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Large shareholder diversification, corporate risk taking, and the benefits of changing to differential voting rights

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ABSTRACT

We show how the change to differential voting rights allows dominant shareholders to retain control even after selling substantial economic ownership in the firm and diversifying their wealth. This unbundling of cash flow and control rights leads to more dispersed economic ownership and a closer alignment of dominant and dispersed shareholder interests. When insiders sell sizeable amounts of their economic interests, firms increase capital expenditures, strengthen corporate focus, divest non-core operations, and generate superior industry-adjusted performance. The change to differential voting rights both fosters corporate control activity and creates higher takeover premiums that are paid equally to all shareholders.

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1. Introduction

Research on the role and effects of concentrated ownership often focuses on how shareholdings of managers and insiders influence firm governance and performance. The work of Jensen and Meckling (1976), Leland and Pyle (1977), and Stulz (1988), among others, finds that greater insider ownership is an effective means of aligning the interests of managers and shareholders. Other work finds that large equity holdings by insiders can lead to risk avoidance with respect to business strategy and investment, given the undiversified financial and human capital of insiders (Amihud and Lev (1981), Amihud et al. (1990), Agrawal and Mandelker (1987)). This tradeoff between interest alignment and risk avoidance may explain why prior evidence about the relationship between ownership concentration and firm performance and value is ambiguous (e.g., Demsetz and Lehn (1985), McConnell and Servaes (1990)). Moreover, there is little work examining the relationship between dominant shareholder diversification and corporate risk taking, even though many public firms are not widely held. La Porta et al. (1999) show that two-thirds of the largest public firms (and a greater proportion of smaller firms) traded on the world's major stock markets have dominant shareholders who control corporate actions.

We contribute to the literature on concentrated ownership by analyzing how a change from one-share-one-vote to a differential voting structure affects economic ownership, firm performance, business strategy, and corporate risk taking. We find economic ownership becomes less concentrated after public firms adopt differential voting structures. Further, performance improves for the firms where insiders sell a sizeable amount of their economic interests while maintaining voting control. This cashing-out behavior fosters corporate restructuring and greater corporate risk taking that increases economic welfare. This pattern is not observed for firms where insiders retain both their voting rights and cash flow interests, nor for firms where ownership structure becomes more dispersed due to dilutive corporate actions. These results indicate that separating ownership from control can help align the interests of dominant and dispersed shareholders. Our evidence suggests that these improvements in firm strategy are unlikely to occur without a corporate governance change, such as differential voting rights, that allows dominant shareholders to diversify their personal wealth without ceding control.

We examine US public firms that change from a single class to a dual class share structure. Before this change, these firms have highly concentrated ownership, with dominant shareholders often holding a majority of the shares. Thus, it is unlikely that concerns about hostile takeovers or the control market are driving the change in voting structure.

For the subset of firms whose insiders cash out, the average economic holdings of insiders falls from $173 million to $140 million.

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These insiders considerably improve the diversification (and liquidity) of their personal wealth while maintaining a substantial economic stake in their firms. Firms with insiders who cash out make business decisions that strengthen corporate focus by divesting non-core assets and expanding investment in core operations. The riskiness of their common stock and the volatility of earnings increase toward industry norms, and these firms demonstrate superior profitability relative to benchmark firms. These findings are consistent with the pursuit of riskier, positive net present value projects that are in the interests of dispersed shareholders, but would probably be rejected under a single class share structure.

There is an active takeover market for firms that shift to a dual class structure. We find that the frequency of takeovers among these firms is similar to a set of single class benchmark firms, but with higher takeover premiums. In each of these takeovers, superior and inferior voting class shares receive the same takeover compensation (per share) even though Delaware law does not mandate equal treatment. This evidence suggests implicit tag-along or coattail rights for low vote shareholders, allowing them to share equally in the takeover gains. We also find a positive relationship between insider ownership and the likelihood that sample firms are acquired. This finding suggests that unbundling voting rights from cash flow rights at closely held firms facilitates transfers of corporate control, consistent with the theoretical model of Ferreira et al. (2010).

Our work provides evidence of an agency problem created by the risk aversion of dominant shareholders at firms with a single class voting structure. This agency problem has implications for corporation law and regulatory policy. In the US, about 6% of listed firms, including many large and well-known companies, have multiple classes of shares with differential voting rights. In Europe, there is an even broader variation in corporate voting structures (including pyramids, double voting rights, and multiple share classes). In recent years, the EU's Internal Market and Services Commissioner has sought to narrow the considerable variation in voting rights, arguing that a one-share-one-vote structure should be made mandatory to encourage cross border takeovers and strengthen the single market. Our findings, however, indicate that economic benefits typically arise when closely held firms adopt a differential voting rights structure. This change leads to greater dispersion of economic ownership in the firm, which enhances risk-sharing, fosters restructuring that increases corporate focus, and strengthens profitability. We find no evidence that the shift to a dual class structure acts as an anti-takeover device.

It is possible that corporate performance of closely held single class firms could improve to an even greater extent if their ownership structures shifted toward greater dispersion without changing the voting rights structure. This perspective is consistent with evidence that the death of large inside blockholders generates a significant increase in firm value and leads to more dispersed ownership (Slovin and Sushka (1993)). However, insiders at closely held firms who derive private benefits from control might be reluctant to voluntarily cede control to dispersed shareholders by selling their economic interests. We contend that dominant shareholders may benefit from cashing-out some of their economic ownership within the framework of a shift to differential voting rights. This is a feasible alternative that can better align the interests of dominant and dispersed shareholders. Our evidence suggests that, within this context, a one-share-one-vote structure is not likely to be a one-size-fits-all solution for corporation law. Thus, our work provides new perspective about convergence in corporate governance and the merits of contractual freedom about corporate voting rights.

Our evidence about the adoption of a differential voting rights structure also has implications about the gains that can be generated by private equity acquisitions of closely held target firms. These gains may not arise in takeovers of such targets by public acquirers with dispersed ownership. Private equity places general (active) partners in direct control of the target firm, replicating the control position of dominant shareholders. However, unlike dominant shareholders at public firms, private equity is a wealth-diversified form of control because the non-voting limited (passive) partners are diversified wealthy investors and institutions. So private equity firms are more likely to eliminate underinvestment problems and change risk-averse investment policies than are firms controlled by poorly diversified dominant shareholders. These risk-increasing decisions can generate gains in target firm performance and value.

The remainder of the paper is organized as follows. Section 2 describes methods for adopting differential voting structures and discusses hypotheses about differential voting. Section 3 presents the sample and methodology. Section 4 reports evidence on subsequent ownership changes, the corporate control market, operating performance, and changes in business strategy and risk. Section 5 concludes the paper.

2. Methods and rationales for adopting differential voting rights

2.1. Methods of recontracting voting rights

Shareholders must vote to amend the corporate charter to adopt share classes with differential voting and cash flow rights. The dominant methods for recontracting shareholder rights are a pro rata special stock dividend or an exchange offer. In the dividend method, a special stock dividend, consisting of a class of shares with limited or no voting rights, is distributed to existing shareholders on a pro rata basis. Changes in firm ownership evolve through market transactions as shareholders alter or rebalance their holdings. If the high vote shares are not tradable, shareholders must convert the shares to low vote shares before selling them, an irreversible action. In the exchange offer method, the firm issues a new class of common stock at a specified exchange ratio, and each shareholder decides which class of stock to hold. Because stock market rules mandate that a new share class not have superior voting rights, shareholders who do not participate retain the high voting class shares by default.

2.2. Differential voting and agency conflict

Prior literature typically argues that disproportional voting structures have unfavorable effects. Claessens et al. (2002) and Lins (2003) find a value discount for disproportional voting structures. Gompers et al. (2010) report a negative relation between the value of a dual class firm and the concentration of voting rights. Masulis et al. (2009) show that dual class CEOs receive higher compensation. Anderson et al. (2009) find that a dual class structure has little effect on the performance of founder or heir-controlled firms.

Prior literature also argues that a dual class structure is an anti-takeover device that facilitates managerial entrenchment.[1] Grossman and Hart (1988) view a one-share-one-vote rule as socially optimal because it induces a bidder to pay the highest price to acquire a firm, deters value-decreasing bids, and insures talented management teams gain control. Ruback (1988) argues that a dual class structure weakens the takeover market. DeAngelo and Rice (1983), Jarrell and Poulsen (1988), and Ruback (1988) contend that a dual class structure fosters decisions that are not in dispersed shareholders' interests and facilitates consumption of perquisites

[1] There is a considerable empirical literature that examines the announcement effects of introducing mechanisms of takeover defense such as poison pills and anti-takeover amendments to corporate charters, but the event study results are inconclusive (Bhagat and Jefferis, 2002).