Harvard Law School Forum on
Corporate Governance and Financial Regulation
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The Life-Cycle of Dual Class Firms

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Editor's note: Martijn Cremers is Bernard J. Hank Professor of Finance at University of Notre Dame Mendoza College of Business, and an ECGI research member; Beni Lauterbach is a Professor of Finance and the Raymond Ackerman Family Chair in Corporate Governance at Bar Ilan University Graduate School of Business Administration, and an ECGI research member; Anete Pajuste is an Associate Professor of Finance and Head of Accounting and Finance Department at the Stockholm School of Economics, and an ECGI research member. This post is based on their recent paper.

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.

In our paper, The Life-Cycle of Dual Class Firms, we consider the market valuation of dual class firms over their life cycle. Dual class financing is on the rise in recent years, particularly among high-tech firms, following Google's seminal 2004 dual-class IPO structure. This financing choice leaves control of the firms in the hands of entrepreneurs, giving outside investors with inferior-vote shares no direct mechanism to influence the board or management. Rather, public investors buying inferior vote shares at the IPO are betting that granting the entrepreneurs such control allows them to better implement their unique vision.

However, as dual class firms mature and their vision is largely accomplished, entrepreneurs' leadership may no longer be needed, and entrepreneurs may start self-serving behavior. Public investors' resentment may then develop, accusing dual class firms' controlling shareholders for wanting their money without any accountability. Such public pressure arguably recently led MSCI to issue a proposal to reduce the weight of inferior-vote shares in MSCI indices by multiplying the regular weight by the shares fractional voting power. Notably, the same MSCI also issued a report a few months ago stating that "[o]ur research shows that unequal voting stocks in aggregate *outperformed* the market over the period from November 2007 to August 2017, and that excluding them from market indexes would have reduced the indexes' total returns by approximately 30 basis points per year over our sample period." Obviously, confusion reigns over the merits of dual class financing.

Bebchuk and Kastiel (2017) (The Untenable Case for Perpetual Dual-Class Stock, *Virginia Law Review*) argue that any initial benefits of dual class structures decay with firm age, while the potential agency costs associated with dual class structures increase with time. Thus, Professors Bebchuk and Kastiel advocate sunset clauses to dual class financing. The sunset clauses would require the "non-interested" public shareholders of the firm to vote on whether or not to extend the dual class structure, some pre-determined number of years after the IPO. If the extension

proposal is declined, firms would unify the low- and high-vote shares, i.e., convert all shares into a single class of shares with "one share one vote".

In our paper, we empirically investigate the desirability of sunset provisions by examining the life-cycle of dual class firms. Using an extensive sample of all single-and dual-class firm IPOs in the U.S. during 1980-2015, and relying on comparing dual class firms to similar single class firms, we document several novel phenomena in the life cycle of dual class firms.

First, the difference in firm valuation between dual and single class firms strongly varies over the corporate life cycle. At the IPO, dual class firms tend to have *higher* valuations, as at the IPO year-end the market valuation of dual class firms is, on average, 11% higher than that of matched single class firms. This initial valuation premium of dual class firms dissipates in the years after the IPO, and on average it becomes insignificantly negative about six to nine years after the IPO. We also find that the difference between the voting and equity stakes of the controlling shareholders of dual class firms (the "wedge") tends to increase as the firm ages. According to one of our estimates, the mean wedge increases from 16% one year after the IPO to 22% five years after the IPO, and to 26% nine years after the IPO. The widening of the wedge is typically associated with more severe valuation reducing agency problems—see Masulis et al. (2009) (Agency Costs and Dual-Class Companies, *Journal of Finance*). Bebchuk and Kastiel (2018)(The Perils of Small-Minority Controllers, forthcoming *Georgetown Law Review*) analyze the perils of the widening wedges and advocate informing the public and capping it.

Second, we document interesting differences between dual class firms with a valuation premium (relative to their matched single class firms) at the IPO and dual class firms with a valuation discount at the IPO. Dual class firms with a valuation premium at the end of their IPO year gradually tend to lose this premium, until their valuations become very similar to those of their single class counterparts about six to nine years after the IPO. In contrast, we find no evidence for a life cycle in the relative valuation of initially discounted dual class firms, as their valuation discount persists from the time of their IPO to when they are mature dual class firms as well. The behavior of the subsample of dual class firms with a valuation premium at the IPO suggests that for some firms the dual class structure does not harm valuations, at least in the first decade after the IPO. On the other hand, the behavior of the subsample of dual class firms with an initial valuation discount, which we find is highly persistent, suggests that a mandatory sunset provision may be useful for these firms.

Third, a natural solution to possible dual class inefficiency is a voluntary firm-initiated dual class share unification, in which all share classes are transformed into "one share one vote". We find that only about 20% of dual class firms unify their shares within 9 years after the IPO. Furthermore, voluntary unifications become rare after six years following the IPO. Most of the mature dual class firms elect to retain a dual class structure, perhaps because unification is against the interests of their controlling shareholders. This implies that some inefficient dual class structures may persist.

Our findings suggest that some sort of a sunset provision might be useful, especially for firms that trade at a valuation discount. Further, regarding the set-in time of any sunset provision, our study suggests to wait at least six years after the IPO. Regulators should also be worried about some potential negative consequences of any sunset regulation. First, some founders may be more reluctant to issue publicly traded shares if their reign over the firm is likely to be more limited in

time. Public may lose the opportunity to invest in some breakthrough firms. Second, controlling shareholders may intensify their private benefits extraction in the period before their extra power expires. Third, it is possible that shareholders may elect to abolish dual class structures even when they are (still) beneficial.

Finally, our paper also documents several other interesting life cycle phenomena of dual class firms such as their higher survival rates, similar stock returns and lower likelihoods of being taken over, compared to matched single class firms. We conclude that unequal vote structures are viable financing tools.

The complete paper is available for download here.