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EVALUATING DUAL CLASS COMMON STOCK: THE RELEVANCE OF SUBSTITUTES

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THE proposal of the New York Stock Exchange to end its prohibition on listing the securities of companies with dual classes of common stock¹ has focused public policy debate over this evolu-

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¹ Since the 1920's, the New York Stock Exchange (NYSE) has refused to list the stock of companies with either non-voting common stock or more than one class of common stock having unequal voting rights. The American Stock Exchange (Amex) has less stringent voting standards, and the National Association of Securities Dealers Automatic Quotation (NASDAQ) system has none. Two changes in the business environment have pressured the NYSE to conform its policy to those of its competitors to avoid the loss of listings. First, improvements in communications technology have, for the first time, made NASDAQ a real alternative to NYSE listing for major companies. Second, as a result of the development of junk bond financing, a much broader range of companies has become potentially subject to hostile takeover. A dual class recapitalization is a truly effective defensive tactic.

The NYSE has responded by proposing amendments that would substantially dilute its voting rights listing standards by requiring that limited voting rights created by a modification of the voting rights of existing shareholders be approved by a majority of both independent directors and public shareholders. The special approval requirements would not apply to limited voting stock outstanding at the time a company first went public, but would apply if such stock were later created, even if the voting rights of existing public shareholders were not altered. The proposal leaves untouched the longstanding prohibition on non-voting common stock. See NYSE's Proposed Rule Changes on Disparate Voting Rights, 18 Sec. Reg. & L. Rep. (BNA) No. 37, at 1389-92 (Sept. 19, 1986) [hereinafter Proposed NYSE Changes] (text of NYSE proposal).

As a self-regulatory organization under section 19 of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(b) (1982), any change in NYSE rules requires SEC approval. Approval of

tion in capital structure² both too broadly and too narrowly.

The debate has been too broad because it has encompassed one situation—an initial public offering by a company with a capital structure containing dual class common stock—that should not be controversial at all.³ Whatever may have originally prompted the New York Stock Exchange's longstanding prohibition against listing non-voting common stock or common stock with voting rights not reasonably related to its equity participation,⁴ there is no longer a persuasive case to be made for restricting, whether by denying listing or otherwise, the initial offering of such securities.⁵ A

the proposed amendments was requested on September 16, 1986, see NYSE Formally Submits Proposal to Allow Unequal Voting Rights, 18 Sec. Reg. & L. Rep., at 1337, and the Commission held public hearings on the proposal on December 16-17, 1986. See, e.g., N.Y. Times, Dec. 17, 1986, at D1, col. 1.

In the months that followed, the SEC encouraged negotiations among the NYSE, Amex and NASDAQ toward the end of a voluntarily adopted uniform rule that protected the voting rights of existing shareholders. When these efforts failed, the SEC issued Exchange Act Release No. 24,623, Voting Rights Listing Standards; Disenfranchisement, 52 Fed. Reg. 23,665 (June 24, 1987), reprinted in [Current Volume] Fed. Sec. L. Rep. (CCH) ¶ 84,143, proposing Exchange Act Rule 19c-4. The proposed rule follows the recommendations of the working paper version of this Article, to which the Release refers, by prohibiting the listing of the stock of issuers that have created a class of limited voting stock by modifying the voting rights of existing common stock, but not restricting new issuances of limited voting stock.

² Although a few public companies have had a dual class capital structure for some time, recent years have seen a flurry of activity in this area. Of the 44 companies that created a class of limited voting rights common stock between 1962 and 1984, 37 (84%) did so between 1980 and 1984. M. Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth* 4-5 (University of Oregon College of Business Administration, Working Paper) (Sept. 1986), 18 J. Fin. Econ. (forthcoming 1987). An additional 26 companies created a class of limited voting rights common stock in 1985 and 1986. G. Jarrell & A. Poulsen, *The Effects of Recapitalization with Dual Classes of Common Stock on the Wealth of Shareholders*, at table 1 (Working Paper) (Apr. 1987) (copy on file with the Virginia Law Review Association). For a current compilation of all NYSE, Amex, and OTC companies with dual class common stock, see Pamepinto, *Dual Class Capitalization and Unequal Voting Rights Plans*, at A-13 to A-15 (Investor Responsibility Research Center Inc.) (Jan. 1987) (copy on file with the Virginia Law Review Association).

³ The NYSE proposal in part suffers from the same overbreadth. Although it exempts initial public offerings of limited voting right common stock from its special approval requirements, it continues the complete ban on non-voting common stock. See Proposed NYSE Changes, *supra* note 1.

⁴ For a detailed history of the NYSE's voting standards, see Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 Geo. Wash. L. Rev. 687, 688-707 (1986).

⁵ The issue remains controversial, however, to administrators of state securities laws. Both the Midwest Securities Commissioners and the North American Securities Administrators Association have adopted a policy statement to the effect that the offering of a sec-

stock's limited voting rights are reflected in a reduced price, so that the company's owners at the time it goes public, and not the purchasers, bear the cost.⁶ Shareholders are not fooled and there is no reason to expect that third parties will be adversely affected. Although a company that goes public with a class of stock with limited voting rights will be substantially sheltered from the market for corporate control, this is not a change in status. The company also was not subject to the market for corporate control before it went public. Thus, to the extent that the public policy debate extends to initial issuances of a limited voting or non-voting class of common stock, it is simply overbroad.

The more important problem with the debate, however, has been its narrowness. The difficulty is that its treatment of the primary object of concern in the NYSE proposal—a public company that alters its capital structure to reduce the voting power of its existing public shareholders—has focused only on a single form by which this result can be accomplished: an exchange that results in a management or family group holding shares with superior voting rights and the public shareholders holding shares with reduced voting rights.⁷ This ignores the fact that there are other forms of transactions that can accomplish the same result.

This myopic focus on a transaction's form is too often characteristic of regulatory methodology: if a particular transaction poses a problem, prohibit that transaction. In contrast, the methodology of finance is the search for least-cost substitutes. If capital markets were complete—the financial economist's version of the no-transaction costs assumption—the form in which a transaction was cast would be irrelevant. All that would matter would be the size of the cash flows and their associated risk; if the form in which the cash flows were packaged was for some reason inconvenient for a particular investor, existing markets would allow the investor to rear-

ond class of non-voting or limited voting stock would be considered unfair and inequitable under state merit regulation. Statement of Policy on Non-Voting Stock, 1 NASSA Rep. (CCH) ¶ 2401, *cited in* Seligman, *supra* note 4, at 713 n.112. Eighteen states, including California, Florida, and Texas, have adopted such a prohibition. See Seligman, *supra* note 4, at 713.

⁶ The application to the capital markets of the insight that a seller bears the cost of unfavorable features of his product originated with Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976).

⁷ For a description of the three principal techniques by which this can be accomplished, see *infra* note 12 and accompanying text.

range the transaction's form to his liking. But in the real world, differences in transaction costs may make the size and risk of a transaction's cash flows depend in part on the form in which the transaction is cast. For the transaction planner, then, the task is to identify which form, among all possible substitutes, is the least-cost way of packaging generic cash flows. For the regulator, the task is to set as few barriers as possible in the way of the planner's quest—a large sign should be permanently affixed to his desk that reads "Don't Create Transaction Costs." A regulator has no independent reason to prefer one transaction form to another unless he believes that some problem with the process systematically leads to the selection of other than the least-cost transaction form.

It is in this context that I want to consider the public policy debate over allowing a publicly held company to change its capital structure to replace a single class of voting stock with two classes, one of which—given to management or an existing shareholder group—has voting power substantially disproportionate to its interest in equity. The justification offered for such a recapitalization, which I will refer to here as a dual class transaction, is Rawlsian: that centralizing control in those receiving the class with superior voting rights somehow will increase the value of the company and, as a result, will increase the value of the shares with limited voting rights. Thus, the substance of the transaction (passing over its form for a moment) is the fixing of control in someone who already has an interest in the company, whether as an employee or as an investor. So described, the dual class transaction has a familiar substitute: a leveraged buyout (LBO), which also serves to shift control to management or an existing shareholder group.

In a perfect capital market, these substitutes would have an identical impact on firm value. The relative prices of the two classes of common stock following the dual class transaction would reflect the same sharing of gains that results from the shift or centralization in control that is reflected in the premium typically received by shareholders in a leveraged buyout transaction. If, as appears to be the case, this equivalence between the two transaction forms is *not* observed,⁸ the first step in resolving the policy debate over shifts to disproportionate voting arrangements is to

⁸ See *infra* notes 16-34 and accompanying text.

understand what accounts for the apparent difference in gain sharing, depending upon the form in which the transaction is cast. We need to understand why, for example, the Haas family chose to take Levi Strauss private,⁹ while the Fisher family chose dual class common stock for the Gap Stores.¹⁰ And we need to understand why that choice has so significant an impact upon the wealth of non-controlling shareholders.

In this essay, I analyze which factors may influence the choice between an LBO and a dual class transaction, in order to determine whether any regulatory response to dual class transactions is called for and, if so, the nature of an appropriate response. Part I develops more fully the concept that LBOs and dual class transactions are perfect substitutes in a complete capital market. Part II sets out the available empirical data concerning LBOs and dual class transactions in the real world of positive and pervasive transaction costs. Part III then describes two alternative explanations—efficient and coercive self-selection—for the data patterns developed in Part II. Finally, Part IV develops a limited regulatory response to dual class transactions that eliminates the potential for coercion without interfering with the potential efficiency characteristics of such transactions.

I. COMPLETE MARKET SUBSTITUTES FOR A DUAL CLASS COMMON STOCK TRANSACTION

The crux of a dual class common stock transaction is to fix control of the company in the hands of those who end up holding the class of common stock with superior voting rights. A variety of benefits are said to result from this alteration in control. First, non-controlling shareholders are thus protected from coercive takeover tactics and from making the mistake of selling the company too cheaply because they lack information possessed by the controlling shareholders. Management, in turn, is protected from losing their positions without their consent. The flip side of this

⁹ See N.Y. Times, July 12, 1985, at D1, col. 4; *id.*, July 31, 1985, at D11, col. 6; *id.*, Aug. 31, 1985, § 1, at 34, col. 6.

¹⁰ See The Gap, Inc., Proxy Statement 15 (May 1, 1986), *cited in* J. Gordon, Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice 43 n.63 (New York University School of Law, Working Paper) (Nov. 1986), 75 Calif. L. Rev. (forthcoming Oct. 1987).

benefit, of course, is the most commonly heard objection: A dual class transaction may be such an effective defensive tactic that it completely shelters management from the discipline of the market for corporate control.

Second, where those who end up with the superior class of stock did not previously control the company, the dual class transaction protects management against loss of bargained-for perquisites through opportunistic behavior by other shareholders. Here the idea is that managers, by making firm-specific investments of their human capital, have thus implicitly contracted for future payments. By accepting a hostile tender offer, shareholders breach that contract.

Finally, where control is already held by the group receiving the superior class of stock, the transaction allows them to reduce their proportion of stock ownership without diluting their control. Thus, by selling off some of their equity position, a controlling group can reduce the excessive unsystematic (and otherwise potentially diversifiable) risk that they bear as a result of their large investment in the company. Alternatively, the group can raise additional equity capital for the company by selling a new class of limited voting shares, while still retaining a majority in voting rights.

For present purposes, however, I wish to put aside the debate over whether such benefits really result from dual class transactions.¹¹ What is of concern is that, at least in complete capital markets, the claimed benefits can be achieved in a variety of different ways.

This point can be illustrated by examining two polar forms of transactions: a dual class transaction effected by an exchange recapitalization, and a leveraged buyout. The first step in a typical recapitalization transaction involves shareholder approval of a new class of common stock that carries multiple votes per share—for example, ten—but which usually has dividend rights ten percent

¹¹ For a sampling of the debate, see, e.g., Buxbaum, *The Internal Division of Powers in Corporate Government*, 73 *Calif. L. Rev.* 1671 (1985); DeAngelo & DeAngelo, *Managerial Ownership of Voting Rights*, 14 *J. Fin. Econ.* 33 (1985); Dent, *Dual Class Common Stock: A Reply to Professor Seligman*, 54 *Geo. Wash. L. Rev.* 725 (1986); Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock (Lexecon Inc.)* (Mar. 1985); J. Gordon, *supra* note 10; Lease, McConnell & Mikkelson, *The Market Value of Control in Publicly Traded Corporations*, 11 *J. Fin. Econ.* 439 (1983); M. Partch, *supra* note 2; Seligman, *supra* note 4.

lower than the preexisting class of common stock. The terms of the superior class generally provide that, if the shares are transferred to or for the benefit of persons outside a shareholder's immediate family, the shares will automatically convert to the preexisting common. Following authorization, shareholders are offered the opportunity to exchange their preexisting common stock for the superior class. Because of the dividend differential, only the group seeking to obtain or maintain control exchanges its shares; the other shareholders decline. Thus, if the new voting ratio is, say, ten to one, so long as the exchanging group held more than nine percent of the preexisting class, when the dust settles they will have a majority of the voting power.¹²

A leveraged buyout is ostensibly a very different kind of transaction. In an LBO the group seeking to obtain or maintain control offers to purchase for cash all of the company's common stock held by other shareholders. So long as a majority of the company's shares are acquired, remaining shareholders are frozen out in a second-step merger.¹³ After the transaction, the shareholders who are not part of the new control group thus cease to be shareholders at all.

Both transactions accomplish the desired goal of shifting or fixing control, but by different processes and, it would seem, with very different end results. In the dual class transaction, public shareholders receive common stock with significantly reduced vot-

¹² See J. Gordon, *supra* note 10, at 48-49. Gordon also reviews the two other principal techniques by which dual class transactions have been effected. The first technique entails a special stock dividend in which a new class of stock, with rights and restraints similar to the new class of stock used in an exchange transaction, is distributed. When shareholders transfer their stock to third parties, the superior voting rights are eradicated, so that all superior voting stock originally distributed to public shareholders will gradually be eliminated. *Id.* at 49-51. The second technique is a voting rights alteration through which, by charter amendment, superior voting rights are given to shares that have been held for a significant period of time. Here the expectation is that normal portfolio turnover will leave public shareholders with limited voting rights. *Id.* at 51.

¹³ See, e.g., Lowenstein, *Management Buyouts*, 85 *Colum. L. Rev.* 730, 732 & n.5 (1985). In a second-step merger, the majority group votes to merge the corporation into a "new" entity that they control. This vote binds those shareholders who either vote against the merger or do not vote at all. These shareholders must either accept the cash offered for their shares or exercise their appraisal rights. See Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 *Stan. L. Rev.* 487, 495-96 (1976) (discussing use of the freezeout merger in buyouts); see also R. Gilson, *The Law and Finance of Corporate Acquisitions* 868-69 (1986) (discussing freezeouts generally).

ing rights, though the stock typically carries a small dividend preference in order to encourage the shareholders' participation in the transaction. In the LBO, public shareholders are no longer participants in the enterprise, having traded their shares for cash. The critical point, however, is that in a complete capital market public shareholders would be indifferent between the two forms of transaction; despite their formal differences, they are substantively identical.

Suppose the transaction is cast as a dual class recapitalization. In this guise a non-exchanging shareholder receives for his voting rights an increase in future dividends. If a non-exchanging shareholder prefers cash, as would have been received in an LBO, a market will exist in which his limited voting right shares can be sold at a price that reflects the present value of the increased dividend stream now associated with the shares. The difference in market price between shares of the single class of common stock before the recapitalization and shares with limited voting rights but a higher dividend after the recapitalization reflects the non-exchanging shareholders' portion of the gain from shifting or fixing control.

In a perfect market, the cash received by a non-exchanging shareholder from the sale of his limited voting right stock should be identical to the cash that the shareholder would have received if the transaction originally had been structured as an LBO. In an LBO, the buyout price of the shareholder's stock also would reflect the pre-transaction value of the stock, plus a premium representing the shareholders' portion of the gain from fixing control—here through an LBO—in the controlling group. Because both forms of transaction bring about the changes claimed to cause the increase in a company's value, the size of the increase should be the same however it is accomplished. Moreover, the public shareholders' portion of the gain should be the same, whether it comes as an increase in a stream of dividends (as in a recapitalization) or as a premium over market (as in an LBO). Put slightly differently, the increase in the value of the non-controlling shares following a recapitalization transaction should be identical to the premium paid in an LBO, and the non-favored shareholders should be indifferent as to the form the transaction takes.

The two forms of transaction are also substantively identical from the perspective of those seeking to fix control in themselves.

Suppose the control group believes that the value of the company would increase if its capital structure included a class of limited voting equity. If the transaction is cast as an LBO, nothing prevents the company from subsequently making a public offering of equity with precisely the same rights, preferences, and privileges as would have been proffered had the transaction been structured as a dual class recapitalization in the first instance. Thus, the form in which the transaction is initially cast is a matter of indifference to both sides because each side—without the cooperation of the other—is free to alter the impact of the transaction to suit its own preferences.¹⁴

The regulatory implications of this identity are straightforward. In a world of complete capital markets, it makes no sense to regulate one form of a transaction without similarly regulating all transactional substitutes. And it makes no sense to regulate all transactional substitutes without a reason to do so. It is only by the introduction of transaction and information costs that a systematic preference for one or another transaction form can develop.¹⁵

II. THE EMPIRICAL CONSEQUENCES OF INTRODUCING TRANSACTION AND INFORMATION COSTS

The critical implication of the analysis of dual class recapitalizations and LBOs in a perfect capital market is that non-controlling shareholders would be indifferent between the two forms of transaction because their portion of the gain from the transaction would be identical in either case. The next step in the analysis is to explore what happens in the real world, where transaction and information costs abound. If there is a difference in the gains to public shareholders that depends on transaction form, the difference may

¹⁴ During a discussion of this question, my colleague Thomas Campbell pointed out that the same proof of equivalence may be made by substitution. If shareholders both start and end with the same thing in both transactions, the transactions themselves must be functionally equivalent.

¹⁵ For development of a transaction cost approach to regulatory design in other contexts, see R. Gilson, *supra* note 13, at 557-87 (1986) (*de facto* merger doctrine); Gilson, Scholes & Wolfson, *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions, in* *Knights, Raiders, and Targets: The Impact of the Hostile Takeover* (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. forthcoming 1987) (tax treatment of corporate acquisitions).

have regulatory implications: the presence of transaction and information costs may result in the systematic selection of other than the least-cost transaction form. The analysis would then shift to examination of the institutional structure in which the transactions take place, in order to determine what might account for the differing empirical results and, consequently, whether any regulatory effort were warranted or possible.

A. *The Data*

Both LBOs and dual class transactions have been the subject of three principal studies. In both cases, the studies present a common picture of the transaction examined. The consistency breaks down, however, when the transactions are compared with each other. Not only are shareholders affected in radically different ways by the two forms of transaction, but the pre-transaction distribution of ownership between management and public shareholders differs sharply in companies that are the subjects of LBOs, as compared to those companies that are the subjects of dual class common stock transactions.

1. *Impact on Shareholder Wealth*

a. *Leveraged Buyouts*

DeAngelo, DeAngelo and Rice,¹⁶ Marais, Schipper and Smith,¹⁷ and Lehn and Poulsen¹⁸ have studied the impact of LBOs on shareholder wealth, using abnormal return event time methodology.¹⁹ DeAngelo, DeAngelo and Rice studied eighty-one proposals

¹⁶ See DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & Econ. 367 (1984).

¹⁷ See L. Marais, K. Schipper & A. Smith, *Management Buyout Proposals and Corporate Claimholders: Explicit Recontracting and Differential Wealth Effects* (University of Chicago Working Paper) (Oct. 1986) (copy on file with the Virginia Law Review Association).

¹⁸ See K. Lehn & A. Poulsen, *Sources of Value in Leveraged Buyouts* (Working Paper) (Feb. 1987) (copy on file with the Virginia Law Review Association).

¹⁹ Abnormal return event time studies make use of recent innovations in financial economics to specify the impact of particular events on the price of a company's stock and, hence, on shareholder wealth. The barrier to accomplishing this in the past was that the price of a stock is affected by general economic conditions as well as by the particular event the impact of which is under study. What was necessary was a means to predict what the stock's price would have been in the absence of the particular event, taking into account the effects of changes in economic conditions. If this prediction could be made accurately, then the difference between the predicted stock price and the actual stock price would measure

made between 1973 and 1980 by which management, alone or with third-party investors, sought to eliminate the participation of public shareholders. Their sample indicated statistically significant positive abnormal returns of 22.27% on the announcement of the proposal, and 30.4% over the forty-day period prior to and including the announcement. Put in terms of a proposal's premium over actual market price rather than in terms of abnormal returns, a subsample of fifty-seven proposals involving only cash consideration reflected an average premium of 56.31% over the market price two months prior to the proposal's announcement.

The large gains that DeAngelo, DeAngelo and Rice report for the entire sample also survive cross-sectional analysis. When the sample is broken down into proposals made by management with third-party investors and proposals made by management alone, the abnormal returns are 16.99% on announcement and 27.03% over the forty-day period for proposals with third-party investors, and 25.17% and 32.8%, respectively, for proposals made only by management. The average premium over market price was 59.21% for proposals with third-party investors and 54.59% for proposals made only by management.

The samples studied by Marais, Schipper and Smith, and by Lehn and Poulsen, are in one sense more limited than those studied by DeAngelo, DeAngelo and Rice, apparently including only

the impact of the event. Developments in financial economics have provided two techniques—the capital asset pricing model and the market model—that facilitate the required prediction. When a company earns more or less than predicted, the difference is referred to as a positive or negative abnormal return (or prediction error).

An additional aspect of the methodology responds to the problem of confounding events. For any particular company, other unusual events may have taken place at approximately the same time as the event under study. When this occurs, there is a problem in assigning responsibility for the result observed. The confounding event problem is mitigated by using a sample of a large number of companies that have experienced, at different times, the event under study. Abnormal returns for the entire sample are then determined with reference to "event time," measured not by chronological dates, but in relation to the date on which knowledge of the event became public. Thus, for example, where there has been no leakage, the date of the event's announcement is set as day 0 for all companies, and computation of an abnormal return is with respect to an event time date—e.g., day 0—or a period—e.g., day -5 through day +5 (from five days before the announcement date through five days after the date of announcement). Because each company in the sample likely will have experienced the event at a different chronological date, confounding events relating either to particular companies or to particular real times will wash out.

For a more detailed discussion of both the technique and the difficulties in interpreting the data generated, see R. Gilson, *supra* note 13, at 213-38.

proposals with third parties, today's classic form of LBO. However, the Marais, Schipper and Smith sample of 287 announcements involving 264 firms is both significantly larger than that of DeAngelo, DeAngelo and Rice, and significantly more recent. Although the sample includes proposals made between 1974 and 1985, 87% were made during the 1980's, and 45% were made during 1984-1985. Similarly, the Lehn and Poulsen sample of ninety-three transactions is also more recent than that of DeAngelo, DeAngelo and Rice, having been drawn entirely from the 1980-1984 period. The currency of the Marais, Schipper and Smith and Lehn and Poulsen samples is of particular importance because the character of the firms that have been the subject of LBOs seems to have changed dramatically around 1980. Although the median value of the publicly held common shares of the firms in the DeAngelo, DeAngelo and Rice sample was less than \$3 million,²⁰ leveraged buyouts in the hundreds of millions, or even billions, of dollars have become commonplace in the 1980's.²¹ Thus, the Marais, Schipper and Smith sample, and the Lehn and Poulsen sample, both capture the magnitude of transactions commonly associated with the LBO phenomenon today. For these samples, Marais, Schipper and Smith, and Lehn and Poulsen, report average abnormal returns on announcement of an LBO proposal of some 13%,²² a figure most comparable with the 16.99% abnormal return reported by DeAngelo, DeAngelo and Rice on announcement of proposals involving third parties. These figures correspond to a premium over market of approximately 40%.²³

As with any empirical research, there are arguably problems with these studies' sample compositions and definitions. In this case, however, both studies report statistically significant positive

²⁰ DeAngelo, DeAngelo & Rice, *supra* note 16, at 382.

²¹ See Lowenstein, *supra* note 13, at 735-37.

²² L. Marais, K. Schipper & A. Smith, *supra* note 17, at 24; K. Lehn & A. Poulsen, *supra* note 18, at table 3. Marais, Schipper and Smith also report that their sample earned an additional 4% over the 159 days prior to announcement of the LBO proposal. L. Marais, J. Schipper & A. Smith, *supra* note 17, at 23. This total abnormal return of 17% from 159 days prior to announcement through announcement compares to the 27.03% figure DeAngelo, DeAngelo and Rice report for the period for 40 days prior to, and through, announcement. DeAngelo, DeAngelo & Rice, *supra* note 16, at 394. In turn, Lehn and Poulsen report abnormal returns of some 20%, measured either from 20 days prior to announcement to 20 days after, or from 10 days prior to 10 days after. K. Lehn & A. Poulsen, *supra* note 18, at 13.

²³ K. Lehn & A. Poulsen, *supra* note 18, at 3.

abnormal returns of a magnitude, and market premiums of a size, that make one conclusion abundantly clear: the wealth effects of LBOs on shareholders of subject companies have been large and positive.

b. Dual Class Transactions

Dual class common stock transactions also have been the subject of three principal abnormal return event time studies, by M. Megan Partch,²⁴ Jeffrey Gordon,²⁵ and Gregg Jarrell and Annette Poulsen.²⁶ Partch examined a sample of forty-four firms undertaking dual class transactions between 1962 and 1984. Abnormal returns were computed for the date on which the proposal for each transaction was first publicly announced, for various intermediate dates, including the shareholder meeting date on which the proposals were approved, and for the entire period from announcement through approval.²⁷

The returns reported for the specific dates are mixed. The entire sample earned statistically significant positive abnormal returns of 1.237% on the announcement date, and 2.125% over all event days examined. Partch regards these figures as misleading, however, because a positive abnormal return does not fairly describe the sample; only roughly half of the returns are positive and it is impossible to reject chance as an explanation for the proportion of positive and negative results.²⁸ This interpretation of the results is consistent with Partch's findings for the entire period. From announcement through approval, the sample experienced negative abnormal returns of 1.755%, which were not statistically significant.²⁹

This pattern—some small, statistically significant, positive (but ambiguous) returns on the event days, but statistically insignificant, negative returns over the entire period—persists when the sample is broken down into various subsamples based on both the form of the transaction and the amount of stock held by the controlling group.³⁰ Partch concludes from the data that “shareholder

²⁴ See M. Partch, *supra* note 2.

²⁵ See J. Gordon, *supra* note 10.

²⁶ See G. Jarrell & A. Poulsen, *supra* note 2.

²⁷ M. Partch, *supra* note 2, at 15-17.

²⁸ See *id.* at 18.

²⁹ *Id.* at 19, table 4.

³⁰ See *id.* at 21, table 5. The pattern is somewhat different with respect to a subsample of companies that selected a technique involving an increase in the dividend for the limited

wealth does not appear to be affected by the creation of a class of limited voting common stock."³¹

Gordon, in turn, studied a sample of nineteen NYSE-listed firms that underwent dual class transactions during 1984-1986. Abnormal returns were calculated for two different periods: from two days before the announcement through one day after the announcement and, to take into account the possibility that the announcement date was not accurately specified, from five days before the announcement through five days after the announcement. For the sample as a whole, Gordon's results were identical to those reported by Partch: shareholders experienced no statistically significant wealth effects as a result of the dual class transactions.³²

Finally, Jarrell and Poulsen complete a consistent picture of the impact of dual class transactions on shareholder wealth. Measured over periods comparable to those considered by Partch and Gordon, Jarrell and Poulsen report no statistically significant abnormal returns for sixty-three dual class transactions occurring between 1976 and 1986 (three-quarters of which occurred after 1982).³³ This result survives cross-sectional analysis: Over periods of up to ten days on either side of the announcement date, subsamples based on the exchange on which the company's stock was traded or on the manner in which the dual class transaction was effected show no statistically significant abnormal returns.³⁴

2. *Distribution of Shareholdings*

a. *Leveraged Buyouts*

Although there are only sparse data available concerning the distribution of ownership between management and public sharehold-

voting stock. For this sample, there were statistically significant positive returns on the event dates and statistically significant negative returns over the entire period. *Id.*

³¹ *Id.* at 25.

³² See J. Gordon, *supra* note 10, at 38. Gordon does, though, report statistically significant results for some subsamples. He found statistically significant negative abnormal returns for the five companies that effected the dual class transaction by charter amendment, *id.* at 39, and for the five firms where the pre-transaction dominant shareholder had sufficient votes to force the transaction. *Id.* at 40, table 2.

³³ G. Jarrell & A. Poulsen, *supra* note 2, at 18, table 2.

³⁴ *Id.* at 19-21, tables 2, 3.

ers in firms that are subject to LBOs, the data are nonetheless suggestive and provide an interesting contrast to the distribution found in firms undertaking dual class transactions (about which there is more information available). DeAngelo, DeAngelo and Rice report that for ten successful LBO proposals between 1973 and 1980 involving third-party participation—the form of transaction most resembling the current LBO paradigm—management on average owned 23.2% of the outstanding common stock before the offer.³⁵ Marais, Schipper and Smith do not report the pre-transaction ownership distribution of companies in their sample, but Lehn and Poulsen report average pre-transaction management holdings of 24.1%, about the same level as reported by DeAngelo, DeAngelo and Rice.³⁶ The median reported by Lehn and Poulsen is only 16.6%, suggesting that a high ownership percentage in some larger transactions increases the mean.³⁷ However, a study by Louis Lowenstein of twenty-eight successful LBOs between 1979 and 1984, each of which involved more than \$100 million,³⁸ suggests lower management ownership as the size of the transaction increases. For Lowenstein's twenty-eight companies, the average size of which was \$498 million, the average pre-transaction management share ownership was 6.5%.³⁹

b. Dual Class Transactions

In comparison to the sparse data on shareholding in companies employing leveraged buyouts, there is more information available concerning the distribution of shareholdings in companies undertaking dual class transactions. What is apparent is that the average company proposing a dual class transaction is already controlled by a dominant shareholder group. Partch reports that, prior to the transactions in her study, an existing group already owned on average 48.6% of the company. Indeed, when the sample is broken down based on the percentage of stock owned by insiders, a dominant group held an average of some 30% of the outstanding com-

³⁵ DeAngelo, DeAngelo & Rice, *supra* note 16, at 383.

³⁶ K. Lehn & A. Poulsen, *supra* note 18, at 23.

³⁷ *Id.* The range of management pre-transaction equity holdings was from .07% to 74.9%.
Id.

³⁸ See Lowenstein, *supra* note 13, at 736-39.

³⁹ See *id.* at 737.

mon stock in even the lowest quartile of the sample (the average was 63.7% for the highest quartile).⁴⁰ Gordon reports average pre-transaction inside group holdings of approximately 30%, with 37% of the sample having an inside group holding over 40%, 47% of the sample having an inside group holding between 20% and 40%, and only 16% of the sample having an inside group holding of less than 20%.⁴¹ Finally, Jarrell and Poulsen report average pre-transaction inside group ownership of 44.5%.⁴²

B. *Patterns in the Data*

Two interesting patterns appear in the data concerning LBOs and dual class common stock transactions. First, and most clearly, shareholders experience large wealth gains as a result of LBOs.⁴³ In contrast, shareholder wealth is, at best, unaffected by dual class transactions. Second, there are typically no preexisting dominant shareholder groups in companies subject to LBO proposals.⁴⁴ Although managers may have only small ownership interests in those companies, they can, because of the absence of dominant shareholder groups, exert control through their position. In contrast, preexisting dominant shareholder groups have virtual majority voting control in companies subject to dual class proposals.

The relation between the two patterns appears in the matrix below. Where there is an effort to fix control of a company by reducing the voting rights of public shareholders, a company without a preexisting dominant shareholder group—a management-dominated company, for instance—is more likely to be the subject of an LBO, with a resulting increase in shareholder wealth. A company with a preexisting dominant shareholder group is, in contrast,

⁴⁰ M. Partch, *supra* note 2, at 9, table 3.

⁴¹ See J. Gordon, *supra* note 10, at 52 & n.71.

⁴² See G. Jarrell & A. Poulsen, *supra* note 2, at table 6. The average ranged from 36.6% for New York Stock Exchange-listed companies, to 48.5% and 48.3%, respectively, for Amex- and OTC-listed companies. *Id.*

⁴³ Jarrell and Poulsen report statistically significant positive abnormal returns for their sample over a longer period of 40 days surrounding announcement of a dual class transaction. G. Jarrell & A. Poulsen, *supra* note 2, at 18-19, table 3. They note, however, that positive abnormal returns over so long a period may not be the result of the dual class transactions but, rather, their cause. *Id.* at 19. This suggests that dual class transactions are motivated by companies' favorable prospects, a hypothesis considered *infra* notes 46-66 and accompanying text.

⁴⁴ See Lowenstein, *supra* note 13, at 737.

more likely to be subject to a dual class proposal, with no resulting increase in shareholder wealth.

	Impact on Shareholder Wealth	Preexisting Dominant Shareholder Group
LBO	Positive	No
Dual Class	Neutral ⁴⁵	Yes

III. ALTERNATIVE EXPLANATIONS FOR THE EMPIRICAL PATTERNS

The analysis in Part I led to the conclusion that if capital markets were complete, shareholders would be indifferent between LBOs and dual class common stock transactions. In contrast, the data described in Part II reveal that in the real world of transactional friction there are patterns to choice of transaction form that result in a systematically different impact on shareholder wealth. But whether those patterns give rise to a need for regulatory intervention depends on what accounts for them. If they simply reflect an efficient market response to the presence of transaction costs—that is, if LBOs and dual class transactions are used to accomplish the same result in circumstances when particular transaction costs render one or the other transaction form superior—no case for regulation exists. Alternatively, if the patterns evidence exploitation of public shareholders by dominant inside shareholder groups—because when such a group has control, perhaps gains from fixing control are no longer shared with public shareholders—then regulation may be necessary. Interestingly, the patterns of data observed are consistent with both explanations.

⁴⁵ Describing as “neutral” the impact of dual class transactions on shareholder wealth accurately reflects the data Partch and Gordon report. However, it should be noted that Gordon argues that the absence of abnormal returns reflects not the neutrality of the transaction, but positive returns from the announcement of favorable projects offsetting negative returns from the dual class transaction itself. See *infra* notes 91-92 and accompanying text.

A. *Efficient Self-Selection: Cash Cows Versus Question Marks*

The more benign explanation for the patterns that appear in the LBO and dual class transaction data contemplates two categories of companies that stand to benefit in radically different ways from fixing control in the hands of non-public shareholders. The first category consists of stable, successful firms with high market shares in slow-growing mature industries. Their market shares and the absence of market growth enable these firms to generate substantial amounts of what Michael Jensen has termed "free cash flow": "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."⁴⁶ An earlier management literature referred to such companies as "cash cows."⁴⁷

Jensen points out that cash cows are subject to particularly severe conflicts of interest between managers and shareholders. Managers want to increase the amount of assets under their management even if that requires undertaking investments with negative net present value, while shareholders prefer that the free cash flow be distributed to them so that they can then invest the funds more profitably on their own.⁴⁸ Where a dominant shareholder group exists, management's self-interest can be constrained di-

⁴⁶ Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 *Am. Econ. Rev. (Papers & Proc.)* 323, 323 (1986).

⁴⁷ This term comes from the strategic management literature commonly associated with the Boston Consulting Group. This literature defines four types of businesses, based on a two by two matrix of relative market share and market growth that stresses the relationship between a business' cash flow and its market share-market growth characteristics. Companies with high market shares in slow-growing markets, which produce cash but require little capital themselves, are "cash cows." Companies with high market shares in fast-growing markets generate both large cash flows and large cash needs and, thus, are self-sufficient with respect to capital. These companies are called "stars." Companies with low market shares in slow-growing industries generate little cash yet require cash investments that, given their unfavorable market position, will inevitably be lost. These companies are called "dogs." Finally, companies with low market shares in fast-growing industries require a great deal of cash to increase their market shares. If they succeed in increasing their market shares, they become stars; if they fail, they become dogs. These companies are called "question marks" because of the uncertainty as to their future. Note that this typology ascribes a life cycle to companies and markets. Companies begin as question marks in fast-growing, immature markets. Those that are successful ultimately emerge as cash cows with high market shares in mature markets where growth has slowed substantially. The Boston Consulting Group matrix is described in M. Salter & W. Weinhold, *Diversification Through Acquisition* 65-75 (1979).

⁴⁸ See Jensen, *supra* note 46, at 323-24.

rectly. Where, however, there is no dominant shareholder group, management is free to indulge its self-interest.⁴⁹

Thus, a cash cow with dispersed shareholdings may present an opportunity for gain by centralizing control. If a dominant shareholder group were to obtain control of the company, the group would have an incentive both to increase the amount of free cash flow by cutting costs, and to distribute that cash to themselves instead of investing it in negative net present value projects. The incentive to improve operating and investment decisions would be even stronger if the dominant group financed the acquisition of its position by debt, since debt serves to bond the promise to pay out (rather than reinvest) free cash flow.⁵⁰ Moreover, the conflict between management and the dominant shareholder group could be further ameliorated by giving managers a significant ownership interest in the company.

This description is consistent with both the companies that have been subject to LBOs and the character of the LBO transaction itself. The data indicate that such companies tend not to have a dominant shareholder group prior to the LBO transactions, that as a result of the transactions managerial ownership increases (on average) by some four times,⁵¹ and that the transactions are financed

⁴⁹ This behavior by management reflects more than simple greed. Managers, unlike shareholders, typically do not hold diversified portfolios because their human capital investment in their employer is not easily diversified. Thus, managers have an incentive to diversify the company's activities in order to diversify their human capital. See R. Gilson, *supra* note 13, at 360-70. Empirical evidence that management-controlled companies engage in conglomerate acquisitions more frequently than owner-controlled companies provides support for this explanation of why managers may prefer to reinvest free cash flow, even in negative net present value projects, rather than distribute it. See Amihud & Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 *Bell J. Econ.* 605 (1981); Amihud, Dodd & Weinstein, *Conglomerate Mergers, Managerial Motives and Stockholder Wealth*, 10 *J. Banking & Fin.* 401 (1986).

⁵⁰ Jensen notes that, for this purpose, debt is a more effective substitute for dividends. The only recourse open to shareholders who are disappointed by management's failure to pay dividends is to replace management. In contrast, debtholders may take the company away from management if interest payments are not made. In addition to forcing managers to pay out free cash flows, this gives managers an incentive to run the company more efficiently. See Jensen, *supra* note 46, at 324. The notion that debt can serve to bond management behavior originated with Grossman & Hart, *Corporate Financial Structure and Managerial Incentives*, in *The Economics of Information and Uncertainty* 107 (J. McCall ed. 1982), who argued that by taking on debt, risk averse (because undiversified) managers effectively bond their claim that they have favorable private information about the company's future prospects.

⁵¹ See Lowenstein, *supra* note 13, at 737.

largely by third-party debt. The free cash flow concept thus can explain the pattern of data reported for LBOs: no preexisting dominant shareholder group and a division of the gain from the transaction with public shareholders because of the market for corporate control.⁵² A dual class transaction simply could not achieve

⁵² There is some direct empirical evidence of a link between free cash flow and LBOs. Measured by a number of statistical techniques, Lehn and Poulsen report a statistically significant positive relationship between the amount of free cash flow and the size of the premium paid in an LBO. This relationship was stronger than for any other combination of the variables they studied. K. Lehn & A. Poulsen, *supra* note 18, at 19-22, table 11.

Lehn and Poulsen also report a second strong relationship: the link between pre-transaction effective tax liability relative to a company's equity and the size of the LBO premium. *Id.* at 20-21, table 9. Lehn and Poulsen take this link as evidence that "tax benefits do play a significant role in valuation of leveraged buyouts." *Id.* at 21. There are two problems with their tax motivation analysis, one methodological and one interpretive.

The methodological problem centers on whether their measure really captures the likelihood of tax benefits from an LBO. To be sure, positive pre-transaction tax liability is necessary for any tax benefits to be possible, and the Lehn and Poulsen measure does capture this. But it does not measure the potential for a step-up in basis, which is the particular tax benefit Lehn and Poulsen treat as available through an LBO. *Id.* at 11-12. The extent to which a potential LBO candidate can capture this benefit depends on the difference between the company's tax bases in its assets and their market value. The tax motivation hypothesis would then be that the larger this difference, the larger the tax gain, and the higher the premium. The Lehn and Poulsen analysis does not test this relationship. Indeed, their tax measure may simply be just a different proxy for free cash flow (which would explain the similar relationship they report between size of premium and both free cash flow and their tax motivation measure).

To see this, assume that for a given firm the relationship between free cash flow and tax liability is constant (although it may vary among companies)—that is, assume that both cash flow and tax liability are functions of income, and that the company's tax strategy is to be treated as a given, short of engaging in an LBO. Because the Lehn and Poulsen tax measure and free cash flow are then both a function of the same variable, stating the relationship between tax liability and size of premium is simply another way of stating the relationship between free cash flow and size of premium.

The interpretive problem concerns whether Lehn and Poulsen's tax motivation analysis is capable of explaining the incidence of LBOs no matter how the potential tax benefit of the transaction may be measured. Gilson, Scholes & Wolfson, *supra* note 15, demonstrate that during the period in which the transactions in the Lehn and Poulsen sample occurred, an LBO was not the only means by which the tax benefits of a step-up in basis could have been achieved. The step-up was also available (though to a more limited extent) through a sale and leaseback. See *id.* at 29-30. What is necessary, then, is an explanation for why management would have chosen to achieve tax gains through a control transaction such as an LBO, rather than through a noncontrol transaction such as a sale and leaseback of appreciated assets.

One plausible explanation for the choice is entirely consistent with the free cash flow concept. Imagine that management discovers a favorable business strategy—increased cash flow through a step-up in basis—that could be implemented in two ways. First, it could be implemented through a sale and leaseback, the gains from which management would par-

the gain from centralizing ownership available to a cash cow company—that form of transaction would serve only to further strengthen management's ability to favor itself at the expense of shareholders. No gain would result in which public shareholders could participate and, because management lacks a significant share of the vote in this type of firm, the proposal would likely fail because public shareholders could not be persuaded to vote for the transaction.⁵³

Now consider a second category of companies that might stand to gain from fixing control in a dominant group. This category differs from the cash cows in two critical respects. First, these companies suffer not from free cash flow, but from a capital shortage. Second, they are in an earlier stage of development, both in terms of the market in which they participate and in terms of their own organization. Here the companies are in markets that are growing quickly, so substantial additional capital investments are necessary to gain or maintain market share. Markets in the growth portion of their life cycles are also characterized by entrepreneurial companies that have only recently gone public (to raise expansion capital), the founding entrepreneurs of which still retain dominant ownership positions. To return to the jargon of the managerial

ticipate in to the extent of its existing equity investment. Alternatively, it could be implemented through an LBO, with the result that management would substantially increase its ownership and, therefore, its share of the value created by the new strategy. Note that both strategies would involve, in effect, the company's borrowing the amount by which the market value of its assets exceeded their tax bases. Thus, both strategies would increase the leverage of the company and, as a result, the risk associated with the managers' undiversified human capital. A sale and leaseback would cause the managers to bear this risk without compensation; an LBO would, though, compensate the managers for the increased risk with an increase in return. Thus, management's preference for an LBO should not be surprising. It would, however, be inaccurate to describe the change in control as tax motivated. A tax motivation goes no further than explaining a transaction that results in a change in tax basis; it does not explain why that transaction takes a form that also results in a change of control.

⁵³ There is some evidence that in another context management's choice of control techniques depends on its ability to control a shareholder vote. See P. Malatesta & R. Walkling, *Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure* (Working Paper) (Sept. 1986) (copy on file with the Virginia Law Review Association). Malatesta and Walkling report that managers of those companies that resort to a poison pill (a technique that does not require shareholder approval for adoption) as a takeover defense own statistically significantly smaller amounts of their companies' stock than the average for other companies in their industries. *Id.* at 24-26, table 5.

literature, these companies in growing markets with large additional cash flow needs are called "question marks."⁵⁴

Dominant shareholders of question marks are faced with a dilemma. If they finance growth by further sales of an existing single class of common stock, their control of the firm will be diluted. But if they avoid dilution by purchasing enough new shares themselves to retain the same percentage of ownership, they will suffer an uncompensated increase in the unsystematic risk of their investment in the company.⁵⁵ In either event, this form of financing growth imposes a cost on dominant shareholders that is not shared by public shareholders.

Engaging in a dual class transaction prior to raising additional equity allows a dominant shareholder group to secure capital for positive net present value investments without forcing them to bear a disproportionate amount of the cost.⁵⁶ Such transactions would be approved by public shareholders not only because the dominant shareholder group already controls a large percentage of the vote, but, more interestingly, also because at the question mark stage of a company's development (in contrast to the cash cow stage) there is little conflict of interest between management and shareholders. The need to maintain or increase market share in an expanding market gives management sufficient incentive to run the firm efficiently. Thus, the product market serves the same purpose for questions marks that the increase in debt from an LBO does for cash cows.⁵⁷

⁵⁴ See *supra* note 47.

⁵⁵ Unsystematic risk is that risk associated with investment in a particular asset that could be eliminated by holding a diversified portfolio. As the amount invested in a single asset increases, so generally does the investor's unsystematic risk. See R. Gilson, *supra* note 13, at 127. Hence, if the dominant shareholders were to increase their investment in their company by buying more shares, they would also increase the unsystematic risk associated with that investment.

⁵⁶ This explanation for dual class transactions is consistent with a model recently developed by Sanford Grossman and Oliver Hart to identify the optimal allocation of voting rights among security holders. See S. Grossman & O. Hart, *One Share/One Vote and the Market for Corporate Control* (MIT, Dep't of Econ., Working Paper No. 440) (Feb. 1987) (copy on file with the Virginia Law Review Association). Although their model is too complex to relate thoroughly here, it predicts an initial voting structure in which a dominant shareholder retains control when the dominant shareholder receives a greater private (i.e., one not shared with other shareholders) benefit from control than would a buyer of control. *Id.* at 5, 7, 22-31.

⁵⁷ Although this explanation remains consistent with a management entrenchment anti-takeover motive, the role of the market for corporate control as a means by which management is disciplined is substantially reduced for question mark companies because a different

The question mark concept nicely explains the patterns of data reported for dual class transactions. The companies generally already have a dominant shareholder group, and Partch reports that those companies she studied that proposed dual class transactions were relatively young: half of the companies had been traded on an exchange or over-the-counter for less than ten years, and some 27% had been traded for less than five years.⁵⁸ Consistent with the question mark concept, virtually all these companies announced that a main purpose of the dual class transactions was to raise additional equity capital without diluting the dominant shareholder group's control.⁵⁹ Moreover, the justification appears to be more than boilerplate. Partch reports that in the two years following the dual class transactions, 38.6% of the sample companies made public equity issues of the class of common with limited voting rights or of securities convertible into limited voting stock.⁶⁰

Finally, the question mark concept can explain the absence of positive abnormal returns associated with dual class transactions, in contrast to the large positive returns experienced by shareholders in LBOs. Recall that the cash cow concept explains that the gains from LBOs result from eliminating the conflict of interest between managers and shareholders concerning the use of free cash flow. In a question mark, there may be no such conflict because the market demands of the company's competitive environ-

market—the product market for the good or service that the company produces—provides an equivalent discipline. Thus, in a world where the product market operates to align the interests of management and shareholders, little role is left for the market for corporate control. This suggests that the market for corporate control operates as a last-ditch means for disciplining management. Only when other market disciplines fail is the market for corporate control triggered. See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *Stan L. Rev.* 819, 837-39, 841-48 (1981).

⁵⁸ See M. Partch, *supra* note 2, at 4-6. Both Partch's data and that of Jarrell and Poulsen also suggest that the companies in their samples were relatively successful. Companies in Partch's sample earned abnormal returns of 6.243% over the 90 days prior to their announcements of the dual class transactions. *Id.* at 17. Measured over the entire year prior to 20 trading days before the recapitalization transaction, companies in the Jarrell and Poulsen sample earned abnormal returns of 44.6%. G. Jarrell & A. Poulsen, *supra* note 2, at 21, table 4.

⁵⁹ See M. Partch, *supra* note 2, at 11-12; G. Jarrell & A. Poulsen, *supra* note 2, at 21.

⁶⁰ M. Partch, *supra* note 2, at 12. In contrast, Mikkelson & Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 *J. Fin. Econ.* 31 (1986), report that of a random sample of 360 NYSE- or Amex-listed industrial companies, only 34% made public equity security offerings for cash at any time over the 11-year period from 1972 to 1982. *Id.* at 37.

ment already serve to align the interests of management and shareholders. The gain from the dual class transaction—the ability of the company to obtain new capital without the dominant shareholder group having to bear a disproportionate portion of the costs—should be reflected in an increase in the value of control shares, not public shares. The market price of the preexisting single class of common, however, reflects the value of non-controlling shares⁶¹ so that, consistent with the data, the dual class transaction should have little impact on the value of those shares.⁶²

The question mark concept thus can explain the pattern of data for dual class transactions: a preexisting dominant shareholder

⁶¹ See Lease, McConnell & Mikkelson, *The Market Value of Differential Voting Rights in Closely Held Corporations*, 57 J. Bus. L. 458, 466 (1984).

⁶² One might expect public shareholders to experience positive abnormal returns because, if the dual class recapitalization is approved, the dominant shareholder group would then cause the company to undertake positive net present value investments. This response assumes, however, that the dominant shareholder group would refuse to make such investments unless the public shareholders approved the transaction. But this strategy would be self-defeating. Recall that a question mark company requires new capital in order to avoid becoming a dog. See *supra* note 47. Precisely because the dominant shareholder group, unlike presumably diversified public shareholders, already bears substantial unsystematic risk, the cost of failing to increase market share falls more heavily on them than on public shareholders. Thus, one would expect the investments to be made regardless of the shareholder vote on the dual class transaction and, as a result, the valuation impact of the availability of positive net value investments already would have been incorporated into the company's stock price.

To be sure, this analysis suggests that public shareholders might have the ability to exact a benefit from the dominant shareholder group because the dual class transaction (although from this perspective not injurious to public shareholders) has value only to the dominant group. While one may question whether dispersed public shareholders can overcome collective action problems so as to exploit their strategic advantage, the 10% dividend increases frequently accompanying dual class transactions might be a result of this phenomenon.

Finally, even a 10% dividend increase might be insufficient to create positive abnormal returns for public shareholders. If a company were not paying dividends anyway (a common situation among cash-poor question marks), the present value of a 10% dividend preference at that point in the future when dividend payments begin might prove quite small. Moreover, Richard Ruback has pointed out that the larger the proportion of equity represented by public limited voting shareholders when dividends commence, the smaller the resulting increase in the value of limited voting stock. As the number of superior voting shares decreases, the increased dividend is funded not by a wealth transfer from the dominant shareholder group to public shareholders, but by a reduction in investments by the company, the cost of which is borne proportionately by the public shareholders themselves. See R. Ruback, *Coercive Dual Class Recapitalizations* 13-14 (MIT, Sloan School of Management, Working Paper) (Dec. 1986) (copy on file with the Virginia Law Review Association). Indeed, if it were believed that when dividends commenced the effect would be to reduce the funds available for net present value investments, the valuation effect of the dividend increase would be negative.

group and no apparent gain to public shareholders from the transaction. The alternative means of fixing control—an LBO—would be unworkable for question mark companies. Their market position requires more, not less, equity capital.

Taken together, the cash cow and question mark concepts explain the data in a way that should be very attractive to those who believe in the resilience of markets. The introduction of positive transaction costs does result in systematic patterns of preference between transaction forms that, in a perfect capital market, would be substantively equivalent. But what explains the patterns is a beneficial effort to reduce the agency costs that arise when we move from a perfect to an imperfect market. Where the conflict of interest between managers and shareholders is not constrained by the product market, as with cash cows, shareholders must rely on the market for corporate control to keep managers in line. Thus, LBOs are imposed on cash cows to eliminate self-serving corporate investment decisions by management.⁶³ Where the product market already serves to align the interests of management and shareholders, as with question marks, the market for corporate control has little role. There a dual class transaction is not used to restrain managers, but to allow equity capital to be raised without diluting the control of dominant shareholders.⁶⁴ And shareholders in these firms need not fear that fixing control in the dominant group will provide unconstrained (i.e., not subject to the market for corporate control) discretion that will work to the detriment of public shareholders, because the product market operates as the necessary constraint.⁶⁵ Thus, in this story the pattern of preferences for transaction form that develops when transaction costs are introduced

⁶³ As was noted earlier, a dual class transaction would not restrain management self-interest, but rather would increase the likelihood of managers favoring themselves at the expense of shareholders. See *supra* text accompanying notes 52-53.

⁶⁴ From a different perspective, this explanation for dual class transactions shares a common theme with Jensen's free cash flow explanation of LBOs. In both, conditions in the product market determine the initial level of agency costs within the company. Only where there is not product market discipline, as for a cash cow, is control market discipline necessary. See *supra* note 57.

⁶⁵ The transaction would serve to solidify control by the dominant shareholder group so that further dispersal of the shares (as a result of, for example, the death of members of the dominant group) still would not expose the company to the market for corporate control. The negative impact of this sheltering effect, however, would be felt only sometime in the future, and its present value would be small. See J. Gordon, *supra* note 10, at 41.

provides no justification for regulatory intervention, because the patterns reflect an efficient response to the presence or absence of an otherwise unconstrained conflict between management and shareholders.⁶⁶

B. Inefficient Self-Selection: Coercion of Public Shareholders

The efficient self-selection story has an appealingly happy ending. It is not, however, the only story that is consistent with the patterns; there is a "dark side" to the data as well. This alternative

⁶⁶ Both the question mark explanation of dual class transactions and the cash cow explanation of LBOs are empirically testable hypotheses. Lehn and Poulsen provide support for the cash cow hypothesis, reporting a statistically significant positive relationship between the amount of the free cash flow of a company that is the subject of an LBO and the size of the premium paid in the transaction. See *supra* note 52. To test the question mark hypothesis, Linda Curtis, Stanford 1987, used data from Ward's Business Directory of the Largest U.S. Companies (1986 & 1987) to determine whether the market growth and market share characteristics of the companies in Partch's dual class sample are consistent with a question mark characterization. L. Curtis, *Companies Engaging in Dual Class Transactions: Are They Question Marks?* (unpublished paper) (Apr. 1987) (copy on file with the Virginia Law Review Association). She found that in both 1985 and 1986, some 90% of the companies in the Partch sample were either question marks or dogs. *Id.* at 13-14. Determining which of the two categories a particular company falls within is more difficult because the Boston Consulting Group's dividing line—market growth of 10% or more—appears to be arbitrary. To avoid this problem, Curtis divided the sample by market growth. Her results are set out in the following table.

Specified Rate	Percentage of Sample in Market with Growth Rates Above Specified Rate			
	7%	8%	9%	10%
1985	73.17	63.41	56.10	51.22
1986	57.89	50.00	39.47	39.47

See *id.* at 13-17. These data suggest that Partch's sample of companies engaging in dual class transactions is dominated by companies that have question mark characteristics. Although the data indicate that the proportion of the sample made up of question marks (as opposed to dogs) is very sensitive to the rate of market growth chosen as a dividing line between question marks and dogs, the data nevertheless do make it quite clear that there is a bunching of companies around the 10% market growth rate. In both 1985 and 1986, approximately half of Partch's sample were in markets with growth rates between 7-13%.

A second finding supports both the question mark and the cash cow hypotheses. Both predict that companies engaging in dual class transactions will not be cash cows. This prediction is borne out by the dearth of cash cows in the Partch sample. For 1985 and 1986, Curtis could characterize only 2.44% and 5.26%, respectively, of the sample as cash cows. *Id.* at 14.

Curtis' methodology could be more precise. See L. Curtis, *supra*, at 18-19 (discussing limitations of the study). Most important, it would have been preferable to measure market growth for the year in which each company's dual class transaction took place. However, because 84% of the transactions took place between 1980 and 1984, the overall results still provide support for the question mark hypothesis.

story also involves selection between an LBO and a dual class transaction based on a particular company's characteristics. But in the dark side story, the selection between transaction forms does not turn on whether the company is a cash cow or a question mark, that is, on whether firm value is increased by an LBO or a dual class transaction. Rather, this story is one of shareholder coercion, a situation in which dominant shareholders impose a wealth transfer from public shareholders to themselves. The critical distinguishing criterion, then, is pre-transaction ownership distribution: a dual class transaction will be selected when there is a dominant pre-transaction shareholder group, the existence of which makes it difficult or impossible for the other shareholders to resist the transaction. Thus, this explanation for dual class transactions focuses on defects in the shareholder approval process that prevent public shareholders from protecting themselves.

Jeffrey Gordon⁶⁷ and Richard Ruback⁶⁸ have developed the dark side story most thoroughly. If the dominant group already owns enough shares to approve the dual class transaction,⁶⁹ those shareholders' ability to impose an unfavorable transaction on public shareholders is readily apparent. But even where the dominant group does not have absolute voting control, both Gordon and Ruback argue that strategic considerations will result in public shareholders approving the transaction, although it may well not be in their best interests.⁷⁰ Consider the public shareholders' position in the type of dual class transaction focused on in this paper, one in which public shareholders who elect to receive limited voting right stock get a ten percent dividend increase. If a public

⁶⁷ See J. Gordon, *supra* note 10.

⁶⁸ See R. Ruback, *supra* note 62.

⁶⁹ Ownership of 40% (and likely significantly less) would give the dominant group sufficient votes to approve the transaction. If a dominant group owned 40% of the outstanding stock, five-sixths of the public shares would have to vote against the transaction for it to fail. Immediately prior to the transactions studied, dominant groups owned an average of 48.6% of the outstanding stock of the companies in Partch's sample, and 44.6% in the Jarrell and Poulsen sample; 37% of the companies in Gordon's sample had pre-transaction groups with more than 40% of the company's stock. See *supra* notes 40-42 and accompanying text.

⁷⁰ Public shareholders may approve the transaction either by voting for the transaction and/or declining to exchange their shares, depending on the form in which the transaction is cast. For present purposes, the difference is not important to the argument. J. Gordon, *supra* note 10, explains the differences in how approval is signalled, depending upon the form of transaction. *Id.* at 47-51.

shareholder believes the transaction will succeed, and will thereby effect a wealth transfer from him to the insider group, then obviously it is best for him to participate in the transaction and at least get the ten percent dividend increase. Even if the shareholder believes the transaction will not succeed, he will participate in the transaction anyway so long as the shareholder believes his action will not affect the overall result. By participating, the shareholder gets the ten percent dividend increase; the decision of other public shareholders not to participate in an unfavorable transaction can be relied on to prevent the feared wealth transfer. The paradox, however, is that as long as the public shareholders are dispersed, so that efforts to organize resistance are costly and no single shareholder owns enough stock to make a difference, all shareholders will follow this strategy and the transaction will be approved.⁷¹

The data patterns for LBOs and dual class transactions are also consistent with this shareholder coercion explanation. In companies that do not have a pre-transaction dominant shareholder group, managers would not be able to gain control through a dual class transaction, because they would not have enough votes to pass it themselves, and shareholders would have no incentive to approve it.⁷² Managers instead would have to use an LBO, and then both the market for corporate control⁷³ and corporate law⁷⁴

⁷¹ See *id.* at 60-62; R. Ruback, *supra* note 62, at 6-18.

⁷² Shareholders in such a company would not face the sort of dilemma that Gordon has outlined, because they would have no reason to believe that the transaction might succeed.

⁷³ The market for corporate control serves to enforce some sharing of the gain from an LBO with shareholders: if the price offered is too low, a third party may overbid. This phenomenon has become commonplace. See, e.g., Lowenstein, *supra* note 13, at 736.

⁷⁴ Efforts by management to shield an LBO from the risk of a competitive bid have met with little sympathy from the courts. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986), and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), two important commercial courts invalidated lock-ups entered into to protect an LBO from competition, despite the fact that in earlier cases both courts had approved the use of lock-ups in other contexts.

In a parallel effort to harness the market for corporate control as a means to police the sharing of gains in LBOs, the Reporters of the American Law Institute's Corporate Governance Project have recommended that prior to director approval of an LBO, "responsible parties who express an interest in bidding in competition" be given both the same information as was given to management's investment bankers, and a reasonable period of time thereafter to examine the information and make a bid. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 6.14 (Advisory Draft No. 7 Sept. 17, 1986). I am one of the Reporters for the Corporate Governance Project. The Advisory Draft referred to has not been considered by the Council or membership of the Ameri-

would force them to share the gain from the transaction with the public shareholders. The LBO patterns are consistent with this description: typically, the patterns show large wealth gains for shareholders and low pre-transaction inside-group ownership.⁷⁵

The analysis of the data patterns for dual class transactions is complicated by the fact that there are at least two plausible versions of the shareholder coercion explanation. In the version assumed by Partch, Gordon, and Jarrell and Poulsen, coercion is employed simply to effect a wealth transfer from the public shareholders to the dominant insider group. This version of the coercion story predicts that public shareholders would experience negative abnormal returns as a result of a dual class transaction. But coercion also might be employed simply to exclude public shareholders from participating in the gains from the dual class transaction. And this version of the coercion story would predict only that public shareholders' wealth would not be affected by the transaction, although the wealth of the dominant inside group would increase.

The data patterns associated with dual class transactions are arguably consistent with either version of the coercion story. With respect to ownership distribution, as shown earlier, companies that propose dual class transactions are characterized by a substantial

can Law Institute and therefore represents only the views of the Reporters. It hardly needs stating that the views I express here are only my own, although I imagine I will urge them on my fellow Reporters.

The practice of securing fairness opinions from investment bankers as to the adequacy of the price offered public shareholders in an LBO, spurred by developments in corporate law, also serves to assure some gain sharing. It is generally believed that a fairness opinion provides directors some protection against claims of breach of fiduciary duty. See *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985); Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 Bus. Law. 1437, 1453 (1985). In their determinations of fairness such opinions explicitly take into account the premiums that would be paid in third-party tender offers. The result will be to cause the allocation of gain between management and shareholders in LBOs to resemble more closely the allocation found in third-party transactions. See generally Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 Bus. Law. 1439 (1981) (addressing usefulness of fairness opinions); Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 Yale L.J. 119 (1986) (arguing for greater judicial scrutiny of fairness opinions).

Of course, if the explanation for an LBO is free cash flow, the choice of transaction form is overdetermined. A dual class transaction would not accomplish what is necessary to create the gain in the first place.

⁷⁵ See *supra* notes 16-23, 35-39 & 51-52 and accompanying text.

pre-transaction inside shareholder group. Moreover, Gordon notes, as do Jarrell and Poulsen, that there was little institutional ownership of the companies in their samples, which would decrease the likelihood that any single shareholder could affect the outcome and increase the cost of coordinating public shareholder opposition.⁷⁶

With respect to impact on shareholder wealth, the data on dual class transactions also fits the predictions of both versions of the coercion story. The unequal sharing version predicts that dual class transactions would have no impact on the value of public shareholders' stock, and a positive impact on the value of the inside group's holdings. Taking the data at face value, those are precisely the results reported by Partch, Gordon, and Jarrell and Poulsen. None of the samples experienced statistically significant positive or negative abnormal returns. Moreover, Jarrell and Poulsen report that over the year following each dual class transaction, the "low vote" stock typically traded at a discount of four to five percent below the "high vote" stock.⁷⁷ If because of the absence of negative abnormal returns the post-transaction difference in value between high and low vote stock cannot be explained by a reduction in value of the low vote stock, then the difference in value may be the result of a benefit accruing *only* to the high vote stock.

One can go further, however, and argue that the data are also consistent with the wealth transfer version of the coercion story. Gordon notes that the results of his study do show a statistically significant negative impact on the wealth of public shareholders for at least some subsamples. Most significantly, for that portion of the sample where the insider group had voting control even prior to the dual class transaction, Gordon finds statistically significant negative abnormal returns of 13.62%.⁷⁸

⁷⁶ See J. Gordon, *supra* note 10, at 53 & n.73 (only four of the companies in the sample had significant institutional ownership); G. Jarrell & A. Poulsen, *supra* note 2, at 25, table 6 (average institutional holdings in sample companies were "relatively low," at only 16% of outstanding shares).

⁷⁷ G. Jarrell & A. Poulsen, *supra* note 2, at 26. If the comparison is limited to only those transactions in which the low vote stock did not receive a dividend increase, the premium widens to 8%. *Id.* These comparisons are limited, however, because not all dual class transactions result in a high vote stock that actually trades. See *id.* at 30 n.16; Lease, McConnell & Mikkelsen, *supra* note 11, at 660-61, 663-67 (reporting a similar disparity in post-transaction trading values).

⁷⁸ J. Gordon, *supra* note 10, at 40. Partch, in contrast, reports that the quartile of sample

More interesting is the possibility that the neutral results for the full sample reported by all studies demonstrate not that dual class transactions have no effect on shareholder wealth, but rather only that the negative effects of the dual class aspect of the transactions are offset by the positive effects of two other important aspects of the transactions. Although the event time methodology used in the Partch, Gordon, and Jarrell and Poulsen studies controls for the occurrence of other events that occur by chance in the same calendar period as a dual class transaction,⁷⁹ it does not control for events that are systematically related to the dual class transaction itself. If such events are present, the empirical result will reflect not the impact of just the dual class transaction, but the net effect of the dual class transaction and the related event.⁸⁰

The first offsetting element is the presence of a dividend increase in many of the dual class transactions. If a dual class transaction is a neutral event, then those dual class transactions that involve a dividend increase should result in positive abnormal returns.⁸¹ The studies of Partch and of Jarrell and Poulsen, however, report results inconsistent with this analysis. Partch finds that a subsample of companies subject to a dual class transaction with a dividend increase earned statistically *negative* abnormal returns of 4.9% over the entire period,⁸² and Jarrell and Poulsen find that a

companies with the largest pre-transaction dominant group, averaging 63.7% of the outstanding stock, M. Partch, *supra* note 2, at 9, table 3, 21, table 5, experienced statistically significant positive abnormal returns of 2.177% on announcement and 4.967% over all event days. *Id.* at 23. Over the entire period, however, this subsample experienced negative, but statistically insignificant, abnormal returns of 4.68%. *Id.* at 21.

⁷⁹ See *supra* note 19 (discussion of event time studies).

⁸⁰ A similar problem arises in other contexts. For example, studies show that neither positive nor negative abnormal returns are associated with the proposal of shark repellent amendments. This could mean that such amendments have no impact on shareholder wealth. But it also could mean that a negative effect from the amendments, because the amendments make it easier for management to avoid a premium takeover offer, is offset by the positive effect of the signal (created by management's proposal of the amendment) that there is an increased likelihood that such an offer is forthcoming. See R. Gilson, *supra* note 13, at 682-85.

⁸¹ Even under Ruback's analysis, see *supra* note 62, the larger the proportion of equity owned by the dominant shareholder group, the greater the benefit of a dividend increase to the public shareholders.

⁸² M. Partch, *supra* note 2, at 21, table 5. The same subsample, however, earned statistically significant positive abnormal returns of 2.76% on announcement and 3.85% on the other event dates. *Id.* Partch interprets these positive returns as consistent with Jensen's free cash flow argument (although the negative returns over the entire period would then be

similar subsample, like their entire sample, earned no statistically significant abnormal returns at all.⁸³ If there were no positive abnormal returns despite a dividend increase, the argument runs, the negative impact of the dual class transaction must have been large enough to offset the positive impact of the dividend increase.

Jarrell and Poulsen's examination of the trading prices of high and low vote stock in the year following the dual class transaction provides some empirical support for this offset analysis. Although they find that the low vote stock trades at a relatively constant discount of some eight percent (compared to high vote stock after transactions that do not provide low vote stock a dividend increase), they find that there is no more than a fluctuating two percent discount after transactions that do provide a dividend increase.⁸⁴ This leads Jarrell and Poulsen to conclude that "the higher dividend largely offsets the lower voting rights."⁸⁵ But then what else could the positive effect of the dividend increase be offsetting than the negative impact of all other elements of the dual class transaction?

The second potentially offsetting element concerns the past and future performance of the companies that are the subject of dual class transactions. With respect to past performance, Jarrell and Poulsen report that, over the year ending twenty days before the announcement of the transaction, the companies in their sample experienced positive cumulative abnormal returns of 44.6%.⁸⁶ These were, then, obviously successful companies. Moreover, in the forty-day period surrounding the announcement, the sample earned statistically significant positive abnormal returns of 6.87%,⁸⁷ the only statistically significant results reported for periods near the announcement. Jarrell and Poulsen conclude that the latter data "suggest that management may prefer to recapitalize in periods in which the firm is performing relatively well."⁸⁸ But then

inconsistent). In a question mark explanation for dual class transactions, however, the free cash flow analysis would be irrelevant because such companies have precisely the opposite problem. See *supra* notes 54-62 and accompanying text.

⁸³ G. Jarrell & A. Poulsen, *supra* note 2, at 23, table 5.

⁸⁴ *Id.* at 26, charts B, C.

⁸⁵ *Id.* at 26.

⁸⁶ *Id.* at 21, table 4.

⁸⁷ *Id.* at 18-19.

⁸⁸ *Id.* at 19.

what accounts for the fact that these companies earn positive abnormal returns in all periods *except* those directly associated with announcement of the dual class transaction? One possibility is that positive abnormal returns associated with the companies' performance are offset by negative abnormal returns associated with the dual class transaction.

With respect to future performance, Gordon notes that the negative impact of dual class transactions may be offset by the positive impact of the announcements of intention to issue new equity that frequently accompany dual class transactions.⁸⁹ These announcements signal that a firm has profitable investment opportunities to exploit,⁹⁰ opportunities that would be expected to yield increases in shareholder wealth. Both Gordon and Partch found, however, that there were no significant changes in shareholder wealth in the subsample of firms that made such announcements at the time they announced a dual class transaction.⁹¹ This, Gordon argues, indicates that the positive effects of the announcements offset the negative effects of the dual class transactions, leading to the neutral results observed.⁹²

The data patterns with respect to LBOs and dual class transactions are thus consistent with either of two versions of a shareholder coercion story. But whether public shareholders' wealth is reduced by a wealth transfer resulting from a dual class transaction, or is merely unaffected by a transaction that benefits only the dominant inside group, this interpretation of the data (in contrast

⁸⁹ See J. Gordon, *supra* note 10, at 42.

⁹⁰ See *id.* Indeed, Gordon notes that in nearly two-thirds of his sample the proxy statement explicitly linked the dual class transaction to the firm's desire to take advantage of new opportunities. *Id.*

⁹¹ *Id.* at 45; M. Partch, *supra* note 2, at 21, table 5, 22.

⁹² J. Gordon, *supra* note 10, at 42-43. This analysis is complicated by a number of studies that show large negative abnormal returns in response to common stock offerings generally. See, e.g., Asquith & Mullins, *Equity Issues and Offering Dilution*, 15 *J. Fin. Econ.* 61 (1986); Masulis & Korwar, *Seasoned Equity Offerings: An Empirical Investigation*, 15 *J. Fin. Econ.* 91 (1986); Mikkelsen & Partch, *supra* note 60. But see also J. Gordon, *supra* note 10, at 43-44 & n.64 (discussing these studies). The explanation offered for this phenomenon is that management's very decision to sell stock signals their belief that the stock is overvalued; if it were undervalued, why would they sell it? See, e.g., Mikkelsen & Partch, *supra* note 60, at 31-33. In the dual class context, the fact that the company operates in a rapidly growing market may serve to verify management's claim that the reason for the offering is that the company has positive net present value projects for which it requires capital. Thus, in this context, the issuance of new equity would be a signal of "good news," not bad.

to the efficient self-selection interpretation) suggests a role for regulation. As with efficient self-selection, the move from a perfect to an imperfect market results in a systematic pattern of preference for transaction form. But in this darker view, the pattern reflects not efficiency but coercion: where there is a dominant shareholder group, it uses its position to exploit public shareholders by a dual class transaction.

IV. THE REGULATORY IMPLICATIONS OF THE EMPIRICAL PATTERNS

I began this essay with the proposition that the case for regulation of dual class transactions depends on demonstrating that the presence of transaction costs results in the systematic selection of other than the least-cost transaction form. I then tried to explain the patterns that appeared when the data relating to LBOs and dual class transactions were examined. The problem, however, was that the data patterns were consistent with two very different explanations of what was really at work. Based on the empirical evidence, one cannot confidently determine whether the choice of transaction form reflects efficient self-selection based largely on whether the product market—mature or expanding—in which the particular company participates adequately constrains agency costs, or whether the chosen transaction form instead reflects inefficient self-selection based on the distribution of shareholdings in a particular company—instances when, because a dominant shareholder group exists, public shareholders are coerced.

In this situation, it is difficult to design a regulatory response that would be certain to improve matters. Consider, for example, Joel Seligman's recommendation that dual class capital structures be prohibited for companies registered under section 12(g) of the Securities Exchange Act of 1934.⁹³ If the true story is efficient self-selection, with cash cows undergoing LBOs because of the presence of agency costs and question marks undergoing dual class transactions because of their absence, a prohibition would be an obvious mistake. In that event, the regulatory effort would deny access to, rather than result in selection of, the most efficient transaction form for a significant number of companies. However, if the true story instead involves coercive self-selection, prohibiting dual class

⁹³ See Seligman, *supra* note 4, at 724.

transactions would have the desired effect of correcting the systematic selection of other than the least-cost transaction form. Finally, if, as seems most likely, there is some of both going on,⁹⁴ there is no way of knowing which way a prohibition on dual class transactions would cut.

Under these circumstances, a successful regulatory effort would have to eliminate those dual class transactions intended to coerce public shareholders, though without interfering with the efficient selection of dual class transactions when warranted by competitive conditions in particular companies' product markets. Although this sounds like a daunting problem of regulatory design, it is resolvable in a straightforward way. For this purpose, it is necessary to focus on the central characteristics of the two competing explanations for dual class transactions. The key to the efficient self-selection story is the firm's ability to raise equity for positive net present value investments without forcing the dominant shareholders to bear a disproportionate amount of the cost because of a dilution of their position, or (if dilution is avoided) because of an uncompensated increase in their unsystematic risk. In turn, the key to the inefficient self-selection story is the ability of a dominant shareholder group to use its position to coerce other, public shareholders into further strengthening the dominant group's control.

What is apparent is that the opportunity for efficient self-selection requires only that it be possible to raise new equity without diluting the dominant group's position; their control need not be strengthened to meet this need. In contrast, the inefficient self-selection story is coherent *only* if the dominant group's position is not merely protected from dilution, but is also strengthened. A rule that would prohibit the conversion of existing stock into dual classes, but not the public offering of a *new* class of limited voting or non-voting common stock, would allow new capital to be raised without diluting the control of the dominant group. Moreover, because this type of initial public offering would neither reduce the voting rights of existing public shareholders nor bolster the position of a dominant group, the offering could not be coercive—the transaction would have no impact at all on control. Thus, a prohibition on altering the voting rights of existing public shareholders,

⁹⁴ For example, companies in the Partch sample seem to be predominantly, but not exclusively, question marks. From 2-5% of the sample were cash cows. See *supra* note 66.

but not on the sale of a second class of common stock, would precisely thread the needle.⁹⁵ Efficient self-selection would not be impaired because new capital could be raised without dilution of the dominant group, and inefficient self-selection would be avoided because the transaction could not improve the dominant group's control position.⁹⁶

Of course, this is not the only regulatory approach that would distinguish between efficient and inefficient self-selection of a dual class common stock capital structure. One could, for example, also require an existing public company that wanted to shift from a single class of common stock to a dual class capital structure to first repurchase all existing common stock owned by public shareholders. Then the company would be allowed to issue a new class of limited voting or non-voting common stock. In effect, the difference between an LBO and a dual class transaction would be eliminated by requiring an initial LBO in all cases.

The logic of this alternative is straightforward. If LBOs are more favorable to public shareholders than dual class transactions, requiring an initial LBO would make public shareholders better off. The difficulty with the approach, however, is that it would be no more effective than a simple ban on dual class transactions in eliminating inefficient self-selection, and it might well impose unintended burdens on efficient self-selection. Most important, for a question mark company an LBO followed by an issuance of a new

⁹⁵ The prohibition would necessarily extend to alternative means of effecting dual class transactions. See *supra* note 12.

⁹⁶ This approach differs from the NYSE's proposal in three important respects. First, it would extend to non-voting common stock while the NYSE proposes to continue its flat prohibition of non-voting common stock. Second, it would require no special approval to issue a new class of limited or non-voting shares, while the NYSE would require special director and shareholder votes even if the transaction would not reduce the voting rights of existing public shareholders. Finally, it would prohibit dual class transactions that would reduce the voting rights of public shareholders, while the NYSE would allow such transactions if they met special approval requirements. See *supra* notes 1 & 3; see also Proposed NYSE Changes, *supra* note 1 (text of proposed changes).

To be most effective, the regulatory approach proposed here would have to be imposed on all publicly traded companies, not just on NYSE companies. This raises issues concerning the SEC's jurisdiction to impose substantive changes on self-regulatory organizations. See, e.g., Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 *Colum. L. Rev.* 1145, 1255-69 (1984); Karmel, *The SEC's Power to Regulate Stockholder Voting Rights*, *N.Y.L.J.*, Aug. 21, 1986, at 1; Seligman, *supra* note 4, at 714-19. Resolution of these issues is, however, beyond the scope of this Article.

class of limited voting common stock might not be an effective substitute for simply issuing the new class without a prior LBO. Not only is an initial LBO expensive in terms of transaction costs, but in a world where information is costly, the LBO might prove difficult (or even impossible) for a question mark company to accomplish. Recall that a question mark company needs additional funds. An LBO would require temporary financing pending the public sale of the new class of limited voting stock. Unless the lender financing the LBO was very confident that the new class could be sold at a price in excess of that paid to public shareholders in the LBO, the debt would be very risky. And if a later public offering could not generate sufficient funds to repay the LBO debt, the company would be crippled competitively. Thus, instead of securing a cash in-flow for the company (which a question mark company needs), the issuance of debt would result in a cash out-flow for debt service.

Thus, there are good reasons not to require an LBO as a precondition to issuing a class of limited voting common stock. All that is needed to eliminate coercion without constraining efficient self-selection is to prohibit dual class transactions with existing shareholders, while leaving companies free to sell new issues of limited voting common stock to third parties.⁹⁷

V. CONCLUSION

I have made two arguments in this essay. The more general is simply that one can neither understand nor regulate financial transactions without understanding what dictates the parties' selection from among the myriad of available transaction forms in which the substance of their arrangement might be cast. It is necessary to understand what about the real world eliminates that perfect substitutability of transaction forms that exists within a perfect capital market.

⁹⁷ Ruback makes a related proposal. He would require a company that wished to dilute existing public shareholders to first issue a new class of limited voting stock and then use the proceeds to repurchase the previously outstanding, now superior, voting shares. See R. Ruhack, *supra* note 62, at 23-26. This would be acceptable under the approach herein proposed. Although such a two-step transaction would not be useful for a question mark company because there would be no net increase in capital, the protections that third-party bids afford public shareholders in an LBO, see *supra* notes 73-74, would similarly minimize overreaching in the dual class recapitalizations.

The more specific argument is intended as illustrative of the general one. When the issue of dual class common stock is approached from the perspective of substitutes, a resolution—prohibition of dual class transactions but not dual class capital structures—becomes apparent. That resolution would leave intact the benefits of the dual class capital structure, while still preventing any dominant shareholder group from using dual class transactions to coerce a firm's public shareholders.