters*, 34 YALE. J. ON REG. 91, 132 (2017).

151. *Supra* note 140 and accompanying text; DEL. CODE ANN. tit. 8, §§ 170(a), 173.

152. For the benefit of network externalities associated with sharing the similar corporate contract terms with other companies, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774–825 (1995); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 734 (1997). For the benefit of emptying a charter and taking advantage of state law amendments, see Henry Hansmann, *Corporation and Contract*, 8 AM. L. ECON. REV. 1, 9–10 (2006).

153. It is worth noting that the practice of sharing boilerplate charter provisions does not mean that many companies have the same cookie-cutter corporate charters. Each company variously selects which issue should be addressed in its charter, and once the company decides to include a charter provision, the company tends to use the boilerplate provision for the issue. Thus, while each provision looks similar, a corporate charter can vary greatly depending on how those provisions are combined.

shareholders, other market participants, and the courts. A certain level of guidance for companies by state corporate laws may reduce these costs.[154]

As discussed, current statutory and case law has not kept up with the recent developments in the corporate practice of changing control with stock dividends,[155] which makes each company's corporate charter the most authoritative governing document on stock dividends. The next Subsection focuses on how charter provisions address the central question of what constitutes a pro rata distribution.

2. Definition of Pro Rata Distribution

The *Sinclair* court distinguished pro rata dividends from self-dealings that trigger a more stringent judicial scrutiny.[156] According to the *Sinclair* court, as long as there was proportional distribution, and without evidence of self-dealing, the court does not second-guess the dividend in respect of the business decision.[157] Thus, whether a dividend is proportional determines applicable judicial scrutiny and the outcome of the litigation.[158] But what is a pro rata distribution? The answer to this central question is relatively straightforward in cash dividends like in *Sinclair*. When all shareholders receive the same type of property (e.g., cash), so long as the amount of dividend is proportional to the number of shares each shareholder owns, the dividend is deemed pro rata. However, when it comes to stock dividends in dual-class stock companies, a new question arises: Does a pro rata distribution require payment in the *same type* of stock? If so, should the type of stock be the same to all classes, or be corresponding to each class's stock?

Some companies articulate a more precise definition of pro rata stock distribution in their charters. The amount, form, and timing are three main factors the companies emphasize in defining pro rata dividends paid in stock. For instance, Albany International Corporation defines "Pro Rata Distribution" as follows:

> [S]uch a distribution of Class A Common Stock to be deemed proportionate hereunder if the number of shares of Class A Common Stock distributed with respect to each share of Class A Common Stock equals the number of shares of Class B Common Stock distributed with respect to each share of Class B Common

154. For the details of a proposal to legislators, see *infra* Section IV.A.

155. *See supra* Section II.A. & B.

156. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971).

157. *Id.* at 722.

158. *See Id.* at 721–22 ("[A] proportionate share of this money was received by the minority shareholders of Sinven. . . . As such, these dividends were not self-dealing. . . . The business judgment standard should have been applied.").

> Stock; such concurrent, proportionate distributions are hereinafter collectively referred to as a "Pro Rata Distribution."[159]

Such definition of pro rata stock distribution may reduce the uncertainty surrounding stock dividends, because it may exclude the application of business judgment rule to cross-class stock dividends that may affect voting control.

3. Board's Discretion on Cross-Class Stock Dividends

While the Delaware General Corporation Law has no specific statutory provision on stock dividends, Section 6.23 of the Model Business Corporation Act addresses a unique set of issues of cross-class distribution, as follows.

> (a) Unless the articles of incorporation provide otherwise, shares may be issued *pro rata* and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend.
>
> (b) Shares of one class or series may not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of incorporation so authorize, (2) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued.[160]

Section 6.23(a) allows a pro rata stock distribution as a default, but Section 6.23(b) prohibits a company from making a cross-class stock dividend unless one of the above conditions is satisfied. Suppose a company has two classes of common stock: Class A common stock and Class B common stock. If the company wants to distribute Class A stock to Class B stockholders as a stock dividend, there must either be an express granting provision in the charter, or the dividend must be approved by Class A stockholders.[161] The Model Business Corporation Act seems to recognize that cross-class stock dividends may dilute other class stockholders' voting power. Forty states have adopted identical state law provisions on cross-class stock dividends.[162] Although 80 percent of state corporate statutes have a default provision that constrains board discretion in stock dividends, only 22.36 percent of the sample dual-class companies are incorporated in those states. Thus, still 77.64 percent of sample companies (including Delaware companies) do not have a state default law provision on stock dividends to fill the gap in their corporate charters.

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159. ALBANY INT'L CORP., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION, art. IV, § 3(a)(iv).

160. MODEL BUS. CORP. ACT § 6.23 (AM. BAR ASS'N 4th ed., 2013) (emphasis added).

161. *Id.* § 6.23 (b).

162. *See* tbl. 4.

Table 4. State Default Laws on Cross-Class Stock Dividends

State Law on Cross-Class Stock Dividends	Number of States	Name of States	Number and Ratio of Sample Companies incorporated in these States
Either (1) allowed in charter provision, or (2) approved by shareholders of the class to be issued. (identical to the Model Business Corporation Act Section 6.23(b))	40	Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming[163]	53 (22.36%)
Silent	10	California, **Delaware**, Kansas, Louisiana, Missouri, Ohio, Oklahoma, Pennsylvania, Puerto Rico, and Texas[164]	184 (77.64%)

The companies are also vigilant on the issue of cross-class stock dividends. Out of 237 companies, 42 companies do not have a charter provision that specifically addresses cross-class stock dividends. As state default law fills the

163. ALA. CODE § 10A-2A-6.23 (2020); ALASKA STAT. § 10.06.373 (2020); ARIZ. REV. STAT. ANN. § 10-623 (2021); ARK. CODE ANN. § 4-27-623 (2019); COLO REV. STAT. § 7-106-204 (2021); CONN. GEN. STAT. § 33-674 (2021); D.C. CODE ANN. § 29-304.23 (2021); FLA. STAT. § 607.0623 (2020); GA. CODE ANN. § 14-2-623 (2021); HAW. REV. STAT. § 414-84 (2021); IDAHO CODE § 30-29-623 (2021); 805 ILL. COMP. STAT. 5/6.25 (2021); IND. CODE ANN. § 23-1-26-4 (West 2021); IOWA CODE § 490.623 (2020); KY. REV. STAT. ANN. § 271B.6-230 (West 2021); ME. STAT. TIT. 13-C, § 624 (2020); MD. CODE ANN., CORPS. & ASS'NS § 2-309 (West 2019); MASS. GEN. LAWS Ch. 156D, § 6.23 (2020); MICH. COMP. LAWS § 450.1341A (2021); MINN. STAT. § 302A.402 (2020); MISS. CODE ANN. § 79-4-6.23 (2021); MONT. CODE ANN. § 35-14-623 (2019); NEB. REV. STAT. § 21-244 (2014); NEV. REV. STAT. § 78.215 (2021); N.H. REV. STAT. ANN. § 293-A:6.23 (2021); N.J. REV. STAT. § 14A:7-15.1 (2021); N.M. STAT. ANN. § 53-11-18 (2021); N.Y. BUS. CORP. LAW § 511 (McKinney 2021); N.C. GEN. STAT. ANN. § 55-6-23 (2021); N.D. CENT. CODE § 10-19.1-61.1 (2021); OR. REV. STAT. ANN. § 60.154 (West 2021); 7 R.I. GEN. LAWS § 7-1.2-614(B) (2006); S.C. CODE ANN. § 33-6-230 (2020); S.D. CODIFIED LAWS § 47-1A-623 (2021); TENN. CODE ANN. § 48-16-204 (2020); UTAH CODE ANN. § 16-10A-623 (West 2021); VT. STAT. ANN. tit. 11A, § 6.23 (West 2021); VA. CODE ANN. § 13.1-645 (2019); WASH. REV. CODE § 23B.06.230 (2020); W. VA. CODE § 31D-6-623 (2020); WIS. STAT. § 180.0623 (2021); WYO. STAT. ANN. § 17-16-623 (2021).

164. CAL. CORP. CODE § 409 (West 2021); DEL. CODE ANN. tit. 8, § 173 (2021); KAN. STAT. ANN. § 17-6423 (2020); LA. STAT. ANN. § 12:1-623 (2020); MO. REV. STAT. § 351.185 (2020); OHIO REV. CODE ANN. § 1701.18 (West 2020); OKLA. STAT. ANN. tit. 18, § 1052 (West 2021); 31 PA. CONS. STAT. § 103.15 (2021); 14 P.R. LEYES AN. tit. 14, § 3598 (2021); TEX. BUS. ORGS. CODE ANN. art. 2, § 21.311 (West 2021).

silence, only 26 companies incorporated in states with no default provisions remain silent on cross-class stock dividends.[165] Accordingly, 211 companies (89.03 percent) have a charter provision or state default law that addresses cross-class stock distributions.[166] These charter provisions can be categorized into six groups based on the level of board discretion they allow.

Board Discretion Level 0 [Ban Cross-Class Stock Dividends] 121 companies from the sample companies (51.05 percent) expressly and absolutely ban cross-class stock dividends. In this case, the board's discretion to reallocate voting control is significantly reduced. The provisions use different language, but the simplest form of the provision is as follows:

> In the case of any such dividend or distribution payable in shares of Class A Common Stock or Class B Common Stock, each class of Common Stock shall receive a dividend or distribution *in shares of its class* of Common Stock and the number of shares of each class of Common Stock payable per share of such class of Common Stock shall be equal in number.[167]

Board Discretion Level 1 [Ban Cross-Class Stock Dividends without Class Vote] 43 companies (18.14 percent) have provisions that restrict boards' rights to pay cross-stock dividends, but with an exception: advance shareholder approval by a separate class voting. After a paragraph that bans boards' issuance of cross-stock dividends, a paragraph as below follows:

> Notwithstanding the foregoing, the Board of Directors may pay . . . a disparate dividend or distribution per share of Class A Common Stock or Class B Common Stock (whether in the *amount* of such dividend or distribution payable per share, the *form* in which such dividend or distribution is payable, the *timing* of the payment, or otherwise) if such disparate dividend or distribution is *approved in advance by* the affirmative vote of the holders of a majority of the outstanding shares of Class A Common Stock and Class B Common Stock, *each voting separately as a class.*[168]

As discussed in the next Section, a separate class voting can be an effective monitoring mechanism for cross-stock dividends.[169] In the sense that boards remain as the primary decision-makers in designing stock dividends, and shareholders evaluate the governance impact of stock dividends on each class of stock via a separate class voting, this type of charter provision balances the

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165. All but two (incorporated in Pennsylvania and Kansas respectively) of these companies are incorporated in Delaware.

166. *See EDGAR Company Filings*, *supra* note 139.

167. CHARTER COMMC'NS, INC., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION 4, art. IV, § C.1.b (2016) (emphasis added).

168. PELOTON INTERACTIVE, INC., RESTATED CERTIFICATE OF INCORPORATION 3–4, art. 4.3 (2019) (emphasis added).

169. *See infra* Section III.B.4.

flexibility of business decisions and the monitoring function of governance decisions.

Board Discretion Level 2 [Ban High-Vote to Low-Vote Cross-Class Stock Dividends] 22 companies (9.28 percent) have a charter provision that restricts cross-class stock dividends, but only in one direction: Low-vote class stockholders cannot receive high-vote class stock as a dividend, but high-vote class stockholders can receive low-vote class stock. In this case, the board has some discretion in cross-class stock dividends but not as much discretion to (potentially significantly) dilute high-vote class stockholders' voting power.[170] Molson Coors Brewing Company's provision is exemplary:

> Dividends payable in Common Stock to the holders of Class A Common Stock may be made in . . . Class A Common Stock *or* in . . . Class B Common Stock, as the Board of Directors determines. Dividends payable in Common Stock to the holders of Class B Common Stock may be made *only* in . . . Class B Common Stock.[171]

Board Discretion Level 3 [No Charter Provision on Cross-Class Stock Dividends] As discussed earlier, when the charter is silent on certain issues, state default laws can fill the gap.[172] Even after reflecting state default laws on stock dividends, 26 companies do not have any default laws to rely on. Delaware General Corporation Law does not offer a default provision on cross-class stock dividend. For those companies, cross-class stock dividends by a board are not subject to any contractual restrictions on the charter, and board discretion is subject only to its fiduciary obligations. Thus, it is obscure if the board can make cross-class stock dividends ex ante.

Board Discretion Level 4 [Allow Cross-Class Stock Dividends in Both Ways Between High Vote and Low Vote] In 17 companies (7.17 percent), the corporate charter expressly gives boards the discretion to make a cross-class stock dividend in either direction. Here, low-vote class stockholders can receive high-vote class stock as a dividend. Because this level of board discretion can dilute the voting power only by a board resolution, at least in theory, the dilution can happen overnight. The board discretion in these companies seems to be at the maximum level, but the provision sets the right to the cross-dividends of the existing class of stock only. In that sense, the board discretion here is not as flexible and versatile as in Level 5. Coca-Cola Bottling has dual-class stock, and Class A Common Stock carries one vote per stock while Class B Common Stock carries 20 votes per stock.[173]

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170. *See supra* Section III.A.1.

171. ADOLPH COORS CO., RESTATED CERTIFICATE OF INCORPORATION G-4, art. IV, § (b)(8) (2003) (emphasis added).

172. *See supra* note 150 and accompanying text.

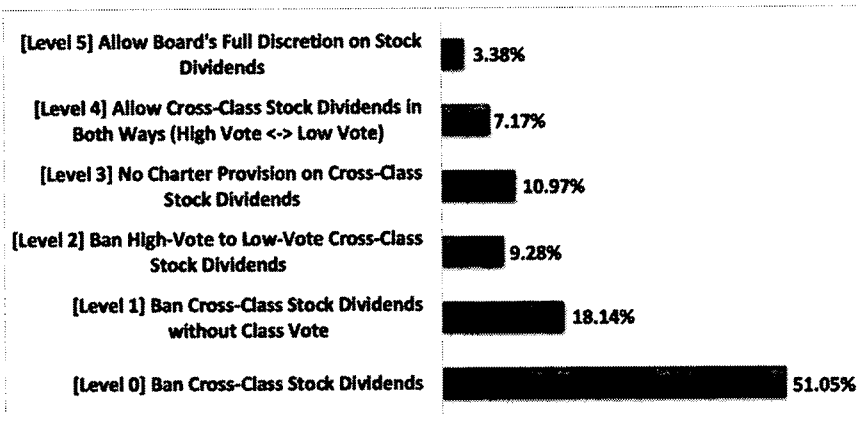
173. COCA-COLA BOTTLING CO., RESTATED CERTIFICATE OF INCORPORATION (3) (May 7, 2003).

> (iii) A dividend of shares of Common Stock may be paid to . . . Common Stock only or to . . . both Common Stock and Class B Common Stock if the number of shares paid per share . . . shall be the same; a dividend of shares of Class B Common Stock may be paid to . . . Common Stock only or to . . . both Common Stock and Class B Common Stock if the number of Shares paid per share . . . shall be the same.[174]

Board Discretion Level 5 [Allow Board's Full Discretion on Stock Dividends] Board discretion maximizes when a charter provision expressly allows cross-class stock dividends. Snap Inc. is one of ten companies that have this type of provision. Here, eight charter provisions (3.38 percent) not only permit but also justify the board's cross-class stock dividends, even if such a dividend may be in violation of the other parts of the charter.

> [I]n the event of a stock split or stock dividend, . . . Class A Common Stock shall receive . . . Class A Common Stock and . . . Class B Common Stock shall receive shares of Class B Common Stock, *unless otherwise specifically designated by resolution of the Board of Directors.*[175]

Figure 1. Board Discretion Level in Corporate Charters on Stock Dividends



The variety of charter provisions demonstrates that companies have different views and needs on cross-class stock dividends, and they proactively exercise the contractual freedom to design charter provisions suitable to their needs.[176] The variety itself is not problematic, and this Article does not intend

174. *Id.*

175. BERKSHIRE HATHAWAY INC., RESTATED CERTIFICATE OF INCORPORATION AS AMENDED (30–31) (Jan. 20, 2010) (emphasis added).

176. *See supra* note 148 and accompanying text.

to discourage the use of cross-class stock dividends. Rather, this Article argues that boards' unilateral cross-class stock dividends are not "pro rata" dividends and thus should not be subject to the deferential business judgment review unless shareholders approve them in advance. The following Section discusses why separate class voting is a more effective approval mechanism for cross-class stock dividends.

4. Approval by Class Vote

The class vote requirement by *every* class has been prevalent among companies that have gone public recently, in a more standardized form. Half of such class vote requirements are adopted by the companies that went public in or after 2017.[177] The standardized terms are different from the Model Business Corporation Act section 6.23(b), which requires a class vote only from the "class or series to be issued."[178] More than 90 percent of the class vote requirements in my sample corporate charters demand a separate class vote from *each* class for cross-class stock dividends. This version of the class vote requirement seems clearer in its application because it is not always easy to identify which class will be adversely affected by stock dividends. In companies with the standardized class vote requirement, any cross-class stock dividend will trigger class votes from each class without identifying the adverse effect of stock dividends.

In dual-class companies, it is common for most of the voting power to be controlled by the high-vote class. Indeed, in 203 of the sample companies (85.65 percent), the high-vote class controls more than 50 percent of the voting power. In those companies, without a separate class vote, any voting agenda up for shareholder voting will always go in favor of the controlling shareholders. This makes the legal effect of shareholder approval voted by all classes together as a single class questionable. Even if a shareholder agrees on the initial arrangement of a dual-class stock company by investing in the company, it does not mean that she agrees on any further changes from the initial agreement.[179] Also, when cross-class stock dividends significantly dilute the voting power of one class, the diluted class may permanently lose its voice in the company. Thus, the approval of all shareholders as one class should not be used to effectuate disproportionate cross-class stock dividends. At least in Delaware, when express conflicts of interest are present, the case law has

177. The provision was adopted by more than 80 percent of the sample companies that went public in or after 2013. *EDGAR Company Filings*, *supra* note 139.

178. MODEL BUS. CORP. ACT § 6.23(b) (AM. BAR ASS'N 4th ed., 2013).

179. *See Idiosyncratic Vision*, *supra* note 4, at 608–09 ("Controlling shareholders could theoretically enjoy more than their pro rata share of the business by using their control to change the firms' governance arrangements midstream either directly through changes in the charter and/or bylaws or indirectly through some business combination, such as a merger. These changes could be inconsistent with the initial contract between the entrepreneur and investors underlying the concentrated-ownership structure.").

developed the majority of the minority condition in the context of shareholder voting, so that the minority shareholders can decide on the issue without any interference from the controlling shareholder.[180] Similarly, in cases where a company has multiple classes of stock outstanding, dividends paid with stock substantially raise the possibility of benefiting one class over another. In these situations, a separate class vote from each class of common stock might be a better guard against boards' or controlling shareholders' entrenchment.[181]

Forty-three out of the 237 sample companies (18.14 percent) have a charter provision necessitating a class voting requirement for disparate stock dividends. Twenty-five companies out of the 43 companies (58.13 percent) are incorporated in Delaware [182] and the class voting requirement is commonly combined with a general ban of cross-class stock dividends.[183] A typical charter provision on class voting states the following:

> [H]olders of Class A Common Stock shall receive shares of Class A Common Stock . . . and holders of Class B Common Stock shall receive shares of Class B Common Stock . . . on a per share basis . . . Notwithstanding the foregoing, the Board of Directors may pay . . . a disparate dividend . . . if such disparate dividend . . . is approved *in advance* by . . . the holders of a majority of the outstanding shares of Class A Common Stock and Class B Common Stock, *each voting separately as a class.*[184]

By implementing the class vote requirement in the corporate charter, each class of shareholders can effectively guard against entrenching stock dividends, and companies can reduce the cost potentially incurred by such

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180. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014).

181. For public companies, additional shareholder approval for stock dividend is required by the major stock exchanges. The NYSE Listed Company Manual 312.03 stipulates that "(c) Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if: (1) the common stock has, or will have upon issuance, voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock . . . or (2) the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20 percent of the number of shares of common stock outstanding before the issuance of the common stock . . . (d) Shareholder approval is required prior to an issuance that will result in a change of control of the issuer." NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 312.03.

182. The remaining 18 companies are incorporated in Georgia (1), Massachusetts (2), Maryland (3), Nebraska (1), New Jersey (1), Nevada (3), New York (3), Pennsylvania (1), Washington (1), and Wisconsin (2). *See EDGAR Company Filings*, *supra* note 139.

183. The other class voting requirements are with the board's absolute discretion provision on cross-class stock dividends in violation of any other charter provision on the issue (Board Discretion Level 5). Thus, none of these class-voting requirements affect the count for each categorization in Figure 1.

184. FACEBOOK, INC., RESTATED CERTIFICATE OF INCORPORATION (2–3) (July 29, 2004) (emphasis added).

governance-changing dividends.[185] Some might argue that the class vote requirement would make the dividend process too costly and cumbersome, possibly preventing the corporation from the issuance of beneficial dividends. While this may be true, it becomes a matter of balance between the benefits of preventing dividends that could undermine governance arrangements and the cost of disallowing dividends that are beneficial to the company. If a company's charter provision on the class vote precisely specifies its contours, the cost can be substantially reduced while preserving each class stockholders' interests.

IV. LEGAL IMPLICATIONS

Based on the legal uncertainties about cross-class stock dividends discussed in Parts II and III, this Part advances normative proposals for state legislators and courts. As an ex ante mechanism, Section A emphasizes the role of state corporate laws in helping each company design its own corporate charter. As an ex post remedy, Section B argues for an enhanced judicial scrutiny over cross-class stock dividends that do not receive the approval of a separate class vote.

A. *EX ANTE MECHANISMS*

State corporate laws largely delegate the right to declare and pay dividends to directors, but also allow shareholders to monitor dividends by imposing restrictions on boards' discretion in corporate charters.[186] Each company can set the degree of the board's discretion in declaring and paying dividends through its corporate charter and customize a dividend policy to reflect the company's unique circumstances.

1. Corporate Charters as Mutual Agreements

A company's charter and bylaws largely determine the extent to which management can influence corporate governance arrangements. Given that state corporate laws consist mostly of default rules, companies are able to customize their governing documents to more expressly and effectively allocate power and assign responsibilities between management and

185. *See* MODEL BUS. CORP. ACT ANN. § 6.23(b) OFFICIAL COMMENT (AM. BAR ASS'N 4th ed., 2013) ("Share dividends may create problems when a corporation has more than a single class of shares. The requirement that a share dividend be 'pro rata' only applies to shares of the same class or series; if there are two or more classes entitled to receive a share dividend in different proportions, the dividend will have to be allocated appropriately.").

186. *See* DEL. CODE ANN. tit. 8, § 170 (2021) ("The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares . . . ."); MODEL BUS. CORP. ACT ANN. § 6.40(a) ("A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection [§ 6.40](c).").

shareholders.[187] State corporate laws make a distinction between charters and bylaws,[188] and most state laws on dividends stipulate that companies can deviate from state default rules only through the charter.[189] Charter amendments require express shareholder approval, and the board has the exclusive power to propose an amendment.[190] In that sense, each company's charter provision on stock dividends reflects an initial *mutual agreement* between its directors and shareholders.[191]

Companies can avoid or reduce costly disputes by shaping their charter to determine the validity of a specific dividend. As illustrated above, charter provisions on stock dividends vary significantly across companies. Those nonstandard terms in a company's charter can be costly because they may be subject to a large amount of uncertainty with respect to judicial interpretation. The standardization of charter provisions has only started recently, partly due to the rise of dual-class stock companies.[192] Notably, all 237 sample companies have adopted customized charter provisions on stock dividends and on dividends more generally, as if the companies acknowledge the potential power of stock dividends on a dual-class company's governance arrangement. Those charter provisions determine whether the holders of different classes of stock have the same or different rights to dividends. Voting and dividend rights tend to differ between preferred stock and common stock, but the variation of dividend rights across different classes of common stock is unusual.

Despite the prevalent charter provisions on dividends, there are few court decisions on their interpretations.[193] Questions such as whether a company

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187. For instance, if a company has very powerful management that is insulated from market forces by various anti-takeover and anti-activism mechanisms, shareholder control over management will be relatively weak and their monitoring relatively ineffective. In such a case, it would be much less difficult for management to influence the company's governance structure through business decisions around a stock dividend.

188. The corporate charter is superior to the bylaws as a governing document. If a company's charter provision differs from a state law default provision, the charter provision prevails. By contrast, if a company's bylaw provision is inconsistent with state law default provision, the latter provision prevails.

189. *See supra* note 186.

190. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242.

191. *See Idiosyncratic Vision*, *supra* note 4 at 608–09.

192. *See supra* Section III.B.3.

193. Ambivalent charter provisions present the issue of interpretation under contract law. One possibility is to try to get at the original intent of the drafters. Another possibility is to interpret the provision against the drafter depending on which party drafted text at issue. (i.e. the doctrine of *contra proferentem*, which means "against the offeror" in Latin.). *See* RESTATEMENT (SECOND) OF CONTRACTS § 206 (AM. LAW INST. 1981). Delaware courts have applied the principle of *contra proferentem* to the interpretation of corporate charters and bylaws. *See, e.g.*, Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392, 398–99 (Del. 1996); *see also* Choi & Min, *supra* note 148. But when a company has a controlling shareholder, the company's management is likely to draft charters under the influence of the controlling shareholder, it is not necessarily clear who

can pay a dividend to only one class of stockholders, whether a company can pay different stock to each class of stockholders, or whether there should be an additional shareholder approval when directors distribute stock as dividends, have not been satisfactorily answered.

The CBS case is a great example of how a previously agreed-upon dividend policy can enable management to reshape a company's governance structure according to their interests with a stock dividend.[194] The company's charter provisions on various issues, such as the dual-class stock, written consent, dividends, and bylaw amendments, were worded so as to substantially empower the controlling shareholder, NAI. When CBS was spun off from Viacom in 2005, CBS's new corporate charter was modeled after Viacom's charter, except for three provisions: (1) shareholders' right to act through written consent; (2) the dividend policy; and (3) the corporate opportunity waiver.[195] With respect to the dividend policy, CBS added a provision on stock distribution,[196] which gave the board two options. The first option was to distribute the identical security to both Class A and Class B common stockholders. The second option was to distribute different securities to Class A and Class B common stockholders.[197] NAI likely approved this provision to solidify its voting power. Quite likely, the drafters (i.e., the drafting directors and NAI) intended to rely more on the second option to retain voting control in Class B common stockholders. The first option, by contrast, could possibly have been considered a nominal option. Paradoxically, the CBS board used the first option to drastically dilute NAI's voting power.[198]

At a minimum, concerning the first option, CBS's charter could have expressly defined "identical" more precisely, or restricted the meaning of "securities" to prevent disputes. For instance, the charter could have explicitly stated that the class of stock as a dividend should be "identical to the class of stock that yields the dividend." Another possibility would have been to say that "securities" do not include Class B stock. A third possibility would have been to restrict the directors' discretion, for example, by stipulating that CBS directors' distribution of Class B stock requires the approval of Class B stockholders.

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should be treated as a drafter of the provision in case the management and the controlling shareholders are two parties of the dispute.

194. *See supra* note 2.

195. *See* Viacom Inc., Registration Statement 63–66 (Form S-4) (Oct. 5, 2005).

196. CBS CORP., AMENDED AND RESTATED CERTIFICATE OF INCORPORATION 2 (Form S-4/A) (Nov. 23, 2005) (defining a "share distribution" as "a dividend of any securities of the Corporation [CBS] or of any other corporation, limited liability company, partnership, joint venture, trust or other legal entity" to the CBS shareholders).

197. CBS's charter provision explicitly limits the difference among classes only to the voting rights. *Id.*

198. *See supra* note 5 and accompanying text.

Private ordering refers to "[t]he sharing of regulatory authority with private actors."[199] As public company ownership increasingly falls to more vocal institutional shareholders, companies have begun to customize their corporate governance arrangements through charters and bylaws, rather than simply relying on default provisions in state corporate laws or using cookie-cutter provisions across companies.[200] Since institutional shareholders have significant bargaining power against corporate directors and controlling shareholders, private ordering solutions have become more effective in monitoring potential entrenchment by management or controlling shareholders.[201] A charter provision that more clearly stipulates the rights and limitations of directors' power to pay stock dividends could substantially eliminate potential disputes over governance change through dividends.[202]

2. The Role of State Legislature

One of the most important roles of state corporate law is to provide companies with template provisions (i.e., a "menu").[203] The current corporate charter provisions on stock dividends can benefit from additional degree of standardization. One reason behind these highly customized and sometimes poorly drafted charter provisions is that Delaware corporate statute does not have a default provision on stock dividends. By offering a sample provision on stock dividends, state legislatures could reduce litigation costs associated with poorly drafted charter provisions. State laws could formulate default rules using an opt-out or opt-in format.[204] If the state adopted an opt-out format, the default provision would automatically apply to companies unless they have a charter provision that explicitly rejects the application of (or "opts out" of) the provision. By contrast, if the state adopts an opt-in format, the default provision would not apply to companies unless they explicitly implemented the provision in their charter. An opt-out format would likely be more

199. Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 (2002).

200. For example, another change in CBS charter via the 2005-spin-off eliminated the prior prohibition on shareholder action by written consent, and set the Delaware General Corporation Law § 228 as the default law. This change in private ordering was meant to facilitate the controlling shareholder's action by bypassing shareholder meetings. Absent the right to act by written consent, it would have taken much longer for the NAI to amend CBS's bylaws even with approximately 80 percent of the voting control. *See* DEL. CODE ANN. tit. 8, § 228 (2021) (Consent of Stockholders or members in lieu of meeting).

201. *See* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227, 231 (2018).

202. For the benefit of deferring to controllers and minority shareholders' choice on who should have the power to reallocate control rights, See *Limits of Judicial Review*, supra note 14, at 986-90. "The best approach for corporate law is to (1) allow the parties ex ante to determine who should have the power to reallocate control rights and (2) judicially settle ex post disputes about whether the controller has the power to reallocate these rights without a vote by minority shareholders." Id. 986–87.

203. *Supra* note 22.

204. *Id.*

efficient if we were to assume that most companies would prefer to adopt the state law's default provision (the "majoritarian default") to minimize transaction costs.

State default laws should offer a list of central issues corporate actors need to discuss. To what extent can the board make stock dividends without shareholder approval as a business decision can be one of the fundamental questions in corporate law. After all, such stock dividends can change the initial allocation of voting power without any shareholder intervention. As to this unilateral change in voting control, state corporate laws should address specifically whether: (1) one class of stockholders should be able to receive the other class's stock as a dividend ("cross-class" stock dividends); (2) a new class of stock with no voting rights can be issued; or (3) class vote requirement should be used to protect non-controlling shareholders. Those itemized state corporate laws would facilitate company-level private orderings on the issue using corporate charters.

B. EX POST JUDICIAL REVIEW

Ex post judicial review plays an important role in addressing agency problems occasioned by stock dividends. When a corporate charter is silent, or when the interpretation of a charter provision is in dispute, courts will have the final say on the validity of the charter provision and/or the board's payment of stock dividends. In the U.S. corporate law, three sets of judicial reviews have been developed: the most deferential *business judgment rule* and the most stringent *entire fairness review* are at the extremes, and somewhere in between the two, we have a few different types of *enhanced review*. This Section examines the conditions under which a certain standard of review should be applicable to a stock dividend.

1. Business Judgment Rule

The business judgment rule has historically protected management's decision to distribute cash dividends on a pro rata basis. In Delaware, when a corporation makes a pro rata distribution to its shareholders, even at the request of a controlling shareholder, courts apply the deferential business judgment review unless the dividend amounts to the wasting of a corporate asset.[205] Even if directors might have acted with an improper motive, case law supports the view that courts will not inquire into the motive of directors or managers until a plaintiff proves it. In *Sinclair Oil*, for instance, the court confirmed that "[t]he motives . . . are immaterial unless [a] plaintiff can show that the dividend payments resulted from improper motives and amounted to waste."[206]

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205. *See* Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811–12 (Sup. Ct. 1976); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971).

206. *See Sinclair Oil Corp.*, 280 A.2d at 722.

The rationale behind the business judgment rule protection of the pro rata cash dividends can be valid for pro rata stock dividends, where shareholders receive dividends in the same class of stock they own proportionally to their ownership interest. In such in-class stock dividends, the legal consequence of the stock dividend are a de facto stock split and have no impact on the governance arrangements. Application of the business judgment rule to such dividends stems from a line of cases dealing with relatively straightforward cash or in-kind dividends, which are properly considered "business decision." In both *Sinclair Oil* and *Kamin*, the distribution of the corporation's cash or property had no bearing or effect on how the corporation's shareholders could exercise their power. The payment of cash dividends closely resembled the business decision over whether to distribute or reinvest the company's surplus. Finally, the dividends were made on a pro rata basis and without any benefit to the directors, according to the factual determinations of the court.[207] In such cases, it seems sensible to subject the board's dividend decision to the deferential business judgment review. The presumption of the business judgment rule given to those *in-class* stock dividends will enhance the efficacy of mechanical stock splits in the form of stock dividends solely for business purposes.

In comparison, when shareholders receive different class of stock from what they own, such cross-class stock dividends can be protected by the business judgment rule only if each class of stockholders separately approves the dividends.[208] Given that the class vote requirement has become prevalent in charter provisions on stock dividends,[209] and it secures the voice of every class of stockholders on the midstream governance change including the reallocation of voting control, courts should defer to the ex ante agreements within each company by applying the deferential business judgment rule. Also, to receive the protection of the business judgment rule, shareholder approval from *each and every* class, voting as a separate class, should be necessary, because the determination of which class of stockholders will be adversely affected by stock dividend is vulnerable to opportunistic interpretation and application. For instance, in Google's 2012 recapitalization to perpetuate its founders' voting control, only the high-vote Class B stockholders had a separate class vote to amend the relevant charter provision, because, according to the board, the amendment "may have an adverse effect on the rights of the shares of Class B common stock." At the same time, the low-vote Class A stockholders did not have an opportunity to vote as a separate class other than voting together with Class B stockholders.[210]

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207. *See Kamin*, 383 N.Y.S.2d at 812; *Sinclair Oil Corp.*, 280 A.2d at 721–22.

208. For the detailed discussion on class vote requirement, see supra Section III.B.4.

209. *Id.*

210. *See* Google 2012 Proxy Statement, *supra* note 15 at S-1.

2. Entire Fairness Review

The entire fairness review is at the other extreme of the spectrum. Although the deferential business judgment rule is the norm with respect to the pro rata distribution of dividends, the Delaware Supreme Court has raised the possibility that the entire fairness test may be applicable to directors' dividend decisions when the challenged dividends amount to self-dealing.[211] Traditionally, the entire fairness test has applied to cases where some type of "self-dealing" or "conflict-of-interest," either by a director or a controlling shareholder, was present. The classic examples are cases where a controlling shareholder is engaging in a freeze-out transaction,[212] or when a director is standing on both sides of the transaction (i.e., a self-dealing transaction).[213] Once the nature of the conflict has been exposed, the defendant will have to show that the transaction is fair to the corporation, both procedurally and substantively.[214]

But as we saw in *Sinclair* and *Williams*, it is not necessarily clear to what extent of benefits will trigger the most stringent judicial review,[215] and it would be challenging to establish an *express* conflict of interest against directors who approved a dividend payment that leads to governance changes, except in the limited circumstance where directors owned a meaningful portion of a company's non-voting stock.[216] For example, as in the CBS case,

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211. *See Sinclair Oil Corp.*, 280 A.2d at 721. ("We do not accept the argument that the intrinsic fairness test can never be applied to a dividend declaration by a dominated board, although a dividend declaration by a dominated board will not inevitably demand the application of the intrinsic fairness standard."); *see also Limits of Judicial Review*, *supra* note 14, at 953.

212. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703–06 (Del. 1983).

213. *See e.g.*, DEL. CODE ANN. tit. 8, § 170 (a) (2021).

214. *See Weinberger*, 457 A.2d at 711; Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663, 687-88; Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 426 (2003).

215. *See Idiosyncratic Vision*, *supra* note 4, at 606 (2016) ("In many cases, however, it is unclear whether close scrutiny is justified solely because the controllers' interests with respect to certain corporate actions are not fully aligned with those of the minority.").

216. Directors' issuance of new class of stock possibly under the directions or influence of a controlling shareholder so as to perpetuate the controlling shareholder's control (e.g., Google, Facebook, and NRG Yield) raise difficult issues when we attempt to analyze it through the usual conflicts-of-interest lens as in *Weinberger v. UOP*. In the usual conflicts-of-interest transactions, a controlling shareholder receives something tangible that they did not initially have "to the exclusion of and detrimental to its minority stockholders." *See Sinclair Oil Corp.*, 280 A.2d at 721; In re EZCORP Inc. Consulting Agreement Derivative Litig., 130 A.3d 934, 939 (Del. Ch. 2016). By contrast, in the new issuance scenarios, controlling shareholders already have the control and all shareholders receive stock on a pro rata basis. Second, there is the problem of market's and public shareholders' expectations. As seen in Google's IPO registration statement, in most cases, companies will advertise that the controlling shareholder intends to and will maintain control. *See* Google Registration Statement *supra* note 111, at 21. ("....[b]ecause of this dual class structure, our founders, directors, executives and employees will continue to be able to control all matters submitted to our stockholders for approval even if they come to own less than 50% of the outstanding shares of our common stock."). To the extent that the market and the public

both sides argued that their actions were for the benefit of corporations and the entire shareholders, without mentioning their own potential self-interest.[217]

3. Enhanced Scrutiny

Corporate law also provides an enhanced standard of review to various corporate actions known as enhanced judicial scrutiny. There is a line of cases that deal with directors' meddling with the shareholder franchise. The most important case is *Blasius Industries, Inc. v. Atlas Corp.*[218] When Blasius Industries, which owned about nine percent of the outstanding stock of Atlas Corp., attempted to wage a proxy fight to increase the board's size from seven to fifteen and to fill the newly created seats with directors favorable to its cause, Atlas's directors amended the bylaws to add two new board seats and filled the seats with its own candidates.[219] The goal of Atlas board's actions was to thwart Blasius from controlling the board. When Blasius challenged Atlas's actions in court, the Delaware Chancery Court sided with Blasius.[220] The court held that, once Blasius established that the board has acted for the "primary purpose of interfering with the effectiveness of a stockholder vote,"[221] the defendant board bore "the heavy burden of demonstrating a compelling justification."[222]

This became known as the *Blasius* "compelling justification" test. The Blasius court seemed especially concerned with protecting the shareholder franchise. The fact that Atlas board's actions dealt with shareholder representation, as opposed to shareholder activism or simply opposing a hostile merger like in *Unocal*,[223] seems to have played an important role. This is evidenced by the fact that the *Blasius* court noted that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[224] Although the *Unocal* test was developed in hostile

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shareholders expect that the controller will stay in charge (possibly for an indefinite future), it becomes more difficult to argue that the controller is taking something away from the corporation to the detriment of the minority shareholders. Third, even without the creation of a new class of non-voting or very-low-voting stock, there are other mechanisms through which the controller can maintain control. The company can use other considerations, such as cash, debt including non-voting debt securities, or non-voting preferred stock issued using the blank check preferred charter provision to engage in acquisition and compensation. If using non-dilutive consideration is not feasible, a more drastic strategy would be for the company to stop or radically curtail its acquisition activity.

217. *See supra* note 6 and accompanying text.

218. *See generally* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (describing an important incident of director meddling in the shareholder franchise).

219. *Id.* at 653–56.

220. *Id.* at 670.

221. *Id.* at 659.

222. *Id.* at 661.

223. *See* Unocal Corp. v. Mesa Petroleum, 493 A. 2d 946, 949–53 (Del. 1985).

224. *Blasius*, 564 A.2d at 659.

takeover context, courts seem to be open to apply the test to cases that deal with shareholder franchise issues.[225]

Since board intervention in shareholder franchise or voting often takes place in the context of a hostile takeover, the *Blasius* test almost immediately came into conflict with existing heightened standards like the *Unocal* test. The case of *MM Companies, Inc. v. Liquid Audio, Inc.* is illustrative.[226] In that case, the Liquid Audio (target company) board increased its size, appointing two new board members as a defensive tactic similar to the plan in *Blasius*, but in the context of a hostile takeover attempt by MM Companies ("MM").[227] Vice Chancellor Jack Jacobs upheld Liquid Audio's defensive tactics under *Unocal* because the board expansion was not preclusive nor coercive,[228] and declined to apply the *Blasius* test because Liquid Audio's board expansion "did not impact the shareholder vote or the shareholder choices in any significant way."[229] The Delaware Supreme Court reversed, holding that the *Blasius* test applied because the "primary purpose" of Liquid Audio's actions was to reduce MM's newly elected directors' ability to influence Liquid Audio's board decisions. [230] The court then invalidated Liquid Audio's board expansion from five to seven board members.[231]

This doctrinal uncertainty would come to the fore again in the case of *Mercier v. Inter-Tel (Delaware), Inc.*[232] There, the Inter-Tel board, fearing that shareholders would vote down a merger proposal in favor of a competing proposal, delayed a merger vote by 25 days in order to provide more information to the shareholders before their vote.[233] Vice Chancellor Strine applied the *Blasius* standard but held that it ought to be "within the context of an appropriate *Unocal* review."[234] According to the court, boards should bear the burden of proving "a legitimate corporate objective served by its decision," showing their proper and non-selfish motivations, and they "must

225. *See* William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1316 (2001) (citing *Chesapeake Corp v. Shore*, 771 A. 2d 293, 323 (Del. Ch. 2000)) ("The post-Blasius experience has shown that the Unocal/Unitrin analytical framework is fully adequate to capture the voting franchise concerns that animated Blasius, so long as the court applies Unocal "with a gimlet eye out for inequitably motivated electoral manipulations or for subjectively well-intentioned board action that has preclusive or coercive effects."").

226. *See* MM Companies, Inc., v. Liquid Audio, Inc., 813 A.2d 1118, 1127–32 (Del. 2003) (discussing the competing standards of review in *Blasius* and *Unocal*).

227. *Id.* at 1131.

228. *Id.* at 1121.

229. *Id.* (citations omitted).

230. *See id.* at 1125–29.

231. *Id.* at 1132.

232. *See* Mercier v. Inter-Tel, 929 A.2d 786, 788 (Del. Ch. 2007) (addressing "the substantial overlap between and redundancy of the *Blasius* and *Unocal* standards").

233. *See id.* at 795–99 (electing to postpone the scheduled merger vote from June 29 to July 23).

234. *Id.* at 788.

show that their actions were reasonable in relation to their legitimate objective" and not preclusive or coercive.[235] Under this recast of *Blasius*, the court held that the Inter-Tel board had met its burden.[236]

Whether the defendant board's burden of proof is higher than what is required under the entire fairness review has been questionable,[237] but the Delaware Supreme Court clarified in *Coster v. UIP Cos.* that satisfying the entire fairness review does not eliminate the potential application of *Blasius*.[238] Although the court did not decide on the relationship between *Unocal* and *Blasius*,[239] the court confirmed that board's action with a "primary purpose" of interfering with shareholder' voting rights will still be subject to the *Blasius* test even when the challenged action is entirely fair and/or boards acted in good faith.[240]

* * *

This competing case law suggests three possibilities for the standard of review that ought to apply to any board decision to make a dividend payment that simultaneously affects the corporation's governance regime: (1) Courts could apply the deferential business judgment review standard to dividend payments made on a pro rata basis, consistent with *Sinclair Oil*[241] and *Kamin*;[242] (2) courts could apply the entire fairness review when they suspect that directors may be using dividend distributions to perpetuate themselves in office; or (3) courts could subject stock dividends with a primary purpose to "interfere with" the shareholders' voting rights and shareholder franchise to *Blasius* review as emphasized in *Coster*,[243] or apply some harmonized version

235. *Id.* at 810.

236. *Id.* at 788, 810.

237. *See* Dale A. Oesterle & Alan Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485, 535 (1994) (stating that the judicial review under the *Blasius* line of cases "is perhaps the most exacting in corporate law. It unequivocally reverses the business judgment presumption. Director action that interferes with the voting process is presumptively *inequitable*.").

238. Coster v. UIP Companies, Inc., 255 A.3d 952, 960 (Del. Supr., June 28, 2021); Jason M. Halper et al., *Delaware Supreme Court's Response to Chancery for Turning Away Stockholder's Claims*, Harvard Law School Forum on Corporate Governance (July 29, 2021), https://corpgov.law.harvard.edu/2021/07/29/delaware-supreme-courts-response-to-chancery-for-turning-away-stockholders-claims [https://perma.cc/4PAG-MRXL].

239. *Coster*, 255 A.3d at 963 n.66 ("Although *Coster* relied on this Court's decision in *Liquid Audio*, she did not argue that a *Unocal* analysis should follow after review under *Blasius*. Thus, we will not consider the impact of *Unocal* review on this case . . . Further, the parties have not asked us to revisit how *Schnell/Blasius* and *Unocal* should fit together in further cases.").

240. *Id.* at 24–27.

241. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971).

242. *See generally* Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (Sup. Ct. 1976) (distributing a third-party company's stock as dividends).

243. *Coster*, 255 A.3d at 962-63.

of the *Unocal* proportionality standard and *Blasius* review, as envisioned in *Mercier*.[244]

What, then, would the *Blasius* compelling justification test require in the context of cross class stock dividends? When plaintiff-shareholders can carry the burden of showing that the board's "primary purpose" in distributing a dividend payment is to meddle with the shareholder franchise, the defendant-board will have to show that there is a "compelling justification" for its action.[245] Given that *Coster* confirmed that *Blasius* is applicable to boards who acted in good faith, *Coster*'s interpretation of *Blasius* seems to lower the burden on plaintiff-shareholders, compared to other equitable reviews and the entire fairness review, in challenging cross-class stock dividends that alter the allocation of voting power. Furthermore, under *Unocal*, as cross-class stock dividends *permanently* dilute the voting power of the affected class, board's burden of proving that the dilutive stock dividend is reasonable and proportional in response to the threat would be challenging.[246]

Beyond the CBS case, there could be other scenarios where the dividend transaction could be subject to enhanced scrutiny. Take the case of a spin-off. While executing a spin-off, directors and managers can also transfer their offices to the spun-off company while erecting various anti-takeover barriers. Since there is an actual separation of the parent company and the subsidiary, and the distribution is done pro rata, the spin-off transaction is the result of a business decision, thereby triggering the deferential business judgment standard of review. At the same time, however, there is the "omnipresent specter" that the directors and managers may be perpetuating themselves in the office, and furthermore, the transaction could substantially weaken the shareholders' voice in the spun-off entity. If the plaintiff shareholders could show that the "primary purpose" of the spin-off transaction was to rearrange the company's governance structure, the defendant directors will have to show that there was some type of "compelling" justification on why they had to modify the corporate governance arrangements.[247]

V. CONCLUSION

Just as the CBS board shocked the corporate community with unprecedented use of stock dividends to undermine a controlling shareholder's lock on control, it is likely only a matter of time until we see other innovative uses of stock dividends in dual-class companies. To address the legal uncertainties about

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244. *See* Mercier v. Inter-Tel, 929 A.2d 786, 786 (Del. Ch. 2007).

245. In cases like CBS, it seemed relatively clear that the "primary purpose" of the board's dividend plan was to rearrange shareholder voting rights and to undermine NAI's control. Less clear was how the courts would have approached the issue of "compelling justification" or the CBS board's argument that the proposed dilution of voting control was to protect the company from NAI's meddling in corporate affairs. *See supra* note 6 & 10 and accompanying text.

246. *See* Unocal Corp. v. Mesa Petroleum, 493 A. 2d 946, 949–53 (Del. 1985).

247. *See Insulation by Separation*, *supra* note 38.

stock dividends, this Article has proposed three approaches: (1) companies should use their charters to more clearly define the rights and limits of board discretion over disparate stock dividends; (2) state legislatures should provide a more useful set of default provisions on stock dividends under state corporate statutes, so that dual-class companies can utilize them in their corporate charters; and (3) courts should limit the business judgment review to a narrowly defined pro rata stock dividends (i.e., proportional, in-class stock dividends), and non-pro rata stock dividends approved by each class of shareholders separately.


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