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The survival of the U.S. dual class share structure☆

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ABSTRACT

In his groundbreaking work "Uncertainty, Evolution, and Economic Theory," Armen Alchian (1950) suggests that survival is the real test of a firm's success. In this paper, I apply the survival test to the use of dual class share structures in the United States. Beginning with its original implementation by the International Silver Company in 1898 to the prevalence of dual class initial public offerings in 2013, I review the evolution and continued sustainability of the dual class structure in the United States. I contrast the structure with the failed use of tracking stocks and illustrate the structure's continued resilience alongside "competitive" anti-takeover devices such as poison pills, staggered boards, and supermajority voting requirements. Despite the external challenges from legislative bodies, shareholder rights groups, and institutional investors, the dual class structure has survived as an alternative means to raise capital for founders and/or controlling stockholders.

1. Introduction

In "Uncertainty, Evolution, and Economic Theory", Armen Alchian (1950) introduces the biological concept of natural selection to economic analysis. He suggests that in a world of uncertainty "profit maximization is meaningless as a guide to specifiable action" and that "realized positive profits, not maximum profits, are the mark of success and viability." In effect, it is survival of the fittest. "Those who realize positive profits are the survivors; those who suffer losses disappear." Regardless of management's noble intentions, success is measured by survival.

In a typical U.S. public corporation, all shareholders are provided identical voting and cash flow rights. For example, each holder of Microsoft Corporation's stock is allowed one vote for each share she owns. In addition, each shareholder has residual cash flow rights to the firm and can receive dividends. As such, shareholders are separated by the number of shares each owns; however, the proportion of voting and cash flow rights is always proportional to the amount invested in the firm. A shareholder who buys 10,000 shares of Microsoft stock has invested 10 times more capital in the firm than the individual who purchases only 1000 shares. Since each share has identical voting and cash flow rights, the holder of 10,000 shares also has10 times the voting power.

This is not the case in a firm with two classes of stock. In a dual class share firm, the investor who purchases 10,000 shares may have the same voting rights as the holder of only 1000 shares. Voting and cash flow rights can be different based on the class of shares held. For example, Facebook has two classes of stock. Class A shareholders are eligible to vote in all corporate matters; however, they only have one vote per share, whereas class B shareholders have ten votes per share. This allows the holders of class B shares to have

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control of the firm while holding a much smaller cash flow stake. In the case of Facebook, founder Mark Zuckerberg holds 74.3% of class B shares. So although he only owns a 16.6% cash flow stake, his class B holdings give him control of the firm with a 55.2% voting stake.[1]

Because of the dual class structure's separation of economic interests and voting rights, the dual class structure consistently garners criticism. Since the early 1900s, critics have called the structure unethical and inherently anti-shareholder. On the other hand, supporters suggest that the structure allows investors to share in the earnings of companies in which maintaining control is valuable to investors (Alchian and Demsetz, 1972). Despite the debate, shareholders continue to purchase dual class stock as they have for the past one hundred years. In this study, I examine whether the dual class structure passes Alchian's “survival test.”

This paper is organized as follows. Section 2 reviews the benefits and disadvantages of the structure. Section 3 reviews the history of the dual class share structure in the United States and points out the evolving nature of the structure. Section 4 discusses the structure's survival amidst the use of alternative anti-takeover mechanisms and contrast the structure with tracking stocks. Section 5 documents the international use of the dual class structure. Section 6 examines the prevalence of the dual class structure through the years and the recent resurgence of the structure in the initial public offering market. Section 7 concludes.

2. Intermediate organizational form

Ever since the original implementation of the dual class structure, the structure has received criticism from both academics and shareholder activist. The critics say it is unethical to stray from a one-share, one-vote structure. While it is true the one-share, one–one vote structure leads to equality among all investors based on their level of holdings, the fact is, organizations are complex. What works best for one firm, is not in the best interest of another. As DeAngelo and DeAngelo (1985) said “dual class firms may be best viewed as an intermediate organizational form which fits somewhere between the polar cases of the dispersed-ownership public corporation and the closely-held firm.” Just like some firms choose to remain privately held, while others decide that it is best to go public, some firms decide that it is in their best interests to access the equity markets while retaining control of their corporation through the dual class structure. In their original S-1 filing with the Securities and Exchange Commission, Google stated “As a public company, we believe a dual class voting structure will enable us to retain many of the positive aspects of being private.”[2]

By allowing dual class structures, exchanges give both the founders/controlling stockholders and minority stockholders the opportunity to participate in this intermediate organizational form. The dual class structure allows investors the ability to invest in companies which they would not have been able to if the firm had not been able to choose the dual class structure. Take for example, the 2004 IPO of Google. Many investors have made tremendous amounts of money investing in the firm. Should we implicitly assume Google's founders would have taken the company public if they did not have the ability to use a dual class structure? A restriction by the Hong Kong Exchange prevented Alibaba, the largest Chinese e-commerce retailer, from listing and led them to choose the New York Stock Exchange.[3]

The dual class structure allows investors to invest in companies in which they desire the controlling party to remain in power. Alchian and Demsetz (1972) state “in fact, we invest in some ventures in the hope that no other stockholders will be so ‘foolish’ as to try to toss out the incumbent management. We want him to have the power to stay in office, and for the prospect of sharing in his fortunes we buy nonvoting common stock.” Take for example, Ford Motor Company, through their class B shares the Ford family maintains a 40% voting stake in the firm. To some investors and car buyers, it is important for them to know that the Ford family's reputation is at stake. In the case of Google, the company's founders, Sergey Brin and Larry Page, have a certain vision for the company. It is important to investors that Google keeps their long-term focus and is not distracted by short term stock price movements or fear of management takeovers. Google's Larry Page stated in Google's original S-1 “we have a dual-class structure that is biased towards stability and independence and that requires investors to bet on the team, especially Sergey and me.” Similar to investors in Google and Facebook, media company investors are willing to buy shares in dual class firms knowing their minority voting stake will not change ownership's goal of editorial independence. In a similar manner, institutions and individual investors routinely invest as limited partners leaving control in the hands of general partners.

In order to fully understand the reasons why the dual class structure continues to be used, an in-depth examination of the benefits and disadvantages of the structure must be made. Controlling stockholders make the decision to use the dual class structure because they believe the benefits outweigh the negatives and investors choose to invest at a certain price when they believe the benefits outweigh the costs. The structure's unique intermediate organizational form leads to benefits and disadvantages from two perspectives: 1) the structure allows the firm to operate as if it were a private firm with diffuse ownership and 2) the structure allows the firm to operate as if it were a diffusely owned firm with a strong takeover defense. The two following subsections outline the potential benefits and disadvantages of the dual class share structure.

2.1. Benefits of the dual class structure

If you compare a dual class firm with an otherwise identical private firm, the dual class firm has three benefits commonly found in diffusely owned firms: 1) the ability to raise external capital, 2) the diversification of unsystematic risk and 3) specialized risk bearing.

[1] Facebook, Inc., March 31, 2014 Form DEF 14A, via SEC Edgar.
[2] Original S-1 Filing by Google, Inc. dated April 29, 2004.
[3] Curran, “Alibaba prompts Hong Kong IPO rethink”, Wall Street Journal, January 9, 2014.

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