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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.

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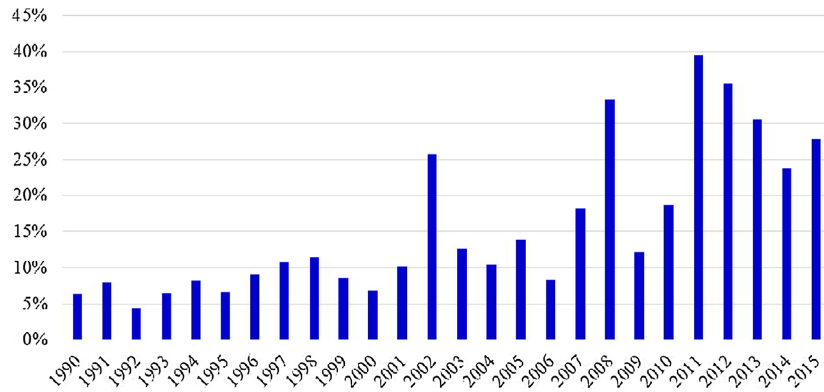
Figure 1. Percentage of initial public offering companies with multiple classes of shares



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/