



GOOGLE, INC. AND ITS PROPOSED RECAPITALIZATION:

A Case Study of Hidden Threats to Corporate
Governance and Diminution of the Franchise, What You
Need to Know to Fulfill Your Duties As Trustee

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Questions Raised for Public Pension Funds With This Type of Transaction:

- As more companies create unequal voting rights and multiple classes of stock, does your Fund have a corporate governance policy on whether to purchase or sell those types of shares?
- Is non-voting stock ever beneficial for a public pension fund?
- Should institutional investors become more aggressive in challenging transactions like the Google Recapitalization which further reduce shareholder impact?



The Google Recapitalization

- In April 2012, Google announced a recapitalization plan.
- The Company proposes to issue non-voting stock to all current shareholders in the form of a 2-for-1 stock split.
- Example: If an investor owns 1000 shares of Google's Class A voting shares before the recapitalization, after he would own 500 shares of Class A voting stock and 500 shares of (newly created) Class C non-voting stock.



In Re: Google Inc. Class C Shareholder Litigation, Case No. 7469-CS (Delaware 2012)

- The Reclassification proposed by Google Founders Larry Page and Sergey Brin is grossly unfair to Google's public shareholders.
- Plaintiffs seek, on behalf of all Google public shareholders, to stop the Reclassification from ever taking effect.
- Allege that the "Special Committee" appointed to review and negotiate the Recapitalization was not sufficiently independent and did not adequately investigate alternatives.
- The public shareholders will suffer billions in damages since the non-voting stock they receive in the stock split will be worth less than voting stock and result in an immediate loss in value.



Google Background

- When Google went public in 2004, the Founders and other insiders received Class B shares of Google which provided for 10 votes per share.
- Class A shares owned by the public have only one vote per share.
- At the time of the IPO, Founders Brin and Page had 32% voting control over Google. The Founders currently hold 56.3% of the voting power, but only 20% of all outstanding equity.
- Stock sales could bring them below 50% voting power and expose them to meaningful shareholder input and Board oversight.



Google Background

- Due to the Founders' control, the required shareholder approval was a mere formality.
- But, more than 85% of the Class A stockholders voted against the Recapitalization.
- As this was a conflicted transaction, the Board appointed a Special Committee to review and negotiate the Recapitalization. A majority of that Committee was seriously conflicted due to business dealings and friendships with the Founders.
- The Special Committee was required to be strong arm's length advocates for the rights of the public shareholders and the Board itself, as both stood to lose power if the Founders secured voting control.
- The Special Committee only negotiated within the confines of the proposal presented to them, instead of revisiting the Company's corporate governance structure.



Google Background

- If the Reclassification is not enjoined, it will cost Class A shareholders billions of dollars as the Class A non-voting shares can be expected to trade at a discount compared to the voting shares.
- Page and Brin would have unchecked control while offering no corresponding benefit to the shareholders.
- After the announcement of the Board's approval of the Proposal, the market verdict was immediate – a \$44.94 (7%) drop in two days, amounting to a drop in market value of almost \$14 billion.



Questions Specifically Raised by the Google Transaction:

- Is entrenchment of a company's visionary ever a valid corporate purpose?
- Must a Trustee determine if it is in the best interests of the company's shareholders for the company to be controlled?
- If so, must the Trustee determine whether the Board has exercised, and will continue to exercise, appropriate oversight?
- Has the Board retained the power and the tools necessary to fulfill their fiduciary duties to the company?



Other Recent IPOs with Multiple-Class Voting Structures

- Facebook
- Zynga
- Groupon
- LinkedIn
- Manchester United
- 20 of 170 IPOs between January 2010 and March 2012 were by companies with a multi-class, unequal voting stock structure, according to the Council for Institutional Investors.



Insight Can Be Drawn from the Debate over Dual Classes of Stock

- Many organizations – from pension funds to corporate governance groups – have condemned dual class, or multi-class, share structures, arguing that they reduce the impact of shareholder votes, allow insiders to take actions that do not benefit share value, and do not provide the oft-cited benefits of long term stability.
- These results are even more likely when one of the classes is *non-voting stock*.
- “The vote is very important. It’s a tool for holding management accountable and having a say on major issues.” Ann Yerger, Executive Director of CII.



Advocated Advantages of Multiple Classes of Stock

- Allows companies to plan for the long-term by reducing impact of quarterly earnings analyses and the pressure of making certain number targets.
- Protects against hostile takeovers.
- Concerned shareholders can sell their stock and opt out of dual class structures and investments.
- Ensures long-term commitment of visionaries and leaders.



Cons of Unequal Voting Classes

- Limits the rights and influence of shareholders, turning them into economic bystanders.
- Economic imbalance: limits the ability of institutional investors to use the shareholder vote as a means to influence boards and management to make corrections or changes.
 - Disconnect between economics and voting authority.
- Insulated boards may ignore or pursue actions that destroy value.
- Companies with dual class structures trade at a discount compared to their single class peers.
- Academic studies show that companies with stronger shareholder rights tend to have higher profits and sales growth. See John Bussey, *The Two Edged Sword of Dual Class Structures*, Wall Street Journal, August 19 2011.



Cons of Unequal Voting Classes, Continued ...

- Multiple classes “foster less accountability from boards and company insiders,” and those companies are “more prone to abuses such as excessive CEO pay and related-party transactions.” (Anne Sheehan, CII Chair and Director of Corporate Governance for CalSTRS)
- “In a company with dual-class stock, the mechanism is disabled because the CEO, as a practical matter, can fire the board. We no longer have rule of law, we have rule of man.” Geoff Colvin, Fortune Magazine, Senior Editor-at-Large.
- Dual class structures are problematic “if one party views the firm not as the public’s company but as their business, one that they own.” Michael S. Geltzeiler, Executive VP and CFO of NYSE Euronext.
- Public cost: exporting monitoring function to the courts, regulators and government



Positions of Relevant Organizations: NYSE & NASDAQ

- For many years the New York Stock Exchange prohibited the issuance of non-voting stock by listed companies, whether or not the non-voting stock itself was to be listed. NYSE also reserved the right to refuse to list stock with unusual voting provisions (particularly where one class of stock has the right to veto the actions of another class.)
- NASD and NASDAQ do not have any restrictions on non-voting stock.
- Several NYSE listed companies issued non-voting stock in spite of NYSE rules or switched to NASDAQ, and NYSE came under increasing pressure to repeal the rule.
- Current NYSE governance rule allows for dual classes of stock when structured that way at the IPO stage. Once a company is public, it cannot move to a dual class (SEC rule 19c-4).



Council of Institutional Investors

- CII is against multiple classes of common stock with unequal voting rights, and has asked both the NYSE and NASDAQ to stop new listings of companies with dual class stock.
- CII stated that a dual class structure “[C]oncentrates voting power into the insiders' hands, giving them effective control of board of director elections and other matters that are put before shareowners for a vote.”
- According to CII, the listing of multi-class stock companies is “essentially prohibited” on other major exchanges, such as the London and Tokyo Stock Exchanges



Investor Responsibility Research Center Institute (IRRCi)

- Commissioned a study performed by Institutional Shareholder Services (ISS): [“Controlled Companies in the Standard and Poor's 1500: A Ten Year Performance and Risk Review”](#)
- Study disputes the claim that multi-class voting structures benefit a company and its shareowners over the long term.
- Finds that, compared to companies with more equal or dispersed ownership, controlled companies had material weaknesses in accounting controls and suffered from more stock price volatility.
- Non-controlled firms outperformed controlled firms over the 3-year, 5-year and 10-year periods ended Aug. 31, 2012.



California Police Employees Pension Fund

- Calpers, the largest pension fund in the US, crafted a set of corporate governance standards which include avoiding IPOs with dual-class structures
- Calpers hopes for support from “our private equity partners, private equity industry associations and the investment banking industry” and wants to build coalitions amongst investors, fund managers and investor forums and networks.
- Further action could include: an equity trading strategy that “does not provide capital for IPOs which do not meet Calpers governance expectations”



California State Teachers' Retirement System

- Anne Sheehan, CalSTRS' Director of Corporate Governance: "Media and tech companies seem to like this strategy [dual class structure] and we continue to have discussions around that because we do believe that in the long run, the market does discount that."
- Regarding Google, Janice Hester Amey, a portfolio manager in the corporate governance unit said, "We worry that this will set a precedent for other people to emulate this move ... It's one thing for them to maintain it [Google founders' voting control], but perhaps they should put their own capital behind it, instead of taking it out of the hide of the existing shareholders."
- CalSTRS owns more than \$400 million in Google shares.
- CalSTRS also publicly criticized Facebook's dual class structure and Zuckerberg's majority control.
- Even more meaningful in light of their Corporate Governance Policy statement that "It is only in very rare circumstances where CalSTRS will take engagement to the public landscape or media. These cases are generally the most egregious cases of poor governance or where companies have been completely unresponsive to our inquiries."



Can Public Sector Pension Funds Even Own Non-Voting Stock?

- The proxy voting guidelines and policies of many pension funds prohibit or discourage:
 - voting for dual classes of stock
 - proposals advocating anything other than a one vote per share structure



Non-Voting Stock

- Most funds have policies against unequal voting rights or dual classes of stock.
- Non-voting stock is a developing and less analyzed area.
- Concerns over a decrease in shareholder influence and share value are exacerbated when existing shares are split into a class of shares with no vote at all.



CALPERS

- Statement of Investment Policy for Global Proxy Voting: Staff will execute all proxies and voting instructions in a manner that is consistent with the Board's Global Principles of Accountable Corporate Governance
- CALPERS' Global Principles of Accountable Corporate Governance:
 - **8.3 Shareholder Protections:** Boards should treat all the company's shareholders equitably and should respect and not prejudice the rights of all investors. Boards should do their utmost to enable shareholders to exercise their rights, especially the right to vote, and should not impose unnecessary hurdles.
 - **8.3.1 Unequal Voting Rights:** Companies' ordinary or common shares should feature one vote for each share. Divergence from a 'one-share, one-vote' standard which gives certain shareholders power disproportionate to their equity ownership should be both disclosed and justified. Companies should keep such structures under regular review, and put their retention up for regular approval by shareholders. Any such structures should be accompanied by commensurate extra protections for minority shareholders.



CalSTRS

- Corporate Governance Principles are not mandatory but “establish a framework for the System’s proxy voting . . . CalSTRS principles are based on what we believe are best practices in the marketplace and we conduct corporate engagements in order to move the marketplace towards these best practices.”
- Dual Class Stock: CalSTRS does not support dual class stock or any provision which gives unequal voting rights. CalSTRS supports the one-share, one-vote philosophy.



Ohio Public Employees Retirement System

- Ohio Public Employees Retirement System – Proxy Voting Guidelines (provide the basis for the Corporate Governance Staff to vote the proxies):
 - **One Share – One Vote:** Each share of common stock should have one vote. The board should not create a dual share class structure where certain classes of stock have superior voting rights.
 - **Majority Vote Requirement:** Shareowners should have the right to approve matters with a simple majority of the shares voted and the board should not impose supermajority voting requirements.



Employees Retirement System of Texas

- Proxy Voting Policy: “The objective of this policy is to provide direction in voting proxies in a manner that gives the most benefit to the participants and beneficiaries of ERS and is consistent with the stated goals and objectives of ERS.”
- Operational issues proposed by management will be supported unless ERS’ review of proposals reveals attempts to limit shareholder rights, increase takeover protections or reduce shareholder value.
- The majority of historical evidence regarding individual corporate anti-takeover devices indicates that companies with management teams more accountable to shareholders and the market outperform companies with heavily entrenched management teams. Proposals designed to instate or increase takeover protection or that eliminate, restrict or inhibit shareholder rights will be opposed.
- Proposals that promote a one-share, one-vote standard and the equal treatment of all shareholders will be supported.



State of Wisconsin Investment Board

- Proxy Voting Guidelines:
 - **Unequal Voting Rights:** SWIB supports equal voting rights for all shareholders. SWIB believes that company founders and those who own a majority of shares already have a significant vote without providing additional rights to their shares.
 - **Stock Class:** SWIB supports one class of stock with equal voting rights.
 - **Supermajority Voting Provisions:** SWIB supports simple majority provisions that require 51% of votes to pass.
 - SWIB believes that the wishes of shareholders should be carried out with a majority vote of the disinterested shares.



American Federation of Labor & Congress of Industrial Organizations

- “The *AFL-CIO Proxy Voting Guidelines* (the Guidelines) have been developed to serve as a guide for Taft-Hartley and union-sponsored plan trustees in meeting their fiduciary duties as outlined in ERISA and subsequent Department of Labor policy statements.”
- **Dual Class Voting:** The trustees oppose any voting system that entrenches company management at the expense of shareholders. The issuance of new classes of stock with unequal voting rights (“dual class voting”) is often designed to enhance the voting rights of company insiders and is common at family controlled companies.
 - The voting fiduciary should generally oppose proposals that limit shareholder power by issuing dual class shares. In recognition of the beneficial role that long-term investors can play in strengthening a company’s corporate governance and management accountability, proposals that seek to enhance the voting rights of long-term shareholders should be given favorable consideration.



Even if Pension Funds Can Own Dual Class or Non-Voting Stock, Should They?

- Limited rights and limited influence over the Board, corporate policy and accountability
- Insulated boards may not pursue share value maximizing activities
- Multiple classes may cause shares to trade at a discount
- If corporate policy moves in a direction that goes against a Fund's policies and principles, Funds will not be able to counter the trend or to sell easily
- The imbalance of power could mean already undesirable dual class shares are converted into non-voting shares
- On the other hand, technology companies often implement multi-class structures, but are also some of today's hottest companies



When Should Pension Funds Sell Dual Class or Non-Voting Stock?

- Public Pension funds cannot easily do the “Wall Street Walk” and sell shares when dissatisfied. Divestment is difficult and expensive (requiring the cost of financial and legal opinions).
 - CalSTRS: “As a predominantly passive investor, we consider our investments long-term, patient capital. Since our investment strategy is heavily weighted towards passive investments, we often do not have the flexibility to simply sell an investment because of governance concerns. We feel it is our duty as fiduciaries to actively monitor and engage the investments in our portfolio for financial, strategic, governance, sustainability risks, and other risks.”
 - Some equities are owned because they are part of broader indexes.
- Public Pension Funds, particularly in California, have used divestment as a tool for social and political change – most recently divesting shares of firearm manufacturers.
- Do the policies of your fund indicate that governance concerns can trigger a need to sell shares?



Questions for Trustees and Pension Funds

- Is your fund prohibited from owning dual class or non-voting stock?
- When is the obligation to sell dual class or non-voting stock triggered?
- Is that obligation balanced against a duty to mitigate the loss associated with an immediate sale of the stock?
- Even for funds not strictly prohibited from owning non-voting stock, should those funds decline to do so as a matter of policy?
- Must a Trustee also evaluate whether it is in shareholders' best interest for a company to be controlled, or whether the Board retained real and meaningful oversight?