THE DUAL-CLASS DILEMMA AND THE SUNSET-CLAUSE SOLUTION

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The desirability of dual-class stock has been a source of substantial controversy. Some scholars, commentators, and industry participants are wholly in favor of such arrangements. Others are wholly opposed. While neither of these diametrically opposed views leads to a satisfactory solution, a more balanced and productive proposition can be found in the employment of dual-class stock with sunset provisions. Sunset provisions allow for the issuance of dual-class stock while simultaneously providing for conversion to a single class of stock upon the fulfillment of specified criteria. Nonetheless, despite the promise associated with these proposals, further debate surrounds which of the numerous variations of sunset provisions are most attractive. This Column explores the extremes of the dual-class debate in addition to several variations of sunset provisions.

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Introduction

The tussle among shareholders, boards of directors, and corporate management for control of the corporation has long been a focus of scholarly debate and real-world controversy. Not to be overlooked within this discussion is the dual-class dilemma—the challenges attendant to the employment of multiple classes of stock by a publicly held corporation.

Shareholders in a public corporation each hold a given number of shares. Each share is entitled to equal voting rights. This basic arrangement may be complexified by the creation of two classes of shares.[1] In this dual-class scenario, each share, regardless of class, is entitled to an equivalent economic interest in the corporation. However, different classes of shares are entitled to differing amounts of voting power. Therefore, all shareholders hold an equivalent per-share economic interest, but some shareholders have more voting power.

Generally, shares with more voting power will be held by founder-CEOs while the remaining shareholders will hold shares with less voting power. Notably, this means that the shares held by these founder-CEOs provide them with voting power in the corporation that exceeds their economic interest in the same.

Unsurprisingly, in light of the varying rights to which different parties are entitled, dual-class arrangements have been a source of major disagreement. This controversy has attracted passionate advocacy and equivalently strong opposition. However, scholars and industry practitioners have also proposed several "middle-ground" solutions, namely sunset provisions, that seek to account for the merits of the arguments of proponents and opponents. This Column provides an overview of the opposing sides of the dual-class debate and discusses several types of sunset provisions.

I. Pro. vs. Anti Dual-Class Advocacy

Dual-class advocacy focuses primarily on insulation. Proponents of dual-class stock structures argue that it insulates management from unproductive reactions to adverse short-term stock movements and insulates the corporation from activist shareholders and corporate raiders who may prey on a vulnerable company. This insulation also encourages capital expenditures with long payoff horizons and allows for fast decision-making by capable leaders. Secondarily, those in favor of dual-class stock structures argue that they attract

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[1] While such arrangements theoretically allow for more than two classes of shares, this article refers only to "dual-class" (two classes) as this is the most commonly discussed arrangement and presents the same relevant substantive concerns associated with more than two classes of stock.

high-growth companies to public markets. Anti-dual class arguments, alternatively, are more multi-faceted. The most salient points are the dangers of management entrenchment, the creation and promotion of adverse incentives and agency costs, opposition to philosophical principles of corporate governance, as well as changes in the benefits of dual-class structures over time.

A. *Pro-Dual Class Advocacy*

Pro-dual class advocacy is primarily an insulation-focused idea but secondarily presents some interesting ideas surrounding public market investment.

Firstly, a dual-class structure is useful in insulating management from overreactions to adverse short-term changes in a company's stock price. Whether by restless institutional investors or Wall Street analysts, corporate managements are often microscopically scrutinized and lambasted if short-term performance lags market expectations. This reprimand usually comes in two forms. First, investors react adversely to the company's purported underperformance by selling or short selling its shares.[2] Second, in response to the decline in share price after this selling and short selling, Wall Street analysts and investors will pressure management to improve short-term performance.[3] To the extent that short-term losses are necessary to create greater long-term value, this pressure to abandon value-creating projects will, by definition, destroy value.[4] But, where a founder-CEO leads a company and maintains control of the corporation, other shareholders are unable to remove her. Thus, while public scrutiny will be intense, and short-term stock price underperformance painful, the founder-CEO protected by this dual-class structure is able to remain faithful to a value-creating long-term strategy.

Secondly, a dual-class structure is useful in insulating the corporation from harm where temporarily adverse conditions make it vulnerable. Opportunistic activist investors and corporate raiders, recognizing this vulnerability, may take advantage of such situations to extract value from other shareholders

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[2] *See generally* Harris Collingwood, *The Earnings Game: Everyone Plays, Nobody Wins*, HARV. BUS. REV. (June 2001), https://hbr.org/2001/06/the-earnings-game-everyone-plays-nobody-wins [https://perma.cc/HH7R-934X].

[3] *See, e.g.*, Razeen Sappideen, *Focusing on Corporate Short Termism*, SING. J. LEGAL STUD. 412, 415 (2011) ("[T]he fact is that pressure by investors on managers to perform and deliver high stock price forces managers to meet targets, budgets, market position, profitability, and high stock price."); *see also* Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYSTS J. 65, 65 (2005) ("Financial analysts fixate on quarterly earnings at the expense of fundamental research. Corporate executives, in turn, point to the behavior of the investment community to rationalize their own obsession with earnings.").

[4] *See* Benjamin Bennett, Réné M. Stulz, & Zexi Wang, *Does Greater Public Scrutiny Hurt a Firm's Performance* 5 (Eur. Corp. Gov. Inst., Working Paper No. 873, 2023) (showing that, in response to increased scrutiny, firms reduce investment and sub-optimally pattern their investments after peers.).

and destroy long-term value.[5] Where a dual-stock structure is in place, opportunistic activists and corporate raiders are unable to overcome the controlling position of the founder-CEO and take advantage of these circumstances.

Thirdly, a dual-class structure encourages companies to make capital expenditures that have extended payoff horizons. For example, a value-creating strategic direction decided upon by a technology company may require years of consistent investment to pay off. Accordingly, the company will invest for some meaningful period of time without seeing immediately attractive results. Without some insulation from outside forces, the management and board of directors overseeing this strategy are likely to face significant pressure from shareholders, at best, or may lose their jobs, at worst. A board of directors and a management team with the opportunity to engage in such a project may also refrain from investing in it. Shareholders would thereby miss out on value-creating opportunities. By contrast, a dual-class stock structure would enable such long-term decision-making because it insulates the founder-CEO and the board from dismissal based on disapproval of a long-term oriented strategy.[6] This benefits both shareholders in the form of higher stock returns and benefits society in the form of creative, useful products.

Fourthly, a dual-class stock structure encourages relatively decisive action and assists in minimizing disruption. Where a controversial but probabilistically profitable decision is to be made, the founder-CEO can decide relatively quickly.[7] A flatter voting structure would likely be accompanied by more indecision and probably unproductive debate.

Finally, proponents of dual-class stock posit that it aids in attracting high-growth, high-quality companies to public markets. Where there are promising companies with talented founders who want to implement a given strategic vision without short-term interference, dual-class structures attract such

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[5] *See* Jeffrey Sonnenfeld & Steven Tian, *Re-Thinking The Hostility Towards Dual-Class Share Structures: When Dual-Class Shares Work Better*, HARV. L. SCH. F. CORP. GOVERNANCE (October 16, 2024), https://corpgov.law.harvard.edu/2024/10/16/re-thinking-the-hostility-towards-dual-class-share-structures-when-dual-class-shares-work-better/ [https://perma.cc/V8MT-NY9B] (discussing utility of dual-class stock in preventing sale of Hershey Food Corporation at discounted price during cyclical downturn).

[6] Bradford D. Jordan, Soohyung Kim, & Mark H. Liu, *Growth Opportunities, Short-Term Market Pressure, and Dual-Class Share Structure,* 41 J. CORP. FIN. 304, 306 (2016) ("Our evidence supports the notion that firms with more long-term growth opportunities (such as firms with high sales growth and high R&D intensity) benefit more from the adoption of antitakeover provisions, such as dual-class shares, so that managers can focus on creating long-term value for shareholders instead of delivering short-term results.").

[7] Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN'S L. REV. 863, 942 (1994) ("[D]ual-class use keeps the key decision makers . . . in control of the firm's voting power. This enables those firms to take advantage of new developments in technology or changes in regulation faster than single-class rivals, whose actions may require a more extended or costly voting process.").

founders to public markets, enabling the broader public to participate in the wealth creation accompanying the company's success.[8]

B. Anti-Dual Class Advocacy

While pro-dual class arguments are largely centered around the insulation of management, anti-dual class arguments are multi-faceted.

Firstly, those who oppose dual-class stock argue that it allows for the entrenchment of management.[9] Effectively, this is the inverse of the insulation effect described by dual-class proponents. Because the founder-CEOs who hold this stock can avoid dismissal via their controlling stakes, they may abuse this freedom and exploit the corporation and its shareholders for personal gain.[10] Were a dual-class structure not in place, such leaders would be subject to removal. Board members would likely be subject to the advances of activist investors and other pro-shareholder voices. Thus, their freedom to engage in self-serving conduct would be limited.

Secondly, opponents of dual-class structures argue that they create adverse incentives. Additionally, a dual-class structure is accompanied by agency costs that are likely to increase over time. First, the adverse incentives stem from the gross misalignment in voting and economic power held by the founder-CEOs of the companies that employ these structures. Substantively, this means that the founder-CEO has a greater say in determining company policy than is represented by the CEO's economic interest.[11] For example, a controlling founder-CEO, on account of dual-class stock, may hold only a 10% economic interest in the corporation. Therefore, while the CEO controls more than 50% of shareholder voting power, he or she only bears 10% of the cost if the company's strategy is ultimately unsuccessful. Second, this difference between voting rights and economic interest is likely to increase over time because founder-CEOs tend to reduce their stake in the company over

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[8] Daniel Valentine, *How dual-class shares will help London attract tech IPOs*, CITY AM (July 1, 2024), https://www.cityam.com/how-dual-class-shares-will-help-london-attract-tech-ipos/ [https://perma.cc/XQF9-4JKV].

[9] *See* Vishaal Baulkaran, *Management entrenchment and the valuation discount of dual class firms*, 54 Q. REV. ECON. FIN. 70, 70 (2014) ("CEOs and directors in dual class firms are more entrenched.").

[10] *Id.* ("With dual class structure, it is difficult to remove a controlling shareholder-manager even when the firm is performing poorly. Therefore, these managers face little or no discipline from the market for corporate control.").

[11] Jill E. Fisch & Steven Davidoff Solomon, *Dual Class Stock* 9, (Eur. Corp. Gov. Inst. Working Paper No. 715, 2023) ("Because voting rights in a dual class structure are severed from economic interest in the company, shareholders bear the financial burden of any decision making"); Paul A. Gompers, Joy Ishii, & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States* 40 (Rodney L. White Center for Fin. Research Working Paper No. 12, 2008) ("[F]irm value is positively associated with insiders' cash-flow rights and negatively associated with insiders' voting rights, and negatively associated with the wedge between the two.").

time.[12] Despite this reduction in the CEO's economic interest, he or she may very well retain control. Therefore, to the extent that the gap between the controller's economic and voting interests was problematic at the time of the IPO, it becomes even more problematic as the founder-CEO maintains control but has a declining economic stake in the enterprise.[13]

Thirdly, dual-class opponents present a normative argument that, they argue, is in accordance with the foundational principles of corporate governance. This is the "one share-one vote" argument: as a matter of principle, each share in the corporation should be entitled to the same amount of voting power. This argument, it appears, seeks to appeal to some quasi-moral, fundamental principle of corporate law and corporate governance. For example, scholars have discussed this rule of proportionality as being rooted in the relationship between risk and power. Where the size of one's economic interest in the company is larger, one should have more power to make decisions for the company. Where one's economic interest is lower, one should, correspondingly, have less decision-making power. [14]

Finally, opponents of dual-class stock structures argue that they are undesirable because the purported benefits of such structures decrease over time.[15] Even if dual-class structures allow for more long-term focused value creation and insulate talented founder-CEOs from unproductive short-term influences, these benefits wane over time. This may be driven simply by the founder-CEO's talent becoming less applicable as the business grows and the business environment evolves.[16] Accordingly, a dual-class stock structure, the opponents posit, may perpetuate value destruction as founder-CEOs who

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[12] Druv Aggarwal et al., *The Rise of Dual-Class Stock IPOs*, 144 J. Fin. Econ. 122, 124 (2022) ("[Between 1994-2006 and 2017-2019], founders' wedge between economic and voting rights increased considerably.").

[13] Martjin Cremers, Beni Lauterbach, & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuations* 3 (Eur. Corp. Gov. Inst. Working Paper No. 550, 2018) ("[W]e show that the difference between the insider voting and equity stakes . . . tends to increase as the dual class firm ages. Wider wedges are associated with aggravated dual class agency problems . . . Consistent with this, we find that dual class firms with an increased wedge in the post-IPO years suffer a relatively sharp and statistically significant market valuation drop in these years.").

[14] Frederico Ghezzi, Chiara Mosca & Maria Lucia Passador, *Rereading the "One Share, One Vote" Principle: Is It Also a Matter of Competition?* 1 U. Chi. Bus. L. Rev. 157, 158 (2022); *Dual Class Stock*, Council of Institutional Investors, https://www.cii.org/dualclass_stock [https://perma.cc/EGP6-367R] (""One share, one vote" is a bedrock principle of good corporate governance. When a company taps the capital markets to raise money from public investors, those investors should have a right to vote in proportion to the size of their holdings.").

[15] Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 Va. L. Rev. 585, 605 (2017) ("[M]any years after the IPO, there is a real possibility that the founder's superiority as the company leader will erode or even disappear. Over time, a once-successful founder may face natural limitations in a fast-evolving technological or business environment."); *see* Steven M. Davidoff, *Thorny Side Effects in Silicon Valley Tactic to Keep Control*, N.Y. Times (Sep. 4, 2013), https://archive.nytimes.com/dealbook.nytimes.com/2013/09/03/thorny-side-effects-in-silicon-valley-tactic-to-keep-control/ [https://perma.cc/Z3MF-22HB] ("Even when the founders stay it hasn't always been a happy outcome.").

[16] Bebchuk & Kastiel, *supra* note 15, at 605.

are no longer valuable to the company are able to maintain an iron grip on control.[17]

II. Dual-Class Sunset Clauses

In considering pro- and anti-dual class arguments, it is evident that both proponents and opponents present salient points. While dual-class stock can provide talented management with valuable insulation from opportunistic and value-destructive parties, it is also accompanied by substantial agency costs that are driven primarily by the gap between a controller's voting power and economic interest. How then can we extract value from this structure while concurrently mitigating the attendant risks? Sunset clauses, particularly time-based provisions, event-based provisions, and ownership-based provisions have been proposed as solutions.

A. *Sunset Clauses*

Sunset clauses present a middle ground that aims to capture the benefits of dual-class stock structures while accounting for the risks. In short, these clauses allow for a dual-class structure at the time of the IPO but extinguish this structure upon the fulfillment of some criterion. In the case of time-based sunset clauses, the criterion is time. As such, the company will employ a dual-class structure at the time of the IPO but will shift to a singular class after a certain amount of time passes. In the case of an event-based sunset clause, a specific event is the criterion. This event is generally the founder-CEO's death, disability, or retirement. A dual-class stock structure would be employed at the time of the IPO but would be substituted for a single-class structure upon the occurrence of any of the aforementioned events (founder's death, sickness, retirement, etc.). Finally, in the case of an ownership-based threshold, the criterion is the founder-CEO's economic interest. At the time of the IPO, the company would employ a dual-class stock structure. However, when the founder-CEO's economic interest is reduced below a certain threshold, the dual-class structure would be substituted for a single-class structure.

Importantly, while practitioners and other industry participants have supported dual-class structures as a means of improving corporate governance, they have also criticized such structures in cases where they are unaccompanied by sunset provisions. For instance, in the wake of Lyft's 2019 IPO, the Council for Institutional Investors criticized the company's proposed dual-class structure, highlighting "the lack of 'sunset provisions' to unwind

[17] *Id.*

[the dual-class structure] within a reasonable time."[18] Likewise, the Investor Coalition for Equal Votes (ICEV), an organization founded in 2022 to oppose unequal voting rights among shareholders, "encourages companies to adopt a 'one share, one vote' capital structure, or at the least to put in place time-based sunset provisions of seven years or less from the time of public listing."[19] In certain foreign markets, such as the UK, recent regulatory proposals have contemplated more flexibility surrounding the issuance of dual-class stock on public stock exchanges but have sought to mitigate the associated risks by requiring some variation of a time-based sunset provision.[20] Therefore, it is evident that sunset provisions, especially time-based sunset provisions, have been central to contemporary discussion within the sphere of corporate governance.

But how do these different sunset provisions work and what do real-life examples look like? I take each of the three types of provisions in turn and provide some examples.

B. Time-Based Sunset Clauses

The first, and most frequently discussed, type of sunset provision is the time-based sunset provision. Simply, this refers to a regime in which a dual-class structure exists at the time of the IPO but is substituted for a single-class structure after the passage of a certain amount of time. While proposals for the appropriate amount of time have ranged from as few as three years to as many as twenty years, the most common proposal is in the range of seven to ten years. While there does not appear to be a scientific basis for this specific number of years, industry participants seek sunset provisions that are long enough to enable founders to implement their strategic vision, yet short enough to protect good-faith, long-term investors who would suffer if founder-CEO power were effectively unrestrained by a perpetual dual-class arrangement.

Scholars have argued that time-based sunset provisions are most appropriate because the costs associated with dual-class stock change predictably

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[18] *Council of Institutional Investors Says Lyft's Planned Dual-Class Structure is Harmful to Investors*, Council of Institutional Investors (Mar. 2, 2019), https://www.cii.org/lyftdualclassipo [https://perma.cc/CS2W-THP9] ("The Council of Institutional Investors (CII) today expressed deep concern about Lyft Inc.'s initial public offering (IPO) filing because of its egregious dual-class share capital structure and the lack of "sunset provisions" to unwind it within a reasonable time period.").

[19] *What we do*, Investor Coalition for Equal Votes, https://www.icevequalvotes.org/what-we-do [https://perma.cc/TTP2-QZ27].

[20] *See* Bobby Reddy, The UK's Dual–Class Shares Reforms – Failing to Throw off the Shackles, Oxford Business Law Blog (Jan. 30, 2022), https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/01/uks-dual-class-shares-reforms-failing-throw-shackles [https://perma.cc/AU28-F2PD].

over time. For example, one of the primary costs associated with dual-class stock is that a once-spectacular CEO may, in a fast-paced business environment, lose the desirability that once made his or her control preferable.[21] Therefore, a time-based sunset provision mitigates this risk by unwinding the dual-class structure after the passage of several years. To the extent that the CEO has lost his or her desirability, he or she will no longer be able to control decision-making. Alternatively, if shareholders believe that the CEO should continue to control the corporation, they can vote to maintain the dual-class structure.[22] Moreover, to the extent that the CEO would have passed on shares to less capable heirs, a time-based sunset provision aids in erasing the dual-class structure before such a transfer occurs. Finally, because founder-CEOs tend to reduce their economic interests in their companies over time, a time-based provision mitigates the increased agency costs associated with that phenomenon by unwinding the dual-class structure after the passage of time.[23]

Notably, several companies have employed such time-based sunset provisions and successfully transitioned from a dual-class regime to a single-class regime. For example, Groupon, an e-commerce marketplace, went public in 2011 with a dual-class structure that entitled each share of Class B stock to 150 votes and each share of Class A stock to 1 vote.[24] However, this dual-class structure was accompanied by a time-based sunset provision that required a shift to a single-class structure five years after the IPO.[25] In 2016, Groupon successfully transitioned to a single-class structure.[26] Similarly, MaxLinear, a technology company focused on network connectivity, went public in 2010 with a dual-class structure entitling each share of Class A stock to 1 vote and each share of Class B stock to 10 votes.[27] As with Groupon's dual-class structure, MaxLinear's structure was subject to a time-based sunset which mandated a shift to a single-class structure upon the seventh anniversary of the IPO.[28] In 2017, according to the scheduled sunset, the company transitioned to a single-class regime.[29]

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[21] *See* Bebchuk & Kastiel, *supra* note 15 at 610–11 ("[A]ny "superior controller" benefits that a dual-class structure might offer at the time of the IPO are likely, on an expected-value basis, to decline or even disappear many years after the IPO.").

[22] *Id.* at 624 ("If a controlling shareholder performs well and extending her control seems to be value enhancing, shareholders would be able to vote to prolong the controller's power for an additional period.").

[23] *See* Bebchuk & Kastiel, *supra* note 15 at 619.

[24] *See* Groupon, IPO Prospectus (Form S-1) (Jun. 2, 2011).

[25] *See id.* at 119.

[26] Companies with Time-Based Sunsets on Dual-Class Stock, Council of Institutional Inv. (October 1, 2020), https://www.cii.org/files/10-1-20%20Time-based%20Sunsets.pdf [https://perma.cc/2K6Q-XU25].

[27] MaxLinear, IPO Prospectus (Form S-1) (Nov. 6, 2009).

[28] *See id.* at 23.

[29] MaxLinear, Definitive Proxy Statement (Form 14A) (Apr. 20, 2017) ("On March 29, 2017, the dual class stock structure that we implemented in connection with our initial public offering terminated.").

Finally, while scholars and industry participants have argued in favor of these time-based regimes, there have been some opponents. Critics have argued that time-based sunset provisions are often arbitrary because they do "not seem to correlate with any theory about the length of time necessary for a founder to implement his or her vision."[30] Firms have not been found to choose the length of sunset periods based on particularly relevant characteristics, such as the age of their founders.[31] As alternatives to time-based sunset provisions, these opponents endorse other forms of sunset provisions. These alternatives seek to retain the benefits associated with dual-class structures and to mitigate against the potential risks associated with them while also addressing the attendant costs more directly than time-based sunset provisions.[32] Event-based sunset clauses and ownership-based sunset clauses, discussed below, are two such alternatives.

C. Event-Based Sunset Clauses

Event-based sunset provisions replace a dual-class structure in favor of a single-class structure upon the occurrence of some specific event. Generally, the events upon which the shift is premised are the controller's death, disability, or retirement.

Scholars have argued that event-based sunset clauses are superior to time-based sunset clauses because they more directly address the issues that time-based sunset clauses aim to address by proxy.[33] To the extent that one worries about a disabled CEO retaining control through a dual-class structure, an event-based sunset provision addresses that concern. It also addresses the issues of age and retirement, as well as the concern that a CEO will pass their controlling stake onto heirs after death. One example of a company that successfully employed and executed an event-based sunset is Zynga. Zynga, which had a seven-to-one distribution of voting rights between its Class B and Class A shareholders, transitioned into a single-class upon its founder Mark Pincus stepping down from his executive chairman role to become nonexecutive chairman.[34] Another variation of an event-based sunset provision can be

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[30] Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 Bos. Univ. L. Rev. 1057, 1081 (2019).

[31] *See e.g, id.* (explaining that since the company Workday "went public in 2012 with a twenty-year sunset provision," one of the founders will be in his nineties and the other in his sixties upon the provision's expiration.)

[32] *Id.* at 1086 ("[Sunset provisions] should focus more precisely on objective events that are more likely to result in the founder losing track of his or her mission . . .").

[33] *Id.* ("[T]he mere passage of time is a poor proxy for evaluating whether the utility of a dual class structure has evaporated. To the extent that sunsets are an appropriate response to a decline in the value of dual class structures, they should focus more precisely on objective events . . .").

[34] *See* Austen Hufford, *Zynga Moves to Single-Class Share Structure*, Wall St. J. (May 2, 2018), https://www.wsj.com/articles/zynga-moves-to-single-class-share-structure-1525293576 [https://perma.cc/6TR8-DLRL].

found in Lyft's IPO filings, whereby high-vote shares held by a co-founder that has died or become disabled would be converted to low-vote shares.[35]

Proponents of time-based sunsets, while acknowledging the advantages associated with event-based sunsets, have primarily leveled two arguments against them. First, event-based sunset provisions fail to effectively address the phenomenon of decreasing founder-CEO value over time. While they may address certain risks such as death or retirement, they do not effectively mitigate the time-based risks.[36] Second, in light of this risk of declining value over time, they provide a young founder with an excessively long period of control over a company.[37] Accordingly, a founder in his or her thirties who does not retire until the age of sixty has approximately thirty years of effectively unrestrained control over the company.[38] If said founder can maintain his or her efficacy, this presents fewer problems. However, such a lengthy period of control can be damaging if the founder-CEO's efficacy indeed decreases over time.

D. Ownership-Based Sunset Clause

Finally, ownership-based sunset provisions substitute a dual-class structure with a single-class structure when the economic interest of the founder-CEO dips below a given threshold.

These provisions seek to mitigate the agency costs that accompany the "wedge" between the voting power and economic interest held by a controlling shareholder.[39] Essentially, where a shareholder's voting rights are proportionally greater than his economic interest in the business, agency costs increase.[40] This is because the controlling shareholder has more power than others to make decisions yet faces less economic loss if he makes a bad decision. For example, pursuant to a dual-class regime, a founder-CEO may have voting rights representing 60% of the company's shares while having an economic interest equivalent to only 10% of the shares. Accordingly, this shareholder has authority commensurate to 60% of the shareholder base while only bearing 10% of the cost when he makes suboptimal decisions. If this founder-CEO reduces his economic interest over time while maintaining control, the gap between his voting power and his economic interest grows. Therefore, the

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[35] Lyft, IPO Prospectus (Form S-1) (Mar. 1, 2019) ("In the event of the death or permanent and total disability of a Co-Founder, shares of Class B common stock held by such Co-Founder . . . will convert to Class A common stock …").

[36] *See* Bebchuk & Kastiel *supra* note 15 at 620.

[37] *Id.* ("For a founder who is young or middle-aged, [an event-based] sunset allows a lock on control that has an excessively long duration.").

[38] *Id.*

[39] *See* Cremers et. al *supra* note 13 and accompanying text.

[40] *See* Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1722 (2009) ("[I]nsiders holding more voting rights relative to cash flow rights extract more private benefits at the expense of outside shareholders.").

agency costs attendant to this gap grow concurrently.[41] An ownership-based sunset provision addresses this concern by effectively erasing the gap when it becomes too big.[42] Where the founder-CEO's economic interest is too small, he loses superior voting rights.

As with other sunset provisions, several companies have employed ownership-based sunset provisions successfully. For example, upon Yelp's 2012 IPO, it employed a dual-class structure.[43] However, this was subject to an ownership-based sunset which would convert the dual-class structure into a single-class structure if the founders' economic stake fell below 10%.[44] The founders' economic interest fell below 10% in 2016, and the conversion occurred shortly thereafter.[45] Apptio, an enterprise software company, employed a dual-class structure when it went public in 2016.[46] In addition to a time-based sunset, the maintenance of the dual-class structure required that the company's Class B shareholders, whose shares entitled them to superior voting rights, maintained at least a 25% of the economic interest in the business.[47] When their economic interest fell below this threshold in 2018, the dual-class structure was automatically converted into a single-class structure.[48]

Like every other sunset provision, ownership-based sunset provisions have also been criticized. Opponents primarily worry about assessing the correct threshold after which the dual-class structure should be converted into a single-class structure, with many companies opting for low thresholds.[49] While there is no clear answer to this question, some policy decisions can provide high-level guidance. For example, in 2018, the Hong Kong Stock Exchange amended its policies to allow innovative companies with dual-class stock structures to list on its exchange, provided that those with superior voting

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[41] *Id.*

[42] *See* Bebchuk & Kastiel *supra* note 15 at 621.

[43] Yelp, IPO Prospectus (Form S-1) (Nov. 17, 2011).

[44] *Id.* at 122.

[45] Yelp Announces Conversion of Class A and Class B Common Stock into a Single Class of Common Stock, Bus. Wire (Sept. 23, 2016), https://www.businesswire.com/news/home/20160923005406/en/Yelp-Announces-Conversion-of-Class-A-and-Class-B-Common-Stock-into-a-Single-Class-of-Common-Stock [https://perma.cc/V2U8-AJLL].

[46] Apptio, IPO Prospectus (Form S-1) (Aug. 26, 2016).

[47] *Id.* at 138 ("All shares of Class B common stock will convert automatically into shares of Class A common stock upon the earlier of (1) the seventh anniversary of the closing of this offering and (2) the date on which the Class B common stock ceases to represent at least 25% of our outstanding common stock.").

[48] *Apptio Announces Conversion of Class B Common Stock into Class A Common Stock*, PR Newswire (May 11, 2018), https://www.prnewswire.com/news-releases/apptio-announces-conversion-of-class-b-common-stock-into-class-a-common-stock-300647175.html [https://perma.cc/Y6U3-UGPX].

[49] *See* Bebchuk & Kastiel *supra* note 15 at 621 ("We note that the ownership-percentage sunsets recently adopted in dual-class IPOs tend to feature low ownership thresholds."); *see also* Fisch & Solomon *supra* note 31 at 1087 ("[T]his threshold [for triggering conversion to single-class] seems arbitrary.").

rights held an economic interest of at least 10% in the business.[50] This may serve as a guidepost for other regions seeking to employ ownership-based sunset provisions.

Conclusion

The dual-class dilemma is complicated and intriguing, but equally important. While there exists equally strong support and opposition for dual-class stock, neither of these extremes is desirable. Instead, sunset provisions, which allow dual-class stock to conditionally convert to a flatter voting structure, make for a productive "middle-ground." There is, however, further controversy as to how to design sunset provisions.

Because the distinguishing feature of a dual-class structure is the divergence between voting rights and economic interests, the increased agency costs associated with that structure relative to a single-class structure must be a product of that difference. Moreover, these agency costs are positively correlated with the divergence between voting rights and economic interest. Accordingly, to address agency costs, it seems most prudent to focus on addressing the divergence. Time-based solutions aim to address agency costs via proxy, while event-based provisions address only the most extreme issues (death, retirement, disability, etc.). Ownership-based provisions, in directly addressing this issue, appear to be most attractive.

Nonetheless, despite the attractiveness of ownership-based sunset provisions, they are not a panacea. Firstly, determining the correct threshold for a given issuer is extremely difficult. Secondly, they fail to deal with some pertinent issues addressed by other types of provisions, such as the risk of a founder-CEO passing a controlling stake on to incapable heirs. This risk is foreclosed by event-based provisions. In essence, ownership-based provisions are most effective at directly attacking the central root of agency costs in a dual-class structure, but time-based and event-based provisions are useful. To compensate for its blind spots, one solution may be to employ ownership-based provisions in all cases, accompanied by some variation of time-based and event-based provisions depending on the circumstances specific to the company in question.

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[50] Minimum Economic Interest at Listing for Weighted Voting Rights Structures, Hong Kong Exchange, Chapter 8A. ("The beneficiaries of weighted voting rights must beneficially own collectively at least 10% of the underlying economic interest in the applicant's total issued share capital at the time of its initial listing.").