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Reexamining dual-class stock

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Abstract Snapchat's initial public offering, which provided shares with no voting rights, is a culmination of the growing trend of dual-class shares. It contradicts the precept of one-share, one-vote that is essential for corporate democracy. Snapchat's action caused an uproar among influential investors. In January 2017, a coalition of the world's biggest money managers, which together control more than $17 trillion in assets, demanded a total ban on dual-class shares. We reason that the increasing prominence of dual-class stock is explained by the confluence of three economic trends: the growing importance of intangible investments, the rise of activist investors, and the decline of staggered boards and poison pills. A dual-class structure offers immunity against proxy contests initiated by short-term investors. It enables managers to ignore capital market pressures and to avoid myopic actions such as cutting research and development, which hurt companies in the long term. Thus, a dual-class structure is optimal in certain scenarios. We put forth alternatives to dual-class structure that enable managers to maintain control while retaining focus on sustainable value creation.
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1. The rise of dual-class firms

Snapchat's much-hyped 2017 initial public offering (IPO) provided shares with no voting rights. This offer contradicted the precept put forth by the late Goldman Sachs co-chair John Whitehead: "[S]hares without voting rights are destructive to capitalism's very basis" (Bloxham, 2017). Is Whitehead right? Why does dual-class structure exist despite its apparent drawbacks? Is dual-class structure an essential feature of modern capitalism? What are the alternatives to dual-class structure? We answer these questions in this article.

Corporate governance, a pillar of a well-functioning capitalist system, confers equitable voting rights to shareholders. Common shareholders use their one-share, one-vote right to influence a company's operations by, for example, electing the board of directors or setting the chief executive officer's (CEO's) compensation. Dual-class structure

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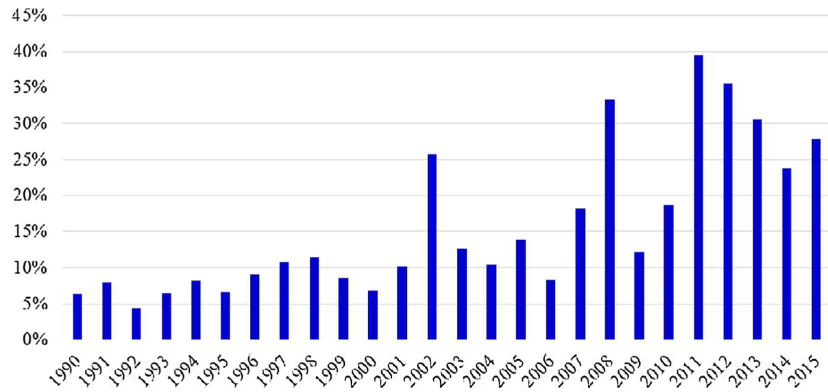
Figure 1. Percentage of initial public offering companies with multiple classes of shares



Data source: https://site.warrington.ufl.edu/ritter/files/2017/01/IPOs-from-1980-2016-with-Multiple-Share-Classes-Outstanding.pdf

gives differential voting rights to various sets of shareholders and is a potential roadblock to shareholder democracy. Many established companies—including Nike, Comcast, Berkshire Hathaway, The New York Times Company, and Ford—have had dual-class stock for decades (Smith, 2007). The practice of dual-class stock has escalated in the 21st century; recent IPOs of commonly recognized companies include Facebook, Google, Alibaba, LinkedIn, Zillow, Groupon, Fitbit, GoDaddy, Planet Fitness, Orbitz, Shake Shack, RE/MAX, WebMD, DreamWorks Animation, and Yelp (see Figure 1). Snapchat took this concept to an extreme by attaching zero voting rights to shares offered to the public.

2. Backlash from institutional investors

Large institutional investors have persistently opposed shares with lesser voting rights (Basar, 2012). Hence, Snapchat's zero-vote offering caused an uproar among influential investors. In January 2017, a coalition of the world's biggest money managers announced that it would push for a total ban on dual-class shares (Lublin, 2017). This 16-member coalition includes asset management giants BlackRock Inc., Vanguard Group, and State Street Global Advisors as well as the state public pension systems of California, Florida, and Washington, which together oversee more than $17 trillion in assets. Dubbed the Investor Stewardship Group (ISG), the coalition demands voting rights in proportion to shareholders' economic interests.[1]

The ISG's demands are not without merit. Managers and controlling shareholders of dual-class companies could appoint a friendly board of directors, pay themselves abnormal compensation, and extract benefits from the company, without having to worry about the welfare of common shareholders. For example, publisher and financier Conrad Black controlled more than 66% of the voting for Hollinger International despite holding a minority share of the company's stock (Shaoul, 2004). He allegedly extracted more than $80 million from the company and was sent to prison for his corporate misdeeds (Arango, 2007).

3. Economic arguments for dual-class stock

Despite its drawbacks, investors continue to clamor for inferior voting stock of public companies. Consider the heavily demanded Class A stock of Facebook. It carries one vote per share compared with ten votes per share for Class B shares held by founding shareholders. (Both classes of shares have equal dividend rights.) Cofounder, chairman, and CEO of Facebook, Mark Zuckerberg, can overcome any move by an opposing shareholder as long as he holds 9.1% of Facebook's Class B stock. Media entities such as CBS, Viacom, Comcast, and The New York Times Company typically have dual-class stock. Some of the largest companies listed in the 21st century with market capitalization exceeding $400 billion, such as Alphabet and Alibaba, have a dual-class structure. Arguably, dual-class stock structure must provide some benefit to shareholders or have some feature essential for the success of founder-led technology companies.

Dual-class stock is a trade-off between ownership and control, which are the core governance issues for

[1] ISG's manifesto, "Corporate governance principles for U.S. listed companies," is available at https://www.isgframework.org/corporate-governance-principles/

a modern corporation owned by two different groups of shareholders: (1) original founders and (2) multiple atomistic shareholders. The first group continues to manage the company. These shareholders do not hold diversified investments, and their fortunes and personal prestige are linked to the success of the company. The second group holds diversified investments, and seeks to earn dividends and capital gains. This group's lone say in the affairs of the company is through a large institution such as the California Public Employees' Retirement System. The objectives and horizons of the two shareholder groups clearly differ. The founders want to maintain control but have to opt for wider ownership in order to access capital markets and to provide liquidity to stock options owned by rank-and-file employees.

Many of these companies compete in technology markets, wherein innovations often have long gestation periods. Here, founders and key executives possess proprietary information and expertise on variables such as product lifecycle and future product pipeline, which can neither be easily explained to common investors nor fully revealed to the market for risk of competitors' advance knowledge. Hence, outside investors are unable to make informed choices about the company's strategic initiatives. In such scenarios, insiders might better be left alone to plan investments and run company affairs rather than be questioned by outside investors regarding each strategic move. In those specific circumstances, managers might need more voting power to maintain control so as to better exploit their private information for the benefit of all shareholders. Dual-class structure provides an optimal, transparent balance here because external investors are made aware of their inferior voting power before they buy the stock.

4. Academic research on dual-class stock

Academic findings are mixed on the merits of dual-class structure. One set of studies shows that, on average, shareholders dislike dual-class stock. Examining data from 1994 to 2002, Gompers, Ishii, and Metrick (2010) found lower stock returns for dual-class firms as compared to single-class firms. Smart, Thirumalai, and Zutter (2008) established that, relative to fundamentals, dual-class firms trade at lower prices than single-class firms, both at the IPO and for at least 5 years subsequent. Management entrenchment among dual-class firms is evident, with less-frequent CEO turnover. Masulis, Wang, and Xie (2009) found that CEOs receive higher compensation, managers make acquisitions that destroy shareholder value more often, and capital expenditures contribute less to shareholder value. Other studies show that dual-class firms have opaque financial reporting and lower credibility of earnings information (e.g., Fan & Wong, 2002; Francis, Schipper, & Vincent, 2005).

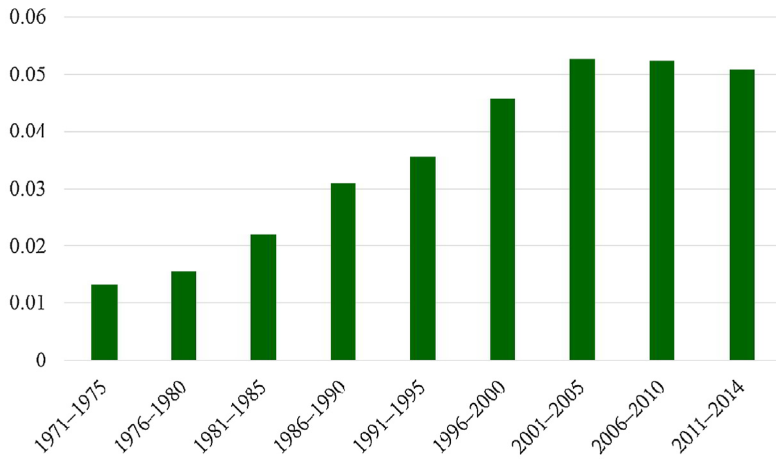
Another set of studies concludes that the dual-class structure is optimal in certain scenarios (Demsetz & Lehn, 1985). Lehn, Netter, and Poulsen (1990) found that firms that convert from single-class to dual-class structure have higher sales growth, research and development (R&D) and advertising expenditures, secondary equity offerings, market-to-book ratios, and undistributed profits. These findings indicate growth opportunities as well as the need for external equity financing, but without passing control to external stakeholders. Dimitrov and Jain (2006) showed that superior, long-term shareholder returns are associated with aggressive-growth dual-class companies.

5. Three economic trends

The increasing prominence of dual-class stock may be explained by the confluence of three significant economic trends. First, creative destruction in U.S. corporations is occurring at an increasingly rapid rate (Govindarajan & Srivastava, 2016). Firms die more quickly but also reach large market capitalization faster than ever before. Hence, intangible investments such as R&D, digital services, and human capital play an evermore important role in shaping and sustaining companies' competitive advantages (see Figure 2). While these investments often produce benefits in years beyond the current reporting period, they hurt profits in the short run. Accounting regulations require that R&D investments be reported as expenses and not as assets, as is the case for investments in property and equipment.

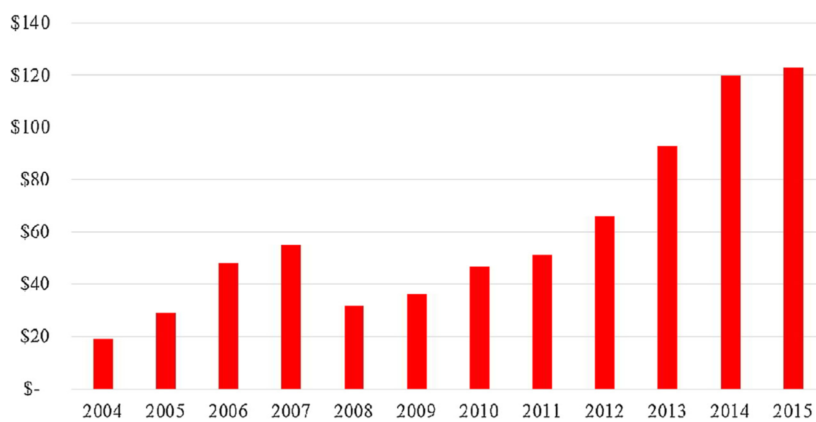
Second, activist investors seeking to boost short-term earnings (Semuels, 2016) are on the rise (see Figure 3). The first trend helps activist shareholders because cutting intangible investments could boost the bottom line, though such actions hurt companies' long-term health. For example, Blockbuster director Carl Icahn forced the company to abandon its digital plans (Sanghoee, 2013). As cofounder of an activist investing firm, Nelson Peltz pursued a merger of Dow Chemicals and Dupont and caused the closure of a corporate research center responsible for the invention of nylon, Kevlar, Teflon, and solar cells (Gandel, 2015). He also drove the breakup of Kraft into a North American company called Kraft and an international company named Mondelez

Figure 2. Average research and development expenditures as a percentage of total assets



Data source: Compustat (www.compustat.com). R&D expenditure (Compustat variable XRD) is scaled by average total assets (Compustat variable AT) at the beginning and the end of the year.

Figure 3. Assets under management of activist investors, in billions of dollars



Data source: https://www.credit-suisse.com/media/assets/microsite/docs/corporate-insights/credit-suisse-corporate-insights-q3-2016.pdf

(George, 2016). Thus, activists' intervention might boost short-term profits or even stock prices but could destroy shareholder value in the long term (George, 2014). Valeant Pharmaceuticals International initially witnessed a run up in stock prices by ruthlessly cutting costs, arguably due to demands from activist investors. Since July 2015, however, Valeant has lost more than 90% of its market capitalization. The market realized that a pharmaceutical company's strategy lacking R&D investments is not sustainable. Thus, activist shareholders' demands often run contrary to the desires of long-term institutional investors who want higher R&D investments (David, Hitt, & Gimeno, 2001).

Third, the practices of staggered board and poison pills—which serve as powerful antitakeover devices and ensure corporate control—are in decline (Matheson, 1999; Solomon, 2012). While this trend makes managers more responsive to the discipline imposed by the market for corporate control, it also makes managers more susceptible to shareholder pressures for short-term profits even when they come at the expense of long-term profits.

6. The rise of another defense mechanism

Arguably, these three trends could explain the rise of a new defense mechanism. Dual-class structure provides immunity against proxy contests initiated by short-term investors and enables managers to ignore capital market pressures (Jordan, Kim, & Liu, 2016). Thus, managers do not have to take myopic actions that might please activist investors but destroy long-term value.

For example, Berkshire Hathaway's Warren Buffet and Charlie Munger are known for their focus on long-term value creation; this would not be possible if they measured their performance solely on the basis of quarterly profits or if activist investors controlled them. The New York Times Company has weathered the economic storms faced by many print media firms while maintaining high editorial standards, foreign reporting, and print editions. Alphabet has extended beyond web search business by investing in self-driving cars, delivery drones, wind turbines, genomics, and healthcare, none of which have earned profits but which nonetheless have enhanced shareholder value. Facebook, which has access to a network of customers and vast amounts of confidential consumer data, has warded off an activist investor's demand to capitalize on those assets to boost short-term profits. Alibaba has committed to setting a strategic course without being influenced by fluctuating capital market attitudes.

7. Banning dual-class shares

The dual-class stock structure might occasionally prevent common shareholders from exercising their voting rights, but it is not always harmful to shareholder interests. Given the changing economics of public firms, which require relentless innovation to survive and grow, public shareholders are better served by managers who undividedly pursue long-term value creation. Banning dual-class shares to eliminate a few bad instances whereby dual-class managers defraud shareholders but cannot be removed might throw the proverbial baby out with the bathwater. That is, growth firms may decide to delist their shares from stock exchanges and go private. Other firms may avoid going public altogether. Certain other firms may decide to list in stock exchanges outside the U.S. These scenarios are not inconceivable. From 1990 to 2011, the share of world IPO activity by non-U.S. firms increased and U.S. IPO activity declined (Doidge, Karolyi, & Stulz 2013). This is not a positive development because, given its role in providing capital market access for growth companies, the U.S. initial public offering market plays a critical role in facilitating entrepreneurship and venture capital in the U.S. economy (Megginson & Smart, 2008). The ban thus would reduce investors' avenues and evolving corporations' strategic choices, adversely affecting the competitiveness of U.S. corporations.

8. Options available to companies

Companies might be able to ward off activists' demands without a dual-class structure (George & Lorsch, 2014). For example, chairperson and CEO of PepsiCo, Indra Nooyi, tenaciously fought Nelson Peltz's demand to split Pepsi into beverage and snack outfits (Belvedere, 2014). She has also thus far kept similar attempts at bay, including one made by 3G, a Brazilian private equity investor. Nooyi has retained her focus on growth and innovation. Similarly, Allergan Inc., a biotechnology company that relies on R&D and innovation to compete, saw through demands by investor Bill Ackman and a rival pharmaceutical company, Valeant (Denning, 2015).

The general theme for outsmarting activist investors—or not having to encounter them in the first place—entails pursuit of a strategy that creates long-term value for all shareholders, not just founding members. We offer five prescriptions.

1. Formulate a long-term strategy and implement it without short-termism or excessive attention to quarterly reporting metrics.

2. Communicate that strategy to the board and influential institutional shareholders, and obtain their support as a team. Note that activist shareholders' first move is to try to divide that team and win them over.

3. Explain any drop in short-term performance—for example, due to extraordinary R&D expenditures or restructuring of a less-profitable division—in a transparent and detailed manner to analysts and common investors. (For example, GE spent $20 billion between 2005 and 2016 on products and services that improve environmental sustainability.) Describe the benefits that would accrue from such extraordinary actions. Investors and analysts pay special attention to soft disclosures in Securities and Exchange Commission filings and press releases, and they are willing to accommodate vagaries in short-term profits if properly explained.

4. Listen to the demands of activist shareholders. Outsiders provide a fresh perspective on shedding unproductive divisions and gaining promising opportunities. These ideas may not be obvious to people absorbed in managing day-to-day operations.

5. Actively pay attention to vulnerabilities in board structure, shareholding patterns, and capital

structure, which permit shareholder activism. If vulnerability is high and the benefits of corporate control exceed the downside associated with inequitable governance, then go for dual-class capitalization.

Even then, there is an alternative. The company can adopt a sunset provision. At a predetermined date—say 5 years from IPO or upon reaching some strategic milestone like $10 billion in revenues—the superior voting stock could automatically convert into ordinary shares. At that point, the company can subject itself to the discipline imposed by capital markets as well as the market for corporate control, reducing the discount associated with its valuation.

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