

Columbia Law School

## Scholarship Archive

---

Ira M. Millstein Center for Global Markets and  
Corporate Ownership

Research Centers & Programs

---

2014

### Changes in Ownership: Beyond the Berle-Means Paradigm

Ira M. Millstein Center for Global Markets and Corporate Ownership  
*Columbia Law School*

Follow this and additional works at: [https://scholarship.law.columbia.edu/global\\_markets\\_corporate\\_ownership](https://scholarship.law.columbia.edu/global_markets_corporate_ownership)



Part of the [Business Organizations Law Commons](#)

---

#### Recommended Citation

Ira M. Millstein Center for Global Markets and Corporate Ownership, *Changes in Ownership: Beyond the Berle-Means Paradigm*, (2014).

Available at: [https://scholarship.law.columbia.edu/global\\_markets\\_corporate\\_ownership/19](https://scholarship.law.columbia.edu/global_markets_corporate_ownership/19)

This Paper is brought to you for free and open access by the Research Centers & Programs at Scholarship Archive. It has been accepted for inclusion in Ira M. Millstein Center for Global Markets and Corporate Ownership by an authorized administrator of Scholarship Archive. For more information, please contact [scholarshiparchive@law.columbia.edu](mailto:scholarshiparchive@law.columbia.edu).



COLUMBIA LAW SCHOOL

---

MILLSTEIN CENTER FOR GLOBAL MARKETS  
AND CORPORATE OWNERSHIP

SESSION BRIEF NO. 1

# Changes in Ownership: Beyond the Berle-Means Paradigm



# Table of Contents

- About the Millstein Center for Global Markets and Corporate Ownership . . . . . 1
- Introduction . . . . . 3
- Section 1: Dual-Class Structures . . . . . 5
  - The Zuckerberg Grip Phenomenon . . . . . 5
  - The Case for Dual-Class Shares. . . . . 5
  - Contrary Views . . . . . 6
- Section 2: Private Equity . . . . . 8
  - Growth in Secondary Buyouts . . . . . 8
  - The Perspective from Private Equity . . . . . 8
  - Secondary Buyouts are Not Predominant . . . . . 9
  - Does the Agency Issue Disappear in Private Ownership? . . . . . 10
    - Can Private Equity Provide Incentives for Long-Term Investment in the Way that Dual-Class Does?
- Section 3: What is the Governance Impact of the Re-Concentration of Ownership? . . . . 11
  - Re-Concentration of Ownership . . . . . 11
  - What does the activist investor do in this new ownership paradigm?. . . . . 11
  - What does the institutional investor do in the activist environment? . . . . . 11
  - Does the re-concentration of ownership really affect governance? . . . . . 11
  - Are institutional investors really passive? . . . . . 12
  - Are boardrooms being affected? . . . . . 12
  - Are activist investors just short term thinkers with little interest in long term value? . . . . . 12
- Participants. . . . . 13
- Bibliography . . . . . 15



# About the Millstein Center for Global Markets and Corporate Ownership

The Millstein Center's research and projects focus on the structure of the capital market and the institutions that comprise it, including pension funds, mutual funds, hedge funds, private equity firms, and sovereign wealth funds. The Center explores which "owners" invest for long-term value creation, which invest primarily for short-term returns, and which are none of the above. The answers are critical, as these institutions are the "shareholders" that ultimately impact corporate governance, and to whom the board is responsible.

Solid research of the investment chain is essential. Informed discussion regarding necessary changes in the structure, regulation, or performance of this chain requires more knowledge than presently available. The Millstein Center aims to provide that knowledge.

The Center's research on the capital market and its impact on corporate governance builds upon the work of the earlier successful "Institutional Investor Project" at Columbia University (1986-94), as well as the successes of the Millstein Center for Corporate Governance and Performance at the Yale School of Management (2005-12).

This paper attempts to provide a brief summary of discussion points, presentations, and findings from the "Changes in Ownership: Beyond the Berle-Means Paradigm" Symposium held in April 2013. The Center's mission is advanced through multiple mechanisms, including scholarly research, classes, conferences, workshops, the internet, interviews, and various academic or white papers.

The Center's white papers are framed as concise summaries of events or reports designed to promote policy discussion or further research. They strive to encompass a diversity

of perspectives and are based on a combination of presentations, independent research, and the experiences of market-leaders and thought leaders who participate in Center events or workshops. Participants generally include corporate board members and managers, institutional investors, service providers, leading academics, regulators, and think tanks or nonprofit organizations, among others.

This paper was prepared under the supervision of Ron Gilson, Marc and Eva Stern Professor of Law and Business, Columbia Law School; Charles J. Meyers Professor of Law and Business, Stanford Law School; Jeffrey Gordon, Richard Paul Richman Professor of Law, Columbia Law School; Co-Director, Millstein Center; and Robert J. Jackson, Jr., Associate Professor and Milton Handler Fellow, Columbia Law School; Co-Director, Millstein Center.

John Jarrett, Executive Director at Chairmen's Forum; Partner at BHJ Partners; and Consultant at Jarrett & Associates, served as lead editor. Milica Brogan, Executive Director of the Millstein Center served as secondary editor.

The Millstein Center is extraordinarily grateful to all of its sponsors and partners, which provide support on an ongoing basis (a list of those bodies can be found on the Center's website).

We would also like to extend a special Thank You to the IRRCi for their contributions and participation to this event in particular.

Any positions taken in this report, and any errors within it, are solely the responsibility of the Center, and do not necessarily reflect the opinions of the Law School, University, or any supporters or particular participants.







# Introduction

The “Changes in Ownership: Beyond the Berle–Means Paradigm” Symposium, held April 2013, explored whether, and how, the recent explosion of new ownership models alters the paradigm of dispersed ownership developed by Adolf Berle and Gardiner Means three generations ago. That model indicated that public corporations were owned by dispersed shareholders whose separate ownership positions were too small to justify extensive monitoring of managerial performance. This view of the distribution of ownership in U.S. corporations has been foundational for both much academic work and for much of corporate law and governance, which have been aimed at addressing the monitoring shortfall.

The Symposium explored three specific developments in corporate ownership that may indicate a sea change in the landscape painted by Berle and Means. The first development was a resurgence of companies going public with dual-class stock, similar to the Swedish capital structure, especially in the technology sector. The second development was the growth in private equity exits through a secondary buyout rather than an IPO or strategic sale. The third and final development explored at the Symposium was the re-concentration of public equity holdings, as a result of investment intermediation, that has put the potential for control into the collective hands of a much smaller, more concentrated group of holders.

This briefing will summarize the day’s discussions on whether these various developments represent an explosion in ownership forms that represent a real diversification and complication of the pattern of ownership of U.S. corporations—a new pattern that truly reaches “Beyond the Berle–Means Paradigm”.



# Section 1: Dual-Class Structures

## The Zuckerberg Grip Phenomenon

Dual-class share structures have been utilized by varied U.S. issuers for many decades, but a recent trend among technology IPOs has seen an increase, particularly in high-profile tech listings. Coined at the time of the Facebook listing, “the Zuckerberg Grip”<sup>1</sup> seems to have become the structure of choice for many tech companies going public. Bruce Alan Mann, a senior partner at Morrison & Foerster, is quoted in an article stating: “Prior to 1987, the New York Stock Exchange wouldn’t even list dual-stock companies. Five years ago, people weren’t asking about them. Now everyone is asking about it right away.”<sup>2</sup>

In the United States, the issuing of non-voting shares started in earnest in the early decades of the 20th century, although commonly the voting shares were held by investment bankers, not the company’s founders. As a result of public backlash, the New York Stock Exchange put a limit on dual-class common stock in the 1920s, and those limits remained in place until the 1980s, when dual-class shares gained favor as a strong takeover defense and the New York Stock Exchange once again allowed for dual-class shares. The Securities and Exchange Commission, however, enacted a rule prohibiting dual-class recapitalizations because those transactions were thought to be coercive. Although the SEC rule was later invalidated by the D.C. Circuit, the SEC convinced the NYSE and NASDAQ to adopt the rule. Firms on those exchanges, even today, may use a dual-class structure at the IPO stage—but cannot later recapitalize from a single-class structure to a dual-class structure.

The use of dual-class shares continued to remain relatively limited until Google bucked the trend with its very public 2004 IPO featuring a multi-class stock structure. While the overall number of dual-class IPOs is still relatively small, they have become popular among high-profile technology listings in the last few years, such as Facebook, Groupon, Zynga, Zillow and LinkedIn. Indeed, 14% of technology firms that went public from January 2011 until June 2012 had dual-class structures, compared to just 6.4% in 1999–2000.<sup>3</sup> Twenty technology firms were listed with dual-class shares during 2011 alone.

As reported by Joanne Lublin in the Wall Street Journal, Marc Andreessen, a partner at venture-capital firm Andreessen Horowitz, previously favored single class share structures for technology IPOs, but now he encourages founders to consider

dual-class structures. His explanation: “The dramatic rise of activist hedge funds, pressure from short sellers and the risk of disruptive hostile takeovers gradually changed his mind.”<sup>4</sup>

Conversely, institutional investors, including CalPERS and CalSTRS, have threatened to boycott dual-class IPOs. And in late 2012, the Council for Institutional Investors petitioned the NYSE and NASDAQ to ban any new dual-class common listings.

## The Case for Dual-Class Shares

The founders of Google argued, at the time of their IPO, that a dual-class structure provides a platform for running the company for the long term, freeing the management team from the pressure of quarterly earnings reports. A 2003 study by Smart and Zutter found that dual-class IPO firms trade at lower valuation multiples; become acquisition targets less frequently within the first five years after IPO; tend to be larger on average; are associated with more reputable underwriters and have higher institutional equity ownership; and are mainly in industries characterized by larger control benefits such as media and entertainment (and, more recently, technology).<sup>5</sup>

Although the concept of dual-class shares has generally been unpopular in governance circles because of its entrenchment effects, an academic presentation at the Symposium illustrated that dual-class shares can be shareholder value maximizing in the hands of high ability managers, but conversely, value reducing in the hands of low ability managers. “High ability managers” can be identified by certain observable characteristics, including the size of the senior management team, a high percentage of MBA holders, a higher average tenure of the management team (but not in one homogenous cohort), CEO dominance, and significant participation on non-for-profit boards by senior managers. Participants at the Symposium debated the efficacy of these measures of management’s ability and had some degree of skepticism about the value of such measures, particularly given that management quality is one of the elusive characteristics sought to be understood by analysts of all companies.

Despite the participants’ skepticism, evidence to date suggests that high quality managers could make good use of the dual-class share structure to allow for long term investment without the need to cater to short term market needs

<sup>1</sup> “Zuckerberg Grip Becomes New Normal in Silicon Valley”, Jeff Green & Ari Levy, Bloomberg News, May 12, 2012.

<sup>2</sup> Id.

<sup>3</sup> “A Fight in Silicon Valley: Founders Push for Control”, Joanne Lublin, Wall Street Journal, July 11, 2012.

<sup>4</sup> Id.

<sup>5</sup> “Control as a motivation for underpricing: a comparison of dual and single-class IPOs,” Scott B. Smart, Chad J. Zutter, *Journal of Financial Economics* 69 (2003).

(as opposed to low quality managers, where such a structure may shield management and does not create additional value). Evidence suggests that if pooled, all dual-class share firms over time were valued lower in the IPO market. However, evidence also shows that high quality managers in dual-class share firms outperform single class share firms in the long run.<sup>6</sup>

Symposium participants also heard that the practical consequences of dual-class shares are limited in the actual marketplace. Investors have a choice whether or not to invest in an IPO. Dual-class firms are not immune to market forces or making sensible business decisions any more than single class firms. And practitioners noted that, for technology firms that rely on Research and Development, not being subject to the tyranny of quarterly earnings has an economic logic.

Many event participants asserted that there should not be any preclusions on allowing owners to bring a company to market with dual-class shares because the market will price the listing appropriately. If the owner lists with anti-takeover provisions, including dual-class shares, the cost of retaining greater control is borne by the owner, by way of a lower price. Participants also noted that dual-class shares are not necessarily permanent; they can be eliminated through a recapitalization. If the founders of the firm pursue such a recapitalization in order to increase the share price and capture the value of control, then that transaction is value enhancing.

Finally, participants pointed out that some arguments in favor of prohibiting dual-class shares, for example, that investors are naive or fooled are unconvincing. Others, however, like the possibility that dual-class structures reduce activist investors' incentives to engage, thereby compromising market efficiency, and might be well worth reconsidering. It was observed that the latter argument in particular is one that offers some basis for constraining founders' freedom of contract.

### **Contrary Views**

A wide range of divergent views were also expressed at the meeting. The assertion that the IPO price will reflect anti-takeover provisions, including dual-class shares, was disputed, especially in cases of stocks that are 'hot' and heavily over-subscribed. In such cases, it was argued, price tends to reflect the advice of the investment banker as to how much value to leave 'on the table' for the new shareholders—which can range from substantial to none. Therefore, the effect of the dual-class structure will not be priced in the IPO. Thus, the limited

cost internalization of takeover defenses, including dual-class shares, by the pre-IPO owner does not really work, allowing founders to retain control without receiving proportionately lower prices for their shares.

Other attendees also argued that while the original owner and entrepreneur may influence the vision of the company in the first 2-3 years, this influence will very often wane. Even if this influence lasts for the first 5-10 years, entrenchment can later become a waste of economic resources, as dual-class shares can effectively entrench incumbents. It was pointed out that firms that are eventually subject to control transactions come about because founding families decide to relinquish control. Nevertheless, there is empirical evidence which shows that there has been a steady stream of conversions from dual-class shares to single class shares—with over 250 conversions over a 15 year period.<sup>7</sup>

Summarized briefly, even if dual-class shares initially have utility, this diminishes over time, even becoming negative. The structure is then reversible—a dual-class firm can be recapitalized as single class firm or be acquired by a single class firm. Of course, there is a time between these situations where there is suboptimal governance—but this can be expected in any "imperfect" system.

Attendees debated whether the use of dual-class shares is based on the needs of each individual company that might require longer term horizons, or rather upon its increasing popularity with investment bankers and lawyers preparing for IPO. For example, the dual-class IPO of supermarket chain Fairway may propel the impression that dual-class shares have simply become 'fashionable.' Participants also suggested that there is too much capital chasing too few opportunities, causing investors to jump in regardless of the governance structure of certain IPOs. A mandatory one share, one vote rule would likely suppress opportunities further, as many owners simply would not go public without some mechanism to preserve control.

Another novel argument against prohibiting dual-class shares was offered as well. Although technology companies need to have a long term investment horizon, public stock markets are able effectively monitor them due to the short life cycle of technology innovation. If the company fails to keep ahead, the market will punish the company regardless of the ownership structure. The pressure for short term performance is being driven by the competitive product market, participants argued, rather than quarterly reporting.

---

<sup>6</sup> More technically, the negative results in the earlier Smart and Zutter paper could be explained by cross-sectional variation within the sample of dual-class IPOs, and that a feasible identification strategy could distinguish between "high quality" and "low quality" management teams.

<sup>7</sup> Jason W. Howell. "The Value of Blockholder Liquidity and the Decision to Unify Share Classes," Midwest Finance Association 2012 Annual Meetings Paper. September 15, 2011.

For firms outside the technology sector—where product-market pressure is much less intense—the market might not provide as close a monitoring of a company. There, the use of dual-class shares could exacerbate management entrenchment, destructive industry trends and even systemic risk.

The concept that the market would appropriately price dual-class structures was challenged by the claim that few people in finance completely understand differences in governance structures or applicable State laws, thereby lowering the likelihood that these structures would be priced accurately.

One way to alleviate the entrenchment effects of dual-class structures, but capture the long-term investment benefits of such structures, participants suggested, would be to limit the extra voting rights by time, limit the ratio of extra votes per share, or require the holders of extra voting shares to hold at least a particular level of the total equity claims on the firm. These measures would reduce the “wedge” between the cash flow rights and the control rights and otherwise limit potential costs of the dual-class form.

Lastly, attendees also discussed whether dual-class companies pose an additional ‘hidden’ cost to investors, namely the cost associated with closely monitoring a company lacking in certain governance provisions. They suggested that additional research should be conducted on whether dual-class structures should be accompanied by other governance devices that enable active shareholder monitoring.

## Section 2: Private Equity

### Evaluating the Proposition that Private Ownership Would “Eclipse” the Public Corporation

In 1989, Harvard’s Michael Jensen predicted that private equity would eclipse the public corporation as a form of corporate ownership. Struck by the improved governance, monitoring, and managerial incentives that private equity offered, Jensen argued that private investments would overtake dispersed public shareholders as the principal corporate ownership model in the United States. Jensen’s prediction, however, has not yet come to pass.

Participants pointed to several reasons why, including (1) private equity investors tend to bring the companies they own public; (2) public corporations can now obtain some of the benefits of private-equity ownership through leveraged recapitalizations and (3) changes to compensation structures; and private equity entities require liquidity through an exit for investors, usually within the ten year term of most funds. Thus, so far private equity has not overtaken public investment as the principal means of corporate ownership.

### Growth in Secondary Buyouts

A growing trend has been giving new life to Jensen’s prediction. Private equity investors now increasingly exit their investments through “secondary buyouts,” or sales from one private equity owner to another. Symposium participants were presented with the evidence below, suggesting that these secondary buyouts have become increasingly common over the last twenty years.

#### Percentage of Exits Through Secondary Buyout

Year of LBO	1970–84	1985–89	1990–94	1995–99	2000–02	2003–05	2006–07
	6%	13%	17%	24%	30%	30%	22%

Note: Less than 50% of transaction in 2003–07 have exited by 2007.  
Source: Stromberg (Dec. 2007).

Note: Percentages do not change materially if transactions are value weighted. Kaplan & Stromberg (2009).

The Symposium explored several reasons why this phenomenon of “serial monogamy” has developed.

Presenters and participants argued that (1) secondary buyouts maintain an efficient governance form despite the need for the first private equity firm to exit;<sup>8</sup> (2) the higher costs of public equity ownership may be drivers of this trend and that private equity investors must consider these costs when

deciding whether to take a company public or sell it to a fellow private equity owner; and (3) public companies face the substantial regulatory burdens of public regulation each year that they are public whereas private companies may face the transaction costs of selling control among private equity ownership, but face these costs much less frequently.

Some data suggests that private equity investors receive lower returns when engaging in a secondary buyout than when they take public companies private. Participants suggested that these data likely reflect the lower risk associated with the already-improved governance of a firm already owned by private equity.

### The Perspective from Private Equity

The event explored the nature of private equity investors and the need to exit, typically within ten years to move forward with the next fund. Although this time frame certainly drives exits, participants noted, it not explain the increase in secondary buyouts. Private equity experts discussed a series of trends that may help explain why secondary buyouts are now sometimes chosen over a public exit through an IPO.

First, secondary buyers are looking for opportunities of where to invest their capital (perhaps related to earlier discussions in the day on limited investment opportunities). Second, these buyers appreciate the prospect of seeking marginal improvements that add further value to the company with lower risk, rather than the prospect of a major overhaul, which usually accompanies going-private transactions, already done by the first owner.

Third, secondary sales are often driven by differences in approaches, expectations and outcomes among private equity firms. The private equity universe is not monolithic. Some are providers of large amounts of capital; others are smaller and have limitations on what they can achieve. If a smaller private equity investor has enjoyed strong returns on an investment, it might seek out a larger private equity buyer with the capital and expertise to engage in more transformative change rather than pursue those efforts itself. Sometimes a particular private equity fund has done all it can with its available expertise and capital and, therefore, might seek to sell to another investor who can do more.

In other cases, one private equity fund may have expertise at building a business through acquisition, but that business may develop into a “messy amalgam” of separate businesses. Participants suggested that these situations call for a private

<sup>8</sup> Ronald J. Gilson & Charles K. Whitehead. “Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets.” *Columbia Law Review*, Vol. 108, p. 231, 2008.

equity firm with expertise in operational improvements. The buyer can make substantial gains through its expertise, and the initial private equity investor profits by selling to a firm better-equipped to add value. One observer pointed out that a successful secondary buyout depends “very much upon having the right owner own the firm at the right point in the firm’s life cycle.”

From the buyers’ perspective, participants noted, there are a number of important benefits when buying a business that is currently owned by another private equity investor. In many cases, the management team has bought into the first deal with significant equity.<sup>9</sup> As part of a secondary sale, that equity can stay in place, ensuring ongoing management incentives. Indeed, the secondary sale will often give management *more* equity in the firm, further strengthening management’s incentives. Also, the fact that the management is already used to dealing with a leveraged environment can also make the firm an attractive proposition, given the experience gained from the first phase of private equity ownership. Some of these benefits in secondary buyout deals have tended to reduce the objections of limited partners in the buying funds, persuading general partners to pursue secondary buyouts over other transactions.

Participants stressed that buyers must ensure that management is still heavily invested in the success of the firm after a secondary sale. When a new board is put in place, there is a risk that management will not have as strong a relationship with the board as previously. There is also a risk that a secondary buyout could upset management’s expectations to cash out a substantial portion of their equity upon exit. Participants urged that secondary buyers must make efforts to convince management to continue to work with the new owners. In some instances, failure to do this has led some secondary buyouts to go sour, and has necessitated the buyer to bring in a new management team altogether.

### **Secondary Buyouts are Not Predominant**

Despite the rise of the secondary buyout as an exit strategy, the majority of deals still do not follow this path. On balance, participants said, secondary buyouts are one of many options a private equity investor will consider. Several factors govern whether a private equity owner will pursue a secondary buyout or an IPO.

The public-listing window often drives this decision, participants noted. Often, the window during which a company can be successfully brought public is limited making a secondary sale a valuable exit option and giving sellers critically needed liquidity, which often cannot be had through an IPO. Participants noted that there are other significant disadvantages to a re-IPO, including IPO lockups that typically require both private equity owners and managers to hold significant blocks of the company’s stock after the firm has been taken public.<sup>10</sup>

Another factor to consider is the pool of secondary buyers, which may be more limited than many might expect. A secondary buyer often needs deep reserves of capital in order to add value to the company, for example through acquisitions or significant restructurings. Secondary buyers will also sometimes need to have international operations; a small private equity firm often will not have the international footprint necessary to participate in international deals.

Other considerations driving secondary sales include broader economic trends. Secondary buyouts require private equity investors to have large holdings of cash and limited access to public capital markets, which tends to occur when the economy is shifting from a period of relatively low growth to a period of relatively strong growth. Public exits are likely to be more restricted after a market downturn, and secondary buyouts can fill that gap.

Participants discussed the perception that the number of publicly listed firms has decreased sharply in recent years, due, in part, to the rise of secondary buyouts. The sense from private equity practitioners, however, was that secondary buyouts are a part, but not the biggest part of their portfolios. Most participants agreed that this trend does not fully explain the decrease in public listings. Rather, it was suggested, that the decline in listings reflects foreign firms delisting from the US market and others delisting for other reasons, including restructuring or the high cost of compliance, among others.

Participants also raised the point that private equity investors’ funds now have far larger funds to deploy than they once did. That is especially true because new investors have begun to embrace the private equity model. The sheer volume of funds available has meant options outside the more common exits of IPOs and strategic sales have become more attractive. As this asset class has matured, the opportunities for outsized gains have likely diminished; particularly, the gains from improvements in governance have become limited as public-company management has improved.

---

<sup>9</sup> For empirical analysis of how private equity owners provide management with equity compensation that leads, on average, to stronger managerial incentives to maximize firm value, see, e.g., Robert J. Jackson, Jr., “Private Equity and Executive Compensation,” 60 *UCLA L. Rev.* 638 (2013).

<sup>10</sup> See, e.g., Jackson, *supra* note 9, at 658 fig. 1 (describing significant private-equity ownership after the IPO—on average, a 20% stake four years after the offering—and attributing that result, in part, to IPO lockups).

## **Does the Agency Issue Disappear in Private Ownership? Can Private Equity Provide Incentives for Long-Term Investment in the Way That Dual-Class Does?**

The final part of the discussion on private equity focused on the differences in governance between private ownership and public ownership—and how these differences manifest themselves when a firm pursues an IPO.

Agency costs are substantially lower in the private equity context, panelists explained, due to the closeness between ownership and the board. Of course, there are still some agency issues—such as between the general partners and limited partners of the private equity investor—but far less than in the public-ownership context. Participants seemed to agree that the agency issue with the board and owners that causes such anxiety in the governance world of public companies is removed from the equation, perhaps making continued private ownership attractive.

Participants finally discussed whether private equity ownership, like dual-class stock structures, provides management with a greater ability to make long-term investments and innovations. Private equity experts agreed that their portfolio companies are able to pursue longer-term strategies because they are able to avoid the public scrutiny of quarterly earnings that is pervasive among public companies. These practitioners noted, however, a key difference from dual-class structures; private equity tends to seek out companies with stable cash flows, rather than highly innovative firms. Therefore, parallels to dual-class structure benefits may not be that strong.



## Section 3: What is the Governance Impact of the Re-Concentration of Ownership?

### **Re-Concentration of Ownership**

A new paper from Ron Gilson and Jeffrey Gordon in the *Columbia Law Review*, observes that recent developments demonstrate a move away from the Berle–Means type of dispersed ownership towards re-concentrated ownership in intermediary institutions, like mutual funds and pension funds, which hold their shares as record holders for the institutions' beneficial owners. This has led to the evolution of a complimentary governance outcome—activist investors.

The institutions' business model makes it unlikely that they will take proactive steps with respect to the strategy of performance of portfolio companies. However, they do take seriously proposals made by activist investors. In turn, the activist investors' business model is symbiotic with that of the intermediary institutions—they identify companies whose strategies could be significantly improved, buy a toe hold stake, and then go public with a plan to convince the company (or the institutional shareholders if the board disagrees and a proxy constant proves necessary) of the wisdom of the activists' strategic proposal. Thus, activist shareholders propose and institutional investors decide, together comprising a kind of market stewardship.

In situations where institutional blockholders may not be in a position to take “activist” actions, activist investors can play a role in bringing an intervention situation to the fore and can provide opportunities for large (but more passive) blockholders to exercise their voice and vote.

### **What does the activist investor do in this new ownership paradigm?**

Activist investors say they look very closely at who holds stock in a possible target. This helps them judge whether an action is worth undertaking; there is no point in taking on a fight if there are not enough shareholders to agree with a proposal. They will have an early conversation with the proxy solicitor on the likely reactions. In such controversial situations, proxy advisers are thought to play an important role. The activist also will have direct conversations with the large institutions, who do not necessarily follow proxy advisers' recommendations.

In addition to a substantive proposal, the activist will look at the company's governance, the management, and company reputation. Key to this process is getting the analysts' and portfolio managers' view of the target's problems.

### **What does the institutional investor do in the activist environment?**

Institutional investors will discuss the situation with other investors to see where they are on the issue. They will also have conversations with the target company on the substance of the case being put forward by the activist investor. In many cases, the target company will have the advantage, as they have more information and have existing relationships. Where the management has not actively engaged in with their investors, they can be at a disadvantage in a contest over strategy. It is a “relationship business” and if there is a lack of prior contact, the target company will have a lot of ground to make up.

In the main, good activist funds have done their work to pick a target that has clear issues, where management is scrambling to retain their position.

### **Does the re-concentration of ownership really affect governance?**

Participants offered counter-arguments to the assertion that there has been a re-concentration of ownership. It was posited that (1) there are different types of stake-buying by investors who expect to have a longer holding period and those that who are looking for a short term gain; (2) many institutional owners are short term (with an average holding period of only one and a half year) with an implication that these investors are focused on short-term strategies rather than long term value; and (3) some large institutions, for example the California Public Employees Retirement System (CalPERS), hold a significant amount of their equity in index strategies, so they may have little incentive to independently assess the merits of an activist's proposal.

There was substantial disagreement among the participants and panelists over many of the characterizations of activists' and institutional investors' incentives and behavior. Participants discussed that many institutional investors have both managers and passive managers, wherein active managers will care a lot about what is happening in a portfolio company, even if those managing the index component do not. Some participants also argued that the data on average holding periods can be misleading, since institutions may “go in and out of stocks”, but remain in the market over time and remain interested in these stocks for the longer term.

### **Are institutional investors really passive?**

One of the key discussions points focused on the average turnover of stock by institutional investors being about one and a half years. Some participants suggested that governance does not really matter when the turnover is high. They also suggested that the index holders have no incentive to take an active role. Other participants disagreed with this characterization of intermediary institutional investors, suggesting that some of the largest holders of index investments or those that have an internal index target are also the most active on governance issues as opposed to business strategy issues.

A fund does not have to be considered ‘activist’ to be concerned with good governance—good governance raises the performance of all companies. Many of the large pension funds are frequently proactive with respect to improving the structure of governance, for instance by opposing staggered boards (it was noted that these institutions tend to have captive beneficial owners).

### **Are boardrooms being affected?**

The participants voiced the view that directors have been adapting to the new concentration of ownership. Importantly, boards were said to have become more responsive to institutions and more commonly reach out to maintain an ongoing dialogue. Discussion focused on how the introduction of “Say on Pay” has held a spotlight on board performance; and that low votes on pay embarrass directors, especially those on compensation committees. This spotlight encourages boards to keep the confidence of their investors and to build goodwill. This effect has extended down to mid and small cap companies, which can no longer ‘fly under the radar’.

Since most large companies have improved their governance over the last few decades, participants asserted that more attention is being focused on mid and small cap companies. However, many of these companies are finding it hard to adapt to the spotlight. They have not faced such scrutiny previously and often have limited resources to devote to governance or to developing relationships with their investors.

### **Are activist investors just short term thinkers with little interest in long term value?**

This issue has been a standard concern in the debate over the role of activist investors. The paper “The Myth That Insulating Boards Serves Long Term Value”<sup>11</sup> demonstrates that activist investors do not cause poorer performance over a five year period compared to other companies, indicating that the gains from the activist intervention are long-term, rather than short term. The exchange highlighted the need for much more clarity about what long-term / short-term labels really mean.

The Symposium heard views consistent with the Bebchuk paper that activist investors are not usually looking for just short term gains, since they have to convince other investors of the long term value of the intervention. Also, the typical intervention puts a minority of directors on the board and if the intervention is to be successful, the full board needs to be convinced.

It was stressed by several practitioners that activist investors do not begin by looking for governance failings to identify targets. Rather, the starting point is underperformance, determining why, and whether it can be addressed. Once a case is built for intervention, the investor might look at the governance as one of the key factors affecting the underperformance. However, it was put to the Symposium, that whether or not you believe good governance is correlated with good returns, it will be the gate through which the solution(s) to particular performance problems must come.

---

<sup>11</sup> Bebchuk, Lucian A., “The Myth That Insulating Boards Serves Long Term Value,” *Columbia Law Review*, Vol 113, Fall 2013 (SSRN No. 2248111).

# Participants

## **Representatives from the following organizations participated in the Symposium:**

Advent International Corporation  
American International Group (AIG)  
Amalgamated Bank  
AMV Fund  
Boston College  
Centerview Partners, LP  
CFA Institute  
Chairmen's Forum  
Columbia Business School  
Columbia Law School  
Columbia University  
Daroth Capital Advisors, LLC  
Dirigo Capital Advisors, LLC  
Eastwind Power Partners, Ltd.  
Fordham Law School  
Georgeson Inc.  
Harvard Business School  
Harvard Law School  
Investment Initiatives, LLC  
Investor Responsibility Research Center (IRRC) Institute  
JANA Partners LLC  
Kohlberg Kravis Roberts (KKR) & Co., LP  
Lache Management Services, Inc.  
Law360  
Mercer, LLC  
Millstein Center for Global Markets and Corporate  
Ownership at Columbia Law School  
Ohio State University  
Oriel Asset Management, LLP  
PineBridge Investments  
Point Capital Partners, LLC  
Sarsenov's Corporate Governance Advisory  
Securities & Exchange Commission  
Standard & Poor's Financial Services, LLC  
Sustainalytics  
The Conference Board, Inc.  
The Shareholder Forum  
Third Point, LLC  
TIAA-CREF  
Weinberg Center for Corporate Governance at the  
University of Delaware  
University of Notre Dame  
University of Pennsylvania Law School  
Weil, Gotshal & Manges, LLP  
XT Capital Partners, LLC  
Yale Law School



# Bibliography

Bebchuk, Lucian A., "The Myth That Insulating Boards Serves Long Term Value," *Columbia Law Review*, Vol. 113, Fall 2013.

Berle, Adolf A. & Gardiner C. Means, *The Modern Corporation and Private Property* (Revised Edition 1967).

Gilson, Ronald & Jeffrey Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Re-evaluation of Governance Rights," *Columbia Law Review*, Vol. \_\_\_\_, May 2013.

Gilson, Ronald J. & Charles K. Whitehead. Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets. *Columbia Law Review*, Vol. 108, Season 2008

Green, Jeff & Ari Levy, "Zuckerberg Grip Becomes New Normal in Silicon Valley," *Bloomberg News*, May 12, 2012.

Howell, Jason W., "The Value of Blockholder Liquidity and the Decision to Unify Share Classes" Midwest Finance Association 2012 Annual Meetings Paper (September 15, 2011).

Jackson Jr., Robert J. "Private Equity and Executive Compensation." *UCLA Law Review*, Vol. \_\_\_\_, 2012.

Lublin, Joanne, "A Fight in Silicon Valley: Founders Push for Control," *Wall Street Journal*, July 11, 2012.

Smart, Scott B. & Chad J. Zutter, "Control as a motivation for underpricing: a comparison of dual and single-class IPOs," *Journal of Financial Economics* (2003).



## COLUMBIA LAW SCHOOL

---

MILLSTEIN CENTER FOR GLOBAL MARKETS  
AND CORPORATE OWNERSHIP

435 West 116th Street, Room 536  
New York, NY 10027

Phone: 212-854-0130 | Fax: 212-854-2368

[millsteincenter@law.columbia.edu](mailto:millsteincenter@law.columbia.edu)

[WWW.LAW.COLUMBIA.EDU/MILLSTEINCENTER](http://WWW.LAW.COLUMBIA.EDU/MILLSTEINCENTER)