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Response to CII Proposal to Amend DGCL

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Editor's Note: **David Berger** and **Amy Simmerman** are partners at Wilson Sonsini Goodrich & Rosati. This post is based on their WSGR memorandum. Related research from the Program on Corporate Governance includes **The Untenable Case for Perpetual Dual-Class Stock** (discussed on the Forum **here**), and **The Perils of Small-Minority Controllers** (discussed on the Forum **here**), both by Lucian Bebchuk and Kobi Kastiel, the keynote presentation on **The Lifecycle Theory of Dual-Class Structures**, and the posts on **The Perils of Dell's Low-Voting Stock**, **The Perils of Lyft's Dual-Class Structure** and the **Perils of Pinterest's Dual-Class Structure** (discussed on the Forum **here**, **here**, and **here**).

Earlier this month the Council of Institutional Investors ("CII") publicly called upon Delaware's legislature and governor to amend the state's corporate code to effectively prohibit publicly traded Delaware corporations from having multi-class stock unless the multi-class structure ends no later than seven years after the company's IPO. CII's lobbying effort in Delaware is only its latest attempt to obtain a mandatory prohibition against dual-class stock; earlier efforts by CII to have the SEC and the national exchanges prohibit dual-class stock proved unsuccessful (although CII has managed to have some indexes exclude certain dual-class companies).

In this newest iteration, CII's proposal would apply to an array of capital structures that involve differential voting power among classes of common stock, including dual-class structures that have become relatively common in recent years, as well as the use of a "golden share" that carries special voting rights. While CII's proposal would grandfather in preexisting capital structures, it generally provides that, going forward, public companies incorporated in Delaware can only have multi-class structures for a period of up to seven years following an initial public offering or approval of the structure by each class of stock. (CII's letter to the chair of the Council of the Corporation Law Section of the Delaware State Bar Association, as well as its full proposal, can be found **here**.

CII's proposal is flawed in several respects. On a very basic level, CII's request to amend the Delaware General Corporation Law (the "DCGL") to prohibit companies from adopting certain types of capital structures demonstrates a lack of understanding of basic principles of Delaware corporate law. In addition, while CII's proposal represents CII's own ideological approach to corporate governance, CII's letter to Delaware in support of its proposal ignores the most recent empirical evidence on the potential benefits of dual-class stock, as well as broader issues of corporate purpose.

CII's proposed amendment conflicts with several longstanding principles of Delaware corporate law. These principles have made Delaware the chosen venue for most public companies in the United States (as well as the model for many foreign companies and countries around the world). One such principle is that the DGCL is an enabling statute, designed to provide investors and other corporate stakeholders broad flexibility to determine among themselves how a corporation should be governed. As then-Vice Chancellor (and now Chief Justice) Strine wrote, the "DGCL is intentionally designed to provide directors and stockholders with flexible authority, permitting great discretion for private ordering and adaption." (*Hollinger Int'l Inc. v. Black*, 844 A 2d.1022, 1078 (Del Ch. 2004), aff'd 872 A 2d 559 (Del. 2005); *see also see* Lawrence Hamermesh, "*The Policy Foundations of Delaware Corporate Law*," 106 *Columbia Law Rev.* 1749 (2006)).

CII's proposal is contrary to the basic enabling structure of the DGCL. CII's proposed amendment would expressly prohibit certain types of capital structures on the basis that CII believes these capital structures limit the rights of public stockholders. Yet even if CII is correct about the negative aspects of dual-class structures, under the enabling theory of Delaware corporate law these types of decisions are best left to stockholders and directors and should not be made by legislative fiat.

This does not mean, of course, that stockholders have no rights if controlling stockholders engage in improper behavior. To the contrary, Delaware law already provides powerful checks and balances on founders and stockholders with significant amounts of voting power. In recent years, the Delaware courts have regularly and methodically addressed controlling stockholder conflicts of interest—finding that where large stockholders possess control over the corporation and receive special benefits or engage in transactions with the company, board members, members of management, and controlling stockholders may be subject to claims that they breached their fiduciary duty of loyalty.

CII's proposal runs counter to a second core principle of Delaware law: that there are very limited distinctions in the DGCL between public and private corporations. This is an important element of Delaware law, as Delaware applies the same fiduciary principles to directors of public companies as it does to private companies, gives stockholders of private companies the same rights to information as public company stockholders, and creates no distinctions between the capital structures public companies can have against those available to private companies. CII's proposal would change this fundamental structure by creating new rules to govern public companies against those governing private companies.

CII's proposal also represents bad policy. CII cites various studies in its letter in support of its proposal. These studies, and the purported perils of dual-class stock, have been frequently discussed in legal academia, including *The Untenable Case for Perpetual Dual-Class Stock*, *The Perils of Small-Minority Controllers*, and the keynote presentation on *The Lifecycle Theory of Dual-Class Structures* by Lucian Bebchuk and Kobi Kastiel. However, CII ignores the most recent empirical research demonstrating why the current system of private ordering remains preferable to any type of mandatory or fixed sunset provisions. This research includes studies by academics and index funds showing that dual-class companies have out-performed their single-class peers for at least a decade. (*Why Dual Class Stock? A Response to CII's Petition to Nasdaq for Mandatory Sunset Provisions* available at **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365154**). In addition, considerable research raises serious questions about the methodology employed in studies that purport to compare dual-class companies to single-class companies. These issues are sufficiently significant that the most recent academic study to consider dual-class stock, *The Problem of Sunsets* by Professors Jill Fisch and Steven Davidoff Solomon, concluded that "compulsory sunsets, and time-based sunsets in particular, are an inappropriate response to the potential problems of dual class stock." (*See* 99 *Boston U. Law Review* 1058 (2019); *see also* Bernard S. Sharfman, "*The Undesirability of Mandatory Time-Based Sunsets in Dual-Classed Structures: A Reply to Bebchuk and Kastiel,"* (May 2019) available at **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3368476**).

Furthermore, CII's proposal comes at a particularly peculiar time, as the debate rages over the purpose of the corporation and boards have come under increasing pressure to take into account important social considerations beyond the monetary interests of stockholders. One reason many technology companies began adopting multi-class stock was to allow these companies to focus on issues in addition to short-term stockholder value and take a longer-term approach to creating corporate value.

Now, as questions about ESG have expanded to the broader issue of corporate purpose, companies and directors are being pushed to move beyond the single-minded mission of stockholder value and consider more fundamental questions about the role of the corporation in society, especially the public corporation. This debate has led many corporate leaders, including the Business Roundtable, and employees, labor leaders, and policymakers, to call for corporations to focus more on all corporate stakeholders, rather than just stockholders.

CII has rejected this expanding view of corporate purpose, arguing instead that stockholder primacy must remain the standard, that it is "government, not companies, that should shoulder the responsibility of defining and addressing societal objectives," and that companies should focus on stockholder value. (*See* Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose, available at **https://www.cii.org/aug19_brt_response**). We believe that CII's narrow understanding of stockholder primacy is not required by Delaware law and is inconsistent with the broader understanding of corporate purpose.

Ultimately, CII's proposal is both bad law and bad policy. Delaware's prominence in corporate law stems from a number of factors, including its capable and expert judiciary, a state-of-the-art corporate filing system in Delaware, and the careful maintenance of Delaware's corporate statute over time. Delaware's balanced approach to the DGCL is the result of legislative process in Delaware that is—quite remarkably in our current times—largely apolitical, measured, deliberative, and driven by experts. As part of this process, each year a group of carefully selected Delaware lawyers reviews and proposes possible amendments to the DGCL. Typically, without much lobbying or fanfare, the legislature and governor are able to vet legislation that is proposed based on its merits. This has allowed Delaware to develop a steady and thoughtful system that provides considerable benefits for corporations and investors. Delaware should just say no to CII's efforts to politicize this process by creating a statutory prohibition against dual-class stock.

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