Harvard Law School Forum on Corporate Governance

Dual-Class Shares: Governance Risks and Company Performance

Posted by Kosmas Papadopoulos, Institutional Shareholder Services, Inc., on Friday, June 28, 2019

Tags: **Boards of Directors**, **Capital structure**, **Controlling shareholders**, **Dual-class stock**, **Entrenchment**, **Firm performance**, **Institutional Investors**, **IPOs**, **Long-Term value**, **Management**, **Shareholder voting**, **Short-termism**, **Tech companies**
More from: **Kosmas Papadopoulos**, **Institutional Shareholder Services Inc.**

Editor's Note: Kosmas Papadopoulos is Managing Editor at ISS Analytics. This post is based on an ISS Analytics memorandum by Mr. Papadopoulos. Related research from the Program on Corporate Governance includes **The Untenable Case for Perpetual Dual-Class Stock** (discussed on the Forum **here**), and **The Perils of Small-Minority Controllers** (discussed on the Forum **here**), both by Lucian Bebchuk and Kobi Kastiel, and the keynote presentation on **The Lifecycle Theory of Dual-Class Structures**.

Initial public offerings of companies with dual-class shares have made headlines in recent years. An increasing number of newly listed companies have introduced classes of stock with superior voting rights, which typically allow company founders and top executives to maintain company control even as their economic stake in the business may diminish. Dual-class companies include some of the most successful and highly-valued companies in the world, such as corporate giants Facebook Inc., Alphabet Inc. (parent of Google), and Berkshire Hathaway Inc. In 2019, some of the largest U.S. IPOs involved classes of stock with superior voting rights, including ride-hailing services company Lyft Inc., social media platform Pinterest Inc., and jeans maker Levi Strauss & Co.

Many investors and corporate governance experts sound the alarm about the growing prevalence of dual-class share structures, given the potential risks that such ownership arrangements pose to common shareholders. They argue that the discrepancy between control and economic ownership reduces accountability to the economic owners of the business, entrenching management and skewing incentives. Meanwhile, proponents of the dual-class share structure contend that control is necessary to protect the company from the short-term pressures of the market and to allow management to focus on growth and long-term strategy.

In this post, we review some of the key trends in dual-class share structures in the U.S., and we examine the links between dual-class share structures with corporate governance and company performance. Based on our analysis, we highlight the following key findings:

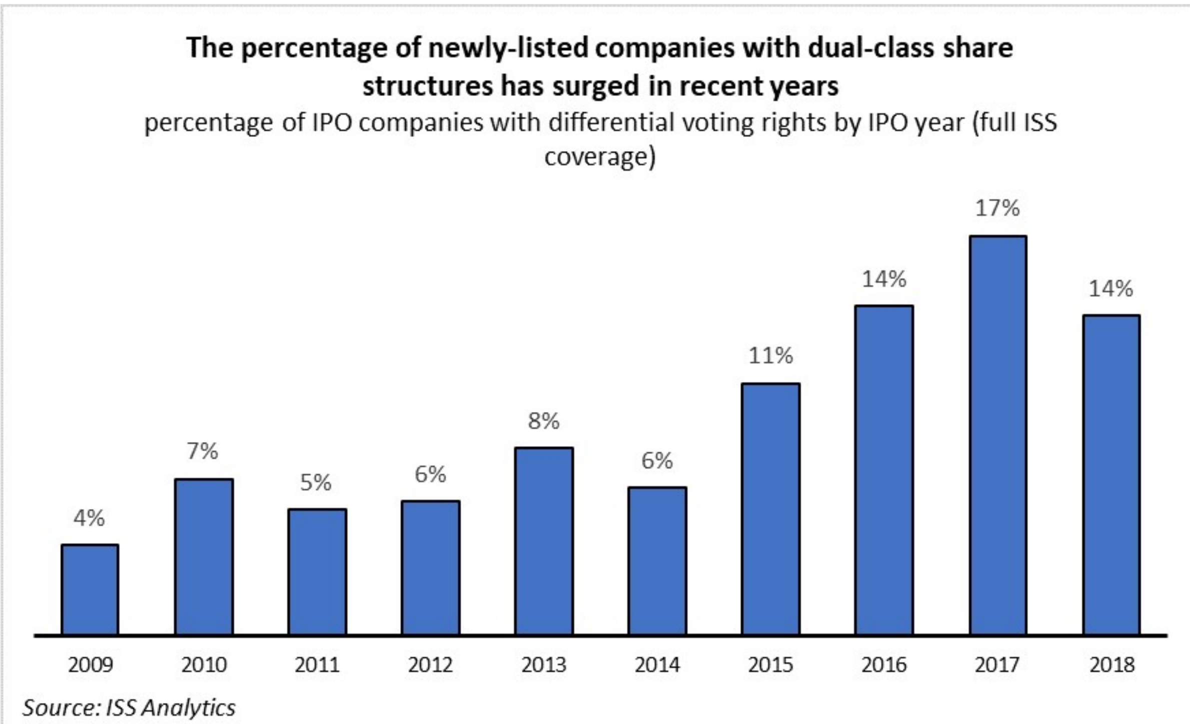
- **Differential voting rights are becoming slightly more common**, primarily among small companies, and are highly concentrated in certain industry groups, such as Media & Entertainment. The proportion of companies in the Russell 3000 with differential voting rights is up one percentage point over the last decade.
- **Investors overwhelmingly favor the one-share, one-vote capital structure**, and they express this preference through their voting at general meetings of companies when given the opportunity.
- **Companies with dual-class share structures face more governance challenges** compared to other companies, as they are more likely to exhibit more problematic corporate governance practices.
- **Dual-class share structures do not necessarily offer an edge on performance**, as the results appear inconclusive. Dual-class companies appear more profitable than their peers, but they fail to show significant

improvement in performance compared to their counterparts.

Prevalence of Dual-Class Share Structures

Approximately 7 percent of Russell 3000 companies currently have a dual class share structure in place. For the purposes of this analysis, we define companies with dual-class share structures as companies where the separate class of stock offers its holders superior voting rights compared to common shareholders, and the class with the superior voting rights represents more than 5 percent of the company's total voting rights.

The percentage of companies with dual-class share structures has increased during the past decade by approximately one percentage point. The relative increase becomes apparent when observing the capital structures of recent IPOs, whereby a growing proportion of newly listed companies adopt a dual-class share structure.



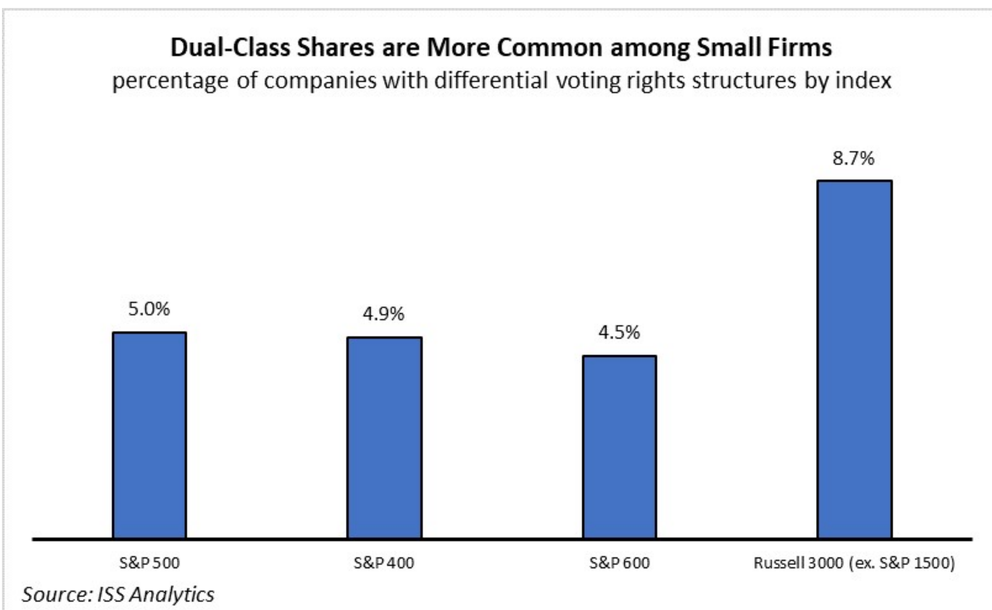
The trend continues into 2019, as seven of the largest 10 IPOs so far have adopted dual-class share structures.

Top 10 IPOs in 2019 (January to May)

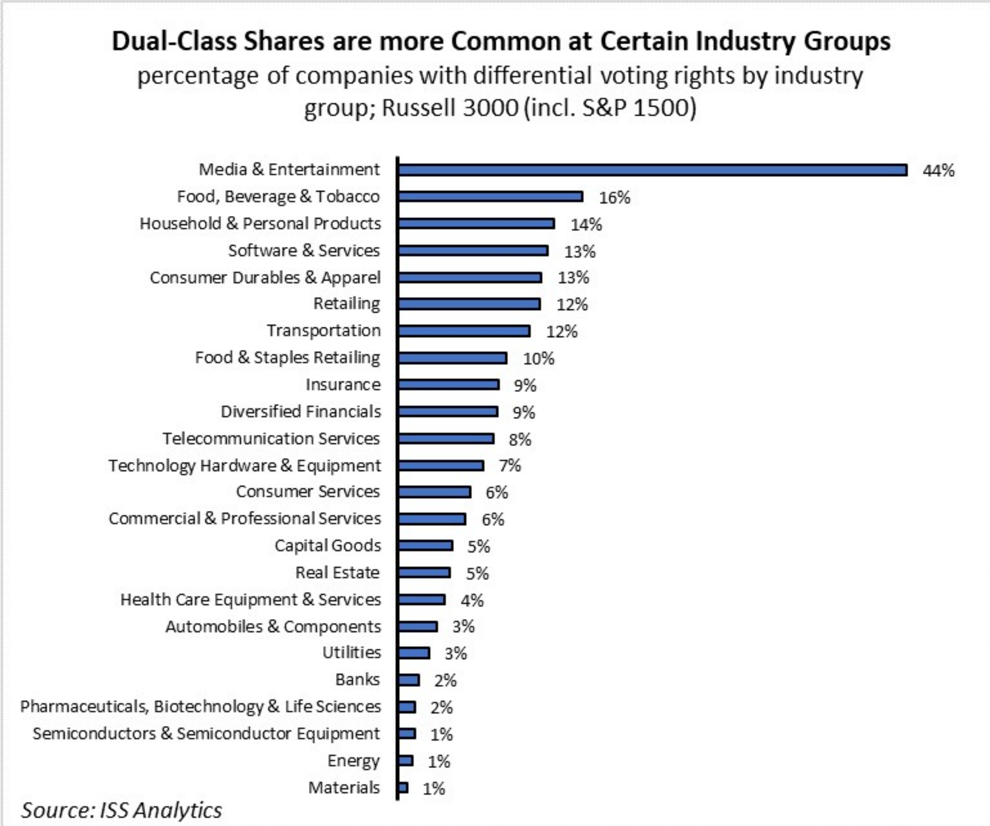
Company Name	TICKER	Offer Amount	Date	Dual Class
Uber Technologies, Inc.	UBER	$8,100,000,000	4/11/2019	No
Avantor, Inc.	AVTR	$2,898,000,000	2/8/2019	No
Lyft, Inc.	LYFT	$2,340,000,000	3/1/2019	Yes
Pinterest, Inc.	PINS	$1,425,000,000	3/22/2019	Yes
PIMCO Mortgage Income Trust Inc.	PMTG	$1,150,000,000	4/18/2019	No
Tradeweb Markets, Inc.	TW	$1,080,000,000	3/7/2019	Yes
Chewy, Inc.	CHWY	$908,960,000	4/29/2019	Yes
Zoom Video Communications, Inc.	ZM	$751,304,340	3/22/2019	Yes
Levi Strauss & Co.	LEVI	$623,333,339	2/13/2019	Yes
Crowdstrike Holdings, Inc.	CRWD	$621,000,000	5/14/2019	Yes

Source: **www.nasdaq.com** and company filings.

ISS data indicate that the increase in the frequency of dual-class share structures primarily occurred among small-capitalization firms, as approximately 9 percent of non-S&P 1500 companies in the Russell 3000 currently employ superior voting rights, compared to less than 5 percent of companies in the S&P 1500.

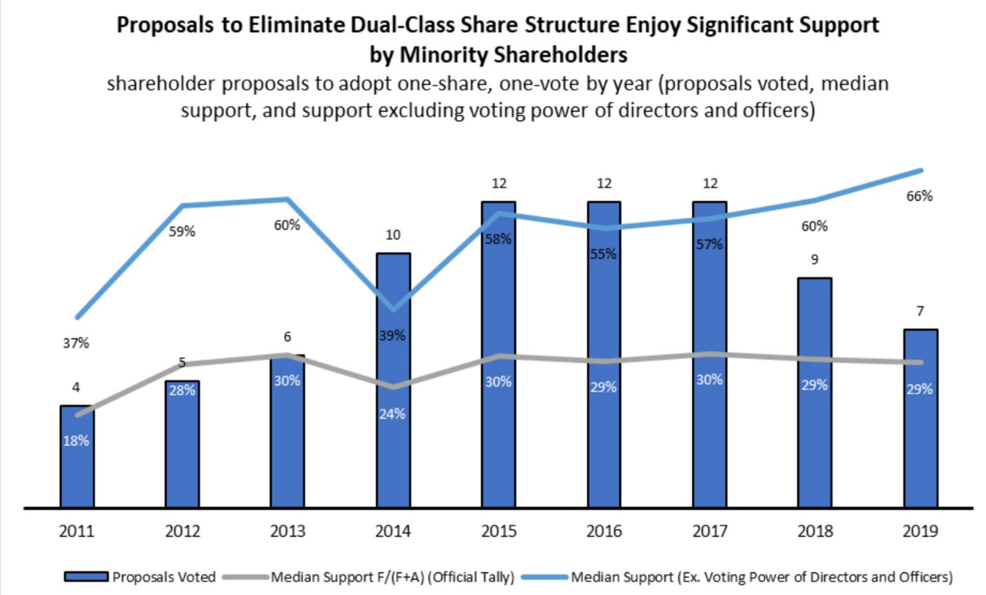


Not surprisingly, dual class share structures are more common at certain industries. The media and entertainment industry group shows by far the highest prevalence of dual-class share structures, including tech giants like Facebook and Alphabet, as well as more traditional media names, such as CBS Corp., Viacom Inc., and News Corp. Food and beverage companies, household and personal products, and software and services also have relatively high concentration of dual-class share structures.



Shareholder Proposals

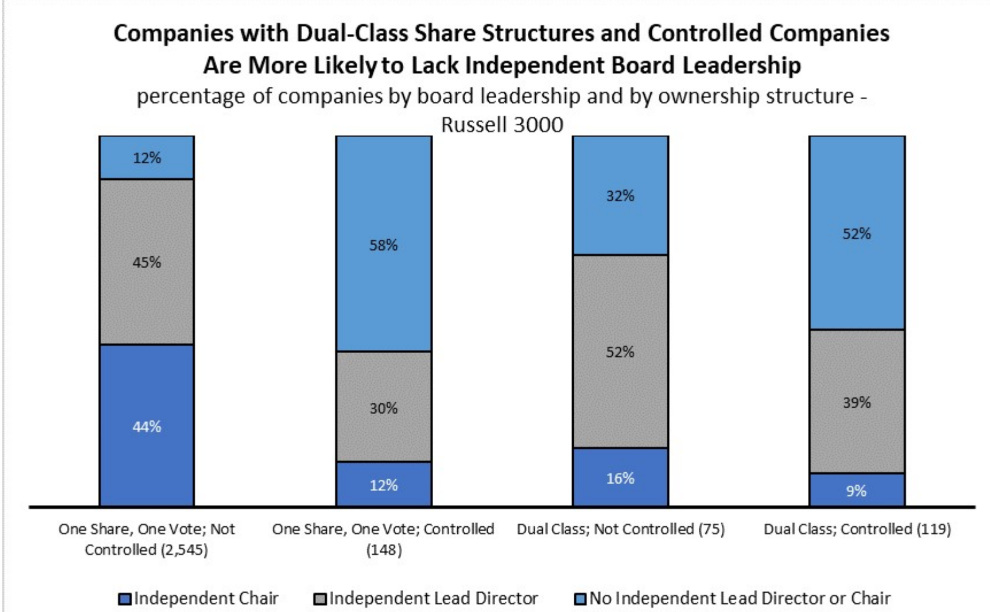
Investors generally oppose capital structures that contain classes of stock with superior voting rights. Many large institutional investors include provisions in their public proxy voting policies that oppose the creation of new classes of stock with superior voting rights, and some expressly support the elimination of such structures. Shareholder proponents have recently revamped campaigns to remove dual-class share structures, with 77 such proposals appearing on general meeting ballots during the past nine years. These proposals rarely manage to receive majority support, given the significant voting power of the share class that they attempt to eliminate. However, we estimate that support rates are high among minority shareholders. Based on a rough calculation of excluding the voting power of directors and officers from the vote tally, we estimate median support rates for these proposals at approximately 60 percent of votes cast. The actual support levels among minority investors are likely higher, since, in many instances, the super-voting stock is also held by non-directors and non-executives.



Source: ISS Analytics

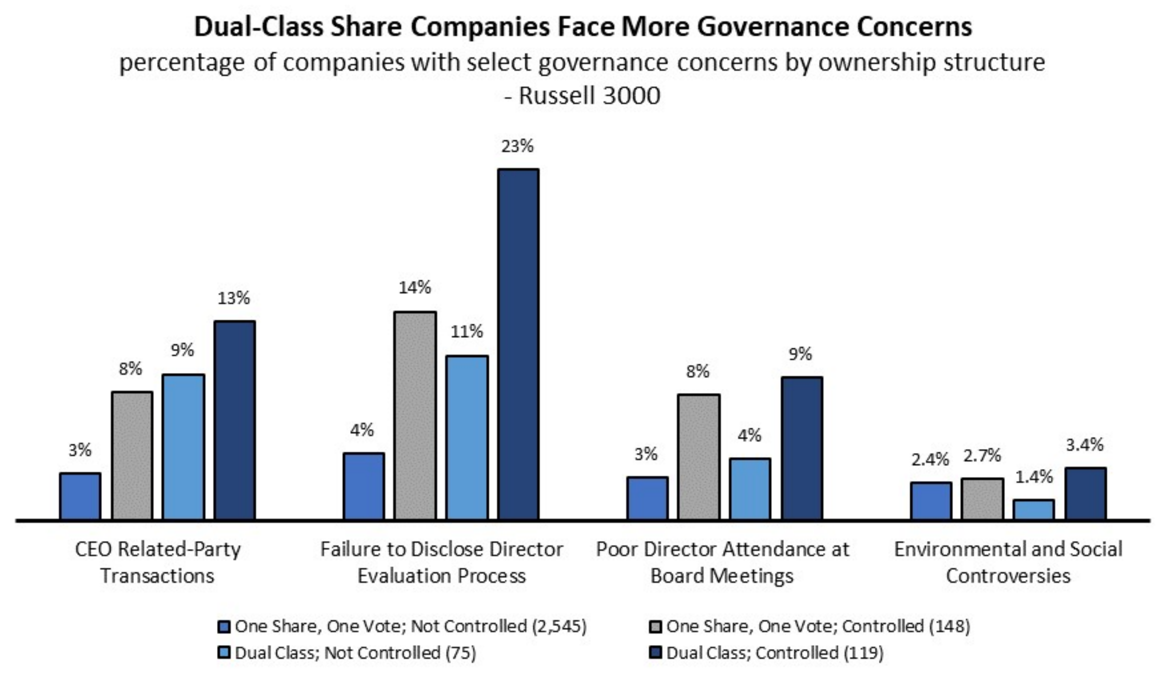
Corporate Governance

Companies with dual-class share structures are more likely to lack independent board leadership. Approximately 52 percent of controlled, dual-class companies do not have an independent lead director nor an independent chair on their board, compared to only 12 percent of one-share, one-vote, non-controlled firms. These trends coincide with our recent findings on **concentrated CEO ownership**, whereby companies whose CEOs have significant voting power tend to also lack independent leadership on the board. We find that the lack of independent leadership is high at companies with dual-class shares irrespective of the voting power of the CEO. In fact, 42 percent of dual-class companies where the CEO controls 10 percent or more of the voting stock lack independent board leadership, compared to 45 percent of dual-class companies where the CEO controls less than 10 percent of the voting stock.



Source: ISS Analytics

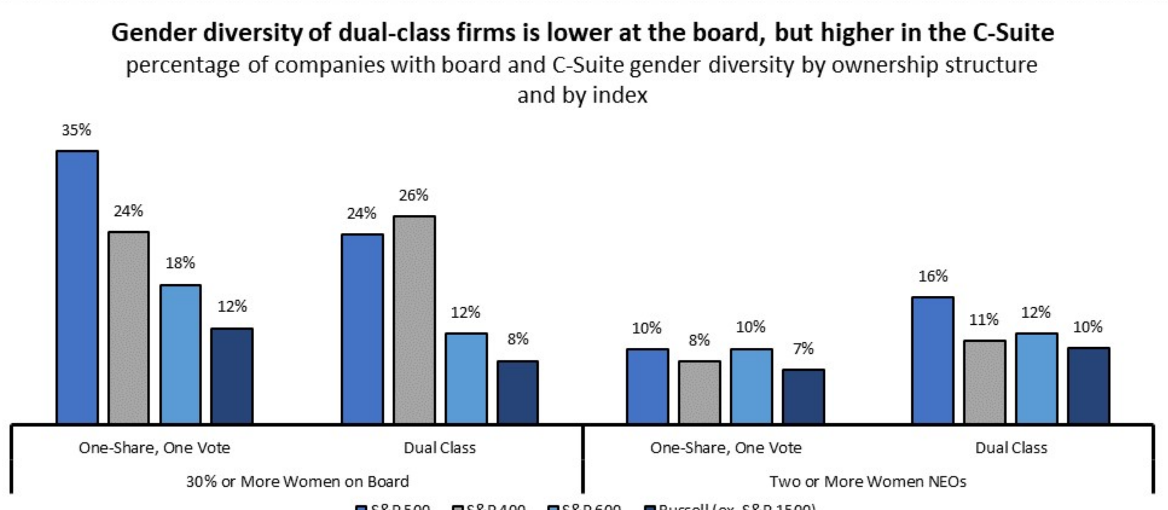
Lack of independent board leadership is only one of several governance factors where dual-class companies lag their peers. We find that dual-class companies, especially those that are controlled, exhibit weaknesses in multiple other governance indicators. For example, companies with dual-class share structures are more likely to exhibit related-party transactions involving the CEO, which may raise concerns about potential conflicts of interest. Further, dual-class companies are less likely to disclose their director evaluation process, which may serve as an indicator of poor board accountability, renewal, and diligence. In addition, directors of dual-class companies are more likely to miss board meetings, which many investors consider a minimum measure of directors' fulfillment of their fiduciary duty to shareholders. Finally, companies with dual-class share structures are more likely to face environmental or social controversies, according to **ISS ESG's Norm-Based Research**, which tracks company adherence to international norms on human rights, labor standards, environmental protection, and anti-corruption.



Source: ISS Analytics and ISS ESG

Gender Diversity

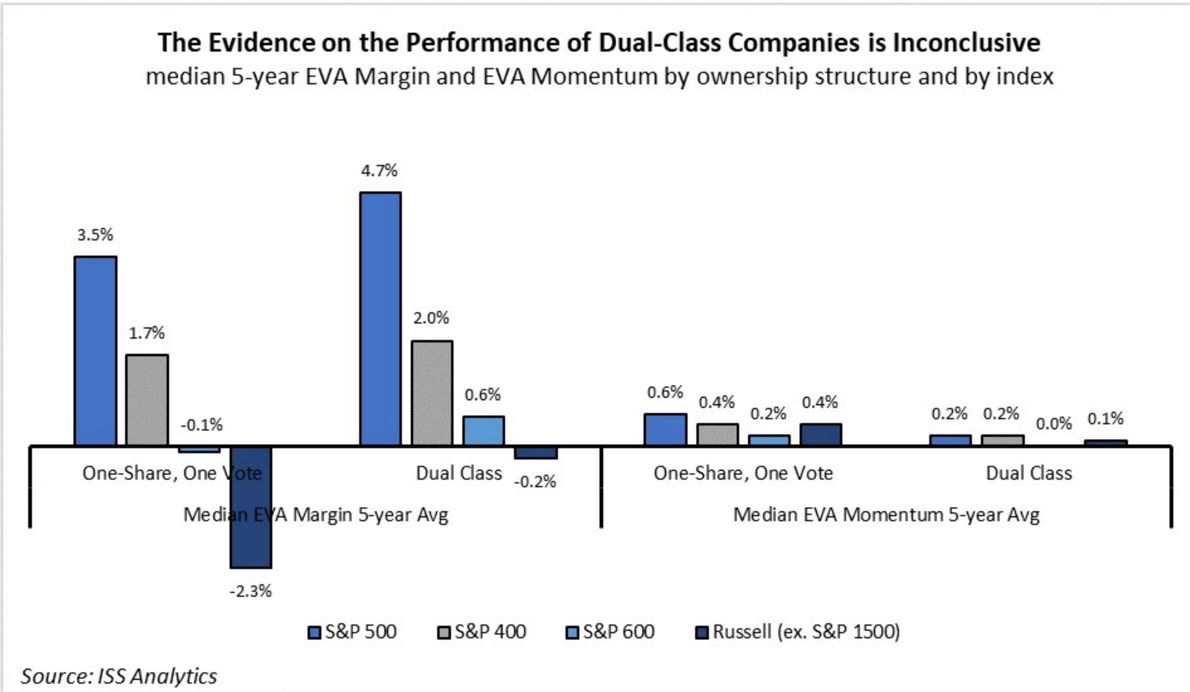
Our research on **concentrated CEO ownership** showed that companies where the CEO had significant voting power showed lower levels of gender diversity in the C-Suite and on the board. In our review of dual-class firms, we find that dual-class firms have higher C-Suite diversity compared to their one-share, one-vote counterparts. However, board gender diversity for dual-class firms is lower, even after controlling for size. These trends suggest independent considerations in the diversity composition of the board and the top executive team.



Source: ISS Analytics

Company Performance

In our review of company performance for dual-class share companies, the results are mixed. For the analysis of company performance, we used ISS' proprietary **EVA (Economic Value Added) methodology**, which measures profitability after subtracting the full cost of capital, and adjusting for accounting statement distortions of economic performance. While dual-class firms appear more profitable compared to one-share, one-vote firms based on the **EVA Margin** metric, the rate of improvement in profitability (EVA Momentum) for dual-class firms is considerably lower. Thus, the advantage that dual-class firms may have established appears to be eroding over time. This trend highlights the risk of stasis upon achieving a certain level of performance.



Dual-Class Shares in Focus

In recent months, calls for regulating the technology sector have increased, with lawmakers expressing concerns about data privacy, content control, taxation, and market competition, among many other factors. Corporate governance could become a part of the conversation of how to address concerns in the sector, given the increasing tendency by many technology firms to insulate management from shareholders. Do dual-class share structures protect companies from short-termism, or does the distortion of a company's ownership structure undermine accountability over the long term? This may be an open question, but it is a question that market participants will need to consider very carefully and address, as the challenges facing technology firms—and firms from all sectors, for that matter—highlight the need for robust governance, preparedness, and accountability. As an effective way to reduce agency costs for long-term investors, the **Council of Institutional Investors** has encouraged the introduction of time-based sunset provisions, which automatically convert the dual class to one share within a reasonable timeframe (typically three to seven years). That approach may indeed be a viable way to address the concerns of the investment community. Some index providers have introduced rules to apply exclusions of dual-class companies from the construction of some indexes. No matter the response, it becomes clear that dual-class shares are now a major policy issue for the investment community with potentially broader implications for multiple stakeholders.