Shareholder Eugenics in the Public Corporation

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SHAREHOLDER EUGENICS IN THE PUBLIC CORPORATION

Edward B. Rock†

In a world of active, empowered shareholders, the match between shareholders and public corporations potentially affects firm value. This Article examines the extent to which publicly held corporations can shape their shareholder base. Two sorts of approaches are available: "direct" or "recruitment" strategies and "shaping" or "socialization" strategies. Direct or recruitment strategies, which attract "good" shareholders to the firm, include going public, targeted placement of shares, traditional investor relations, the exploitation of clientele effects, and "de-recruitment." Shaping or socialization strategies, which transform shareholders of a "bad" or unknown type into shareholders of the "good" type, include choice of domicile, choice of stock exchange, the new "strategic" investor relations, and capital structure. For each type of strategy, I consider the extent to which corporate and securities law facilitates or interferes with the strategy as well as the ways in which it controls abuse. In examining the relationship between shareholder base and firms, this Article attempts to merge investor relations, very broadly construed, with corporate governance.

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INTRODUCTION

A private corporation chooses its shareholders. New participants can be recruited or shunned. When a firm goes public, it relinquishes much of this freedom. As Warren Buffett put it: “Mrs. Astor could select her 400, but anyone can buy any stock. Entering members of a shareholder ‘club’ cannot be screened for intellectual capacity, emotional stability, moral sensitivity or acceptable dress. Shareholder eugenics, therefore, might appear to be a hopeless undertaking.”1

Is “shareholder eugenics,” in fact, a hopeless undertaking? Are there tools for screening entering members for capacity, stability, sensitivity, or dress? To what extent does the law facilitate shareholder eugenics? To what extent does it interfere? When it interferes, does it do so unnecessarily?

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Many of the reasons for choosing good co-investors in the private firm (and for avoiding bad ones) carry over into the publicly held firm. We know from venture capital that sophisticated investors may be able to contribute managerial skill, relationships with customers and suppliers, contacts with investment bankers, and sage counsel to a start-up business. Likewise, we know from private equity experience that sophisticated investors may be particularly skilled at several different but important functions: reorienting a mature business that has lost its focus while public, including undoing excessive diversification; providing high-powered incentives to managers combined with high-powered monitoring; and providing patient capital during a period of unsettled market conditions. Similarly, in the public corporation context, there are reasons to believe that the right match between investors and firms can be important to firm value. Is shareholder eugenics as hopeless an undertaking as it might first appear?

There are, in fact, a wide variety of modes of shareholder eugenics. At the same time, there are clear limits to a firm’s ability to craft its shareholder base. Once one seriously entertains the notion that the composition of a firm’s shareholder base can impact a firm’s success, the methods for shaping that base—for good or for ill—become a salient dimension of corporate governance, a dimension that has been largely ignored. Put differently, investor relations, broadly construed, begins to converge with corporate governance.

From the perspective of financial economics, this Article focuses on the relationship between the shareholder base and firm value. Two seminal contributions are the models developed by Amihud and Mendelson and Merton. Both start from the intuition, nicely stated by Merton, that the “portfolios held by actual investors (both individual and institutional) contain only a small fraction of the thousands of traded securities available” and then draw a link between the shareholders of a company and its cost of capital.

The Merton model starts from the observation that shareholders will only choose among known stocks—the “investor recognition hy-

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2 See generally Paul Gompers & Josh Lerner, The Venture Capital Cycle 127-54, 157-70 (2d ed. 2004) (discussing the structure of venture capital investing and the importance of the private equity organizational form); Andrew Metrick & Ayako Yasuda, Venture Capital & the Finance of Innovation 9-14, 94-183 (2d ed. 2011) (discussing the history and development of the venture capital industry and examining how top-tier venture capitalists add value through investing, monitoring, and exiting).


6 Id. at 488, 499–504; see Amihud & Mendelson, supra note 4, at 223–24, 246–47.
pothesis," an assumption of incomplete information.\(^7\) This limits a firm's ability to raise capital.\(^8\) Merton's model introduced the useful concept of "set-up" costs:

If an investor does not follow a particular firm, then an earnings or other specific announcement about that firm is not likely to cause that investor to take a position in the firm. If, for each firm, investors must pay a significant "set-up" (or "receiver") cost before they can process detailed information released from time to time about the firm, then this fixed cost will cause any one investor to follow only a subset of the traded securities. Because this fixed cost is a "sunk cost" for existing shareholders, the effective information received by current shareholders, even from a public announcement by the firm, will not be the same as that received by other investors.\(^9\)

Merton shows that, especially for small firms, these set-up costs can raise the cost of capital and reduce the value of the firm.\(^10\)

By contrast, Amihud and Mendelson developed a model in which liquidity generates a clientele effect: short-term investors prefer stocks with a small bid–ask spread, while longer-term shareholders gravitate towards larger-spread assets.\(^11\) Because longer-term shareholders get paid for giving up liquidity in the form of higher expected returns, there is a connection between liquidity and the cost of capital. Thus, as in the Merton model, the shareholder base and cost of capital are correlated.\(^12\)

Although these models draw different (but potentially complementary) connections between the identity of the shareholders—the shareholder base—and the firm's cost of capital, the key foundational insight of both is that there is such a connection. The models have generated a large literature, which this Article will address as it becomes relevant.\(^13\) As will become clear, these models are important for understanding the extent to which companies can tailor their shareholder base and the means for doing so. An immediate implication of both models is that firms have an incentive to invest in expanding their shareholder base. Indeed, the process of attracting investors who do not currently own shares may be similar to marketing the firm's products.\(^14\) Buffett's question about shareholder eugenics involves both (a) the link between shareholder base and firm

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\(^7\) See Merton, supra note 5, at 488, 494–95.
\(^8\) See id. at 484–87.
\(^9\) Id. at 489–90 (internal footnote omitted).
\(^10\) See id. at 484–85, 502.
\(^11\) See Amihud & Mendelson, supra note 4, at 246.
\(^12\) See id. at 224, 246.
\(^13\) See infra Part II.D.3.
\(^14\) See Merton, supra note 5, at 501.
value, and (b) the extent to which a firm can influence its shareholder base.

We live in an era of empowered shareholders. Shareholding is more concentrated than ever before. Shareholders vote on more things than they ever have, with proposals to give them even more power. Activist shareholders and intermediaries of various stripes have emerged and have had a significant impact. Although controversy continues over whether empowering shareholders is good or bad, different and more interesting questions arise from an acknowledgement that shareholders are empowered. That new reality requires rethinking the relationship between shareholders and the firm. Learning how to interact productively has never been more important to shareholders or firms. From a regulatory perspective, we need to reconsider some current limitations that treat shareholders like children.

This Article is an investigation into the tools available for recruiting and shaping the shareholder base. Part I briefly explores the goals of crafting a shareholder base in a public corporation. Part II turns to the available tools for directly shaping that base, what I refer to as “direct” or “recruitment” strategies: the tools for identifying “good” shareholders and bringing them into the firm (and the related “de-recruitment” strategies of discouraging or ousting bad shareholders). They include going public, targeted placement of shares, traditional investor relations or communications strategies, the exploitation of clientele effects, and de-recruitment. Part III examines what I refer to as “shaping” or “socialization” strategies, which transform shareholders of a “bad” or unknown type into shareholders of the “good” type. In contrast to the direct or recruitment strategies, shaping or socialization strategies largely shape the shareholder base by modifying the shareholder role. They include choice of domicile, choice of stock exchange, “strategic” investor relations, and capital structure. For each type of strategy, I consider the ways that corporate and securities

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law facilitates or undermines the strategy, as well as the ways in which it controls abuse. I close with a brief conclusion.

I
GOALS IN CRAFTING THE SHAREHOLDER BASE IN THE PUBLIC CORPORATION

What are firms looking for in shareholders? In short, they are looking for good shareholders and hoping to avoid bad ones.

A. What is a Good Shareholder?

What makes a shareholder a good shareholder? First and foremost, shareholders provide money. In particular, firms look for money that is committed to the firm forever and that is available at an attractive price. Thus, in going public, both Blackstone and KKR, the pioneers of private equity, acknowledged the comparative advantage of the public company form in raising long-term committed capital that permits long-term investments. As Blackstone stated in its S-1:

We have decided to become a public company:
- to access new sources of permanent capital that we can use to invest in our existing businesses, to expand into complementary new businesses and to further strengthen our development as an enduring institution;
- to enhance our firm's valuable brand;
- to provide us with a publicly-traded equity currency and to enhance our flexibility in pursuing future strategic acquisitions;
- to expand the range of financial and retention incentives that we can provide to our existing and future employees through the issuance of equity-related securities representing an interest in the value and performance of our firm as a whole; and
- to permit the realization over time of the value of our equity held by our existing owners.¹⁹

Similarly, KKR described the advantage of listing on the NYSE as providing "a significant source of permanent capital to further grow our business and an equity currency that we may use to attract, retain and incentivize our employees and to fund opportunistic acquisitions."²⁰

But the relationship with shareholders is a long-term relationship. In addition to providing money, shareholders create the secondary market for shares. A well-functioning market for shares allows existing shareholders to exit at a price that is a reasonable estimate of

¹⁹ Blackstone Grp. L.P., Securities Registration Statement (Form S-1), at 7 (Mar. 22, 2007).
²⁰ KKR & Co. L.P., Securities Registration Statement (Form S-1), at 1 (Sept. 16, 2010).
the value of the investment in the firm and likewise allows new shareholders to enter at a reasonable price. Moreover, a secondary trading market with reasonably accurate prices means that shares can be used to make acquisitions without dilution of the buying firm’s shareholders (in the case of undervalued shares) or dilution of the selling firm’s shareholders (in the case of overvalued shares).\(^1\) Similarly, a reasonably accurate stock price makes stock- or option-based compensation a more useful tool for aligning manager and shareholder interests. Therefore, one definition of a “good shareholder base” is a shareholder base that produces a stock price that reasonably approximates firm value. In this context, a good shareholder is one who evaluates firms according to long-term fundamental value rather than short-run earnings.\(^2\)

Beyond these two fairly uncontroversial propositions, one may also understand a good shareholder to be one who increases firm value. Here, controversy abounds over who counts as a good shareholder. One person’s “active monitor” is another person’s “intrusive busybody” or “speculator.” A shareholder who is good from a shareholder’s perspective may be bad from a manager’s perspective. In what follows, I largely bracket the question of what sorts of shareholder activities increase or decrease firm value and focus instead on mechanisms for shaping the shareholder base. But, before doing so, it is worth considering some of the ways in which shareholders can potentially add value.

Shareholders may bring specific skills or expertise to a firm. For example, they may bring “monitoring” expertise.\(^3\) These skills can vary and may be more valuable to some firms than to others. When Warren Buffett invested in Goldman Sachs during the darkest days of the financial crisis, it was viewed as a huge vote of confidence in Goldman Sachs’ soundness.\(^4\)

Using Hirschman’s typology, monitoring expertise can impact governance through the exercise of “voice” or “exit.”\(^5\) Voice, in this


\(^3\) Id. at 2482.


context, includes all the modes of shareholder activism from informal discussions with management to full-fledged proxy fights. Exit and the threat of exit impact governance largely through the effect (or threatened effect) on stock price. In some models, one may understand a good shareholder as one who, through self-interested decisions to sell or not sell, renders the firm's strategies and disclosures more credible and incentivizes managers to increase firm value. But the goodness of shareholders can also be more diffuse and aggregative; one may view the stock price, which emerges from the interaction of buying and selling shareholders, as a running commentary on managerial performance. For both voice and exit, the size of a shareholder's block may be critical in providing incentives to invest in monitoring and in limiting a shareholder's ability to exit.

Shareholder monitoring—and thus shareholders with particular monitoring skills—may be more or less valuable depending on the volatility of the returns, the nature of the assets, the presence of other constituencies (e.g., institutional lenders or government regulators) who provide some monitoring, and a host of other factors. In addition, shareholders may increase firm value through their ability to help the firm with management or marketing, either through experience with similar companies or through industry contacts. In yet another variant, shareholders—or shareholdings—may be "hostages" that support bilateral exchange. For example, in a joint venture, cross-shareholdings may be part of the glue that holds the relationship together and facilitates investment in relationship-specific assets.

As I discuss below, the contestability of control that accompanies going public creates obvious dangers of its own. Outside parties may threaten disruption as a way of extracting payments. If the market price undervalues the firm, buyers may try to buy the firm on the cheap. Shareholders with conflicting interests may support plans that benefit other firms. A good shareholder is one who will protect a corporation from these dangers.

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27 See Edmans & Manso, supra note 26, at 2398–99, 2404.


29 Cf. id. at 551–52 (noting that shareholders may have incentives to monitor management).


31 See id. at 124–37.
B. What is a Bad Shareholder?

Bad shareholders are the inverse of good shareholders. An example of this type of shareholder is one who, through their manic-depressive personalities or attitudes or by intentional actions, causes the stock price to depart from a reasonable estimate of long-term fundamental value. This can hurt the firm by increasing its cost of capital or by interfering with the positive contribution that can be made by a steady, accurate stock price.\(^3\)

A different type of bad shareholder is one who seeks to gain at the expense of other shareholders by extracting non-pro rata payments (e.g., targeted share repurchases or "greenmail") or by benefiting a different firm. Another variety of bad shareholder is one who pursues short-term gain at the expense of long-term value. This could mean triggering a change of control at an inopportune time or pressuring a firm to pay dividends beyond the free cash flow. Additionally, a bad shareholder can be one who brings bad publicity on the firm for personal gain (e.g., a shareholder who is net short and seeks gain by convincing the market that the stock price is overvalued, when it is not).\(^3\) Finally, a bad shareholder may be an excessively litigious shareholder who, to collect fees, brings litigation that injures the shareholders as a group.\(^3\)

The line between a good and a bad shareholder may be a fine one, as it depends on the interpretation of the shareholder’s conduct. In addition, different firms are likely to need different sorts of shareholders, and a shareholder who injures one type of firm may aid another, and vice versa.

It is beyond the scope of this Article to take a position on what proportion of shareholders are good or bad, or on whether any particular shareholder or shareholder action hurts or helps any particular firm. Because my focus is primarily on the mechanisms of shareholder eugenics, I assume that shareholders of both types exist, but I remain agnostic on their identities and the proportions of the two types. Moreover, one cannot assume that the shareholder type is an inherent or intrinsic characteristic. Indeed, in general, shareholder type is likely to be significantly a function of incentives. This malleability is what makes shareholder eugenics possible.

\(^{32}\) See, e.g., Letter from Warren E. Buffett, supra note 1.

\(^{33}\) For example, Overstock.com claims to have been the victim of such a "bear raid." See Press Release, Overstock.com, Rocker Pays $5 Million to Overstock.com to Settle Lawsuit (Dec. 8, 2009), available at http://investors.overstock.com/phoenix.zhtml?c=131091&p=irol-newsArticle_pf&ID=1363917&highlight=.

\(^{34}\) See generally Bratton & Wachter, supra note 18, at 655–726 (discussing problems with shareholder control).
C. The Potential Benefits of an Optimal Shareholder Base: A Simple Illustration

Suppose that a firm has a choice between two investments. Project A has an expected value of ten and is easy to understand and communicate to the market. Project B has an expected value of fifteen but is complex and hard to explain, and thus the value is unlikely to be reflected in stock price until the project has come to fruition. Suppose further that shareholders come in two types: impatient and patient. Finally, suppose that shareholders collectively have enough power, one way or another, to influence the managers' choice of projects.35

If firms cannot effectively shape their shareholder base and end up with impatient shareholders, managers are likely to "manage to the market"36 and choose project A: responsive to their impatient shareholders, they choose the lower value project that will be reflected in the stock price and leave the extra five on the table because of the unbridgeable asymmetry of information. On the other hand, if firms can craft a shareholder base of patient shareholders, who are willing to trust managers and wait for hard-to-value projects to come to fruition, then managers will be free to choose project B with its higher returns.37 Indeed, even if shaping the shareholder base is costly, it would make sense to spend up to five in doing so to capture the higher returns from project B.38

D. The Dangers of Picking Your Shareholders

The ability to choose shareholders can be abused. Indeed, nearly every structure and strategy of shareholder eugenics discussed below can benefit managers or controlling shareholders at the expense of noncontrolling shareholders. As I will show, the law makes many of these strategies possible. It also addresses, albeit incompletely and imperfectly, the dark side of shareholder eugenics.

The problem, of course, is that certain sorts of shareholders may be good for managers or controlling shareholders but bad for share-

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35 This is a variation of a hypothetical by William Bratton and Michael Wachter. See id. at 700–03.
36 Id. at 690.
38 As this example shows, the link between shareholder base and firm value is entirely consistent with common views of the informational efficiency of markets. See, e.g., Edmans, supra note 22, at 2504–05 (arguing that shareholders who hold small blocks of shares can have a significant impact on the firm's value by "gathering and trading on intangible information").
holders overall, or vice versa. To the extent managers or controlling shareholders have discretion to shape the shareholder base to increase firm value, they can use that discretion to benefit managers or controlling shareholders at the expense of firm value.

The dark side of manager and controlling-shareholder discretion is a pervasive issue in corporate law. Indeed, many features of corporate law—from independent directors and shareholder voting to management compensation and shareholder litigation—are at least partially responses to these agency problems. I will not rehash these general arguments. Rather, with regard to each of the structures or strategies of shareholder eugenics discussed below, I will identify the distinctive agency costs that can emerge and any specific legal responses.

II
TOOLS FOR CRAFTING THE SHAREHOLDER BASE: "DIRECT" OR "RECRUITMENT" STRATEGIES

As noted earlier, there are numerous means for recruiting shareholders of a desired type, at least in part. In this Part, I examine some of them.

A. Going Public

In the first instance, going public itself is a fundamental choice about shareholder base. In going public, the company is embarking on a process in which the existing shareholders (employees, venture capitalists, private equity investors, or other private investors) are replaced with shareholders of a very different sort. Institutions like mutual funds, pension funds, insurance companies, and charitable endowments rarely invest directly in privately held companies but do in public companies. Similarly, most individual investors do not and cannot invest in private companies but often are quite keen to invest in newly public companies.

As a result, the initial public offering (IPO) will often mark the beginning of the end of the relationship with sophisticated investors who played a prominent role in the company during its period as a private company. When a venture capital-financed start-up company goes public, the venture capital funds are often expected to exit in a secondary offering shortly thereafter. Likewise, when a company taken private by a private equity fund reemerges as a public company, the private equity fund will begin to cash out its position either in the IPO itself or shortly thereafter in a secondary offering. In each case,

the investor's comparative advantage is in developing or restructuring companies while private. Once the company goes public, these specialized investors desire to redeploy their capital to other engagements where their ability to profit is greater.40

Further, once a firm goes public, its relationship with its shareholders is transformed. While a private firm is free to share information with shareholders without revealing it to the world (and competitors), doing so is much harder for public companies. Moreover, a private company can be selective in revealing information to shareholders to a much greater degree than a public company can. Regulation Fair Disclosure (FD) limits (although does not eliminate) a public firm's ability to make such selective disclosures.41

1. Underwriter Share Placement in IPOs and Secondary Offerings

The process of going public provides an opportunity for choosing a shareholder base. Whether in a firm-commitment or best-efforts underwriting, the underwriter's key role is to place the shares of the issuer with investors. Underwriters play this role both in IPOs as well as in subsequent offerings. The IPO is of particular interest because it is when the issuer is first introduced to the capital markets, its shareholder base is first created, and the share price in the secondary market creates the baseline for subsequent offerings.42

The IPO process and the persistent phenomenon of "underpricing" have attracted much theoretical and empirical interest.43 One of the key stylized facts that has emerged from the literature is that underwriters typically do not sell the shares by open auction but rather allocate them. In particular, it is generally believed that underwriters seek to place the shares with "long-term investors" who have a track record with the underwriter.44 When Goldman Sachs went public, for example, it placed shares "with a group of institutional investors and rich individuals who Goldman believed would remain loyal, long-term holders and not 'flip' the stock after its opening."45 This general view

40 Id. at 252–58.
42 See Fox et al., supra note 21, at 345.
is supported by survey evidence\textsuperscript{46} as well as an examination of underwriters' books.\textsuperscript{47}

Share placement provides one of many explanations for IPO underpricing.\textsuperscript{48} From the investors' perspective, a commitment to hold for the long term creates a risk for which they need to be compensated. From the issuers' and underwriters' perspectives, underpricing both compensates the investors for this increased risk and bonds the investors' commitments to hold for the long term.\textsuperscript{49}

The terms of investors' implicit commitment to hold remain somewhat unclear. On the one hand, it is a commitment not to sell (much) in the early days following the IPO. Overall, investors only sell around 15% of their allotment during the first days after an IPO.\textsuperscript{50} The reselling of these shares, combined with short selling and market-making activity, results in a relatively high trading volume.\textsuperscript{51} Interestingly, flipping is less common in "cold" than "hot" IPOs: in cold IPOs, institutional investors sell on average about 20\% of their allocations, while in hot IPOs they sell close to 47\% of their allocation.\textsuperscript{52} Under the typical underwriting agreement, when investors flip shares the managing underwriter can reclaim fees earned by broker-dealers through the imposition of a "penalty bid."\textsuperscript{53} The Depository Trust Company's IPO Tracking System allows underwriters to monitor flip-

Given these data, one can view the commitment not to flip during the stabilization period as fundamentally a commitment by buyers not to undermine the public offering to the detriment of the underwriter. In the case of cold IPOs, the underwriter will end up buying back the flipped shares, so flipping is particularly problematic.\footnote{See id. at 115.} In hot IPOs, flipping is less of a problem. First, because of the excess demand for the shares, flipping does not impose any costs on the underwriters. Second, investors who sell their allotment may not be acting opportunistically. In a hot IPO, the allotments to specific investors may be smaller than requested and also smaller than an investor's minimum block size. Under these circumstances, it is understandable that an investor would decide to sell the allotment rather than buy additional shares at the overheated market price.\footnote{See id. at 115, 127.} Indeed, underwriters may even be pleased to see flipping in hot IPOs because it generates volume and commissions.\footnote{See id.}

Yet the expectation and the commitment seem to extend beyond the first few days. In placing shares, the anecdotal evidence described earlier suggests that issuers and underwriters are, in fact, seeking long-term shareholders, not simply trying to avoid flippers.\footnote{See Jenkinson & Jones, supra note 43, at 1496 fig.4.} Although Aggarwal's data show a low level of flipping after IPOs by both institutions and individuals, the data do not extend far enough to allow the calculation of average holding periods.

Viewed in this way, the allocation of shares in an underwriting provides an example of directly building a shareholder base, an effort that is costly but that presumably provides benefits in return. The key benefit provided by selling to long-term shareholders seems to be stability in the secondary trading market for shares: stable shareholders limit the number of shares traded. From this perspective, a good shareholder is one who will hold the allotted shares for the long term and thereby provide stability in the development of a secondary trading market.\footnote{See Jenkinson & Jones, supra note 44, at 2310.}

Directly limiting the transfer of shares would not achieve the same stability in the secondary trading market for at least two reasons. First, it would undermine the emergence of a genuine secondary market. Second, it would muddy the desired signal: shareholders who are...
legally prohibited from selling will not convey confidence in the current price.\textsuperscript{60} Instead, underwriters rely on softer, blurrier restraints underpinned by repeat interactions and motivated by investors’ desire to be offered underpriced shares.

2. \textit{Controlling the Dark Side of Going Public}

The general risks of going public are twofold. First, when a company goes public, shareholders who have an incentive and the ability to monitor (such as the original venture capitalists) are replaced with dispersed shareholders without the incentives or skills to do so. This can lead to an increase in managerial slack. Second, corporations sometimes go public and then fail to grow to efficient scale. When this happens, they end up as “zombie” companies: ignored by analysts and investors, bereft of many of the key levers of corporate governance. Such companies are often poorly governed. Because these risks are well known and because, on the whole, the cost is borne by the selling shareholders, the law does not worry much about them.

The collapse of the dot-com bubble revealed some lesser-known practices, including “spinning” and “laddering.”\textsuperscript{61} In spinning, the underwriter offers shares of a hot IPO to top executives of clients or potential clients, with the hope or expectation of future business.\textsuperscript{62} This sort of share allocation hurts the issuer in two ways: first, by allocating shares to buyers likely to flip instead of to long-term investors; and second, by depriving the issuer of the quid pro quo for the underpricing. It also hurts the firm for which the buyers work, because it diverts an investment opportunity that the buyer’s employer could have exploited and introduces a distortion into the choice of investment banker. Spinning can be attacked under state law as a diversion of corporate opportunity as well as under various agency theories (and against the banker as aiding and abetting a breach of fiduciary duty).\textsuperscript{63} In some instances, favored clients were expected to return some of their profits to the underwriter—a practice that, if undisclosed, violates federal securities law.\textsuperscript{64}

\textsuperscript{60} Although, one can also imagine an offsetting effect where shareholders willing to accept selling restrictions would manifest an extra level of confidence in the current price that might more than compensate for any decrease in confidence.


\textsuperscript{62} Id. at 738.


The related practice of laddering (also known as a "tie-in") is even more obviously illegal: in laddering, the recipient of an allocation in a hot IPO agrees, explicitly or implicitly, to buy additional shares in the secondary market, as a way of increasing volume and pushing up the price. As the SEC has reminded market participants, such agreements violate Regulation M (which governs IPO stabilization activities) and may well violate antifraud and antimanipulation provisions.

Although this sort of "funny business" interferes with creating the desired shareholder base in an IPO, and while it may have been fairly widespread during the dot-com boom, even then the magnitude seems not to have been large. Aggarwal's data, which come from the early stages of the dot-com boom (May 1997 to June 1998), show a system of share allocation that largely creates the sort of shareholder base that issuers seek: mostly institutional with a degree of individual participation. While the system is subject to abuse, especially during frothy periods, the existing legal framework is well adapted to control those abuses. More importantly for our purposes, the framework does not interfere with targeting IPO allocations to desirable shareholders.

B. "Relational" Investing

Another version of direct recruitment is the private placement of shares with an investor thought to be of a good type. Goldman Sachs' sale of $5 billion in preferred stock to Warren Buffett is a classic example. In the late 1980s and 1990s, commentators referred to this sort of share placement as "relational investing," and it had a period of

67 See Aggarwal, supra note 50, at 116–17, 117 tbl.1.
68 See Hurt, supra note 61, at 773 n.350, 788, 790.
69 However, some of the more radical proposals in response to these abuses could interfere with targeting IPO allocations to desirable shareholders. See id. at 778, 787–90.
70 See White, supra note 24.
popularity. More recently, when practiced by private equity funds, it is called "PIPE" investing (Private Investment in Public Equity).

Warren Buffett has acted as a relational investor for decades. He has a long track record of being supportive of management (which management views as a good characteristic) while also being a savvy judge of companies. He also acts quickly. His attributes made him the perfect (and maybe the only) relational investor for Goldman Sachs during the panic in the Fall of 2008. Goldman's challenge was to convince the markets that it had adequate funding sources even during the credit crunch and would thus not go broke. Buffett's investment provided credible reassurance: markets viewed him as a smart investor who would not invest without confidence that Goldman was sound; if he was wrong, he would lose his investment.

Because Buffett's reputation is valuable to him both personally and in being offered opportunities to buy businesses for Berkshire Hathaway, Goldman could count on him to uphold his side of the bargain. In addition, he has a long track record of doing so.

But Buffett's services do not come cheaply. Berkshire Hathaway invested $5 billion in exchange for perpetual preferred stock with a 10% annual dividend and warrants. It has proved to be an extremely profitable investment.

As was clear in the earlier period of relational investing, the challenges include identifying a good type, ensuring that the good type stays good, and negotiating the price for being good. As the Buffett example shows, a good relational investor can provide substantial value to the firm. Because Goldman's interest was in securing Buffett's support at the lowest price it could pay, while Buffett sought a profitable investment, the arm's-length bargaining protected shareholder interests. Buffett's reputation and his limited ability to exercise any control bonded his commitment.

73 See White, supra note 24.
74 See The Goldman Sachs Grp., Inc., Current Report (Form 8-K), at 3 (Sept. 23, 2008) [hereinafter Goldman Sachs' Form 8-K].
76 See Rock, supra note 71, at 1024.
But relational investing can also go wrong. Sometimes it fails because the contract negotiated by the firm and the investor creates a misalignment of incentives. Thus, in the toxic convertible PIPEs cases, the conversion option gave investors an incentive to act in ways that hurt the company.\(^7\)

Sometimes relational investing can serve the interests of the managers (e.g., by providing “takeover protection”) without serving the interests of the shareholders. In an earlier period of relational investing, examples of this sort of takeover protection emerged.\(^7\) As I have discussed elsewhere, in this sort of relational investment, arm’s-length negotiations—the typical hallmark of a fair transaction—will not suffice to protect the shareholders.\(^7\) As in any protection racket, while arm’s-length negotiations will occur—the buyer of protection (the managers) will seek the lowest price for the most protection from the seller (the relational investor), who has opposite goals—those negotiations will not assure that the agreement reached benefits the shareholders.\(^8\) In sum, there are minimal specific legal protections against corrupt relational investing, with most of the work of limiting such activities achieved by general techniques such as contractual provisions that align the interests of managers and shareholders.\(^8\)

C. Sale of Control Blocks

Yet another “recruitment” device is the identification and recruitment of a new control shareholder. The personality and characteristics of a controlling shareholder can be important to the success of a firm. A controlling shareholder who seeks to manage the company well has the advantage of large financial incentives to succeed and the ability to implement plans. This can be of great benefit to noncontrolling shareholders. On the other hand, control shareholders who focus on extracting non-pro rata distributions at the expense of non-controlling shareholders can cause a great deal of harm, both to the noncontrolling shareholders and to the firm itself. The personality of the control shareholder, in turn, will affect what sorts of investors are willing to invest in noncontrolling shares of the company.

The transfer of a control block can thus be of great importance in the creation or preservation of a “shareholder base.” In particular, the transfer from a bad controlling shareholder to a good controlling


\(^8\) See Rock, *supra* note 71, at 990.

\(^8\) *Id.* at 1011-12.

\(^8\) See id.

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shareholder can be very valuable to the firm, while the reverse can injure it.

What does Delaware law do to facilitate such transfers? Delaware law makes clear that, within limits, a controlling shareholder may sell its control block for a premium. The limits are not entirely clear, however. Under Delaware law:

[W]hen the circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.

Less certain is how far the controlling shareholder’s right to sell control extends beyond the naked sale of the stock. In In re Digex, Inc. Shareholders Litigation, the court held that when the controlling shareholder leaned on the board of directors of the controlled corporation to waive the antitakeover protections of section 203 of Delaware’s General Corporate Law, the board’s decision would have to meet the standards of “entire fairness.” Delaware case law is undecided, however, about whether a controlling shareholder who uses its control to induce the company to cooperate in due diligence efforts must meet the standards of entire fairness.

Whatever the outer limits of a controller’s right to sell, Delaware leaves a large amount of flexibility in the substitution of one controller for another. This presents an interesting puzzle: although Delaware is relatively permissive of the sale of control blocks (in comparison to other countries), sales of control are rare. The best explanation is that, for a variety of reasons (e.g., Delaware’s limits on

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83 Harris, 582 A.2d at 235. A minority view holds that the seller must have actual notice. See, e.g., Gerdes v. Reynolds, 28 N.Y.S.2d 622, 647 (Sup. Ct. 1941).

84 789 A.2d 1176, 1207–09 (Del. Ch. 2000).

85 In Harris v. Carter, Chancellor Allen noted the Delaware principle that “when a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation.” Harris, 582 A.2d at 234. This principle could ground a duty to use such control for the benefit of all the shareholders and not just the controlling shareholder. Gilson and Gordon, recognizing that a doctrinal foundation for such a claim exists under both Delaware law and the American Law Institute’s Principles of Corporate Governance, argue that such actions by the controlling shareholder should not limit the controlling shareholder’s ability to sell its shares for a premium. See Gilson & Gordon, supra note 82, at 810–14.

related party transactions, cultural factors, etc.), private benefits of control are low in the United States. With few opportunities for improper gain, purchasers seem generally to prefer to buy 100% of the company to capture 100% of the gains of improved performance.\textsuperscript{87}

D. Traditional Investor Relations

1. What is Investor Relations?

Investor relations (IR) is now an established part of the corporate landscape, although not part of what we generally think of as “corporate governance.” Its history is fairly recent. Although the first company to have an IR department was GE, which has had one since 1953,\textsuperscript{88} the field exploded during the 1990s. A professional organization, the National Investor Relations Institute (NIRI), was established in 1969, and now has “more than 3,500 members represent[ing] 2,000 publicly held companies.”\textsuperscript{89} It was not until 1994 that a majority of Fortune 500 companies had an official IR function.\textsuperscript{90} By the late 1990s, IR had become standard at large companies and was increasingly recognized in smaller companies. The growth of IR thus tracks the emergence of institutional investors as an important force in corporate governance.\textsuperscript{91}

Although originally regarded as part of the public relations function, with most IR managers drawn from that field, by the late 1990s the profile began to change. More and more IR managers began their careers as analysts or investment bankers.\textsuperscript{92} At the same time, because the IR group must be well informed to communicate effectively with shareholders, it has become more common for the chief IR officer to be “involved in the top management strategy, planning and operational meetings.”\textsuperscript{93} Moreover, as the “voice of the market,” the chief IR officer commonly meets with the board to explain the “market’s” view of the company.\textsuperscript{94}


\textsuperscript{88}William F. Mahoney, The Evolution of IR Practice: IR Professionals Take Changing Role in Stride, 9 INVESTOR REL. Q. 4, 5 (2000).


\textsuperscript{90}See Hayagreeva Rao & Kumar Sivakumar, Institutional Sources of Boundary-Spanning Structures: The Establishment of Investor Relations Departments in the Fortune 500 Industrials, 10 ORG. SCI. 27, 28 (1999).

\textsuperscript{91}Kahan & Rock, supra note 15, at 995–98.

\textsuperscript{92}See GREGORY S. MILLER, DANIELA BEYERSDORFER & ANDERS SJÖMAN, IR AT BP: INVESTOR RELATIONS AND INFORMATION RECONNAISSANCE 3 (2006).

\textsuperscript{93}Id.

\textsuperscript{94}See id.
IR is about managing a firm's relationships with its shareholders. As described by NIRI, "[i]nvestor relations is a strategic management responsibility that integrates finance, communication, marketing and securities law compliance to enable the most effective two-way communication between a company, the financial community, and other constituencies, which ultimately contributes to a company's securities achieving fair valuation." This vision of IR contrasts with using public relations to keep the stock price high, a form of IR that NIRI and leading IR practitioners condemn.

Although IR can be viewed as a communications function, it also involves shareholder recruitment, stability, and conditioning. Accordingly, I will divide my discussion of IR somewhat artificially between recruitment of shareholders, discussed here, and the "shaping" of shareholders, discussed below.

IR is first and foremost a communications function: to provide information to analysts and investors so as to attract them to the firm. For public companies at risk of being ignored, this provides tremendous value. By reducing the asymmetry of information, IR can increase liquidity and, in turn, increase share prices. For public companies without a wide following, the IR strategy typically starts with encouraging current shareholders to be more active and building a retail following. In implementing these strategies, IR professionals typically use direct mail, press releases, and other attempts to get press coverage. With greater visibility usually comes greater interest by analysts and, if successful, greater interest by institutional investors.

For companies that already have liquidity and visibility, IR efforts are somewhat different. As with small companies, communication is the core of the function. But with analysts already following the company, the role shifts to interacting with analysts—providing them with the information they need and making sure they understand the information they have. Here, again, IR professionals talk about telling a clear and consistent story about the company.

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95 About Us, supra note 89.
96 See Miller et al., supra note 92, at 2; Brian J. Bushee & Gregory S. Miller, Investor Relations, Firm Visibility, and Investor Following 1, 9 (Jan. 2005) (unpublished manuscript), available at http://ssrn.com/abstract=643223 ("Many IR professionals noted that they will not accept clients whose management is only looking for a short-term boost in stock price without the intention of developing a longer-term IR strategy.").
98 See Bushee & Miller, supra note 96, at 11-12.
99 See id.
100 See id.
101 See Brennan & Tamarowsk, supra note 97, at 27.
102 See Bushee & Miller, supra note 96, at 10.
Berkshire Hathaway, as in many other areas, provides a distinctive alternative to conventional wisdom. Warren Buffett's annual shareholder letters provide a straightforward and consistent description of his investment approach and of Berkshire Hathaway's results. Equally important are the communications Berkshire Hathaway does not provide: no quarterly or annual guidance on revenues, earnings, or other financing information; no conference calls, analyst meetings, or investor conferences.103

Buffet has consciously sought to maintain a shareholder base of long-term individual holders and has succeeded: approximately 80% of Berkshire's Class A common stock (the original, high-voting stock) is held by individuals, compared to 40% of General Electric's,104 in 2007, less than 15% of the company's outstanding shares traded, compared to 109% for Exxon Mobil.105

Indeed, at least once a firm achieves reasonable visibility and liquidity—something that most publicly held firms probably do not achieve—the possibilities for IR expand. In an interesting Harvard case on British Petroleum (BP), BP's IR Officer argued strongly that the market view of, for example, the future of the oil business or the level of investment by competitors, could usefully be incorporated into the internal BP planning models, at the very least as a check, and potentially even as an independent source of information.106 Another approach, as illustrated by Berkshire Hathaway, is for IR to focus on recruiting good shareholders, discouraging bad shareholders, and teaching shareholders of an uncertain type to be good shareholders.107 One sees aspects of this role in IR efforts to build a shareholder base of long-term, patient shareholders who understand the firm's business and can properly put developments, both good and bad, in context.108 Recently, proxy statements are beginning to attempt to educate shareholders through something like a "Directors' Discussion and Analysis" section as a supplement to the mandatory "Management's Discussion and Analysis" in annual reports.109 Like-

104 See id. at 20–21.
105 See id. at 22.
106 Miller et al., supra note 92, at 9–12.
108 See, e.g., id. at 1.
wise, with the rise of hedge funds and other “disruptive” investors, IR offices share the task of explaining to the shareholders why management’s plans are, in fact, better than the alternatives hedge funds present.\textsuperscript{110}

2. The Legal Framework

Because the IR function is, first and foremost, a communications function, the federal securities laws provide the basic regulatory framework, and a substantial part of a typical IR textbook is devoted to an overview of that legal framework. Thus, one guide to running an effective IR department covers the basics of the Securities Exchange Act, including separate chapters on disclosure, Management’s Discussion & Analysis, forward-looking statements, and proxy solicitations.\textsuperscript{111} In addition, it covers related regulation including state blue-sky laws and stock exchange listing requirements.\textsuperscript{112}

Over the last decade, two developments have significantly complicated the function, both of which emerged out of a concern for equity analyst “independence”: Regulation FD and the 2003 Global Research Settlement.

Regulation FD, which became effective in 2000, targets “selective disclosure” to investors and analysts.\textsuperscript{113} From the SEC’s perspective, there was a problem that reflected both its sense of the practice of IR as well as a judgment about that practice:

\[ \text{[W]e have become increasingly concerned about the selective disclosure of material information by issuers. As reflected in recent publicized reports, many issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark.} \]

\textsuperscript{110} Shareholders may have conflicting interests regarding transparency. For example, a large shareholder with private information on firm value may prefer that the firm be opaque so as to maintain an informational advantage over other shareholders to generate trading profits.


\textsuperscript{112} \textit{Id.} at 183, 206–08.

\textsuperscript{113} \textit{See} 17 C.F.R. § 243.101 (2011). Prior to Regulation FD, the legal treatment of selective disclosure was unsettled. While the SEC viewed selective disclosure as a violation of Rule 10b-5, the courts took quite a different approach. \textit{See Dirks v. SEC, 463 U.S. 646, 666 n.27 (1983) (discussing Rule 10b-5 violations); SEC v. Bausch & Lomb Inc., 565 F.2d 8, 18 (2d Cir. 1977) (“[T]here is no \textit{per se} rule requiring the issuance of an injunction upon the showing of a past [section 10(b)] violation.”); Stevens, Litigation Release No. 12813, 48 SEC Docket 739, 1991 WL 296537 (noting the SEC’s request to have a CEO permanently enjoined from violating Rule 10b–5).
Regulation FD is also designed to address another threat to the integrity of our markets: the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. As noted in the Proposing Release, in the absence of a prohibition on selective disclosure, analysts may feel pressured to report favorably about a company or otherwise slant their analysis in order to have continued access to selectively disclosed information. We are concerned, in this regard, with reports that analysts who publish negative views of an issuer are sometimes excluded by that issuer from calls and meetings to which other analysts are invited.\(^{114}\)

In Regulation FD, the SEC essentially banned selective disclosure by mandating that an issuer who discloses material nonpublic information to a securities market professional—including both analysts and investors—must make simultaneous public disclosure of the same information if the disclosure was intentional, or prompt disclosure if unintentional.\(^{115}\) In the adopting release, the SEC made clear that earnings guidance would be a violation of the rules.\(^{116}\)

The regulation of equity analysts was spurred by the dot-com collapse, which revealed some appalling duplicity by buy-side equity analysts who responded to pressure to issue positive recommendations for investment-banking clients.\(^{117}\) Elliot Spitzer, then–New York attorney general, went after the large brokerage houses and reached a “Global Research Settlement” in 2003.\(^{118}\) Congress, through the Sarbanes-Oxley Act, mandated regulation of analysts by the SEC.\(^{119}\) The SEC and the exchanges adopted a series of measures designed to insulate analysts from pressure from investment bankers.\(^{120}\) The goal of these various regulatory or quasi-regulatory initiatives was to mandate analyst independence.\(^{121}\)

These two regulatory developments had a substantial impact on how IR professionals performed their work. Regulation FD prohibited the informal, confidential relationship between IR officers and select analysts or investors that had been common and that allowed the IR officer to present in detail, and without fear of general disclo-
sure, the firm's plans, problems, and results. Instead, anything told to any particular analyst or investor has to be publicly disclosed. From the perspective of the IR community, Regulation FD was a huge change that threatened to chill the production of information and firms' relationships with analysts and investors.122

The 2003 Global Research Settlement, against the backdrop of Regulation FD, affected IR programs in a somewhat different way: the number of analysts declined significantly and a large number of public companies were no longer followed by any analyst. In a 2006 report to the SEC, the Advisory Committee on Small Public Companies reported that approximately 1,200 of the 3,200 NASDAQ-listed companies, and 35% of all public companies, receive no analyst coverage at all. Statistics provided by the SEC Office of Economic Analysis indicate that in 2004 approximately 52% of companies with a market capitalization between $125 million and $750 million and 83% of companies with a market capitalization less than $125 million had no analyst coverage.123

It is beyond the scope of this Article to analyze in detail the merits of either Regulation FD or the 2003 Global Research Settlement. What I can say, however, is that the combined effect has created a real problem for smaller public companies. The loss of analyst coverage adds to the other governance problems that afflict such companies and can hardly leave shareholders better off.

3. The Finance Framework

Merton's approach, noted above, provides a useful framework for thinking somewhat more systematically about the effect of regulation on IR. Gomes, Gorton, and Madureira, drawing on Merton, divide the transmission of information from firms to markets into four channels:

122  See Boris Feldman, Frequently Asked Questions About Regulation FD, 3 INVESTOR REL. Q., no. 4, 2000 at 86, 86; Harvey L. Pitt, Karl A. Groskaufmanis, Jonathan P. Scott & Daniel H. Anixt, Preparing to Implement Regulation FD, the SEC's Selective Disclosure Rule, 3 INVESTOR REL. Q., no. 4, 2000 at 82, 82; Louis M. Thompson, Jr., Regulation Fair Disclosure: Unintended Consequences and Emerging Practices, 4 INVESTOR REL. Q., no. 1, 2001 at 4, 4–5; Editorial Staff, Editorial, Goodbye, 2001: A Look Back at a Difficult Year Reg. FD, Pro Forma and Credibility Issues Dominate the Corporate Disclosure Landscape, INVESTOR REL. BUS., Jan. 14, 2002, at 1 ("An audience survey on an Investor Broadcast Network Regulation FD Webcast found that while the disclosure rule made no difference to the amount of information companies were disclosing, it was succeeding in ruining many relationships between companies and analysts."); Howard Stock, Year in Review: A Look Back at the Events That Shaped 2002, INVESTOR REL. BUS., Jan. 13, 2003, at 2.
(1) [F]irms, in addition to mandatory disclosures, can disclose in-
formation to the public voluntarily (e.g., earnings pre-announce-
ments); (2) firms can selectively disclose information, e.g., phone
calls, or one-on-one meetings; (3) “sell-side” analysts can produce
research which is released to the public, e.g., analysts reports; (4)
private information can be produced by outsiders, “informed traders,” who then trade on the basis of their information.\textsuperscript{124}

This sets the landscape of the IR function. Items (1), (2), and (3) can
all involve the IR officer in one way or another.

Within this framework, one can see how legal reform has affected
IR. As described above, Regulation FD prohibits channel 2, while the
2003 Global Research Settlement constrained channel 3. Because
there are some sorts of information that can be better conveyed in
one-to-one meetings with trusted interlocutors than in more public
settings,\textsuperscript{125} Regulation FD was expected to, and has in fact, changed
the information environment within which firms function. Now, in
place of closed meetings or conference calls, firms must choose be-
tween disclosing to an open forum or not disclosing at all. Regulation
FD caused “a reallocation of information-producing resources” which
affected asset pricing.\textsuperscript{126} Gomes, Gorton, and Madureira “document
that small firms on average lost 17 percent of their analyst following,
while big firms gained 7 percent, on average.”\textsuperscript{127} Moreover,

the stocks of small firms that completely lost analyst coverage after
Reg FD experienced significant increases in the cost of capital,
while small stocks with no previous analyst coverage—which presum-
ably did not have any analysts benefiting from selective disclo-
sure pre-FD—experienced no significant change in the cost of
capital. Moreover, we find that more complex firms (using intangi-
ble assets as a proxy for complexity) are more adversely affected by
Reg FD than less complex firms.\textsuperscript{128}

E. Exploiting Clientele Effects

The Merton model and the Amihud and Mendelson model both
predict various sorts of segmentation of the shareholder population.
This segmentation has led to the analysis of various sorts of “cliente

\textsuperscript{124} Armando Gomes, Gary Gorton & Leonardo Madureira, \textit{SEC Regulation Fair Disclo-
\textsuperscript{125} See \textit{id.} at 324 (“Bushee et al. (2004) empirically find that firms with more complex
information (as proxied for by the level of intangible assets) were more likely to use closed
conference calls to disseminate information in the pre-FD period (i.e., calls that restrict
access to invited professionals, typically buy- and sell-side analysts).” (citing Brian J. Bush, DAWN
A. Matsumoto & Gregory S. Miller, \textit{Managerial and Investor Responses to Disclosure Regu-
\textsuperscript{126} \textit{id.} at 302.
\textsuperscript{127} \textit{id.}
\textsuperscript{128} \textit{id.}
effects," a kind of selection effect. To what extent can public firms exploit selection effects in shaping their shareholder bases? How does the law create or influence these selection effects?

1. **Dividend Policy**

Modigliani and Miller (M & M) showed that in perfect and complete capital markets, dividend policy will not affect firm value. But capital markets are neither perfect nor complete. In the wake of M & M, there has been a cottage industry engaged in trying to understand dividend policy within their framework. Because one assumption of the M & M result was "no taxes," one approach has been to ask whether the presence of taxes can explain the observed practice of paying dividends, in preference to other corporate payout methods, principally share repurchases.

In many periods for certain investors, dividends have been taxed differently than capital gains. For example, dividends received by individual investors have often been taxed as ordinary income while capital gains were taxed at a substantially lower rate when realized. By contrast, for corporations, the opposite has been the case: intercorporate dividends have been taxed at a low rate, while capital gains were taxed at the higher, corporate income tax rate. Could these differences in tax treatment explain the pattern of corporate payouts? If so, then dividend policy could be used to select for a particular sort of shareholder.

In the very active and rich theoretical literature, a variety of models have sought to explain dividend policy as a result of, or an attempt to attract, particular shareholder "clienteles." In models in which minimizing taxes drives investment decisions, individuals will hold low-dividend stocks, corporations will hold high-dividend stocks, while medium-dividend stocks will be held by tax-free investors or investors who can otherwise avoid tax. From the perspective of these models,
the puzzle is why we observe individual investors in high tax brackets holding substantial amounts of dividend-paying stocks. A variety of models have sought to explain this puzzle, many of which have recognized that investors can adopt active tax minimization strategies and, therefore, not have to limit themselves to particular sorts of stocks. In light of this, Allen and Michaely conclude that “a pure dividend-related tax . . . clientele does not exist.”

Of course, there may be other dividend–clientele effects. Practitioners have long observed that individual investors prefer to own dividend-paying stocks, a view for which there is some supporting evidence. Some have tried to explain these observations based on investor behavioral biases.

For our purposes, the issue is not whether there is a theoretical basis for thinking that clientele affects the shareholder base. There clearly is. The more important question is which clientele are significant? Pure tax-driven clientele effects do not seem to be observable, while the practitioner belief that widow-and-orphan investors gravitate towards dividend-paying stocks is fairly persuasive. What is the magnitude of the effect? To what extent can managers use dividend–clientele effects in shaping the shareholder base? Although the evidence for any strong overall average effect is lacking, there do seem to be situations in which the choice whether or not to pay dividends or to continue to pay dividends can have a significant effect on the shareholder base. Specifically, to the extent that individual investors are attracted to dividend-paying stocks, companies that seek individual investors as shareholders—perhaps because of a belief, like Buffett’s, that they are more reliable—can increase their proportion in the shareholder base by paying dividends (although Berkshire Hathaway does not, itself, pay regular dividends).


137 Allen & Michaely, supra note 132, at 49.


140 See DeAngelo et al., supra note 138, at 208.

2. The Choice of Country and Stock Exchange

The phenomenon of "home bias," another form of segmentation, is well documented. Investors, including the most sophisticated investors, disproportionately (and suboptimally) invest in their own country's companies.\textsuperscript{142} Customers of Regional Bell Operating Companies disproportionately invested in their local company over other Regional Bell Operating Companies (when there still were local Bell Operating Companies!).\textsuperscript{143} Portfolio managers tend to prefer closer companies over farther companies.\textsuperscript{144} One of the explanations for cross-listing on different stock exchanges is to broaden the investor base. Foerster and Karolyi show that cross-listing by non-U.S. firms on U.S. exchanges results, on average, in an increase of around 28% in the number of U.S. shareholders.\textsuperscript{145}

Besides these geographic effects, there are other ways in which investors sort themselves. NASDAQ is the launching pad for technology companies and thus attracts investors interested in technology companies. Goldman Sachs' GS Tradable Unregistered Equity OTC Market is an all-institutional investor marketplace in which unregistered shares can be traded among qualified investors.

Given these various forms of "home bias," the choice of corporate headquarters, domicile, and listing can become, at least to a degree, the choice of shareholder base. When an Israel-based start-up wants to go public, it often chooses the NASDAQ because of the appetite of NASDAQ investors for technology companies. Indeed, anticipating a future IPO, an Israel-based technology company can ease its future acceptance among investors who prefer Silicon Valley technology companies (over foreign technology companies) by initially incorporating in Delaware, designating its Silicon Valley office as its headquarters, and presenting itself as a Silicon Valley technology company.\textsuperscript{146}

But the advantages of the familiar can play out in different ways as well. When a company's products have a particular geographic focus (e.g., a European online-betting site) a company may choose to go public in London because potential investors may well have heard of

\textsuperscript{144} See Joshua D. Coval & Tobias J. Moskowitz, Home Bias at Home: Local Equity Preference in Domestic Portfolios, 54 J. FIN. 2045, 2045 (1999).
the firm's product either from product advertising, word of mouth, or press coverage.\textsuperscript{147} Likewise, product advertising can affect shareholder base.\textsuperscript{148}

Different exchanges have different listing requirements and different rules for listed companies. The NYSE prides itself on attracting large, high-quality companies. One understanding of the decision to list on the NYSE is that it is a credible signal of quality that attracts the largest, best-known institutional investors.\textsuperscript{149} To the extent this signal is accurate, listing on the NYSE can likewise be thought of as part of a strategy for shaping shareholder base.

3. Stock Price

Stock price itself can potentially affect the composition of the shareholder base. Here, the classic example is Berkshire Hathaway, whose original, high-voting, Class A shares have never been split and currently trade for around $120,000 per share.\textsuperscript{150} Buffett famously resisted splitting shares of Berkshire Hathaway until the threatened emergence of Berkshire Hathaway "unit trusts" (that would have sold fractional interests in Berkshire Hathaway Class A shares to investors who could not afford a whole share) led Berkshire to offer low voting "Class B" shares.\textsuperscript{151} In 1983, when Berkshire's shares were trading at $1300 per share, Buffett devoted a portion of his annual shareholder letter to explaining his decision:

> We often are asked why Berkshire does not split its stock. The assumption behind this question usually appears to be that a split would be a pro-shareholder action. We disagree. Let me tell you why.

> One of our goals is to have Berkshire Hathaway stock sell at a price rationally related to its intrinsic business value. (But note "rationally related", not "identical": if well-regarded companies are generally selling in the market at large discounts from value, Berk-

\textsuperscript{147} One example is Playtech, an Israel-based supplier of online gaming software. See About, \textsc{Playtech}, http://www.playtech.com/html/#page/about (last visited Mar. 11, 2012). Note that a London listing, with a restriction against U.S. shareholders, also insulates Playtech from U.S. gambling regulation. See Alistair Osborne, \textit{Playtech Game Plan Questioned; Opinion Divided About Software Supplier from Which Israeli Founder Has Taken £500m}, \textsc{Daily Telegraph} (London), Apr. 14, 2011, Business, at 5.


\textsuperscript{150} Berkshire Hathaway's (BRKA) closing price on March 11, 2012, was $118,430. \textit{Berkshire Hathaway Inc.}, NYSE \textsc{Euronext} (Mar. 11, 2012, 7:18 PM), http://www.nyse.com/about/listed/lcddata.html?ticker=BRKA.

shire might well be priced similarly.) The key to a rational stock price is rational shareholders, both current and prospective.

If the holders of a company’s stock and/or the prospective buyers attracted to it are prone to make irrational or emotion-based decisions, some pretty silly stock prices are going to appear periodically. Manic-depressive personalities produce manic-depressive valuations. Such aberrations may help us in buying and selling the stocks of other companies. But we think it is in both your interest and ours to minimize their occurrence in the market for Berkshire.

To obtain only high quality shareholders is no cinch. Mrs. Astor could select her 400, but anyone can buy any stock. Entering members of a shareholder “club” cannot be screened for intellectual capacity, emotional stability, moral sensitivity or acceptable dress. Shareholder eugenics, therefore, might appear to be a hopeless undertaking.

In large part, however, we feel that high quality ownership can be attracted and maintained if we consistently communicate our business and ownership philosophy—along with no other conflicting messages—and then let self selection follow its course. For example, self selection will draw a far different crowd to a musical event advertised as an opera than one advertised as a rock concert even though anyone can buy a ticket to either.

Through our policies and communications—our “advertisements”—we try to attract investors who will understand our operations, attitudes and expectations. (And, fully as important, we try to dissuade those who won’t.) We want those who think of themselves as business owners and invest in companies with the intention of staying a long time. And, we want those who keep their eyes focused on business results, not market prices.

Investors possessing those characteristics are in a small minority, but we have an exceptional collection of them. I believe well over 90%—probably over 95%—of our shares are held by those who were shareholders of Berkshire or Blue Chip five years ago. And I would guess that over 95% of our shares are held by investors for whom the holding is at least double the size of their next largest. Among companies with at least several thousand public shareholders and more than $1 billion of market value, we are almost certainly the leader in the degree to which our shareholders think and act like owners. Upgrading a shareholder group that possesses these characteristics is not easy.

Were we to split the stock or take other actions focusing on stock price rather than business value, we would attract an entering class of buyers inferior to the exiting class of sellers. At $1300, there are very few investors who can’t afford a Berkshire share. Would a potential one-share purchaser be better off if we split 100 for 1 so he could buy 100 shares? Those who think so and who would buy the stock because of the split or in anticipation of one would definitely downgrade the quality of our present shareholder group. (Could
we really improve our shareholder group by trading some of our present clear-thinking members for impressionable new ones who, preferring paper to value, feel wealthier with nine $10 bills than with one $100 bill?) People who buy for non-value reasons are likely to sell for non-value reasons. Their presence in the picture will accentuate erratic price swings unrelated to underlying business developments.\textsuperscript{152}

There is a lot here—including the source of this Article's epigraph—that applies more generally to the possibility of "shareholder eugenics" in a public corporation. For present purposes, though, I want to focus on unpacking Buffett's argument that keeping the stock price high will attract a better class of shareholder. First, unlike unknown small- or medium-sized public companies, Berkshire Hathaway is legendary, with a reputation that builds and is built by its CEO's reputation. This gives Berkshire Hathaway the luxury of worrying about attracting the attention of the right sort of shareholders, rather than simply attracting the attention of any shareholders. Second, Buffett, the controlling shareholder of Berkshire, can afford to, and has the power to, pursue his own vision of the appropriate stock price and what counts as a responsible investor.

Now consider the argument on its merits. As noted earlier, Berkshire Hathaway has a remarkably stable shareholder base, with fewer than 15\% of the shares trading hands each year. Moreover, it stands out as having a largely individual rather than institutional shareholder population, with some 80\% of its shares in the hands of individual investors (at a time when somewhere around 70\% of all shares are in the hands of institutional investors).\textsuperscript{153} The "manic-depressive" traders that Buffett sought to dissuade were institutional investors. For many years, because of the control block and the small size of the float, Berkshire Hathaway was not included in the S&P 500 index and thus not in the largest index funds. This changed in January 2010 when Berkshire replaced Burlington Northern—the company it had acquired in conjunction with a 50-for-1 split of Berkshire Class B shares.\textsuperscript{154} But, for all the years that Berkshire was out of the index—

\textsuperscript{152} Letter from Warren E. Buffett, supra note 1.
as a result of the high share price—it had minimal institutional ownership, which is precisely how Buffett liked it.\footnote{See id.}

The effect of stock price on shareholder base can move in the opposite direction as well. Baker, Greenwood, and Wurgler propose a “catering” theory of nominal stock prices in which firms supply shares at a lower price level when investors place higher valuations on low-price firms, and vice versa.\footnote{Malcom Baker, Robin Greenwood & Jeffrey Wurgler, Catering Through Nominal Share Prices, 64 J. FIN. 2559, 2559–63 (2009).} To the extent that, for example, individual investors prefer shares with a low nominal price, a firm can shift its shareholder base towards individual investors by splitting its stock to reduce the nominal price.

4. \textit{Liquidity}

In that same 1983 shareholder letter, Buffett also addressed the “liquidity” concern:

One of the ironies of the stock market is the emphasis on activity. Brokers, using terms such as “marketability” and “liquidity”, sing the praises of companies with high share turnover (those who cannot fill your pocket will confidently fill your ear). But investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pickpocket of enterprise.

For example, consider a typical company earning, say, 12% on equity. Assume a very high turnover rate in its shares of 100% per year. If a purchase and sale of the stock each extract commissions of 1% (the rate may be much higher on low-priced stocks) and if the stock trades at book value, the owners of our hypothetical company will pay, in aggregate, 2% of the company’s net worth annually for the privilege of transferring ownership. This activity does nothing for the earnings of the business, and means that 1/6 of them are lost to the owners through the “frictional” cost of transfer. (And this calculation does not count option trading, which would increase frictional costs still further.)

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(We are aware of the pie-expanding argument that says that such activities improve the rationality of the capital allocation process. We think that this argument is specious and that, on balance, hyperactive equity markets subvert rational capital allocation and act as pie shrinkers. Adam Smith felt that all noncollusive acts in a free market were guided by an invisible hand that led an economy to maximum progress; our view is that casino-type markets and hair-trigger investment management act as an invisible foot that trips up and slows down a forward-moving economy.)
Contrast the hyperactive stock with Berkshire. The bid-and-ask spread in our stock currently is about 30 points, or a little over 2%. Depending on the size of the transaction, the difference between proceeds received by the seller of Berkshire and cost to the buyer may range downward from 4% (in trading involving only a few shares) to perhaps 1 1/2% (in large trades where negotiation can reduce both the market-maker’s spread and the broker’s commission). Because most Berkshire shares are traded in fairly large transactions, the spread on all trading probably does not average more than 2%.

Meanwhile, true turnover in Berkshire stock (excluding interdealer transactions, gifts and bequests) probably runs 3% per year. Thus our owners, in aggregate, are paying perhaps 6/100 of 1% of Berkshire’s market value annually for transfer privileges. By this very rough estimate, that’s $900,000—not a small cost, but far less than average. Splitting the stock would increase that cost, downgrade the quality of our shareholder population, and encourage a market price less consistently related to intrinsic business value. We see no offsetting advantages. Buffett is thus not just indifferent to Berkshire’s large bid-ask spread, but seems positively to value it. Is this a plausible strategy as an element of his shareholder eugenics, or is it just perverse?

Consider Amihud and Mendelson’s model and subsequent work. They have convincingly demonstrated that the bid-ask spread generates a clientele effect: short-term investors prefer stocks with a small (relative) bid-ask spread, while longer-term shareholders gravitate towards higher-spread assets. Moreover, they show that longer-term shareholders get paid in the form of higher expected returns for giving up liquidity. Their explanation is entirely intuitive: shareholders who trade in and out of shares rapidly want to minimize their transaction costs.

The implications of this liquidity effect on corporate governance are complex. Bhide argues that high liquidity undermines corporate governance because unhappy shareholders exit rather than expend resources on monitoring or exercising voice. Maug counters that illiquidity will deter potential shareholder monitors from buying

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157 Letter from Warren E. Buffett, supra note 1.
158 See Amihud & Mendelson, supra note 4, at 224. Liquidity is the ease of trading a security. Sources of illiquidity are various: transaction costs; demand pressure and inventory risk; asymmetry of information regarding the fundamentals of the security and the order flow; and search frictions (the difficulty of locating a counterparty). Yakov Amihud et al., Liquidity and Asset Prices, 1 FOUND. & TRENDS FIN. 289, 270–71, 301, 340 (2005). Liquidity is a complex and elusive concept but, to a first approximation, can be identified with the bid-ask spread.
159 See Amihud & Mendelson, supra note 4, at 229.
blocks, while liquidity is likely to increase shareholder monitoring by making it easier to buy and increase blocks. More recently, Edmans, Fang, and Zur have shown that liquidity will affect the choice of governance mechanism, with high (low) liquidity tilting governance towards exit (voice). Norli, Ostergaard, and Schindele find that shareholder activism is more likely the more liquid the stock.

When an investor holds a large block, illiquidity makes it more difficult for the investor to exit, thereby reducing his or her ability to trade short term and pushing the investor to focus on long-term value and governance by voice. But for this to work, the potential profits must be sufficiently large to induce the investor to acquire a hard-to-trade block position initially.

The Amihud and Mendelson results and the subsequent literature generate a number of intriguing shareholder base strategies. If, for example, a firm wishes to shift its shareholder base toward long-term shareholders—as many companies claim—it can and should adopt financial policies that increase (or avoid policies that decrease) the bid–ask spread. Although Amihud and Mendelson correctly suggest that their results show that firms have an incentive to increase their value by adopting financial policies that increase their liquidity, their results also support the opposite strategy: by adopting financial policies that reduce liquidity, firms can attract more patient capital. Although firms will pay more for their capital, in return they will attract longer-term holders.

Alternatively, if firms wish to expose themselves to greater governance by exit, increase the size and number of block holdings, especially by hedge funds, and increase the amount of shareholder activism, then efforts to increase liquidity are appropriate. I suspect that if one explained to directors that these are some of the benefits of increased liquidity, they might well be skeptical of the wisdom of such efforts.

Buffett seems to have adopted the first strategy as he crafts his optimal shareholder base. Given the Amihud and Mendelson result,

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164 See id.
165 See Amihud & Mendelson, * supra* note 4, at 246 ("The higher yields required on higher-spread stocks give firms an incentive to increase the liquidity of their securities, thus reducing their opportunity cost of capital. Consequently, liquidity-increasing financial policies may increase the value of the firm.").
the question for the firm becomes whether the benefits to the firm of a longer-term shareholder base justify the cost in increased cost of capital? That is a difficult calculation that requires, inter alia, an estimate of the magnitude of the liquidity effect on shareholder identity. Buffett, at least, seems to think that such a strategy is cost justified.

But how does a firm implement such a strategy? What are liquidity-suppressing financial policies? What steps can a firm take to maintain a large bid–ask spread? Going public, standardization of contractual forms of securities, limited liability, exchange listing, and information disclosures can all operate to some degree as investments in increased liquidity. Avoiding such steps, then, can be viewed as a strategy for decreasing liquidity.

As the 1983 shareholder letter suggests, Buffett believes that not splitting the stock will reduce liquidity (by a tolerable amount). As the stock price gets higher and higher, volume is reduced with a predictable increase in the bid–ask spread. This strategy is interestingly and importantly counterintuitive.

Buffett's strategy bucks the conventional wisdom that once a stock price gets above the "normal range," a corporation should split its stock. An example of this conventional wisdom appears in the letter announcing Marriott's 2006 two-for-one split:

It is my pleasure to inform you that on April 28, 2006, the Board of Directors of Marriott International, Inc. ("Marriott") approved a two-for-one split of the company's Class A common stock in the form of a stock dividend. The stock split was declared in recognition of our strong confidence in our company's strength, competitive position, and growth prospects. We also believe that the split will make a share of Marriott common stock more affordable to a broader range of potential investors and increase liquidity in the trading of Marriott shares.

According to surveys, "managers justify splits on the basis that they improve liquidity and marketability." Stock splits are common (over one hundred per year), typically occurring after very strong firm performance, and are accompanied by small excess-positive abnormal returns.

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166 Id.
167 Letter from Warren E. Buffett, supra note 1.
170 See id. at 3, 22.
But the conventional wisdom is puzzling. How can it be that slicing the pizza into twice as many slices increases the size of the pie? Various theories have emerged to try to explain both the prevalence of stock splits and the fact that they seem to correlate with increased firm value.\textsuperscript{171} The most convincing group of theories views the stock split as a credible signal of strong future prospects.\textsuperscript{172}

Another variety of explanations focuses on the observation that firms strive to keep their shares within some "optimal" trading range. For example, between 1943 and 1994, the average share price on the NYSE remained at $30, despite a 1500% increase in the S&P 500 and a 500% increase in the consumer price index.\textsuperscript{173}

The studies evaluating the "liquidity" explanation are particularly interesting. It is hard to find any increase in trading volume and, to the extent that liquidity is measured by the bid-ask spread as a percentage of the share price, the bid-ask spread does not seem to be reduced.\textsuperscript{174} So it may be that stock splits do not genuinely increase liquidity, which makes the conventional wisdom even more puzzling. Moreover, stock splits seem to correlate with an increase in volatility.\textsuperscript{175}

On balance, then, it is difficult to make a strong case that stock splits increase firm value. Instead, the best explanation seems to be a combination of signaling and agency costs: managers of companies that are performing strongly and with private information about strong future performance split their shares.\textsuperscript{176} Intermediaries (brokers and market makers) who benefit from a per-share based commission have an incentive to promote the stock heavily. With more promotion, more investors buy the stock, expanding the shareholder base.\textsuperscript{177}

This, of course, is not a very strong justification for stock splits, especially given the Amihud and Mendelson findings that lower bid-ask spreads attract short-term investors. To the extent that firms are genuinely interested in attracting long-term investors and avoiding


\textsuperscript{172} See, e.g., Yildizhan, supra note 169, at 22-24.

\textsuperscript{173} James J. Angel, Tick Size, Share Prices, and Stock Splits, 52 J. Fin. 655, 655 (1997).

\textsuperscript{174} See Yildizhan, supra note 169, at 33-34.

\textsuperscript{175} See id. at 2-3.

\textsuperscript{176} See id. at 40-41.

\textsuperscript{177} See id. The link between stock splits and liquidity is complicated by the "round lot" tradition of brokerage fees. In Japan, where firms can choose their stock-trading unit, Amihud, Mendelson, and Uno show that the reduction in the minimum trading unit increases the number of individual investors, liquidity, and stock price. Yakov Amihud, Haim Mendelson & Jun Uno, Number of Shareholders and Stock Prices: Evidence from Japan, 54 J. Fin. 1169, 1169-71 (1999).
short-term pressure, resisting the urge to split the stock after a period of strong performance may be the best strategy for avoiding trigger-happy shareholders.

Berkshire Hathaway’s disclosure policy is also likely to increase the bid–ask spread. As noted earlier, Berkshire Hathaway, unlike most public companies, refuses to provide quarterly or annual guidance on revenue, earnings, or other financial information; it does not hold conference calls, analyst meetings, or investor conferences. Instead, it complies with the requirements of federal securities law and, beyond that, limits its communications to shareholders mainly to the annual report and annual meeting. This approach, nearly the opposite of conventional practice and against IR best practices, seems intentionally designed to deny analysts timely access to the information they most want. This restriction on the flow of information likely increases the bid–ask spread.178

Another Buffett tactic for limiting liquidity may have been his indifference or aversion to the inclusion of Berkshire Hathaway in the S&P 500 index. Until its inclusion in January 2010 as a result of the stock-for-stock acquisition of Burlington Northern and the related stock split of Berkshire B shares, Berkshire was by far the largest firm not included in the index.179 Inclusion in the index results in a great deal of trading by index funds and hedgers of index funds and index options that is not based on firm- or stock-specific information and thereby dramatically increases its liquidity.180 Within the Amihud and Mendelson framework, inclusion in the index will predictably shift the shareholder base toward short-term holders.

Is Berkshire Hathaway sui generis, or might other publicly held firms be wise to make a similar choice? There are certainly unique aspects to Berkshire Hathaway: Buffett holds a controlling position, he seems largely indifferent to the share price, he has a long track record of success, and the company holds a large amount of cash.181 Berkshire Hathaway does not need to raise equity capital from the financial markets and can ignore market sentiment for long periods of time.

But, given managers’ perennial complaints about “short-term” shareholders and speculators, the Berkshire Hathaway strategy, understood within the Amihud and Mendelson framework, provides a

179 See Patterson, supra note 154.
180 See Amihud et al., supra note 158, at 319.
181 See White, supra note 24.
strong argument for management to reconsider whether increasing liquidity is worthwhile. Anecdotally, at least, it seems that becoming the darling of short-term investors can lead to wildly gyrating stock prices that can damage firms.\textsuperscript{182}

F. De-recruitment: Avoiding and Eliminating “Undesirables”

The counterpart of recruiting good shareholders is avoiding bad shareholders. A private company can blackball bad players: it can deny them admission by refusing to allow them to invest; if they are already shareholders, there are a variety of ways to throw them out. What about in a public company?

1. Getting Rid of Disruptive Shareholders

The best-known example of de-recruitment in public companies is targeted share repurchases.\textsuperscript{183} When used in the control context, it is also known as “greenmail.”\textsuperscript{184} In the classic situation, the board approves the repurchase of shares of a disruptive investor at market price or a premium above market because, the board claims, the investor poses a threat to the company.\textsuperscript{185} Although Delaware law was quite permissive, greenmail in the control context has largely or entirely disappeared. First, it was not particularly effective: although the bothersome shareholder could be eliminated, paying him off attracted other equally bothersome investors. Second, the poison pill was both more effective and cheaper and became the preferred defensive tactic.\textsuperscript{186} Third, greenmail became sufficiently distasteful that it attracted punitive tax treatment and made directors reluctant to succumb.

An extreme version of de-recruitment is a “going private” transaction in which all of the public shareholders are bought out. A standard justification of such transactions is that the pressures for quarterly results from public shareholders interfere with maximizing the value of the firm, and thus the firm is better off privately held.

462235274960.html (discussing the recent volatility of hedge funds).
\textsuperscript{184} See id.
\textsuperscript{186} See Kahan & Rock, supra note 81, at 875.
2. Keeping Bad Investors Out of a Company

Recall Buffett’s warning: “Mrs. Astor could select her 400, but anyone can buy any stock.”187 Is there really no way to keep a bad shareholder out of a company? There are two aspects to this question. First, can it be done as a practical matter? Second, is it legal?

There are a number of circumstances in which a corporation excludes particular sorts of potential shareholders. For example, under the Aviation Act, only a “citizen of the United States” may carry passengers on domestic routes, where a “citizen of the United States” is defined as:

(A) an individual who is a citizen of the United States;
(B) a partnership each of whose partners is an individual who is a citizen of the United States; or
(C) a corporation or association organized under the laws of the United States or a State, the District of Columbia, or a territory or possession of the United States, of which the president and at least two-thirds of the board of directors and other managing officers are citizens of the United States, which is under the actual control of citizens of the United States, and in which at least 75 percent of the voting interest is owned or controlled by persons that are citizens of the United States.188

Foreign investors can own no more than a total of 49% of the equity of a U.S. airline.189 As a result, it is critical for U.S. carriers to ensure that no more than 24.9% of their voting interest is held by foreign citizens. Airlines use a number of techniques to ensure that they do not lose their U.S. citizenship under the statutory definition. United Airline’s certificate of incorporation limits voting rights of certain foreign persons.190 Continental maintained two stock registers to assure that they did not lose their operating certificate.191 U.S. Air, which

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187 Letter from Warren E. Buffett, supra note 1.
189 See Acquisition of Nw. Airlines, Inc. by Wings Holdings, Inc., Order No. 91-1-41, at 7–9 (Dep’t of Transp. Jan. 22, 1991); see also 49 U.S.C. §§ 40102(a)(15), 44102(a); 14 C.F.R. § 204.2(c) (2011).
190 See United Cont'l Holdings, Inc., Restated Certificate of Incorporation of United Continental Holdings, Inc. pt. V, § 2, available at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NjQ2MTV8Q2hpbGRJRD0tMXxUeXBiPTM=&t=1 (“Non-Citizen Voting Limitation.”). UAL shares must contain a legend describing the voting restrictions: UAL's restated certificate of incorporation limits the total number of shares of equity securities held by persons who are not “citizens of the United States,” as defined in Section 40102(a)(15) of Title 49 United States Code, to no more than 24.9% of the aggregate votes of all equity securities outstanding. This restriction is applied pro rata among all holders of equity securities who fail to qualify as “citizens of the United States,” based on the number of votes the underlying securities are entitled to.
191 Continental’s 2009 report to stockholders explains:
imposes a cap on voting rights of 24.9% and an "absolute cap amount" of 49.9%, uses a somewhat more complex approach that includes both a voting cap and an ownership cap, with provisions to suspend voting rights and nullify nonconforming transfers.¹⁹²

Delaware General Corporation Law section 202(b) permits these sorts of limitations:

A restriction on the transfer or registration of transfer of securities of a corporation, or on the amount of a corporation's securities that may be owned by any person or group of persons, may be imposed by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation. No restrictions so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.¹⁹³

Section 202(c) authorizes four types of transfer restrictions, including a provision that "[p]rohibits or restricts the transfer of the restricted securities to, or the ownership of restricted securities by, designated persons or classes of persons or groups of persons, and such designation is not manifestly unreasonable."¹⁹⁴

Given the foreign ownership restrictions under U.S. law, such a provision in an airline charter would clearly not be manifestly unreasonable. Moreover, Delaware specifically permits forced redemption of shares to the extent necessary to prevent the loss of a license or franchise from a government agency.¹⁹⁵

Enforcement, however, is somewhat trickier, especially given widespread patterns of custodial ownership. In the airline sector, this

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¹⁹³ DEL. CODE ANN. tit. 8, § 202(b) (2011).
¹⁹⁴ Id. § 202(c)(5). In addition to the specific reasonableness limitation in this section, section 202 is understood to codify the prior common law rule, which had a "proper purpose" limitation. See Grynberg v. Burke, 378 A.2d 139, 141 (Del. Ch. 1977) (incorporating the proper purpose standard from Lawson v. Household Fin. Corp., 152 A. 723, 727 (Del. 1930)); 1 EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW GCL-VI-7 to 22 (5th ed. 2011); Jesse A. Finkelstein, Stock Transfer Restrictions Upon Alien Ownership Under Section 202 of the Delaware General Corporation Law, 38 BUS. LAW. 573, 586-88 (1983).
¹⁹⁵ DEL. CODE ANN. tit. 8, § 151(b)(2).
is largely handled by requiring transferees to certify compliance with the alien transfer restrictions.\(^{196}\)

Could a firm use section 202 transfer restrictions to, for example, prohibit hedge funds from acquiring shares? To start with, because transfer restrictions are not binding on shares issued prior to the adoption of the restriction, except when holders agree or vote in favor of the restriction, any such transfer restriction would have to be in the IPO charter.\(^{197}\) For the sake of the hypo, assume that situation is the case. Would such a restriction be "manifestly unreasonable"?\(^{198}\) There is some authority that such a restriction would be evaluated under the business judgment rule and that a reasonable business purpose would suffice.\(^{199}\) In the airline context, such a standard would clearly be satisfied. But would a charter provision banning sales to hedge funds also pass muster?

In an interesting case arising under the common law, Greene v. E.H. Rollins & Sons, Inc., the chancellor considered a charter provision that gave the board of directors a right of first refusal to buy any shares “to insure the harmonious conduct of the business of the Corporation and to prevent the introduction of any Common Stockholder for any reason deemed unsuitable."\(^{200}\) In rejecting the corporation's demurrer, the court found that the restriction on alienation was excessively broad and the reason given insufficient:

They amount to no more than this—that the corporation ought at all times to have a body of stockholders among whom there should never be any whom the directors find not agreeable, for it is to be remembered that it is the directors whose judgment is final in passing on the suitability of the stockholder.\(^{201}\)

A provision barring hedge funds could be attacked on the same basis, although obviously a firm would counter that hedge funds are disruptive forces with interests that are not aligned with those of the shareholders as a whole and therefore pose a threat to legitimate corporate interests.

Another model for excluding certain shareholders can be seen in companies worried about retaining their net operating losses (NOLs). Under section 382 of the Internal Revenue Code, a company’s ability to shelter income from taxation by using NOLs can be lost if it under-

\(^{196}\) See Finkelstein, *supra* note 194, at 581.

\(^{197}\) See id. at 578.

\(^{198}\) Del. Code Ann. tit. 8, § 202(c)(5).


\(^{200}\) 2 A.2d 249, 250 (Del. Ch. 1938).

\(^{201}\) Id. at 252.
goes an "ownership change." Under section 382(g)(1), a corporation undergoes an ownership change if:

[A]fter any owner shift involving a 5-percent shareholder or any equity structure shift—

(A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over

(B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

Although the exact method of calculating whether an ownership change has occurred for purposes of section 382 is quite complex, the critical feature is that only 5% blocks count in the calculation. As a result, the creation of any new 5% block holders is of significant concern because it can jeopardize the valuable NOLs. Indeed, the simple acquisition of a 5% block could irreversibly invalidate billions of dollars' worth of NOLs.

This risk is handled in different ways. United, which as of April 2010 had more than $9 billion in NOLs, has a provision in its certificate of incorporation prohibiting sales by or to existing 5% stockholders or sales that would create new 5% stockholders without prior approval of the board. The certificate imposes restrictions on recording any prohibited transfer and provides measures for unwinding prohibited transactions. As discussed earlier, these restrictions are likely valid under Delaware General Corporation Law section 202.

An alternative means of excluding shareholders who may jeopardize NOL carryforwards is an NOL poison pill with a 4.99% trigger. This is the sort of poison pill recently upheld by the Delaware Supreme Court in Versata Enterprises, Inc. v. Selectica, Inc. The advantage of the NOL poison pill over a charter amendment is that it can be adopted by board action. It can be adopted immediately, rather than having to wait for or schedule a shareholder meeting, and will apply to all shares, not just subsequently issued shares. Because NOLs cannot be reclaimed once forfeited, it can be important to act quickly to prevent the creation of a 5% block.

203 See id. § 382(g)(1).
204 See id.
205 See UAL Corp., Definitive Proxy Statement (Form DEF 14A), at 46 (Apr. 30, 2010) (explaining the reasons for extending the ownership limit first adopted in 2006); United Cont'l Holdings, Inc., supra note 190, at pt. V, § 5 ("5% Ownership Limit.").
207 5 A.3d 586, 608 (Del. 2010).
208 See, e.g., id. at 595 (discussing how a board of directors passed a resolution adopting the poison pill without reference to amending the corporate charter).
But could a poison pill be used to exclude specific, potentially disruptive shareholders based on their identity instead of their size? Would a pill deployed against hedge funds as a group, rather than against any investor who passes the threshold, pass muster? This is an open question under Delaware law.

### III

**Tools for Crafting the Shareholder Base:**

**Transforming Shareholders into Good Shareholders**

The direct strategies take shareholder type as given, seeking to recruit shareholders of the good type and avoid shareholders of the bad type. But shareholder type may not be immutable. In this Part, I consider strategies and structures by which a firm can transform investors into shareholders of the desirable type. The core intuition is Winston Churchill’s: “We shape our buildings, and afterwards our buildings shape us.”

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**A. Control-Shareholder Ownership Structure**

Corporate law has long recognized that the presence of a control shareholder in a firm directly affects the corporate governance challenges that are presented. An alternative way of understanding the impact of a control shareholder is that it is an important factor in determining the role of noncontrolling shareholders in the governance of the firm. When a control shareholder is present, shareholders necessarily are cast into a substantially more passive role than in a corporation whose shares are dispersed. In a controlled corporation, the controlling shareholder typically elects all the directors, effectively chooses executive management, sets management compensation, determines the direction of the firm, sets dividend policy, decides whether or not the firm should be sold, and carries out any other decision it wants to.

This means that a noncontrolling shareholder’s ability to act is sharply constrained. Whatever an investor’s typical preference for involvement, in a corporation with a control shareholder, the other shareholders have minimal say. Indeed, the one area in which shareholders of the controlled firm play a significant role is in policing interested-party transactions, either through decision rights or through litigation.

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210 See Gilson & Gordon, supra note 82, at 785–86.

211 See Kahan & Rock, supra note 17, at 1037–39.
The potential benefit of opting to create such a shareholder base by adopting a controlling-shareholder ownership structure is that a good “Buffett-like” controlling shareholder can act effectively and without interference in ways that benefit the noncontrolling shareholders. The downside is equally obvious: bad controlling shareholders may use their control to take non-pro rata distributions at the expense of the noncontrolling shareholders, or the bad controlling shareholders may be incompetent.

But there is another potential downside. By casting shareholders in this distinctive and subordinate role, the structure may discourage “responsible” shareholding at the same time as it encourages noncontrolling shareholders to challenge actions by the controlling shareholder as self-dealing.

Moreover, corporate law’s construction of the role of noncontrolling shareholders will have a selection effect. Shareholders whose specialty or preference is to take an active role in influencing the direction of the firm will tend to stay away from controlled companies, while shareholders who specialize in detecting and prosecuting self-interested transactions will be drawn to such companies. Hedge funds that specialize in challenging going-private transactions provide a particularly clear example.\(^\text{212}\)

### B. Choice of Domicile or Stock Exchange

Choice of corporate domicile, combined with choice of exchange, likewise exerts a powerful influence on the sort of shareholders a firm has. Above, we discussed the clientele effects of choice of stock exchange. But the choice has a broader influence.

Consider a venture choosing between incorporating in Delaware with the ultimate aim of going public on NASDAQ, on the one hand, and incorporating in the United Kingdom with a London listing on the other. How will the choice affect the shareholder base? As has long been noted, Delaware is a board-centered jurisdiction while the United Kingdom is shareholder-centric. These differences emerge in a variety of ways: The center of decision making under U.K. law is the shareholders acting in the general meeting; in Delaware, the center of decision making is the board of directors.\(^\text{213}\) With respect to directors, U.K. shareholders have the power to elect directors, and importantly they have the power to remove directors with or without cause.

\(^{212}\) See id. at 1037–39 (discussing tactics taken by hedge funds—including litigation, shareholder revolts, exercising appraisal rights, and negotiating the share price—to improve the terms of a merger or acquisition).

before the expiration of the director's term.\textsuperscript{214} This power is important because shareholders also have the power to call a general meeting without board acquiescence or a special provision in the articles of incorporation.\textsuperscript{215} These provisions prevent the entrenchment provided by staggered boards.\textsuperscript{216} By contrast, Delaware shareholders have no power to call a meeting, and when there is a staggered board, directors can only be removed for cause.\textsuperscript{217} In the United Kingdom, shareholders may force the company, at company's expense, to circulate resolutions to be voted on at the annual general meeting, which, if adopted, are binding.\textsuperscript{218} Shareholders of a Delaware corporation may only enact bylaws, and the scope of permissible bylaws is sharply limited.\textsuperscript{219} The shareholder-centric character of U.K. corporation law is particularly striking in the control context. Under the City Code, directors must remain largely passive when a tender offer is made for the shares of the company and cannot take any "frustrating action" without shareholder approval.\textsuperscript{220} U.S. shareholder activists dream about such a provision.\textsuperscript{221}

The exchange rules parallel these doctrinal differences: the board of a Delaware corporation listed on the NASDAQ or NYSE can adopt, for example, a poison pill or agree to breakup fees with a favored bidder, while a U.K. company listed on the London Stock Exchange is subject to the City Code and its no-frustration, no-assistance rules.\textsuperscript{222} These differences may affect how shareholders act, even if shareholders' preferences, skills, or investment in activism stay constant. Thus, institutional investors like Fidelity or TIAA-CREF might

\begin{footnotes}
\item[214] See Companies Act, 2006, c. 46, § 168(1) (Eng.).
\item[215] See id. §§ 303–05.
\item[217] See DEL. CODE ANN. tit. 8, § 141(k).
\item[219] See, e.g., CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008) (noting that shareholders lack management power and have limited ability to adopt bylaws).
\item[220] The Panel on Takeovers & Mergers, The City Code on Takeovers and Mergers, Rule 21 (10th ed. 2011), available at http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf; see also id. at Gen. Principle 3 (stating that the board "must not deny the holders of securities the opportunity to decide on the merits of the bid"). See generally Armour & Skeel, supra note 216, at 1729 (explaining that the United Kingdom's self-regulation system protects investors by preventing management from engaging in defensive efforts to block a takeover).
\item[221] See Bebchuk, supra note 16, at 896 ("[S]hareholders [should have] the power to adopt binding resolutions instructing management not to block a particular tender offer.").
\item[222] See Armour & Skeel, supra note 216, at 1735–77. For an overview of U.K. takeover regulation, see generally id.
\end{footnotes}
do more as shareholders in U.K.-incorporated or LSE-listed firms simply because they can do more things.\textsuperscript{223}

Relatedly, investors may choose to invest more in activism because there is a greater payoff to activism. A U.S. investor who is largely passive in the U.S. could hire experts in shareholder activism to work on their U.K. portfolio because there is greater scope for activism in the United Kingdom.

Finally, there may be a selection effect. Investors may choose to invest because a situation affords them the ability to be more active. When a body of corporate law provides a minority veto in a freezeout, that veto right may provide an attractive investment opportunity.\textsuperscript{224}

Thus, although there is evidence that hedge funds pay attention to corporate law rules when choosing investments, there is little evidence that institutional investors like Fidelity are more active in the United Kingdom or invest more in activism because of these differences.\textsuperscript{225}

\section*{C. New Investor Relations: Strategic Engagement with Key Shareholders}

It is now accepted that the shareholder base has been transformed: ownership is more concentrated than ever; shareholders vote on ever more matters; shareholder activism is a fixture of the corporate governance landscape, with proxy contests, short-slate proxy contests, and “just vote no” campaigns relatively common; Institutional Shareholder Services (ISS) has emerged to play a critical role, either as a catalyst, a conduit, or an initiator, depending on one’s perspective; and shareholder passivity seems to be a vestige of the past.

While some bemoan these changes, others recognize the opportunities that arise out of these developments in the corporate governance landscape. A few pioneers with deep contacts among institutional investors have begun to play an intermediary role between issuers and their shareholders. In contrast to traditional IR efforts (the continuous communication function described above)—this “New Investor Relations” function tends to be more episodic, led by high-level outside actors, and involves the highest levels of the company. This version of “managing the shareholder relationship” takes seriously the current importance of empowered shareholders and

\begin{itemize}
\item \textsuperscript{223} Fidelity U.S. and Fidelity U.K. have some overlapping ownership (the Johnson family owns just under half of each) but are independent firms. For a long time, Fidelity U.S. delegated the selection and management of U.K. investments to Fidelity U.K. See Telephone Interview with Eric Roiter, former Gen. Counsel, Fidelity (Sept. 14, 2011).
\item \textsuperscript{224} See Marina Strauss, Desjardins Heads to the Sears Checkout; Outspoken Sears Canada Minority Investor Quietly Sells Its Stake After Hedge Fund’s Bid to Take It Private Fails, GLOBE & MAIL (Canada), Apr. 25, 2007, at B5.
\item \textsuperscript{225} See Telephone Interview with Eric Roiter, supra note 223.
\end{itemize}
seeks to shape that relationship.\textsuperscript{226} It can thus be understood as a potentially important part of the second type of shareholder eugenics; namely, the shaping of shareholders of a bad or unknown type into shareholders of a good type.

Examining a couple of the pioneers of the New Investor Relations will help bring the role into better focus. Wilcox is now the chair of Sodali, a European-based consulting firm whose "mission is to help companies anticipate, understand and deal effectively with the expectations of investors, minority shareholders and the financial markets. To this purpose, it provides strategic advice, governance education, research, communications and transactional services designed to optimize Companies' responsiveness towards their debt and equity holders."\textsuperscript{227}

Wilcox comes to this role with a long, deep relationship with the shareholder community. For many years, he was a senior figure (and chairman) at Georgeson & Company, a leading proxy solicitation firm. He subsequently moved to TIAA-CREF, a leading institutional investor, where he was Senior Vice President and Head of Corporate Governance.\textsuperscript{228} He thus brings contacts from the institutional investor world to his new role of helping firms improve their relationships with their shareholders.

In arguing that IR and corporate governance are converging, Wilcox explains that:

Shareholders now want to know how board decisions serve their long-term interests. The board’s willingness and ability to explain its decisions, disclose its procedures and clearly articulate its policies and goals are particularly important with respect to the following issues: remuneration, “tone at the top,” CEO leadership, ethics, entrepreneurial spirit, internal equity and employee morale, integrity, business standards, social policy and community relations. If the board’s explanation of its policies and decisions is clear and convincing, shareholder support will not waver.

The barriers to the convergence of IR and CG are primarily behavioral and practical, not legal. The reasons include: unwillingness to change old ways and habits, defensiveness, outdated assumptions, ego, bad advice, peer pressure, inertia, privilege, vested interests, fear.\textsuperscript{229}

\textsuperscript{226} See generally Bushee & Miller, supra note 96 (discussing how firms' use of IR strategies can lead to a larger, more knowledgeable shareholder base and an improvement in the firms' market valuation).
\textsuperscript{229} John Wilcox, Presentation Outline: Is There a Convergence of Investor Relations and Corporate Governance?, SODALI (Jan 19, 2010), http://www.nevir.nl/att_documents/Sodali\%20-\%20IRGR\%20-\%20Amsterdam\%20-\%202010.03.23.pdf; see also Richard H.
Christopher Young provides another glimpse over the horizon. In 2004, Young joined ISS as Director of M&A and Proxy Fight Research. In that capacity, his role was to build ISS’s analytic capacity in evaluating contested transactions and proxy fights to provide better voting advice to ISS’s investor clients. He came to this role with a background in investment banking and M&A law. While at ISS, he played a role in nearly every high profile deal or proxy fight and developed contacts with a wide range of leading institutional investors.

In the spring of 2010, Young left ISS for Credit Suisse to become head of the Takeover Defense practice within the M&A group. To his new role, Young brings a Rolodex full of shareholder contacts and a strong sense of their concerns. This knowledge puts Young in a position to alert companies to emerging shareholder dissatisfaction and allows him to work with companies to better explain themselves to their key shareholders. The idea seems to be that investors, who know and trust Young from his days at ISS, will still be willing to return his phone calls.

This is an “investor relations” function, but with a twist. It focuses on contentious or potentially contentious situations; becomes crucial when there is a proxy fight over a transaction or a board election; is directed at the highest levels of the company and investor community; and, when it works, is a spring board for an investment-banking relationship with the company. What is so interesting about the role is that it takes shareholder empowerment as a given and asks how firms can improve relationships with their shareholders so that the shareholders will be supportive rather than resistant.

Wilcox and Young are both betting on a new corporate governance landscape in which influential shareholders are a salient feature. With that starting point, they are carving out roles facilitating productive engagement between firms and their shareholders—engagement that goes beyond “check the box” corporate governance and can shape the shareholders’ involvement in the firm. That engagement is in the interests of both firms and shareholders and will sometimes be decisive.

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Koppes, Structural Strength: A Team Approach Provides the Best Support for the Triangle of Corporate Governance, 6 Investor Rel. Q., no. 3, 2004 at 4, 4 (suggesting that the IR officer should participate in corporate governance).


232 See id.

233 See id.
In the New Investor Relations, the legal framework of traditional IR discussed above—Regulation FD, the 2003 Global Research Settlement, and federal securities law—is beside the point. Instead, two rather different features of the legal landscape are more prominent. The first feature, ERISA, provides some of the motivating force behind shareholder activism and the prominent role of ISS. Over the last decade, the recognition that ERISA requires that covered fiduciaries treat corporate votes as an asset, and therefore manage them prudently, has pushed institutional investors to fulfill those duties by relying on, or at least subscribing to, outside recommendations from proxy advisory firms. The idea has been that it is reasonable for an ERISA fiduciary to rely on an expert proxy advisory consultant. From this perspective, the fees paid to ISS and Glass Lewis can be thought of as rather minor “ERISA insurance” premiums.234

The second feature of significance is the entrenched liability-focused culture of the U.S. boardroom. The overall shape of U.S. securities law—with multiple rules, detailed requirements, and robust public and private enforcement—has engendered a compliance-focused mentality. This mentality, as Wilcox has argued,235 stands in the way of productive, informative communication between public companies’ boards and their shareholders. It is difficult to imagine managers and directors of a U.S. public company sitting down with major shareholders to discuss their strategic vision openly and directly in a setting unscripted by lawyers. Such a dialogue, common in the private equity or venture capital world of privately held corporations, can clearly be of great value to both firms and investors, but is nearly unimaginable in the current environment.

D. Alternative Capital Structures as Shaping Strategies

A variety of other strategies may significantly shape the shareholder base within the U.S. system. In this regard, consider two options that firms may use in shaping their capital structure: dual-class shares and tenured voting.

234 See Alan R. Palmiter, Mutual Fund Voting of Portfolio Shares: Why Not Disclose?, 23 CARDOZO L. REV. 1419, 1442–43 (2002) (stating that the Department of Labor “has recognized that proxy votes have economic value and that pension managers have fiduciary responsibilities in voting portfolio shares”).

235 See Wilcox, supra note 109, at 3–4 (arguing that “textbook compliance with governance rules [does] not guarantee good governance in practice” and suggesting that boards of directors increase and improve communication with shareholders).
1. Dual-Class Shares

Dual-class shares—a capital structure in which one class of shares is low- or nonvoting while the other class of shares is high-voting—will shape the shareholder base both by shaping the shareholder's role and through the resulting selection effects. When a single shareholder or group holds the high-voting shares, the effect on the investors holding low- or nonvoting shares will be identical to the controlling shareholder structure described above. As with controlling shareholder structures, a dual-class capital structure largely eliminates low-voting shareholders' ability to influence the course of the company through the normal ways, such as electing directors or voting on significant decisions or transactions. As such, dual-class shares tend to turn shareholders into passive shareholders, except insofar as low-voting shareholders play a special role in regulating related-party transactions (which may make some shareholders hyperlitigious).

In principle, although rarely in practice, a company may have a dual-class capital structure but no controlling shareholder or group. In this context, the shaping function of the structure and its selection effects would be quite obvious: shareholders who wished to be active could opt into the high-voting shares; those who wished to be passive could opt into low-voting shares. The fact that such a structure is either rare or nonexistent is good evidence that the use of dual-class capital structures is tightly linked to maintaining control with less than a majority of the equity in the firm. As such, in terms of the effect on the shareholder base, dual-class structure can be analyzed in the same way as control shareholder structures.

The evidence of the agency costs created by dual-class structures is quite robust. This raises the principal downside of dual-class structures: they allow a controlling shareholder to maintain control without continuing to own a majority of the equity in the company. This, in turn, exacerbates the divergence of control rights and cash

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238 See generally Paul A. Gompers, Joy Ishii & Andrew Metrick, Extreme Governance: An Analysis of Dual-Class Firms in the United States, 23 Rev. Fin. Stud. 1051, 1053–81 (2010) (analyzing the impact of ownership rights on firm value and finding that maintaining insider control reduces the value of the firm); Ron W. Masulis, Cong Wang & Fei Xie, Agency Problems at Dual-Class Companies, 64 J. Fin. 1697, 1697–1722 (2009) (finding that firm value declines as insiders gain more control rights because of the agency problem).
flow rights, creating incentives to take private benefits of control. Yet, at the same time, some of the most successful companies in the United States have dual-class structures, including Berkshire Hathaway, Comcast, Ford, Google, Liberty Media, News Corp., Turner Broadcasting, and Viacom.\textsuperscript{239} Evidently, in large companies with substantial need for equity capital, dual-class structures are a useful and perhaps essential way to maintain a controllingshareholder structure. The success of these companies suggests that the benefits of controllingshareholder structures may sometimes outweigh the costs that accompany dual-class capitalization.

2. \textit{Tenured Voting}

Tenure Voting (TV), also known as time-phased voting, is a strategy for giving long-term shareholders more votes than short-term shareholders.\textsuperscript{240} It can be implemented in a variety of ways. At Potlatch Corp., a forest products company that adopted TV as an antitakeover measure in 1985, shareholders who held for four years or longer received four votes per share, while shareholders who held for a shorter period could cast one vote per share. Upon adoption in 1985, Potlatch presumed that each shareholder had held for more than four years and received four votes per share. As shares were sold, they dropped down to one vote per share.\textsuperscript{241}

As a technical matter, implementation was straightforward: record shareholders were presumed to have held the shares for the period shown in the share registry; nominees were presumed to have held shares for less than four years, unless otherwise certified on the voting instruction form (subject to verification by Potlatch). Potlatch provided exceptions, inter alia, for shares acquired pursuant to certain employee benefit plans and shares acquired by gift, inheritance, or under the terms of a trust.\textsuperscript{242}


Alternative models are available. The line between short-term and long-term can be adjusted. Shares can gain increased votes more gradually (e.g., by one vote per year to a maximum of four votes). The ratio in voting power between short-term and long-term shares can vary. It can be entirely prospective so that all shareholders start out with short-term shares and only those who hold end up with long-term shares. Each implementation can have a different effect on the shifting of influence among the shareholding population.

In all of its versions, however, the effect of TV is to give long-term shareholders (however defined) a bigger say. As such, it is a particularly interesting shaping strategy. Consider the following shareholder profile, which provides a rough example of a widely held company:

\[ x < 1 \text{ year: } 25\% \]
\[ 1 \text{ year} < x < 2 \text{ years: } 25\% \]
\[ 2 \text{ years} < x < 4 \text{ years: } 25\% \]
\[ 4 \text{ years} < x: 25\% \]

where \( x \) is the holding period. Assuming the company has 100 shares outstanding, without TV there would be twenty-five votes in each category. Under TV with a four-year trigger, by contrast, the voting rights would be distributed as follows:

\[ x < 1 \text{ year: } 25 \text{ votes} \]
\[ 1 \text{ year} < x < 2 \text{ years: } 25 \text{ votes} \]
\[ 2 \text{ years} < x < 4 \text{ years: } 25 \text{ votes} \]
\[ 4 \text{ years} < x: 100 \text{ votes} \]

In other words, under TV, shareholders who held for less than a year would have to convince at least a portion of the 4+ year shareholders to vote with them to carry the day. If a single shareholder is the 4+ year holder (e.g., a founder), TV will give that shareholder voting control.

Unlike mechanisms that shift the focus of decision making from shareholders to the board of directors, like the poison pill, TV shifts decision-making power within the shareholder group. In shifting decision-making power to long-term shareholders, it provides greater incentives to longer-term shareholders to invest in making those decisions and greater incentive to remain shareholders to enjoy the increased voting rights. If length of ownership is a reasonable proxy for being a good shareholder (a highly contestable proposition on which I take no position), then TV shifts power from bad shareholders.

\[ \text{For example, at Milacron, the holding period was three years. Williams v. Geier, 671 A.2d 1368, 1372 (Del. 1996).} \]
\[ \text{At Milacron, the ratio was } 1:10. \text{ Id. (shareholders received one vote per share until they had held their shares for three years, at which point they received ten votes per share). At Potlatch, it was } 1:4. \text{ See Potlatch Corp. Proxy Statement 2005, supra note 241 (long-term shares received four votes while short-term shares received only one).} \]
(and, in doing so, rendering them more passive) to good shareholders or to shareholders who, by virtue of their greater power, will become good. TV can thus shift the character of the shareholder base.

The downsides are the inverse of the upsides. TV may cement control in a group of insiders with a smaller equity stake thereby creating or aggravating a divergence of decision-making power and share of cash flows. Long-term shareholders may be less responsible than short-term shareholders if long-term shareholders are typically index funds who, in competing on price, resist portfolio firm-specific investments, while short-term shareholders include hedge funds with focused financial incentives because of lack of diversification.

3. Regulatory Treatment

As a matter of substantive corporate law, Delaware has long permitted both dual-class and TV capital structures, so long as they were clearly spelled out in the charter. At present, it is also permissible under federal securities regulation. The most significant legal barrier arises from stock exchange listing requirements: all the major exchanges prohibit midstream adoption of either.

Federal securities law takes no official position regarding departures from one-share, one-vote. In general, voting rights are considered a part of state corporate law defining the fundamental rights that shareholders have. In the late 1980s, in response to a wave of dual-class restructurings perceived as abusive, the SEC departed from this general view and adopted rule 19c-4, which mandated that stock exchanges adopt a rule prohibiting the listing of shares of any company that "issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to section 12 of the Act." The text of the rule and discussion made clear that this prohibited any "corporate action to impose any restriction on the voting power of shares of the common stock of the issuer held by a beneficial or record holder based on the length of time such shares have been held by such beneficial or record holder," namely, TV. The stock
exchanges complied. Subsequently, although the SEC rule was held invalid, the stock exchanges proposed, and the SEC approved, nearly identical rules.

The NYSE listing requirements provide that:

Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.

The current state of play, then, is that firms may go public with dual-class and TV capital structures but may not amend their charters to adopt it midstream.

The basis of the prohibition of midstream changes was a concern that disorganized shareholders, in a version of the familiar prisoner's dilemma, could be manipulated to vote in favor of a midstream change that is not in their interests. For example, by tying a sweetener to the value-reducing change, disorganized shareholders could rationally vote for a change that reduces the value of their shares.

In an age of empowered shareholders, in which firms should think about selecting and shaping an optimal shareholder base, prohibiting a key design tool is inappropriate. With everything else we let shareholders vote on—excusing directors under Delaware General Corporation Law section 102(b)(7), say on pay, 14a-8 proposals, director elections, mergers—not trusting them to vote intelligently on midstream changes to capital structure is unnecessary. This

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253 See Jeffrey N. Gordon, Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 CALIF. L. REV. 1, 48–49 (1988); see also Ronald J. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 VA. L. REV. 807, 832–34 (1987) (illustrating how public shareholders will participate in dual-class transactions due to incentives, even though the transaction is not in their collective best interests).
is not to say that shareholders or firms will choose these structures: Potlatch eliminated its time-phased voting system in 2005 in response to institutional shareholder pressure, organized by ISS. But firms and shareholders should at least have the option to experiment with different ways of shaping the shareholder base.

CONCLUSION

Shareholders occupy one vertex of the corporate governance triangle. As the metaphor suggests, and as I have argued above, the identity of the shareholders and their fit with the board of directors and the managers (the other two vertices) are potentially important to firm value. What, then, are the implications of this analysis for legal policy and firms? Are there practical takeaways? I think there are several.

First, rather than passively accepting whatever shareholder base emerges and then complaining about it, public companies should think about who they want as shareholders and why. As I show above, companies can do quite a lot to select and shape a productive shareholder base.

Second, once companies decide what sort of shareholders they want, they should think systematically about how to create the desired shareholder base. Given the potential effect of shareholder base on firm value, crafting the optimal shareholder base is a strategic decision for the firm. Choice of corporate domicile, stock exchange, public image, disclosure policy, stock price and liquidity, and many other factors affect what sorts of shareholders are attracted to a given company. For example, before splitting shares, a board should think about how it will affect the composition of the shareholder base, and, in particular, whether the benefits of increased liquidity will offset any harms from a shift to shorter-term shareholders.

Third, the IR function, in its various forms, is a key part of shaping a shareholder base. Building relationships around fundamental issues of corporate strategy and policy rather than quarterly earnings reports holds the potential for changing an adversarial relationship into a more cooperative and productive one. There are a variety of proposals for how this might be done. A “Directors’ Discussion and Analysis” section of the proxy statement or annual report would be a starting point. Regular meetings between the board and major investors on topics such as corporate strategy, risk control, compensation, ethics, CEO succession, and ESG (environmental, social, and corpo-

254 See Potlatch Corp. Proxy Statement 2005, supra note 241, at 31; INSTITUTIONAL S’HOLDER SERVS., PROXY ANALYSIS, POTLATCH CORP. 10 (May 3, 2004); INSTITUTIONAL S’HOLDER SERVS., PROXY ANALYSIS, POTLATCH CORP. 10 (May 2, 2005).
rate governance) could be a useful way to create good shareholders.\textsuperscript{255}

Fourth, corporate architecture can be a powerful force. If a firm's structures empower (or pacify) shareholders in particular ways, it will attract particular sorts of shareholders and shape the ones it attracts. A legal rule that casts shareholders as the monitor of conflicted transactions will produce shareholders willing to sue over conflicted transactions. We should remove regulatory barriers that block architectural experimentation such as the prohibition on midstream adoption of departures from one-share, one-vote.

Fifth, the law needs to avoid chilling communication and transforming the shareholder–board relationship into a lawyer-driven, sterile interaction. For example, creating a safe harbor from Regulation FD for a defined set of "high level" topics would facilitate productive communication. The model should be the sort of relationship that exists between private equity funds or venture capitalists and the managers in a private company, with the exclusion of price-sensitive information like earnings.

Sixth, managers, boards, investors, and regulators need to rein in their distrust of all things new or unusual. We need not be suspicious of every communication between boards and shareholders. Directors are not necessarily going behind the CEO's back. Investors are not necessarily seeking to trade on material nonpublic information. Large investors do not necessarily disadvantage small investors when they get privileged access to directors and managers.

Seventh, productive relationships between investors and companies are likely to be company specific and thus unlikely to be susceptible to "check-the-box," "one-size-fits-all" solutions. "Best practices" may be a useful starting point, but investors and companies should be open to alternative approaches.

Finally, intermediaries (e.g., lawyers, bankers, consultants) may want to find ways to profit from the transformed landscape of corporate governance in which shareholders are more active and advisory firms give advice.

Although there are good reasons to believe that the composition of the shareholder base and the firm–shareholder relationship matter, concerns with the shareholder base have largely fallen outside of the corporate governance debate. This Article is an attempt to bring these matters into the discussion. Indeed, once one starts thinking about how firms shape their shareholder base, it turns out that there are numerous ways to do so. Sometimes the law helps; sometimes it hinders. In this preliminary inquiry, I have sought to map the land-

\textsuperscript{255} See Wilcox, \textit{supra} note 109, at 4.
scape and to appreciate some of its salient features. As Buffett suggests, contrary to first impressions, shareholder eugenics is not an entirely hopeless undertaking.