Journal of Corporate Finance 26 (2014) 1–19

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Corporate payout policy in dual-class firms☆

Bradford D. Jordan[a,1], Mark H. Liu[a,2], Qun Wu[b,*]

[a] Gatton College of Business and Economics, University of Kentucky, Lexington, KY 40506, United States
[b] School of Economics and Business, State University of New York-Oneonta, Oneonta, NY 13820, United States

ARTICLE INFO

Article history:
Received 1 June 2013
Received in revised form 4 February 2014
Accepted 6 February 2014
Available online 14 February 2014

JEL classification:
G30
G32
G34
G35

Keywords:
Dual class shares
Voting rights
Cash flow rights
Dividends
Payout policy
Stock repurchase

ABSTRACT

We examine corporate payout policy in dual-class firms. The expropriation hypothesis predicts that dual-class firms pay out less to shareholders because entrenched managers want to maximize the value of assets under control and the associated private benefits. The pre-commitment hypothesis predicts that dual-class firms pay out more to shareholders because firms use corporate payouts as a pre-commitment device to mitigate agency costs. Our results support the pre-commitment hypothesis. Dual-class firms have higher cash dividend payments and total payouts, and they use more regular cash dividends rather than special dividends or repurchases, compared to their propensity-matched single-class firms. Dual-class firms with severe free cash flow-related agency problems and few growth opportunities rely even more on corporate payouts as a pre-commitment mechanism. We also rule out the alternative explanation that dual-class firms pay out more because super-voting shareholders lack the ability to generate home-made dividends by selling shares since super-voting shares are often non-tradable or very illiquid.

1. Introduction

Whether a dual-class share structure and other antitakeover mechanisms enhance or destroy shareholder value is an ongoing debate in the literature. Many recent studies find that dual-class share structures may exacerbate agency problems. Insiders of dual-class firms typically have voting rights that exceed their cash flow rights. Therefore, many researchers argue that this wedge between voting rights and cash flow rights makes it easier for firm insiders to expropriate value from outside investors. For example, Masulis et al. (2009) find that, in dual-class firms, as the wedge between insiders' voting rights and cash flow rights increases, corporate cash holdings are worth less, CEOs receive higher compensation, and managers make more value-destroying acquisitions. In a similar vein, Gompers et al. (2010) find that dual-class firms trade at lower valuations than single-class firms.

However, if the use of dual-class shares allows insiders to entrench themselves at the expense of outside shareholders, why do so many firms still adopt it, including many prestigious corporations (e.g., Google, Facebook, and Ford Motor)?[3] And why do

☆ We thank Tom Chemmanur, Amy Dittmar, Jason Howell, Kershen Huang, editors Harold Mulherin and Jeff Netter, an anonymous referee, and conference participants at the 2012 Eastern Finance Association meetings and the 2012 Financial Management Association Meetings for helpful comments. All errors and omissions are our own.

* Corresponding author: Tel.: +1 607 436 3186.
E-mail addresses: bjordan@uky.edu (B.D. Jordan), mark.liu@uky.edu (M.H. Liu), wuq@oneonta.edu (Q. Wu).
[1] Tel.: +1 859 257 4887.
[2] Tel.: +1 859 257 9842.

[3] For example, Gompers et al. (2010) find that about 6% of all Compustat firms are dual class.

http://dx.doi.org/10.1016/j.jcorpfin.2014.02.004
0929-1199/

investors and regulators not completely ban its use? Some researchers argue that dual-class shares may enhance shareholder value under certain scenarios. For example, Chemmanur and Jiao (2012) argue that dual-class shares may increase long-term firm value in the hands of high ability managers, even though it may increase agency costs and destroy firm value in the hands of low ability managers. They argue that the dual-class share structure allows high ability managers to create value for the firm by investing in risky, long-term projects. Such managers may not invest in long-term projects in the absence of dual-class shares due to the fear of losing control to rival management teams in a control contest under asymmetric information if the firm's project is in temporary difficulty. Similarly, Stein (1988) argues that antitakeover provisions (such as dual-class shares) may benefit shareholders by mitigating managerial myopia.

We shed light on the debate regarding how antitakeover provisions in general, and the dual-class share structure in particular, affect shareholder value by examining corporate payout policies in dual-class firms. On the one hand, if dual-class shares are used by insiders to entrench themselves and expropriate wealth from outsiders, then dual-class firms may be less willing to pay out cash dividends or buy back shares than single-class firms because paying cash dividends or buying back shares will reduce the value of assets under insider control and the associated private benefits. We call this hypothesis the expropriation hypothesis. Under this hypothesis, the total payout of the firm should decrease with the wedge between insiders' voting rights and cash flow rights. The greater disparity between insiders' voting rights and cash flow rights creates a greater conflict of interest between insiders and holders of inferior-voting shares, which gives insiders greater incentives to pay out less in order to expropriate value from minority shareholders.

Alternatively, dual-class shares may be used by high-ability managers to enhance shareholder value, as suggested by Chemmanur and Jiao (2012). In this case, insiders in dual-class firms may use different governance mechanisms to mitigate agency problems associated with the dual-class share structure. One approach is to use corporate payout policy as a pre-commitment device to reduce outsiders' concerns about expropriation. If so, dual-class firms may be more willing to pay out cash dividends or buy back shares than single-class firms. We call this alternative the pre-commitment hypothesis. Under this conjecture, the total payout of the firm will increase with the wedge between insiders' voting rights and cash flow rights because the greater the wedge, the more severe the potential agency problem and the greater the need for the firm to pre-commit to pay out to mitigate agency problems.

When we turn to the data, we find that dual-class firms are more likely to pay out than single-class firms. The propensity to pay out and the amount of the payout increase with the wedge between insiders' voting rights and cash flow rights. Further, conditional on a firm paying out to outsiders, the proportion of cash dividends (especially regular cash dividends) among total payouts (the sum of cash dividends and stock repurchases) is also greater among dual-class firms than single-class firms, and this proportion increases with the wedge between insiders' voting rights and cash flow rights. These results support the idea that dual-class firms use payout policy as a pre-commitment device to mitigate agency problems, especially by paying regular cash dividends, followed by special cash dividends, and finally stock repurchases. We recognize that dual-class firms are generally different from single-class firms. Therefore, for each dual-class firm in our sample, we use a propensity-score matching method to find a matching single-class firm that has the closest ex-ante propensity to be a dual-class firm as our sample firm. Our results hold for single-class firms in general and for matching single-class firms as well.

If dual-class firms pay out more to reduce agency costs, then we expect the effect to be more pronounced among low-growth firms and firms with more free cash flows. The cost of paying out cash to investors is high for high-growth firms because firms may have to forgo valuable investment opportunities. In contrast, the cost of paying out cash to investors is low in low-growth firms because these firms do not have many investment opportunities and paying out cash to investors is usually in shareholders' best interest. More generally, firms with greater free cash flow have more severe agency problems. Therefore, dual-class firms with greater free cash flows have a stronger need to use high payouts as a way to reduce the agency problem. Our results show that the difference in corporate payouts between dual-class and single-class firms is more pronounced among firms with low Tobin's Qs (i.e., low-growth firms) and firms with more free cash flow. Among dual-class firms, the positive relation between corporate payouts and the wedge between insiders' voting rights and cash flow rights is also more pronounced among firms with low Tobin's Qs and more free cash flow.

One potential alternative explanation for our results is the home-made dividend hypothesis. If a single-class firm pays little or no cash dividends, investors who need cash can sell some of their shares to generate a “home-made” dividend. In contrast, if the super-voting shares of a dual-class firm are non-tradable or very illiquid, then holders of super-voting shares have very little ability to generate home-made dividends. Therefore, dual-class firms may have to pay a sizeable cash dividend regularly to meet the cash demands of super-voting shareholders. We find no evidence for this alternative explanation. There is no significant difference in cash dividend yield or the ratio of cash dividends to total payouts between dual-class firms with tradable and non-tradable super-voting shares.

An alternative hypothesis for our result that dual-class firms buy back more shares than single-class firms is the “further entrenchment” hypothesis. The literature has documented that share repurchases can deter takeovers (Billett and Xue, 2007), and firms may do so especially when there is a takeover contest (Denis, 1990). Therefore, insiders in dual-class firms may buy back more shares to increase their voting power so that they can further entrench themselves or so that they can fend off takeover threats to stay in control.[4] However, under this hypothesis, dual-class firms will pay out less cash dividends than single-class firms because cash dividends will not increase insiders' voting power, and at the same time, it leaves insiders with less cash to buy back shares to further entrench themselves. Our result that dual-class firms pay out more cash dividends than single-class firms contradicts this prediction.

[4] We thank an anonymous referee for suggesting this alternative hypothesis.