CalPERS Suit Marks Another Loss for Multiclass Stock Plans

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Multiclass stock structures have suffered tremendous defeats of late. The recent case of California Public Employees' Retirement System v. IAC/InterActiveCorp illustrates how institutional investors can use litigation to successfully protect their voting rights, and recent actions by stock index provider S&P further diminish corporations' incentives to pursue multiclass structures.

For decades, activist corporate founders and controllers have sought ways to entrench their positions atop the corporate hierarchy by granting themselves and other insiders "supervoting rights." Such arrangements, known as "dual-class" or "multiclass" stock structures, diminish the voting power of institutional and individual investors alike, and can distort managerial incentives by providing controllers voting power out of line with their actual economic interests in public companies.

This dynamic has worsened in recent years, as several companies have authorized new classes of nonvoting stock as a means to allow controllers to monetize their economic interests without reducing their voting control. Given these harmful corporate governance practices, institutional investors are pursuing litigation to halt planned multiclass structures. CalPERS' recent suit to stop Barry Diller's IAC/InterActiveCorp from giving Diller and his family perpetual control of IAC through a proposed issuance of nonvoting shares could mark a turning point for investors. The case has ended in capitulation, with IAC conceding the case and withdrawing its multiclass plan.

CalPERS' suit was initiated against the backdrop of a rising tide of companies creating or expanding their multiclass stock structures. In 2012, for instance, Google — which already protected its founders through Class B shares that had 10 times the voting power of Class A shares — moved to further lock in the founders' voting power by issuing third-tier Class C shares with no voting rights. This allowed Google's founders to sell their economic interests in the company without affecting their voting power. Shareholders, led by a Massachusetts pension fund, filed suit, alleging that the board's approval of the issuance breached their fiduciary duties. On the eve of trial, the parties agreed to settle the case by allowing the issuance but structuring a one-time payment to shareholders based on the trading discount between the Class A shares and the nonvoting shares. Google was forced to pay over $560 million, as the market determined that the nonvoting shares were less valuable.

In more recent years, numerous other emerging technology companies have either instituted multiclass structures or announced plans to do so. Tech companies Snap, Alibaba, LinkedIn, Square and Zynga have each implemented dual-class structures. At the same time, investors have responded by filing suit in order to protect valuable voting rights. In 2016, after Facebook announced a plan to distribute nonvoting shares and solidify founder and CEO Mark Zuckerberg's control, the pension fund Sjunde

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AP-Fonden and numerous index funds filed suit, alleging breaches of fiduciary duty and challenging the multiclass plan. Facebook dropped its plan to issue these nonvoting shares in the face of the institutional investor community's legal response. Investors are also convincing stock index providers to take a stand against multiclass companies. In the wake of Snap's no-voting-rights IPO in early 2017, investors called for stock index providers to bar Snap's shares from becoming part of major indices due to Snap's nonvoting shares. On July 31, 2017, S&P Dow Jones Indices LLC responded. The index provider announced not only that it would ban Snap from its hugely important S&P 500 index, but also that the S&P Composite 1500 and its constituent indices (including the S&P 500, the S&P MidCap 400 and the S&P SmallCap 600), will no longer add any companies with multiple share class structures.

This is a significant action that keeps index fund investors' cash out of such companies' stock, and thus provides concrete costs for companies seeking to go to market with nonvoting shares. As Anne Sheehan, director of corporate governance for the California State Teachers' Retirement System, has concluded, "[t]he action by S&P should send a signal to ... companies that you can't do this. You can't set up multiclass share structures. Shareholders will not accept it. ... If you are asking for our capital, we demand an accountability mechanism."

Even against the backdrop of increasingly aggressive multiclass stock issuances, IAC's effort to strip shareholders of their voting rights was particularly egregious. Last year, Diller, the controlling shareholder and chairman of the board of IAC, attempted to create a new, nonvoting class of stock that would solidify his power and ensure his ability to pass control of the business to his heirs. At the time, IAC had common shares that afforded one vote per share, and supervoting Class B shares that had 10 votes per share. Through his ownership of Class B shares, Diller owned less than 8 percent of the company's stock, yet wielded a disproportionate 44 percent of the company's voting power. However, because IAC used stock for executive compensation and to fund acquisitions, Diller's control over IAC would diminish as the company made such further issuances of voting stock. By devising a plan to create and distribute new, nonvoting Class C stock instead, Diller created a mechanism to solidify his and his heirs' control in perpetuity.

In November 2016, IAC informed investors that the IAC board of directors had approved the plan to issue the Class C stock. Within weeks, CalPERS filed a class action in the Delaware Chancery Court alleging breaches of fiduciary duty and requesting an order preventing the company from issuing the nonvoting stock. CalPERS' complaint in the case highlighted that Diller achieved board approval of the issuance of IAC nonvoting stock by threatening to use his voting power to prevent the company from making valuable and necessary acquisitions that used IAC stock as consideration.

On June 23, 2017, after months of contentious litigation, IAC announced that it had abandoned the plan to issue nonvoting stock, effectively conceding the litigation. CalPERS stipulated to the dismissal of the lawsuit and noted in a press release that the IAC plan had constituted an "egregious violation of th[e] principle" of one share, one vote corporate governance.

By shedding the light of litigation on IAC's nonvoting share plan, CalPERS achieved a significant victory for shareholders' core right to vote. Combined with the pushback from the S&P, this result should make founders and controllers considering nonvoting stock issuances think twice, as institutional investors will act decisively to defend and assert their right to vote when faced with these threats. Such protective actions will continue to promote open and responsive capital markets, and the long-term value creation that comes with them.

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DISCLOSURE: Bernstein Litowitz represented CalPERS in In re IAC/InterActiveCorp Class C Reclassification Litigation*, C.A. No. 12975-VCL, in the Delaware Chancery Court.*