What do we know about dual class firms?

I recently reviewed published studies that explore dual class firms. Below, I will discuss what can be learned from these studies about dual class firms. I will address a series of questions: What are dual class firms? Why do dual class share structures exist? What firms have dual class structures? What consequences do these structure have? I will conclude by highlighting key takeaways.

What are dual class firms?

The term "dual class firms" refers to firms that deviate form the one share-one vote regime and have morethan one class of shares, with different classes of shares having differentvoting rights. For example, a first class might include shares that each giveits holder one vote while a second class of shares includes shares that eachoffer its holder ten votes. In the latter case, there is a difference, called wedge,between the cash flow rights and voting rights that a shareholder has.

Why do firms have dual class share structures?

When firms choose a dualclass structure, shareholders with superior voting rights (i.e., who hold sharesthat have more than one vote per share), which are oftentimes their managersand families (DeAngelo and DeAngelo 1985), have relatively high control over the firm and can pursue the projects theywant. Conversely, shareholders with subordinate voting rights (i.e., who holdshares with one or zero votes per share) have little if any control over thefirm.[1] Dual class firms thus empower actors with superior voting rights shareholdersand disempower those with subordinate voting rights shareholders (Burkart and Lee 2008).

Superior voting rightsshareholders are protected from the interference of other shareholders. Thisprotection can benefit dual class firms when it allows superior voting rightsshareholders to select and execute projects that are difficult to explain to and/or unpopular with other shareholders, such as those that emphasize the longterm without catering to short term pressure, or those that take into account otherstakeholders (e.g., groups with social and environmental concerns) (Arugaslan, Cook, and Kieschnick 2010). Therein, however, also lies also the risk associated with dual class sharestructures: superior voting rights shareholders can engage in practices that transferfirm wealth to themselves, away from other stakeholders, includinginferior-voting shareholders. Much of the research tries to disentangle thesetwo scenarios, in an effort to determine whether dual class structures are beneficial by facilitation project selection and execution or whether they provide superior voting rights shareholders with the means to expropriate otherstakeholders.

What firms have dual class share structures?

Research has explored thevarious features that characterize dual class firms. Consistent with dual classstructures being beneficial in that they give superior voting rights shareholders leeway over project selection and execution, firms are more likely to engage indual class recapitalization when they have greater growth opportunities (Lehn, Netter, and Poulsen 1990) and are more likely to forego reunifyingof their dual class share structures when they are financially unconstrained (Dittmann and Ulbricht 2007).

At the same time, institutional investors often shun dual class firms, especially when thesefirms are more established. After an initial public offering of shares, dual class firms have higher institutional ownership, in terms of number and as a percentage of equity they hold, than single class firms (Smart and Zutter 2003). This result suggests that institutional investors find attractive dual class firms that have gone public and do not see them as harming their interests, which is consistent with the hypothesis that dual class structures are beneficial for project selection and execution. In stark contrast, the evidence in Arugaslan, Cook, and Kieschnick (2010) suggests that managers take their firms public using dual class structures not for project selection and execution, but rather to keep control while reducing the costs associated with their lack of diversification. Over time, however, investors appear to grow weary of dual class structures. In a general sample of dual class firms, institutional investors, especially those with a long-term focus, have lower ownership in dual class firms than in single class firms; institutional investors increase their ownership when firms unify their dual-class shares into a single class (K. Li, Ortiz-Molina, andZhao 2008).

Overall, research on the determinants of dual class firms does not allow to draw a clear picture that neatly discriminates between the hypothesis that dual class structures allow for superior project selection and execution and the hypothesis that dual class structures facilitate wealth transfers to superior voting rights shareholders.

What are the consequences of a dual class share structure?

Research on the consequences of dual class structures has, as well, probed the question of whether these structures are beneficial or whether they offer a means for superior voting right shareholders to expropriate other stakeholders.

To start, dual class firms appear to make particular investment choices. As the wedge between voting and cash flow rights in dual class firms widens, corporate cash holdings are worthless to outside investors, managers make more acquisitions that lower shareholder value, make capital expenditures that contribute less to shareholder value, and engage in less tax avoidance (Masulis, Wang, and Xie2009;

McGuire, Wang, and Wilson 2014).

A number of studies have focused on the value of dual class firms. A series of recently published studies suggests that dual class structures are detrimental for firm value, which is consistent with the expropriation explanation for dual class ownership structures. For example, firm value is lower when insiders have more voting rights and lower cash rights, that is, when the insiders' wedge between voting and cash flow rights is larger (Gompers, Ishii, and Metrick2010). Also, dual-class firms trade at lower prices than single-class firms, both at the initial public offering of their shares and during the subsequent five years at least (Smart, Thirumalai, and Zutter 2008; Smart and Zutter 2003). The discount at which dual class firms trade compared to single class firms is more pronounced when managers of dual class firms are more entrenched (Baulkaran 2014). This result raises the question of why investors appear to like dual class firms that have just had an IPO, as suggested by (Smart and Zutter 2003). Are they perhaps irrational in their investment choices?

Also, firm value is lower infamily firms with dual-class ownership structures than in family firms with single-class structures; the difference in firm value is about 17% in Canada (in a sample of 613 firms between 1998 and 2005) (King and Santor 2008). Similarly, Smith, Amoako-Adu, and Kalimipalli (2009) document that dual class firms in Canada sell at a significant discount compared to single class firms.

Firm value increases when dual class firms unify their share structures (Lauterbach and Yafeh 2011; Lauterbach and Pajuste 2015), and the increase in value is larger when majority shareholders lose higher percentages of votes (Hauser and Lauterbach 2004). Contesting this evidence is research documenting that when dual class firms unify their share structures, they fail to experience a substantial increase in performance and value (Lauterbach and Yafeh 2011). Similarly, Hoi and Robin (2010) fail to find an association between firm value and dual class structure. Finally, Cornett and Vetsuypens (1989) document that, between 1962 and 1986, when firms announced that they were going to issue multiple classes of common stock with different voting rights, their share prices increased, which is not consistent with expropriation.

Research has explored the mechanisms and practices that underlie the association between firm value and dual class structures, in particular the evidence suggesting that dual class firms trade at a discount. This work points to corporate governance and suggests that it can be problematic. For instance, CEO turnover fails to be sensitive to performance at dual class firms, which is not the case in single class firms (Smart, Thirumalai, andZutter 2008). Managers at dual class firms are paid more than managers at single class firms (Masulis, Wang, and Xie2009; Smart and Zutter 2003; Tinaikar 2014). As the wedge between voting and cash flows rights in dual class firms widens, they provide fewer disclosures about managerial compensation (Tinaikar 2014). Family members in the C-Suite at dual class firms are paid more than those atsingle class firms; the excess pay is in the form of higher incentive compensation (i.e., bonus and stock options), perhaps to align the interests of managers with those of subordinate voting rights shareholders (Amoako-Adu, Baulkaran, and Smith 2011).

Moreover, financial reporting at dual class firm governance is particular. Relative to single class firms, dual class firms in Canada pay a larger amount of non-audit feeds to auditors, in terms of the absolute dollar amount and as a proportion of total audit fees (Niu 2008). As the wedge between voting rights and cash flow rights in dual class firms widens, audit fees increase, suggesting that dual class firms with a wider wedge face higher audit risk (Khalil, Magnan, and Cohen 2008).

Research also sheds light onwhy audit risk might be increasing with the wedge in dual class firms. The reason does not appear to be earnings management: dual class firms manage earnings less than single class firms, and they increase their earnings management when they unify their share structure (Nguyen and Xu 2010). Similarly, in a study ofearnings management at 12,672 dual class firms in 19 countries between 1994 and 2010, T. Li and Zaiats (2017) document that Canada is among the countries (with Sweden and Australia) that manage earnings the least.

At the same time, the earnings reported by dual class firms are particular. For instance, as the wedge between voting rights and control rights rises, dual class firms are less timely in recognizing bad news as losses in their financial reports (Khurana, Raman, and Wang 2013). In general, earnings are less informative for investors in dual class than single class firms, including in Canada (Niu 2008; Francis, Schipper, and Vincent 2005). Dividends, on the otherhand, are at least as if not more informative for investors as earnings, suggesting that dual class structures lower the credibility of earnings while enhancing that of dividends as a performance measure (Francis, Schipper, and Vincent 2005).

Beyond earnings credibility, transparency and comparability of financial reports also appears to be at stake. Following the mandatory adoption of IFRS, the voting premium at dual class firms declined by 8% on average, especially when adopters experienced anincrease in transparency and comparability and when they were situated incountries with strong legal enforcement (Hong 2013).

Further highlighting the role of the environment in which firms operate is a study that examines dual class firms that cross-list in the US. Non-US dual class firms that cross-list on a US stock exchange have voting premia that are 43% lower than non-US dual class firms that do not cross list; the voting premia are lower for both high- and low-voting shares, although relatively more so for low-voting shares (Doidge 2004). This evidence suggests that cross-listing in the US enhances minority shareholder protection, and lowers the private benefits of control (Doidge 2004).

Overall, research on the consequences of dual class structures cautions that these structures can be associated with discounts in firm value that widen with the wedge between voting and cash flow rights. Dual class firms have particular corporate governance regimes, in terms of their compensation and financial reporting practices that may contribute to this discount.

Good governance at dual class firms

While the literature discussed so far tells a rather cautionary tale about firms with dual class structures, there are also more hopeful narratives to be found. These narratives point to practices that dual class firms adopt to discourage superior voting shareholders from expropriating other stakeholders.

For instance, dual class firms pay out higher cash dividends, in the form of more regular rather than special dividends or repurchases, than similar single-class firms (Jordan, Liu, and Wu 2014). This evidence is consistent with dual class firms using corporate payouts as a pre-commitment device to mitigate expropriation. Also, the relative price difference between various classes of shares, that is, the voting premium, decreases when a dual class firm has better corporate governance practices (in terms of disclosures, board composition, conflicts of interests and shareholder rights), and regulatory changes increase investor protection (Carvalhal da Silva and Subrahmanyam 2007). In the same spirit, the discount at which dual class firms trade compared to single class firms is lower when managers are less entrenched (i.e., managers have lower tenure and firms have fewer anti-takeover provisions) (Baulkaran 2014). Also, the private benefits of control are lower when capital markets are more developed, and when there is media pressure and tax enforcement (Dyck and Zingales 2004).

Overall, this work points towards different mechanisms that can help dual class firms in ensuring that superior vote shareholders do not expropriate other stakeholders, including dividend payment and corporate governance. The environment in which dual class firms operate plays a role as well, in particular investor protection (which is good in Canada), capital markets development (which is high in Canada), media pressure and tax enforcement.

Takeaways

I have done a tour of the research that has been done since the 1980s on dual class firms; much of this work was done in North America, including in Canada. In this research, the following elements stand out.

- Dual class firms trade at a discount compared to single class firms, in Canada and elsewhere; this discount often widens as the wedge between voting rights and cash flow rights increases. Dual class share structures thus seem to not become to shareholders, and shareholders, especially institutional investors, shun dual class firms that have been established for a number of years. This evidence suggests that dual class firms are not beneficial in that is has detrimental consequences for shareholder value. Does this necessarily mean that superior vote shareholders be expropriate other stakeholders? No, and here is why. What is being measured in studies that document the dual class discount is shareholder value. It is possible, although this has not been analyzed, that dual class firms are concerned with something other than shareholder value, and with stakeholders other shareholders.
- Managerial compensation is generally higher in dual class than in single class firms, and this appears to be driven by stronger incentive pay, including share-based incentive pay and bonus-based incentive pay. Managers are thereby encouraged to work hard and to take into account the interests of shareholders (via share-based incentive pay) and, potentially, other stakeholders (via bonus-based pay)
- Financial reporting practices in dual class firms are particular. Even though dual class firms, including those in Canada, do not engage in earnings management, they pay higher audit fees. The earnings of dual class firms are less informative to shareholders than those of single class firms; conversely,

dividends of dual class firms are relatively more informative.
- Dual class firms can adopt practices that mitigate any expropriation that superior voting rights shareholders may engage in, namely, ensure good corporate governance (i.e., in terms of disclosures, board composition, conflicts ofi nterests, shareholder rights), limit managerial entrenchment (i.e., lower managerial tenure and fewer anti-takeover provisions), and pay out dividends.
- Dual class firms can choose environments that discourages superior voting right shareholders from expropriating other stakeholders. These environments include those with high shareholder protection, developed capital markets, active media and thorough tax enforcement.

Your thoughts?

Photo, unchanged, from Per.

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[1] Corporate officers and their families often hold large stakes in dual class (Amoako-Adu and Smith 2001; DeAngelo and DeAngelo 1985).