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Debating the Pros and Cons of Dual Class Capital Structures

The debate over dual class capital structures has grown louder, as a number of high-profile companies recently have gone public with dual class structures. Although opponents argue that dual class structures destroy shareholder value, there is compelling evidence that these structures can benefit companies, shareholders, and capital markets.

**By Stephen I. Glover and
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Dual class capital structures have been used in some of the most high-profile recent initial public offerings (IPOs) by technology companies, including the offerings by Facebook, Google, LinkedIn, and Zynga. Other large IPOs outside the technology sector also have used the dual class approach. In January 2013, for example, Pfizer implemented this structure when it spun off its animal health business, Zoetis. The Facebook and Zoetis dual class IPOs were the largest in U.S. history.

Companies with dual class structures create a low-vote class of common stock entitled to one vote per share, and a high-vote class of common

stock entitled to several votes per share (often ten). These companies sell the low-vote common stock to the public in their IPOs. The founders and early investors retain the high-vote common stock to ensure that they maintain control, even when they no longer own a majority of the company.

Institutional investors and their representatives, including the Council of Institutional Investors (CII), the California Public Employees' Retirement System (CalPERS), and Institutional Shareholder Services (ISS), have voiced strong opposition to dual class structures. These opponents argue that dual class capitalization creates the equivalent of a corporate safe room by making it nearly impossible for shareholders to replace directors, challenge management, or force change in control transactions. CII has urged the New York Stock Exchange (NYSE) and Nasdaq to adopt rules prohibiting companies with dual class structures from going public.¹

There are strong arguments both for and against dual class capital structures. This article briefly reviews the historical background of dual class structures, describes some of the reasons why specific companies have implemented dual class structures, summarizes the arguments in opposition to dual class structures, and finally considers how shareholders are protected, in and can benefit from, dual class structures. Despite the claims of some institutional investors, dual class structures offer key advantages to companies, shareholders,

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and capital markets that warrant their continued use on U.S. stock exchanges.

Historical Background

The debate over dual class capital structures has persisted for almost 100 years. In the 1920s, several corporations used two classes of stock—one class with full voting rights and another class with no voting rights. Dual class stock issues by Dodge Brothers, Industrial Rayon Corporation, A&W Root Beer, and Fox Theaters sparked academic speeches, scholarly articles, and press coverage on the topic. Even then-President Calvin Coolidge took an interest in the issue. According to Harvard Professor William Z. Ripley, non-voting stock was the “crowning infamy” in a series of corporate actions intended to disenfranchise the public investor.² In 1926, the NYSE chimed in with its statement of disapproval of dual class structures; and in 1940, the NYSE formally prohibited the issuance of non-voting securities.

IPOs by companies with dual class structures are still permitted.

During the 1980s, however, dual class recapitalizations emerged as a popular takeover defense. Managers of potential takeover targets recognized that they could reduce significantly the likelihood of a hostile acquisition if they maintained control of the vote, since a corporate raider cannot oust managers who can outvote it.³ More than 65 public companies adopted dual class capital structures as takeover defenses during the 1980s. Listed companies left, or threatened to leave, the NYSE for Nasdaq or the American Stock Exchange, both of which permitted dual class stock. To remain competitive with Nasdaq and the American Stock Exchange, the NYSE was forced to relax its prohibition on dual class structures.

Investors grew worried by the proliferation of dual class stock, and urged Congress or the

Securities and Exchange Commission (SEC) to take action and prohibit dual class structures. In July 1988, the SEC responded by adopting Rule 19c-4, which effectively amended the rules of the stock exchanges to prohibit a company’s securities from being listed if the company issued securities or took other actions to nullify, restrict, or reduce the voting rights of existing shareholders. The SEC did not adopt a strict one share, one vote standard primarily because empirical evidence on the effect of dual class stock on shareholder wealth was inconclusive. However, Rule 19c-4 was short-lived. In 1990, the D.C. Circuit invalidated Rule 19c-4 because it dealt with a matter of corporate governance beyond the scope of the SEC’s authority.⁴

After the D.C. Circuit’s decision, the SEC urged the U.S. stock exchanges to adopt a uniform policy on dual class structures. The exchanges responded by agreeing to prohibit companies that are already listed from engaging in dual class recapitalizations. They continued to permit listing by companies that established dual class structures before they went public. These rules remain in force today, and IPOs by companies with dual class structures are still permitted. In fact, 20 of 170 IPOs between January 2010 and March 2012 featured dual class structures.⁵ Further, all of the big technology IPOs of 2012—Groupon, LinkedIn, Yelp, and Zynga—had dual class structures. Thus, the debate over dual class structures continues.

Review of Companies with Dual Class Structures

Over the years, dual class structures have been used most frequently and prominently by media and communications companies, fashion and home goods companies, employee-owned companies, and technology companies. Such structures also are often used by public companies that take their subsidiaries public and by companies facing foreign ownership restrictions. A review of these companies reveals that there are strong industry-specific,

transaction planning, and regulatory arguments in favor of dual class capitalizations.

Several companies in the media and communications industry have dual class structures, including News Corp., The New York Times, and The Washington Post. The founding families of these companies—the Murdochs, Sulzbergers, and Grahams—use dual class structures to keep control within their families. They argue that they need to maintain control to protect editorial integrity. They reason that dual class structures allow their companies to remain committed to serious news coverage, even when short-term results are fluctuating and shareholders, focused on financial matters, might seek to change the composition of the board or management. In a recent editorial in *The New York Times*, Joe Nocera notes that the protections offered by dual class structures grew even more pronounced “as the newspaper business declined, [and] financial engineers came knocking” with plans to increase profits at the expense of the news.⁶ According to Nocera, “If you buy New York Times stock, you are buying into the notion that you’ll let the family run the show, as it has done for more than a century. And the Sulzbergers will put The Times’s journalism ahead of all else, because that is what is in the family’s DNA.”⁷

Relatedly, the founders reason that dual class structures provide a strong takeover defense.

Dual class structures are also common in the fashion and home goods industry, with Martha Stewart Living and Ralph Lauren being prominent examples. Consumers of these companies are not just buying a commodity, they are buying the brand. Many of these fashion and home goods companies have an individual or family closely associated with the brand image. The founders of these companies argue that their strong control position gives them a continuing

incentive to build the desired brand equity, which translates into a strong market position and profitable stock returns.

Employee-owned companies similarly find advantages in dual class structures. They take the position that by enabling employees to own the majority of company stock, the dual class structure creates a positive corporate culture with high employee morale and increased productivity. The company’s management can reap the benefits of going public without undermining this positive culture.

The increased use of dual class structures to protect the implementation of business plans.

Currently, the most high-profile examples of companies with dual class structures are technology companies, including Facebook, Google, Groupon, LinkedIn, Yelp, and Zynga. The founders of these technology companies reason that they have a dynamic, long-term vision for the company. They need to retain control in order to continue to innovate and remain an industry pioneer. Short-term market forces and risk-averse shareholders should not dictate or interfere with the founders’ vision. Relatedly, the founders reason that dual class structures provide a strong takeover defense, keeping the company on track to achieve their long-term objectives.

In Google’s 2004 Registration Statement, co-founder Larry Page candidly states:

In the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. This [dual class] structure will also make it easier for our management team to follow the long term, innovative approach emphasized earlier. ...

The main effect of this structure is likely to leave our team, especially Sergey [Brin] and me, with significant control over the company's decisions and fate, as Google shares change hands. New investors will fully share in Google's long term growth but will have less influence over its strategic decisions than they would at most public companies. ...

From the point of view of long-term success in advancing a company's core values, the structure has clearly been an advantage. Academic studies have shown that from a purely economic point of view, dual class structures have not harmed the share price of companies. ...

Google has prospered as a private company. As a public company, we believe a dual class voting structure will enable us to retain many of the positive aspects of being private.

The increased use of dual class structures to protect the implementation of business plans speaks to a broader point about today's investors. In the postwar era, most shareholders were individual investors who held on to stocks for the long-run and exerted little pressure on the companies in which they invested.⁸ In contrast, today's market is dominated by large institutional investors who are far more aggressive in trying to influence companies' agendas and who often have far shorter investment time horizons.⁹ The average annual turnover of a mutual fund portfolio is 100 percent—for a hedge fund portfolio, it is 300 percent.¹⁰ In this context, companies find dual class structures useful in mitigating shareholder influence in order to pursue their core values and objectives.

Dual class capital structures are sometimes used not because of concerns about short-term market pressure and takeover threats, but to achieve tax or other transaction planning objectives. For example, when a parent company decides to spin off a subsidiary, it often also decides to raise capital before the spin-off by causing the subsidiary to engage in an IPO. If the parent company maintains at least 80 percent of the voting power in the

subsidiary following the IPO, the subsequent spin-off receives tax-free treatment. Raising lots of capital, however, may require the parent company to sell more than 20 percent of the subsidiary's common stock. The dual class structure offers a solution. The parent company can create a dual class structure in the subsidiary, sell low-vote stock to the public in the IPO, and retain the high-vote stock. This allows the parent company to sell as much stock as necessary to raise capital, while still maintaining 80 percent of the voting power in the subsidiary to realize tax benefits. In the Zoetis IPO this past January, Pfizer used the dual class structure to raise \$2.2 billion in the IPO while maintaining 98 percent of the voting power in Zoetis and preserving the flexibility to conduct a tax-free spin-off at a later stage.¹¹

Regulatory requirements also may support the use of dual class capital structures.

Regulatory requirements also may support the use of dual class capital structures. These structures are used frequently by companies subject to U.S. or foreign rules requiring that a certain percentage of the company be owned by U.S. or foreign nationals respectively. For example until August 2012, the Federal Communications Act of 1934 strictly prohibited foreign entities from owning more than 20 percent of the voting stock of U.S. telecommunications companies.¹² In response to similar Canadian regulations limiting foreign ownership of large telecom companies to less than 46.7 percent, the Canadian telecom company Telus adopted a dual class structure in order to sell low-vote stock to foreigners and high-vote stock to Canadians.¹³

Opposition by Institutional Investors

As noted above, in October 2012, CII sent letters to both the NYSE and Nasdaq urging the

exchanges to prohibit dual class IPOs and dual class recapitalizations.¹⁴ CII argues that dual class structures are directly at odds with the one share, one vote bedrock principle of shareholder democracy. It believes that the capital markets system works best when voting power is proportional to economic interest.

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CII further reasons that dual class structures insulate management or the control group from all challenges. This insulation increases the likelihood of corporate misconduct and decreases accountability.¹⁵ CII concedes that dual class structures may seem appealing when brilliant visionaries are heading the company.¹⁶ But what happens when the vision fails, or when abusive or less-inspired managers take the reins?

In a dual class structure, CII argues that the incentives of management and the board are not aligned with the interests of all shareholders. It states that dual class structures are most concerning in the context of two specific situations. First, CII worries that dual class structures facilitate conflict of interest transactions, by permitting management to engage in transactions that benefit members of the control group at the expense of public shareholders without fear of any consequences. Second, CII argues that dual class structures preserve the status quo, even where management's strategic vision is failing or where bad business decisions are made. Shareholders are powerless to seek remedies or effect change in both of these situations. Nor can shareholders depend on effective board oversight. Since directors are beholden to those in control of the vote for their jobs, they do not act in the best interests of all shareholders.¹⁷

CII claims that its opposition to dual class structures rests on strong empirical support. Citing an academic study conducted by ISS, CII concludes that companies with dual class structures reduce shareholder value. The ISS study, *Controlled Companies in the Standard and Poor's 1500: A Ten Year Performance and Risk Review*, finds the following:¹⁸

- Dual class companies significantly underperform single-class companies over 3-year, 5-year, and 10-year periods. Dual class companies only outperform single-class companies over a 1-year period.
- Dual class companies have more related party transactions than single-class companies.
- Dual class companies exhibit more stock price volatility than single-class companies.
- Dual class companies are less likely to have standard corporate governance features relating to board accountability and shareholder rights than single-class companies.
- Dual class companies are more insulated and engage in less outreach than single-class companies.

Dual class structure secures key benefits for that company as well as the broader shareholder base.

Although CalPERS has announced that it intends to boycott investments in dual class companies,¹⁹ CII says its members cannot do that. CII notes that many shareholders are forced to invest in dual class companies through passive investment strategies; for example, pension and index funds often require their participants to invest in all listed stocks. Thus, CII believes that an outright ban on dual class structures is appropriate. CII points out that dual class structures are currently prohibited on several major international exchanges, including the London and Hong Kong stock exchanges.

Some shareholders also have urged companies to eliminate their dual class structures through shareholder proposals. In 2012, such shareholder proposals were included in the proxy statements of News Corp.²⁰ and Google.²¹ These proposals echo the arguments of CII, and claim that dual class structures misalign economic incentives and voting power, allow management to extract private benefits at the shareholders' expense, and create a corporate culture of no accountability. However, as discussed below, these shareholder proposals have not received significant support.

Shareholder Protections and Benefits

A survey of companies with dual class structures indicates that the founders have strong rationales for their decision to use dual class structures, and that the dual class structure secures key benefits for that company as well as the broader shareholder base. Further, shareholders are not entirely without protection should the risk of improper management become reality.

First, corporate law provides shareholders with protections against abuses by those in control of the corporation. Directors and controlling shareholders owe shareholders a fiduciary duty of loyalty. The duty of loyalty requires that directors and controlling shareholders act in the best interests of the company and its shareholders, and without regard to personal motivations not shared by shareholders generally. Directors or controlling shareholders may be found to have violated the duty of loyalty if they approve transactions in which they have a conflict of interest because they or someone with whom they are aligned will benefit from the transaction. Such conflict of interest transactions are subject to an entire fairness review unless procedural protections, including an independent committee and minority shareholder approval, are used. To survive the stringent entire fairness review, the transaction must be the result of fair dealing and must be at a fair price. Any breach of the duty of

loyalty entitles shareholders to seek judicial relief and remedies.

There have been several judicial actions where the control group in a dual class company has been successfully challenged by shareholders. For example, in *In re Delphi Financial Group Shareholder Litigation*, the court agreed with the shareholders that the controlling shareholder in a dual class company breached his fiduciary duties by seeking and obtaining a control premium for his shares during merger negotiations, when the company's certificate of incorporation stipulated that both classes of stock must be treated equally in a merger.²² In another case, *Levco Alternative Fund Ltd. et al. v. The Reader's Digest Association, Inc.*, the court enjoined the recapitalization of a dual class company, because the independent committee that negotiated the recapitalization breached its fiduciary duties by failing to evaluate the fairness to non-voting shareholders of the company's payment to the voting shareholders.²³ The court noted that "[g]iven the obvious conflicting interests of the shareholder classes, the conceded absence of an evaluation of fairness of the recapitalization on the [non-voting] shareholders is significant."²⁴ Thus, courts are cognizant of the conflict of interest risks that dual class structures can pose to shareholders, and will take steps to protect shareholder rights when they conclude that the duty of loyalty has been breached.

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In addition, although the founding family or controlling shareholder may have sufficient votes to appoint and remove board members, this power does not give it the ability to control directly the company's business decisions. The power to supervise management resides with the directors, who have a fiduciary obligation to

exercise their business judgment for the benefit of all shareholders. Conscientious directors will honor this obligation, even when the founder or controlling shareholder makes demands or threatens to replace them. CII suggests that most directors would find it hard to withstand this pressure, and that in any event, controlling shareholders can place friends on the board who share their vision. But stacking a board with cronies is not as easy as it might seem. The NYSE and Nasdaq listing rules require that a majority of a company's board members be independent, and that the key board committees consist entirely of independent directors. Prior relationships with the controlling shareholder may disqualify the board members from service. Thus, shareholders can rely, in part, on conscientious or independent directors to consider and safeguard their interests.

Second, shareholder protections are often built into the organizational documents of dual class companies. Many dual class company charters stipulate that if high-vote shares are transferred, the transferee will not obtain the high voting power.²⁵ The charters often also provide that the high-vote shares lose their special voting power after a specified time period or upon the death of the controlling shareholder.²⁶ Some charters stipulate that high-vote shares will not receive a premium in a merger.²⁷ If the company or the controlling shareholder violates any of these provisions, the shareholders can sue.²⁸

Prior relationships with the controlling shareholder may disqualify the board members from service.

Third, shareholders who choose to invest in dual class companies benefit from market forces during the IPO process. During the period leading up to pricing, potential investors have an opportunity to demand a discount for the risk associated

with an investment in low-vote shares. In effect, the IPO process for a dual class company can be viewed as an arm's length negotiation among prospective public investors, the underwriters, and the control group. The price set during the IPO process contains a discount for risk, with the size of the discount dependent on the overall attractiveness of the company. Underwriters generally will warn companies that want to use a dual class structure that the price they receive for their shares may reflect a discount—or that the market may not be willing to accept low-vote shares at all.

Fourth, shareholders can sell their shares of dual class companies if they believe that the implicit risk discount is not adequate, or if they become concerned about management's actions. Although CII argues that shareholders may be locked into their shares through passive investment strategies like pension and index funds, it is not clear that the inherent limitations of this investment approach should drive regulatory policy.

As discussed above, most shareholders choose to invest in dual class companies because they believe in the company's strategy or the founders' vision. During the 2012 proxy season, only four shareholder proposals urged companies to eliminate their dual class structure, and these proposals only received an average level of support of 33 percent.²⁹ The shareholders at both News Corp. and Google overwhelmingly voted against the elimination of the company's dual class structure.³⁰

Further, if dual class structures were not an option, some founders might choose to sell fewer shares to the public, delay going public, or not go public at all. Founders who want to maintain control may choose to bypass public markets in favor of private capital. The result would be additional friction in the capital formation process and fewer investment opportunities for the public. Of relevance to this point,

the number of IPOs has decreased sharply in the past decade, and the number of public companies in the U.S. has fallen by more than 40 percent since 1997.³¹

CII's call for an outright ban on dual class structures also would adversely affect the competitiveness of the NYSE and Nasdaq. For example, in August 2012, Manchester United chose to list its dual class shares in New York over Singapore, because Singapore prohibited dual class structures at the time. Singapore is now considering allowing dual class structures to maintain its competitiveness as a financial center.³²

Although CII points to studies concluding that dual class structures destroy shareholder value, the empirical evidence is far from clear. For example, in a study of dual class IPOs that is not cited by CII, dual class companies were found to have outperformed their single class counterparts both in terms of stock market returns and accounting measures of company performance.³³ And in a study of dual class recapitalizations, dual class companies experienced long-term positive stock returns and superior operating performance over the four years after the recapitalization.³⁴ Given these contrary findings, it is difficult to conclude that the empirical evidence strongly supports a ban on dual class stock. Just as shareholder returns can vary among single class companies, shareholder returns can vary among dual class companies. At least some of these companies have produced attractive returns; dual class companies do not automatically destroy shareholder value.

Conclusion

As *Financial Times* columnist Andrew Hill observes, "the advantage of a dual class share structure is that it protects entrepreneurial management from the demands of ordinary shareholders. The disadvantage of a dual class share structure is that it protects entrepreneurial management from the demands of shareholders."³⁵

Although the empirical evidence is inconclusive, there are benefits to dual class structures. Dual class share structures permit companies to stay true to their founders' core values. Although this requires some insulation from the demands of ordinary shareholders, it also can generate large shareholder returns. In addition, shareholders are protected from the risks of dual class structures through various judicial, contractual, and market mechanisms. Further, dual class share structures create new investment opportunities, by allowing public companies to retain some of the benefits of being private. Contrary to the arguments of certain institutional investors, dual class structures can benefit companies, shareholders, and capital markets alike.

Notes

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 18. Investor Responsibility Research Center Institute, *Controlled Companies in the Standard & Poor's 1500: A Ten-Year Performance and Risk Review* (Oct. 2012), <http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf>.
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