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In Practice: Retaining Control Post-IPO

Companies going public, but unwilling to relinquish control to common stockholders, can create dual-class stock structures to maintain voting powerSecurities

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An initial public offering of a company's securities may result in the founders and existing shareholders losing control over the shareholder vote. To keep control following an IPO, insiders often implement dual-class stock structures, in which one class of shares has superior voting rights to the other, prior to going public.

Dual-class structures come in a variety of forms. A typical dual-class structure has one class of common stock with one vote per share (Class A), which is publicly traded, while the other class has multiple votes per share and is not publicly traded (Class B). These super-voting Class B shares can be used to ensure that a subset of pre-IPO shareholders remain in control of the shareholder vote even after an IPO. Typically, the Class B common stock may be converted into Class A common stock at the option of the holder, and may also include provisions for the automatic conversion of the Class B common stock into Class A common stock upon the occurrence of certain events, e.g., on a certain future date, upon transfer of the Class B common stock to a non-permitted transferee, upon cessation of affiliation of a holder of Class B common stock with the company, or when the aggregate number of shares of Class B common stock is less than a certain percentage of the then outstanding common stock.

For presumably historical reasons described below, many companies use a voting differential of 1 to 10 or less, e.g., Class A has one vote per share, and Class B has 10 votes or less per share. Other companies implement a variation of this voting differential depending on the matter to be voted upon, e.g., the Class B vote may be reduced to one per share on fundamental corporate matters such as a change-of-control transaction.

Other variations on the dual-class voting structure include multiple-class voting structures and time-phased voting plans. In a multiple-class voting structure, a company may have three or more separate classes of common stock with different voting rights. A time-phased voting structure conditions the voting rights of shareholders based on the length of time they hold the shares. Companies may adopt a timephased voting structure as an incentive for long-term shareholding. Time-phased voting structures also prevent short-term shareholders from exercising disproportionate voting control relative to longerterm shareholders.

In addition, if a dual-class structure creates a majority shareholder or group of shareholders (50 percent or more of the voting power for the election of directors is held by an individual or group), then a company may take advantage of the "controlled company" exemptions under the stock exchange rules. While beyond the scope of this article, subject to limited exceptions, a "controlled company" is not required to comply with the "majority independent board" requirement and certain other governance requirements of the exchanges.

No matter their form, dual-class structures must be carefully structured to comply with applicable stock exchange rules and governing state corporate law.

STOCK EXCHANGE AND REGULATORY HISTORY

From 1926 until 1984, the New York Stock Exchange declined to list dual-class stock, and maintained a policy of "one share, one vote." In 1984, the NSYE formed a subcommittee to examine the "one share, one vote" policy, largely due to increased competition from Nasdaq and the American Stock Exchange, both of which allowed dual-class listings. In 1985, a NYSE subcommittee recommended that the NYSE permit dualclass structures that (1) were approved by two-thirds of shareholders and a majority of outside directors, (2) with voting differentials of not more than 10 to 1, and (3) where the rights of the two classes were substantially the same except for voting power. The NYSE never adopted the subcommittee's proposal, and instead proposed a rule that would permit dualor multiple-class structures if they were approved by a majority of the company's shareholders and a majority of the outside directors. AMEX and the

NASD proposed their own rules that differed from NYSE's proposed rule.

In 1988, after the exchanges could not agree on a uniform policy, the SEC adopted Rule 19c-4 under the Exchange Act, which prohibited the listing or continued listing of any security if the issuer took action that would have the "effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock." The rule prohibited dual-class structures in public companies, but would have permitted IPOs of companies with dual-class structures and subsequent offerings of lesser voting stock. Rule 19c-4 was vacated in 1990 by a federal court that held the rule exceeded the SEC's rule-making authority.

Following the court's decision, in 1994, NYSE, NASD and AMEX agreed on, and the SEC approved, a uniform voting rights policy which provides that voting rights of existing shareholders of publicly traded common stock cannot be disparately reduced or restricted through any corporate action or issuance of stock. The SEC release announcing approval of the policy explained that the policy permits companies to issue dual classes of stock with unequal voting rights in an IPO and to subsequently issue additional shares of those classes because there are no existing public shareholders affected by the transaction.

STOCK EXCHANGE RULES

All three major exchanges allow companies to list dual-class voting shares during an IPO, but prohibit the creation of most dual-class structures after a company is listed. The exchanges have substantially identical rules, mirroring former Rule 19c-4, and providing that the voting rights of existing shareholders cannot be disparately reduced through any corporate action or issuance, including time-phased voting plans and the issuance of super-voting stock. However, companies with pre-existing dual-class structures are generally permitted to issue additional shares of either preexisting class without violating voting rights policies.

Under the voting rights policy, it is possible for a public company to issue a new class of stock with voting rights greater than those of an existing class. Per the SEC release announcing approval of the voting rights policy, such a structure should be analyzed by the exchanges on a case-bycase basis, taking into consideration the information disclosed to shareholders in the creation of the existing outstanding classes, the purposes and economics of the issuance of the new class, and the disenfranchisement of each existing class. Alternatively, a public company generally can create a dual-class structure post-IPO by issuing a new class with lower voting rights compared to existing classes. However, an issuance will violate the exchange rules, even if it involves a lower voting class, if it is constructed in a manner to disenfranchise existing shareholders.

While the creation of dual-class structures by already public companies is generally prohibited, subject to certain limited exceptions, there are no exchange rules that specifically bar dual-class structures preIPO. In responses in its frequently asked questions section, Nasdaq states that it will generally accept any proposed voting structure for an IPO.

STATE CORPORATE LAW

For companies incorporated in Delaware, the Delaware General Corporation Law provides that each stockholder is entitled to one vote per share unless otherwise provided in the company's certificate of incorporation, and Delaware courts have affirmed the ability of Delaware corporations to issue classes of stock with disparate voting rights as a valid exercise of the board of directors' business judgment. However, Delaware courts have also enjoined the issuance of stock with superior voting rights in the context of a proxy contest or when there is improper coercion of the shareholder vote.

Companies wishing to implement a dualclass voting structure can take certain measures to strengthen the likelihood that the recapitalization transaction will be reviewed by Delaware courts under the business judgment rule, which is generally deferential to the board's determination to recommend the recapitalization plan to shareholders and the application of which is more likely to result in the court upholding the shareholder vote to approve the recapitalization. These measures include obtaining the approval of disinterested and independent directors and ensuring that shareholders are fully informed of the impact on their voting power and cognizant of the possibility that their voting power may decrease through subsequent offerings.

In Practice articles inform readers on developments in substantive law, practice issues or law firm management. Contact Vitaly Gashpar with submissions or questions at vgashpar@alm.com. Kathleen M. Wells is a corporate partner in the Silicon Valley office of Latham & Watkins and co-chair of the firm's internet and digital media industry group. Her practice focuses on corporate and securities law, and her transactional experience includes numerous public securities offerings, mergers and acquisitions and venture capital financings. Ashley W. Wagner is an associate in the Silicon Valley office whose practice focuses on transactional matters.